THE INTERNATIONAL INSTITUTE
OF ISLAMIC THOUGHT

١٤٠١هـ — ١٩٨١م
1401 AH—1981 AC

ISLAMIZATION OF KNOWLEDGE (17)

CONTRIBUTION OF ISLAMIC THOUGHT TO MODERN ECONOMICS

Proceedings of the economics seminar held jointly by al Azhar University and the International Institute of Islamic Thought (Cairo, 1988/1409)

V. II (English)

Edited by Misbah Oreibi

The Editor

Misbah Oreibi

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Contribution of Islamic Thought to Modern Economics

2nd Edition of the English papers of the Seminar (1418/1998)
1st Edition of the Proceedings of the seminar,
Arabic and English (1992)

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Library of Congress Cataloging-in-Publication Data

Contribution of Islamic thought to modern economics : proceedings of the economics seminar held jointly by al Azhar University and the International Institute of Islamic Thought, Cairo, 1988/1409 / edited by Misbah Oreibi.

p. 246 cm. — (Islamization of knowledge ; 17)

"This book contains papers presented at the Conference on the Contribution of Islamic Thought to Modern Economics held in Cairo, Egypt, on 25-28 Muharram, 1409 A.H./6–9 September, 1988 A.C. sponsored by Salih Kamil Center for Islamic Commercial Research and Studies at al Azhar University and the International Institute of Islamic Thought."— Introd.

Includes bibliographical references.

Vol. (2) ISBN 1–56564–262–7 (English),

Vol. (1) ISBN 1–56564–265–1 (Arabic)

1. Economics--Religious aspects--Islam--Congresses.
2. Economic development—Religious aspects—Islam—Congresses.
I. Oreibi, Misbah. II. International Institute of Islamic Thought.
III. Markaz Ṣāliḥ 'Abd Allāh Kamil lil Abḥāth wa al Dirāsāt al Tijārīyah wa al Islāmīyah. IV. Conference on the Contribution of Islamic Thought to Modern Economics (1988 : Cairo, Egypt)
V. Series: Islamization of knowledge series ; 17.

BP173.75.C66 1997
297.2'73—dc21 97-41875
CIP

Printed in the United States of America by International Graphics
10710 Tucker Street, Beltsville, Maryland 20705-2223-USA
Tel: (301) 595-5999 Fax: (301) 595-5888
Email: igfx@aol.com

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Introduction

Misbah Oreibi

This book contains papers presented at the Conference on the Contribution of Islamic Thought to Modern Economics held in Cairo, Egypt, on 25-28 Muḥarram, 1409 A.H./ 6-9 September, 1988 A.C. sponsored by Salih Kamil Center for Islamic Commercial Research and Studies at al Azhar University and the International Institute of Islamic Thought.

Islamic economics is not entirely a new subject; it has been developed as an integral part of the wider subject of Islamic jurisprudence (fiqh), and is as old as the Islamic way of life. Fiqh *al mu'āmalāt* branch of Islamic jurisprudence covered different aspects of economic activities such as market organization, sale contracts, financial dealings, types of company structures in production and consumer protection. Gradually, international trade became an important economic sector that required tariff estimation and collection, organized transport facilities and trained personnel.

The economic life of the early Muslim community grew in complexity with the expansion of Islam into most parts of the world and international trade played an important role in this expansion. In the process of Islamic expansion new peoples accepted Islam and new territories and countries became part of the caliphate (khilāfah). Muslims encountered new and complex methods of production, new technology, and a wider range of products and crops. The free exchange of goods and the free movement of people within the Muslim state enhanced the well-being of its citizens, increased its financial resources thereby allowing it to extend welfare services to all its citizens, irrespective of their belief, race, or background. Even when the unity of the caliphate was no longer sustainable, the free exchange of goods and capital and the free movement of people continued to be the rule rather than the exception.

Islamic scholars studied economic exchange in the light of the Holy Qur'an and the Sunnah, and established basic principles for the protection of consumers, workers, merchants, and financiers. Ijtihad (opinion) was used to develop further al *mu'āmalāt* for smoother economic exchange whenever that was needed. For example, the *salām* sale contract (a contract allowing full payment in advance) was introduced to meet the special needs of agricultural producers.

However, the development of Islamic economics like all other intellectual activities came to a halt with the disintegration of the khilāfah and the decline of Islamic civilization. The rising powers of the European nation states, who occupied the Muslim lands, imposed their own social and economic systems. The newly imposed way of life was buttressed by secular education. Islamic education was confined to traditional *madāris* (religious schools), depriving the Muslim community of its most valuable and dynamic support to revitalize itself.

Islamic awakening needed a new economic doctrine, efficient and morally superior to the secular economic doctrines dominating the modern world. A few Muslim economists championed the reintroduction of Islamic economic doctrine. They held conferences, seminars and workshops. They published papers and books that attracted the attention of economists, students and learned circles in the Muslim world as well as in Western countries.

This conference is part of the intense on going efforts to reintroduce Islamic economics on more firm theoretical grounds. Parallel to this theoretical effort, some Muslim businessmen put into practice the concept of Islamic banking, creating interest-free banks. Inspite of the difficulties engendered by the international financial system, and the rather negative attitude of governments in the Muslim world, Islamic banking proved to be successful. The venture of interest-free banking has confirmed moral principles as a base for successful financial intermediation. Demand for the services of interest-free banking has expanded in the last decade. Islamic banks are now handling over 80 billion US dollars.

Muslim economists who studied modern economics and mastered the tools of economic analysis, turned to researching Islamic economics not only to prove the feasibility of an interest-free economic system, but also to prove its fundamental moral and spiritual superiority. At the center of the economic model, Islam replaces the selfish and greedy individual with the individual shaped by strong moral and spiritual values. A Muslim, as an economic agent, is not the classic economic man—an agent of greed and selfishness. Although, in a Muslim society, greedy and selfish individuals do exist, they are the exception rather than the norm.

The papers included in this volume are part of the ongoing effort to reintroduce Islamic economics using modern analytical tools. The first two papers are concerned with teaching Islamic economic programs. The first one by Iqbal and the second one by Khan discuss in detail the existing Islamic economic programs and introduce new ideas and concepts to improve on its teaching and research.

Iqbal compares different existing curricula for teaching Islamic economics in four well-known Islamic educational institutions. He carefully considers the objectives of teaching Islamic economics, highlighting the balance in the existing programs between the traditional shari'ah contents with those of modern economics. Detailed information on the existing programs is presented in an appendix, where comparison can easily be made.

Khan's paper covers extensive ground and points in the direction of further research. His handling of the microeconomics program for the undergraduate level is complete and profound. Microeconomics lies at the center of economic analysis. We are now considering the micro-foundations of macroeconomics. A well designed program of microeconomics is vital to any teaching program. Khan's methodology, prerequisites, coverage, and duration of Islamic economics courses, digs deeply into the epistemological foundations of Islamic economics, discussing the concept of ownership in Islam, the theory of demand, work and leisure, and intertemporal choices. In each of these basic topics, he explores new grounds and points to new directions for further research. He goes into detailed discussions of the theories of production, distribution, costs, and the firm in a comprehensive teaching program of Islamic economics that he suggests for undergraduates in an Islamic university.

The third paper, by Chapra, is centered around economic development strategy. He explores the differences between what he calls the imported development strategy and the Islamic development strategy. Imported strategies have been tried in Muslim countries and have failed to achieve serious economic progress, whether they were capitalist or socialist. The spectacular failures of the imported strategies were due to the fact that they were not in harmony with the system of values and the spiritual aspirations of Muslim societies. The value system of western development strategies is in conflict with the value reference of Islamic countries, so the institutional setup erected by the colonial powers in the Muslim countries represent a superstructure not related to the values and morality of Islam. Despite intensive government efforts and foreign aid, development efforts simply have been in vain.

As an alternative, Chapra develops an Islamic development strategy based on the *maqāṣid* (objectives) of the shari'ah. Equity and efficiency are the focus of the Islamic development strategy. While efficiency is at the core of the secular capitalist economic system that dominates the international arena, it has all but neglected equity. The socialist system, on the other hand, has stressed equity but has failed to realize it and at the same time has lost track of efficiency.

The Islamic development strategy embraces the two concepts of equity and efficiency as vital components. Economic policies are needed to achieve equity and efficiency in the Islamic development strategy as required by the shari'ah. Special attention should be directed to encourage small enterprises, financial intermediation, the human factor, and the reduction of wealth concentration. The role of government is emphasized and governments are urged to take the necessary steps to restructure the Muslim countries' economics to ascertain a positive outcome from the development strategy.

Chapra's paper is a serious contribution to development economics from an Islamic perspective, and will constitute an indispensible reading for the students of economic development.

The fourth paper, by Mirakhor and Zaidi, is critical to the development of Islamic economics. Economic policies and, in particular, monetary policies have been controversial. It has been said that in an

Islamic economic system there is no way to assure the success of economic policies, fiscal or monetary, in the absence of the rate of interest. The question is how to counter economic instability and promote growth where the interest rate is no longer at the disposal of the government and the central bank?

The inability of the government to set rate of return in the PLS system does not exclude the effectiveness of monetary policy in an open economy. This is the basic thrust of the analysis of the Mirakhor and Zaidi paper. They affirm using the supply of credit and money, in general, to successfully implement the required monetary policies to stabilize the economy and promote its growth. The model presents a valuable advance in the development of theoretical analysis in Islamic economics.

It is proved that a banking system free of interest, and using *muḍārabah* (partnership between one who has capital and one who has expertise) and *mushārakah* (joint venture, partnership in which the participants contribute both capital and expertise), can be the basis of a monetary policy that fixes the rate of return on capital and enhances saving and investment.

Included in this volume are extensive discussions and comments by economists whose interest in Islamic economics is well known, and who make valuable contributions to the debate.

Finally, there is an extensive bibliography of references and published materials on development in the Islamic perspective by Muḥyiddin Aṭiyah that makes this volume a necessary companion for students and researchers in the subject. We hope that this book will also be used by students and teachers in Islamic universities, and by students and teachers in secular centers of education as a reference to raise the awareness of the emergence of the new paradigm.

Rajab 1418 A.H./October 1917 A.C.
Washington, D.C.

Teaching Programs in Islamic Economics: A Comparative Study

Munawar Iqbal

Introduction

Islamic economics is a new discipline but it is gaining strength and maturity very quickly. Its development in the last few years has led to the establishment of teaching and training programs at a number of places in several countries. With increasing literature of high quality becoming available due to tremendous interest in the area, it is hoped that several new programs will appear in the near future. Therefore, it is a very crucial stage in its development. The seed has been sown but there are years of hard work ahead. This is the time for fertilizing and watering on the one hand and weeding and pruning on the other. While it is imperative to increase the present effort manifold, it is also important to keep a vigilant eye on the experiments under way in order to ensure that they achieve the objectives for which they were designed. It is in this spirit that the present comparative study of the major teaching programs in Islamic economics are being undertaken.

Initially, Islamic economics was introduced as one of the subjects in degree programs in the economics and shari'ah faculties in some universities. It was comprised of only one or two one-semester courses. The number of courses gradually increased. It was only in the early 1980s that complete degree programs in Islamic economics were introduced. At present, there are four accepted teaching programs—the partial program, the undergraduate program, the graduate program, and the training program (designed to meet the short-term needs of the Islamization process). In the following pages we will say a few words about each of them. But before doing so we present some broad objectives that the teaching programs should attempt to achieve. The existing programs shall be evaluated according to these.

Objectives of Teaching Programs in Islamic Economics

The major universities of most of the Muslim countries have inherited or borrowed their style of teaching economics from Western universities. Their approach is purely secular and the contents of their courses mundane. Such an approach is, of course, quite suitable to countries whose ground is materialism and secularism but is most contradictory to Islamic societies where all disciplines should have a profound imprint of Islam so as to provide Islamic vision. Before listing the objectives of teaching programs in Islamic economics, some general remarks about the existing education system may be useful. The major defects from which the education system in most of the Muslim countries suffer may be identified as follows:

- First, the education system has been bifurcated into so-called 'modern' and 'religious' education. The two are being imparted through entirely independent and completely different institutions with no interaction between them. In most of the Muslim world, religious education is given through *madāris* (literally, schools, but here meaning religious schools) while secular, modern education is imparted through colleges and universities.
- Second, religious education receives neither patronage nor recognition. Public funds controlled by the state support the public schools and universities while it is left to charitable institutions to support religious schools. Similarly, the graduates of *dīni madāris* (religious schools) receive no official recognition; almost all public jobs go to the graduates of colleges and universities. The graduates of *madāris* have to survive on very meager and irregular allowances in the informal sector. They have no status in the society and are often looked down upon by the so-called 'educated class'. The natural result has been that most of the talent flows into the secular system of education.
- Third, the quality of education has been pathetically low. The curricula and syllabi for the university education are out-

dated. The system of education and examination is such that the critical and creative abilities of the students are not promoted. The situation in the religious schools is even worse. The system of education and examination is very loose. Quite often it is very informal. Even curricula and syllabi are not standardized. They vary from one madrasah to another both in coverage and standard. There is hardly any place for the study of modern developments, new technology, or research.

The brief review of the problems given above provide useful insights into planning out a strategy for their solution. Any prescription for the treatment of the ailing system must include the following elements:

- So-called 'modern' education and the 'religious' education systems must be fused together.
- Education must be purpose-oriented. It should be considered as *'ibādah* and must result in a better understanding of the Islamic faith. It should aim at character building and spiritual elevation along with an increase in knowledge.
- Quality of education must be improved so as to produce people who are not only qualified in modern science and technology but are also imbued with Islamic knowledge, character, and spirit. They should have all the necessary qualities that will enable them to reconstruct modern knowledge on the foundations of Islam and to suggest ways and means for putting it into practice.

In the light of these broad principles the teaching programs in Islamic economics should aim at the following:

- Knowledge of Arabic good enough to enable the students to have direct access to classical Islamic literature and original sources.
- Knowledge of the shari'ah in general and Islamic economics in particular.
- Knowledge of traditional economics.
- Knowledge of 'quantitative' tools of analysis.
- Ability to critically evaluate economic theory.

- Professional awareness of the need for a new approach towards the science of economics.
- Motivation of the students to participate in the process of Islamization of knowledge.
- Preparation of the students for the job market in order to meet the requirements of Islamization efforts on the one hand and to provide a decent means of living for the graduates on the other.

Salient Features of Various Kinds of Teaching Programs in Islamic Economics

Partial Programs

Overall content

As mentioned in the introduction, there are four kinds of programs being offered. The partial program is the least ambitious of them. It involves only one or two courses in Islamic economics. The contents of these courses vary but they are usually very elementary. A typical course is "Economic Values and System of Islam" offered at Punjab University, Pakistan and includes the following topics:

1. **Meaning and scope of Islamic economics:** Economic system of Islam as a part of its overall philosophy of life; sources of Islamic economic concepts; Islamic economics and modern economics.
2. **Basic Values and Principles:** Concepts of equality *musāwāh* (equality), *ikhwah* (brotherhood), *'adl* (justice), *taqwā* (fear of Allah), *iḥsān* (benevolence), and *ta'awwun* (cooperation) as the basis of all economic policies; concepts of halal and haram and their application to economic activities; islamic code of business ethics.
3. **Islam and other economic systems:** The economic system—its meaning and functions; a comparative analysis of the broad economic features of Islam, capitalism, and socialism.

4. **Consumption:** Importance and principles of consumption in Islam; principles of moderation and its economic significance; behavior of the Muslim consumer.
5. **Production:** Islamic approach to production; areas of private and public ownership in Islam; ownership and cultivation of land; forms of business organizations—*muḍārabah* (partnership between one who has capital and one who has expertise) and *mushārakah* (joint venture, partnership in which the participants contribute both capital and expertise).
6. **Dignity of labor:** Importance, dignity and rights of labor in Islam; measures to improve labor-capital relationship.
7. **Product pricing:** Concept of just pricing in Islam; prohibition of exploitative prices—monopolistic, speculative, etc.; regulation and control of prices; behavior of firms under the influence of the Islamic spirit.
8. **Principles of distribution of national income and wealth:** Qur'anic emphasis on the circulation of wealth among all sections of the community; limits on rents and profits; Islamic approach to determination of wages; measures against accumulation of personal wealth—the institutions of zakah (poor-due; public welfare tax), *ṣadaqah* (charity), *khayrah* (good deed), and *awqāf* (endowments); distributional aspects of the Islamic law of inheritance; state's power for further measures; rights of specified sections of the community to receive pensions; death duties; the revolutionary concepts of al *'afw* (waiver of punishment).
9. **Interest-Free Banking and Insurance:** Prohibition of interest and its economic and social significance; interest-free banking; introduction of interest-free investment and deposit accounts in Pakistan; insurance and Islam.
10. **Public finance, fiscal policy and budgeting:** Taxation in Islam; the institution of *bayt al mal* (public treasury); principles of public expenditure; the institution of zakah; zakah as an instrument of fiscal policy; the Zakah and *'Ushr* (one-tenth) Ordinance, 1980.

11. **International trade:** Islamic approach to trade among nations; new world economic order and Islam.
12. **Economic development and planning:** Islam's keen interest in economic development; encouragement of technology, inventions, and innovations; nature and importance of economic planning in Islam; goals for development policy in Islam.
13. **Role of the state:** Maintenance of law and order; security of life and property; social security; provision of basic necessities of life; social overhead capital; education and *tabligh* (spreading the message of Islam); economic development; social justice.
14. **Social justice in Islam:** Social justice in Islam; goals, strategies and instruments.
15. **Role of Muslim economists:** Muslim civilization and the development of world trade, commerce, agriculture, technology and transportation; contribution of Muslim economists to development of economics as a science.
16. **Islamization process in Pakistan:** The character and objectives of any Islamic economy; the choice of an appropriate policy package.

Two one-semester courses

It goes without saying that partial programs cannot help much in the objective of Islamization of knowledge. However, they have their own importance. They are a good precursor to full-fledged degree programs where introduction of the latter is not possible for one reason or another. They are like the first few drops of rain that herald a downpour. The contents of these courses can, however, be improved. Assuming only two one-semester courses to be offered, we suggest the following sequence: Economic Doctrines of Islam and Introduction to Islamic Economic Theory.

In addition, every teacher should be asked to introduce Islamic elements into the conventional courses as far as possible. The suggested contents of the two courses are given below:

Economic Doctrines of Islam

1. What is Islamic economics and how does it differ from secular economics?
2. Islamic economic system: a comparative study; salient features of the Islamic economic system.
3. The Islamic principles guiding consumption and production.
4. Shari'ah guidelines for the theory of exchange.
5. The concept of ownership and its limits in an Islamic framework.
6. The redistribution mechanism in an Islamic economy.
7. The concept of *ribā* (interest), its interpretations and implications.
8. Alternative institutions to interest-based operations and their justification in the shari'ah.
9. Zakah and its economic role: The place of zakah in Islamic fiscal policy, its effects on consumption, saving and investment activity in the country.
10. Institutions of *'ushr*, *kharāj* (land tax), *jizya*, (head tax on free Nonmuslims under Islamic rule), etc. as sources of public revenue.
11. The economic role of state in an Islamic economy.
12. Muslim economic thinking: A survey of contemporary literature.

Introduction to Islamic economic theory

1. Consumer behavior in Islamic perspective and its effect on demand.
2. Behavior of firms in the Islamic framework and its effect on supply.
3. Market equilibrium.
4. Islamic view on market structures—perfect competition, monopoly, oligopoly, and monopolistic competition.
5. Factors of production and determination of return.
6. Distributive justice and need fulfillment.
7. Measurement of gross and net national product—some considerations from an Islamic perspective.

8. An introduction to macroeconomic modeling for an Islamic economy
9. Consumption—saving and investment functions in an Islamic economy.
10. Interest-free banking and monetary policy.
11. Public sector economics in an Islamic economy.
12. Project evaluation from an Islamic perspective.
13. Shari'ah guidelines for international trade.
14. Concept of economic development in Islam.

Undergraduate Programs

Undergraduate programs are most important for the achievement of the desired objectives. However, designing a program that can accomodate the discipline's many needs is not easy.

In order to prepare the student for his profession, he must be exposed to a large number of subjects, the latest analytical techniques and technology, as well as the relevant shari'ah topics. The student must obtain a good understanding of both English and Arabic to gain access to both the rich heritage of the shari'ah knowledge as well as to the 'traditional' economic literature that is in English. The design of the degree program is constrained because one of its objectives is to merge *madrasah* (religious school) education with college education, and the different backgrounds from which graduates of these two streams come. One has to come up with a mixture of courses that produce graduates prepared to meet the challenge of promoting the discipline of Islamic economics while meeting job market requirements. In addition, the problem of preparing bilingual graduates has to be solved.

Given the time constraint, fitting in all the requirements is a very difficult task. Each institution is coping with these requirements in a different way, all of them involve compromise. In this section, we review the programs of four major institutions engaged in undergraduate teaching. They are the International Institute of Islamic Economics at the International Islamic University, Islamabad,

Table 1
Structure of Undergraduate Programs
A Comparative Statement

	IIIE Islamabad	IIU Malaysia	Imam Muhammad Univ. Riyaḍ	Imam Sadiq University Tehran
1. Duration of the Program	4 Yrs.	4Yrs.	4 Yrs.	5 Yrs.
2. Medium of Instruction	English/Arabic	English/Arabic	Arabic	Persian
3. Credit Hours Required	216	134	153	200
i. Shari'ah Subjects (%)	39 (18.05)	28 (20.90)	64 (41.85)	69 (34.50)
ii. Economics (%)	84 (38.88)	63 (47.01)	43 (28.10)	45 (22.50)
iii. Complementary (%)	24 (11.11)	27 (20.14)	21 (13.72)	8 (4.00)
iv. Language (%)	69 (31.94)	16 (11.95)	25 (16.33)	78 (39.00)
4. Number of One Semester Courses	56	48	59	82
5. Average Number of Courses Per Semester	7	6	7.4	8.2
6. Average Hours of Instruction Per Week	27	17	19	20

Pakistan (IIIE); the Faculty of Economics at the International Islamic University in Malaysia (IIU); the Department of Economics, the Faculty of the shari'ah at Imam Muhammad University, Riyaḍ, Saudi Arabia; and the Department of Economics at Imam Sadiq University, Tehran, Iran. A summary of the undergraduate program structure in Islamic economics at these institutions is given in Table 1. The detailed curricula of these programs are given in Appendix A.

Except for Imam Sadiq University, all programs require four years, after completing the higher secondary school level. Program IIIE appears to be the most intensive, in the sense that it requires completion of 216 credit hours. *Ḥifz* (memorization of Qur'an) requirements and some noncredit courses are in addition to these. Hours of classroom instruction required per week is 27. The most extensive program is the one at Imam Sadiq University in Tehran. It extends over five years and requires 82 one-semester courses. The program at the Faculty of Economics (IIU) in Malaysia is more traditional, in the sense that it follows the work load common in most

Western universities (120 to 135 credit hours). The average number of courses to be taken per semester ranges from 6 to 8.2 in the four institutions under review.

From a study of the composition of these programs and of their course contents, two distinct models emerge. The program of Imam Sadiq University and Imam Muhammad University place much more importance on shari'ah subjects as compared to the programs of IIIE Islamabad and IIU Malaysia. The relative weight of shari'ah subjects is almost double in the former two programs as compared to the latter two. The case of economic subjects is exactly reverse. The result is that the graduates produced by the first model will lack sufficient background in economics while the graduates produced by the second model will be weak in their shari'ah background. Finding the right balance between the two is the most important issue in teaching Islamic economics.

Within the second model, the relative share of economics and related subjects which include statistics, mathematics, quantitative methods, etc., is higher in the case of IIU Malaysia (67 percent as compared to 50 percent) but in absolute terms the IIIE Islamabad program has a larger component of economics and complementary subjects (108 credit hours as compared to 90 credit hours). Therefore, one can safely conclude that, in terms of economics, the program of IIIE is the strongest. It also devotes a lot of time to languages, 69 credit hours, which again are the highest in the four year period. The problem with the IIIE program is that it has a very high work load which may not be sustainable in the long run. Secondly, the shari'ah component of the program is rather weak. While the graduates of IIIE can be compared to the graduates of any reputable university in terms of their background in economics, their shari'ah background remains much lower than the professed objective of producing scholars who can serve as the vanguards of efforts to Islamize knowledge. Another objective that the IIIE program has not been able to achieve is the merger of the college and *madrasah* streams of entering students. The reason is that, from the start, the program is very technical, and

Table 2
Proposed Structure for a B.A. Degree Program in Islamic Economics

		Credit Hours Required		
Subjects	Core	Major in Economics	Major In Fiqh	Double Major
Shari'ah Subjects	24	24+12=36	24+24=48	24+24=48
Economics	36	36+24=60	36+12=48	36+24=60
Complementary Subjects	15	15	15	15
Languages (Arabic and English)	21	21	21	21
Optional Subjects	—	15	15	18
Total:	96	96+54–150	96+54=150	96+69=165

the *madrasah* students, who usually have a weak technical background, find it difficult.

A feature common to all the programs is the lack of options available to the students. The program at the International Islamic University in Malaysia (IIU) does provide some options but they are only within the area of economics and business. At an undergraduate level so much concentration is perhaps undesirable. Furthermore, within the discipline itself, if some diversification can be provided, it will suit the varying aptitudes of the students better.

In the light of this discussion we are of the view that some improvements are required in the present undergraduate programs. We offer the following suggestions for improvement:

- The work load should not exceed 150 credit hours in total, nor 20 credit hours in one semester.
- A more judicious balance between economics and shari'ah subjects should be maintained. In this regard, it should be remembered that since the degree to be given is in economics, it should not be dominated by shari'ah subjects. However, the shari'ah component should be strong enough to produce the kind of blend that Islamic economics aims at.
- It is desirable to cater to varying aptitudes of students by introducing the system of majors. Initially two majors, i.e., a major in economics and a major in fiqh can be introduced. More majors can be added later.

Table 3
Curriculum for Proposed Structure of a B.A. Degree Program in Islamic Economics

Core Subjects (To be taken by all)	Credit Hours	Additional Subjects for A Major in Economics	Credit Hours	Additional Subjects for A Major in Fiqh	Credt Hours	Additional Subjects for A Double Major	Credit Hours
Shari'ah Subjects							
'Ulūm al Qur'ān I	3	Islamic Studies I	3	*'Ulūm al Qur'ān*	3	*'Ulūm al Qur'ān* III	3
'Ulūm al Qur'ān II	3	Islamic Studies II	3	*'Ulūm al Qur'ān*	3	*'Ulūm al Qur'ān* IV	3
'Ulūm al Ḥadīth I	3	Fiqh for Economics I	3	*'Ulūm al Ḥadīth* III	3	*'Ulūm al Ḥadīth* III	3
'Ulūm al Ḥadīth II	3	Fiqh for Economics II	3	*'Ulūm al Ḥadīth* IV	3	*'Ulūm al Ḥadīth* IV	3
'Uṣūl al Fiqh I	3			*'Uṣūl al Fiqh* III	3	*'Uṣūl al Fiqh* III	3
'Uṣūl al Fiqh II	3			*'Uṣūl al Fiqh* IV	3	*'Uṣūl al Fiqh* IV	3
Fiqh al Mu'āmalāt I	3			Fiqh for Economics I	3	Fiqh for Economics I	3
Fiqh al Mu'āmalāt II	3			Fiqh for Economics II	3	Fiqh for Economics II	3
Economics							
		Microeconomics III	4			Microeconomics III	4
Microeconomics I	3	Macroeconomics III	4			Macroeconomics III	4
Macroeconomics I	3	Economics of Welfare and Distribution	4			Economics of Welfare and Distribution	4
Microeconomics II	3	Monetary Economics	4	Monetary Economics	4	Monetary Economics	4
Macroeconomics II	3	Economics of the Corporate Sector	4	Economics of the Corporate Sector	4	Economics of the Corporate Sector	4
Money and Banking	3	Public Sector Economics	4	Public Sector Economics	4	Public Sector Economics	4
Public Finance	3						
International Economics	3						
Economic Development and Planning	3						
History of Economic Thought	3						

Table 3 (Continued)
Curriculum for Proposed Structure of a B.A. Degree Program in Islamic Economics

Core Subjects (To be taken by all)	Credit Hours	Additional Subjects for A Major in Economics	Credit Hours	Additional Subjects for A Major in Fiqh	Credt Hours	Additional Subjects for A Double Major	Credit Hours
Economics							
Comparative Economic Systems	3						
Contemporary Islamic Economics	3						
Economic Survey of Muslim Countries	3						
Complementary Subjects							
Statistics I	3	Statistics I	3	Statistics I	3	Statistics I	3
Statistics II	3	Statistics II	3	Statistics II	3	Statistics II	3
Basic Mathematics	3	Basic Mathematics	3	Basic Mathematics	3	Basic Mathematics	3
Mathematics for Economists	3	Mathematics for Economists	3	Mathematics for Economists	3	Mathematics for Economists	3
Introduction to Computers	3	Introduction to Computers	3	Introduction to Computers	3	Introduction to Computers	3
Optional Subjects							
Five/Six Courses Selected as Follows:		**List 1**		**List 2**		**List 3**	
1. Economics Majors Must Select at		Econometrics		- Aqeedah I, II		Islamic History I	
Least Two from List 1.		- Advance Mathematics		- Tafsir I, II, III		- Islamic History II	
2. Fiqh Majors Must Select at Least		- Project Evaluation		- Hadith I, II, III		- Political Science I	
Two from List 2.		- Computer Programming		Fiqh I, II		- Political Science II	
3. Double Majors Must Select at Least		- Labor Economics		- Maqasid al Shari'ah		- Sociology I	
Two from Both List 1 and List 2.		- Resource Economics		- Islamic Law		- Sciology II	
4. The Rest of the Courses May Be		- Economics of Agriculture				- Foreign Language I, II, III	
Selected from any of the Lists.		- Industrial Economics					
		Principles of Accounting					
		- Principles of Auditing					
		- Principles of Marking					
		- Principles of Business Management					

- Some optional subjects from other disciplines, such as Islamic history, sociology, philosophy, political science, law, business management, accounting, etc., may be allowed. This will help broaden the outlook of graduates.

New Proposed Structure of Undergraduate Programs in Islamic Economics

In the light of the above remarks, we have attempted to design a slightly modified program for undergraduate teaching in Islamic economics. The structure of a four year program leading to a bachelors degree in economics is given in Table 2, while the suggested curriculum is given in Table 3.

In many countries there are local course requirements determined by the government. We suggest that these be accommodated within the 150 hours. However, in exceptional cases the work load may be marginally increased.

The time reserved for languages (i.e., 21 hours) should be divided between English and Arabic for each student depending upon his level in these two languages. For example, students coming from the college stream would take more Arabic while students coming from the *madrassa* stream would take more English.

Three separate lists of optional subjects have been suggested. Out of the five or six optional courses economics majors must take at least two courses from the first list. Similarly, students with a fiqh major must take at least two courses from the second list. Students with a double major should take two courses from each of these lists. The rest of the optional courses may be taken from any of the three lists. Note that these lists are only indicative. More courses can be added to each list. Each department may also choose only a few of these to be offered if facilities do not exist to offer all.

Graduate Programs

Graduate programs in Islamic economics have been started at the International Islamic University in Islamabad (IIIE) and the Faculty of the shari'ah at both Umm al Qura University in Mekkah and Imam Muhammad University in Riyāḍ. All of these programs are new and it may be a little premature to evaluate them. We will only offer a few remarks.

The same two tendencies that we find at the undergraduate level are observed at the graduate level. The shari'ah dominates the programs of Imam Muhammad University and Umm al Qura University and economics dominates the program of IIIE.

Most of the material available in the Islamic economics literature can be covered at the undergraduate level. Therefore, presently, there is not enough graduate level material. With the passage of time more material will surely become available for the graduate level. For this reason, there are people who have reservations about starting graduate programs at this time. However, there are others who believe that today's graduate programs will lead to good quality papers, dissertations, research, as well as producing teachers for undergraduate programs. The next few years will show the product of graduate programs and an evaluation can then be objectively made.

Training Programs

Training programs are meant to cater to the manpower requirements of the process of islamization. In the field of teaching itself, the most severe constraint has been the availability of qualified manpower. The present generation of economists have had little or no formal education in Islamic economics nor have they had its prerequisite subjects. In order to meet immediate requirements, some orientation programs are needed. Towards this end, IIIE, in 1984, conducted a two-week refresher course for Pakistani universities' teachers of Islamic economics. The contents of this course are given in Appendix B. In 1988 another refresher course with international coverage was planned under the joint auspices of IIIE and the Islamic Research and Training Institute of the Islamic Development Bank in Jeddah.

Table 4
List of Courses for a One-Year Diploma in Economic Theory for Shari'ah Graduates

First Term
1. English Language I
2. English Language II
3. Basic Economic Concepts
4. Introduction to Economic Theory
5. Money and Banking
6. Public Finance

Second Term
1. Microeconomic Analysis
2. Macroeconomic Analysis
3. International Economics/Internationa Economics Institutions
4. Development and Planning
5. Islamic Economics
6. Comparative Economic Systems

Summer
Summer will be required only for deficiency courses in language or other subjects, if any.

While these programs were a good beginning, two-weeks can hardly be considered sufficient time in which to provide teachers the required training. A cursory look at the course contents reveals that there is too much material to cover in two weeks. Only a broad brush treatment of the topics is possible. Because on-the-job training programs cannot be conducted for much longer periods, one has to settle for short training programs of two- to four-weeks duration and hope that the participants will be motivated to continue their study either through self-study or through follow-up courses.

We believe, however, that in order to meet immediate requirements additional efforts have to be made. We suggest the following two crash programs: a One-Year Diploma in Shari'ah/Islamic Economics for Graduates in Economics and a One-Year Diploma in Economics for Shari'ah Graduates. Tables 4 and 5 present the proposed structures of these programs.

The Diploma of Economics for Shari'ah Graduates will be very useful in assimilating *madrasah* students into the degree programs. They may be required to complete this diploma before entering the degree programs. This will also be useful for shari'ah experts who

Table 5
List of Courses for a One-Year Diploma in Shari'ah for Economics Graduates

First Term

1. Arabic Language I
2. Arabic Language II
3. *Tafsīr*
4. *Usūl al Hadith*
5. *Usūl al Fiqh*
6. History of Islamic Economic Thought

Second Term

1. *Maqāṣid al Shari'ah*
2. Fiqh al Mu'āmilāt
3. Fiqh for Economists I
4. Fiqh for Economists II
5. Introduction to Islamic Economic Theory
6. Readings in Contemporary Islamic Economics

Summer

Summer will be required only for deficiency courses in language or other subjects, if any.

are teaching fiqh courses to economists or who are involved in research on contemporary problems. These diploma programs will go a long way in bridging the communication gap that presently exists between economists and *fuqahā*. They can then work together to find Islamic solutions to contemporary economic problems.

Another purpose of training programs is to provide qualified manpower for Islamic banking. A beginning was made in this regard by the International Federation of Islamic Banking which established the International Institute of Islamic Banking and Economics in Cyprus. The IIIE started a diploma program in Islamic banking. Unfortunately, the Institute ran into financial problems and was closed down in 1984. The gap created by the cessation of this program has not yet been filled.

The International Islamic University in Islamabad (IIIE) started a Senior Officers Training Program (SOTP) in Islamic Economic Doctrines and their Practical Application in 1986. This is a four-week program meant for senior officers of economic ministries and bank executives. The contents of this program are given in Appendix C. So far, three such programs have been conducted. The course is running very successfully and is creating a very good impact. Given sufficient resources, the Institute plans to offer this program internationally. Since this program is meant for senior officers the need for similar programs for middle-level management of Islamic banks is still present.

Conclusion

In this paper we have described the major teaching and training programs in Islamic economics, provided some comparative assessment, and, most importantly, identified some of the areas where improvements in the existing programs are needed. An attempt has also been made to identify areas where new programs are required to meet pressing needs. Some suggestions have been made only to initiate the discussion.

Appendix A

Table 1
Curriculum for the B.Sc. (Hons.) Degree at IIIE Islamabad

Semester I		Semester II	
Course Title	No. of Credits	Course Title	No. of Credits
First Year			
Arabic (Reading) I	4.5	Arabic (Listening Practice)	4.5
Arabic (Grammar) I	4.5	Arabic (Grammar) II	4.5
Arabic (Conversation & Composition)	4.5	Arabic (Conversation & Composition) II	4.5
Islamic Studies (Arabic) I	4.5	Islamic Studies (Arabic) II	4.5
English (Reading) I	3	English (Reading) II	3
English (Grammar) I	3	English (Grammar) II	3
English (Composition) I	3	English (Composition) II	3
Total Credits	27	Total Credits	27
Second Year			
Arabic III	4.5	Arabic IV	4.5
English III	4.5	English IV	4.5
Introduction to Economic Theory I	4.5	Introduction to Economic Theory II	4.5
Mathematics for Economics I	4.5	Mathematics for Economics II	4.5
Usul al Fiqh I	3	Fiqh al Muamilat al Maliyya I	3
Pakistan Studies	3	Economic Doctrines of Islam	3
The Islamic Man	3	The Islamic System	3
Total Credits	27	Total Credits	27

Table 1 (continued)
Curriculum for the B.Sc. (Hons.)
Degree at IIIE Islamabad

Semester I Course Title	No. of Credits	Semester II Course Title	No. of Credits
Third Year			
Microeconomics I	4.5	Microeconomics II	4.5
Macroeconomics I	4.5	Macroeconomics II	4.5
Monetary Theory	4.5	Public Finance	4.5
Introductory Statistics	4.5	Basic Econometrics	4.5
Usul al Fiqh II	3	Usul al Fiqh III	3
Fiqh al Muamilat al Maliyya II	3	Fiqh al Muamilat al Maliyya III	3
Arabic	3	Arabic	3
Total Credits	27	Total Credits	27
Fourth Year			
Advanced Microeconomics	4.5	Advanced Macroeconomics	4.5
Comparative Economic Systems	4.5	Economic Development	4.5
Readings in Islamic Economics	4.5	Economies of Muslim Countries*	3
International Trade and Finance	4.5	Current Issues in Islamic Economics	4.5
History of Economic Thought	3	Readings in Economic System of Islam	4.5
Research Methods for Social Scientists	3	Research Project**	3
Usul al Fiqh IV	3	Fiqh al Muamilat IV	3
Total Credits	27	Total Credits	27

* Alternatively: "The Pakistan Economy"	3
** Alternatively: "Project Evaluation"	3

Total credits in 4 years = 54 + 54 + 54 + 54 = 216
Total subjects in 4 years = 14 + 14 + 14 + 14 = 56

Table 2
Curriculum for the B.A. Degree in
Kulliyah of Economics
International Islamic University, Malaysia (IIU)

Semester I		Semester II	
Course Title	No. of Credits	Course Title	No. of Credits
	First Year		
Economics I	3	Economics II	3
Quantitative Analysis I	4	Quantitative Analysis II	4
Introduction to Business Administration	3	Introduction to Accounting	3
Introduction to Islam & Its Aqidah	2	Introduction to al Qur'an	2
Elementary Qur'anic Language I	2	Elementary Qur'anic Language II	2
Elementary English Language I	2	Elementary English Language II	2
Total Credits	16	Total Credits	16
	Second Year		
Microeconomics	4	Macroeconomics	4
Fiqh for Economists I	3	Fiqh for Economists II	3
Introduction to Computers & Information Processing	3	Introduction to Development and Planning	3
Introduction al Sunnah	2	Fiqh al Ibadat	2
Introduction to al Shari'ah	2		
Intermediate Qur'anic Language I	2	Intermediate Qur'anic Language II	2
Intermediate English I	2	Intermediate English I	2
Total Credits	18	Total Credits	16

Table 2 (continued)
Curriculum for the B.A. Degree in
Kulliyah of Economics
International Islamic University, Malaysia (IIU)

Semester I Course Title	No. of Credits	Semester II Course Title	No. of Credits
	Third Year		
Economic Analysis I	4	History of Islamic Economic Thought	3
Monetary Economics	3	Fiscal Economics	3
Economics of Welfare & Distribution	3	International Economics	3
Econometrics I	4	Economic Analysis II	3
Ethical Philosophy of Islam	2	Research Methodology	3
The Preaching of Islam	2	Islamic Civilization	2
Total Credits	18	Total Credits	17
	Four Year		
History of Western Economic Thought	3	Regional Cooperation among Muslim Countries	3
Comparative Economic Systems	3	Project Evaluation	3
Project Paper	2	Project Paper	2
Two of the following elective course(s):		Two of the following elective course(s):	
Development Studies		**Development Studies**	
Economic Planning	3	Econometrics II	3
Development Finance	3	International Trade & Development	3
Comparative Development	3	Regional Economics	3
International Studies		**International Studies**	
International Economic Institutions	3	Econometrics II	3
Issues in International Economics	3	International Trade and Development	3
International Relations	3	International Finance	3
Modern & Contemporary History of Islam	2	Regional Economics	3
Islam and Society	2	Islamic Thought & Contemporary Issues	2
Total Credits	15/18	Total Credits	15/18
Total hours in 4 years = 32 + 34 + 35 + 35 = 136			

Table 3
Curriculum for the Undergraduate Program at
Imam Muhammad University, Ryāḍ, Saudi Arabia

Semester I		Semester II	
Course Title	No. of Credits	Course Title	No. of Credits
	First Year		
Al Qur'an al Karim	1	Al Qur'an al Karim	1
Tafseer and Ulum al Qur'an	6	Al Fiqh and al Siyasah al Shariah	2
Al Tawheed	2	Mathematics for Economists	3
Islamic Studies	2	Basic Economics (Macro)	3
Basic Economics (Micro)	3	Accounting	2
Principles of Accounting	2	Principles of Business Administration	2
English Language	3	Arabic Language	4
		English Language	3
Total Credits	19	Total Credits	20
	Second Year		
Al Qur'an al Karim	1	Al Qur'an al Karim	1
Al Fiqh and al Siyasah al Shariah	4	Al Tafseer and al Ulum al Qur'an	6
Islamic Studies	2	Usul al Fiqh and Principles of Fiqh	4
Microeconomic Analysis	3	Islamic View of Public Revenue	3
Principles of Statistics	2		
Arabic Language	4	Statistics Analysis	2
English Language	3	English Language	3
Total Credits	19	Total Credits	19

Table 3 (continued)
Curriculum for the Undergraduate Program at Imam Muhammad University, Ryāḍ, Saudi Arabia

Semester I Course Title	No. of Credits	Semester II Course Title	No. of Credits
	Third Year		
Al Qur'an al Karim	1	Al Qur'an al Karim	1
Al Hadith	6	Al Fiqh and al Siyasah al Shariah	4
Usul al Fiqh & Principles of Fiqh	4	Islamic Studies	2
Macroeconomic Analysis	3	Money and Banking	3
Economic History for Society	2	International Economics	3
Mercantile Law and Companies	2	History of Islamic Economic Thought	3
English Language	2	English Language	3
Total Credits	20	Total Credits	19
	Fourth Year		
Al Qur'an al Karim	1	Al Qur'an al Karim	1
Al Hadith	3	Al Hadith	3
Al Fiqh and al Siyasah al Shariah	2	Al Fiqh and al Siyasah al Shariah	2
Islamic Studies	1	Islamic Studies	1
Econometrics	3	Theory of Distribution	3
Economic Development and Planning	3	Mathematical Economics	3
Project Evaluation	2	Islamic Economics (Seminar Course)	2
Islamic Economics (Theory)	3	Saudi Arabian Economy and the Economics of the Islamic World	3
Thesis	1		
Total Credits	19	Total Credits	18

Total hours in 4 years = 39 + 38 + 39 + 37 = 153
Total subjects in 4 years = 15 + 13 + 14 + 17 = 59

Table 4
Curriculum for the B.A. Degree at
Imam Sadiq University, Tehran, Iran

Semester I Course Title	No. of Credits	Semester II Course Title	No. of Credits
		First Year	
Tajweed	1	Qur'an	1
Islamic History	1	Islamic History	1
Aqeeda	2	Aqeeda	2
Logic	2	Logic	2
Fiqh	2	Fiqh	2
Arabic Conversation	5	Arabic Grammar	5
Grammar (English or French)	2	Arabic Conversation	1
Conversation (English or French)	2	Grammar (English or French)	4
Physical Training	1	Conversation (English or French)	2
Total Credits	20	Total Credits	20
		Second Year	
Tafseer	1	Tafseer	1
Islamic History	1	Islamic History	1
Aqeeda	2	Aqeeda	2
Logic	2	Fiqh	2
Fiqh	2	Arabic Grammar	5
Arabic Grammar	5	Arabic Conversation	1
Arabic Conversation	1	Grammar (English or French)	4
Grammar (English or French)	4	Conversation (English or French)	2
Conversation (English or French)	2	School of Philosophy	2
Total Credits	20	Total Credits	20

Table 4 (continued)
Curriculum for the B.A. Degree at
Imam Sadiq University, Tehran, Iran

Semester I Course Title	No. of Credits	Semester II Course Title	No. of Credits
		Third Year	
Tafseer	2	Tafseer	2
Islamic History	1	Islamic History	1
Fiqh	4	Usul al Fiqh	3
Arabic Grammar	3	Fiqh	3
Arabic Conversation	1	Arabic Grammar	3
Grammar (English or French)	2	Arabic Conversation	1
Principles of Economics	4	Grammar (English or French)	2
Mathematics for Economists I	3	Mathematics for Economists II	3
		Macroeconomics	3
Total Credits	20	Total Credits	21
		Fourth Year	
Usul al Fiqh	3	Usul al Fiqh	3
Fiqh	4	Fiqh	4
Arabic Conversation	1	Arabic Conversation	1
Maani wa Biyan	3	Maani wa Biyan	3
Grammar (English or French)	2	Grammar (English or French)	2
Microeconomics	3	History of Economic Thought	3
Statistics	4	Econometrics	4
Total Credits	20	Total Credits	20
		Fifth Year	
Fiqh	4	Fiqh	4
Arabic Conversation	1	Arabic Conversation	1
Grammar (English or French)	2	Grammar (English or French)	2
Economic Planning	3	Economics of Iran	4
Growth and Development Economics	3	Socialist System of Economic Planning	2
Money and Banking	3	Economic Planning in Islamic Economics	3
Multinational Corporation	2	Research Report	3
International Economic Institutions	2		
Total Credits	20	Total Credits	19

Total hours in 5 years = 40 + 40 + 41 + 40 + 39 = 200
Total subjects in 5 years = 18 + 18 + 17 + 14 + 15 = 82

Appendix B
Contents of the Two Week Refresher Course For Teachers of Islamic Economics

The Nature of Islamic Economics

1. Zarqa, A. "Islamic Economics: An Approach to Human Welfare." In *SIE:* 3-18.
2. Hasanuzzaman, S. Muhammad. Definition of Islamic Economics. *JRIE* 1(2), Winter 1984: 51-53.
3. Khan, Muhammad Akram. Islamic Economics: Nature and Need. *JRIE* 1(2), Winter 1984: 55-61.
4. Kahf, M. "Islamic Economics and Its Methodology." TIE: Chapter 1: 1-11.
5. Ahmad, K. "Introduction." In SIE: xiii-xxiii.
6. Mawdudi, S.A.A. "Ma'ashi Qawaneen ki Tadween-e-Jadid aur Uskay Usul" (Guidelines for Reconstruction of Economics from an Islamic Perspective). In MI: Chapter Eleven, 417-436. (U).
7. Tasin, Muhammad. "Islami Iqtisadiyat sey Muta'allaq Chang Usuli Baten" (Some Fundamental Issues in Understanding Islamic Economics). *Fikr-0-Nazar,* 14(2), August 1976: 81-101; 14(3), September/October 1976: 209-220. (U)
8. Mannan, Mohammad A. Islamic Economics as a Social Science. *JRIE* 1(1), Summer 1983: 49-61.

Muslim Economic Thinking

1. Siddiqi, Muhammad Nejatullah. "Muslim Economic Thinking: A Survey of Contemporary Literature." In *SIE:* 119-315.
2. ——— "Recent Works on History of Economic Thought in Islam: A Survey." *ICRIE,* Research Series in English, Paper No. 12, 1982.
3. Boulakia, J.D.C. Ibn Khaldun: A Fourteenth Century Economist. *Journal of Political Economy* 79(5), September/October 1971: 1105-18.

4. Zaim, S. "Contemporary Turkish Literature on Islamic Economics." In *SIE:* 316-50.

Islamic Economic System/Economic System of Islam

1. Mawdudi, S.A.A. "Qur'an ki Ma'ashi Ta'limat" (Economic Teachings of the Qur'an). In *MI:* Chapter Two, 67-117. (U)
2. —— - "Islami Nizame Ma'ishat kay Usul aur Maqasid" (Principles and Objectives of Islamic Economic Order). In *MI:* Chapter Four, 141-163. (U)
3. ——— "Sarmayadari aur Islam ka Farq" (Different between Capitalism and Islam). In *MI:* Chapter Three, 119-139. (U)
4. Qazi, A.G.N. "Economic System of Islam." Speech delivered at National Defence College, Rawalpindi on 6th August 1983. Karachi. State Bank of Pakistan, 1983.
5. *IKIN.*
6. Siddiqi, Muhammad Nejatullah. *Some Aspects of Islamic Economy*. Lahore: Islamic Publications Ltd., 1970.
7. —— "Guarantee of a Minimum Level of Living in an Islamic State." Paper read at *21CIE*. (See also comments on this paper by S.N.H. Naqvi at the Conference.)
8. —— – *Islam ka Nazriyya-e-Milkiyyat* (Ownership in Islam). 2 Volumes. Lahore: Islamic Publication Ltd, 1968. (U)
9. Chapra, Muhammad Umar. *The Economic System of Islam.* Karachi: University of Karachi, 1971.
10. —— "The Islamic Welfare State and Its Role in the Economy." In *SIE:* 143-169.
11. —— – Review on Ethics and Economics: An Islamic Synthesis. *The Muslim World Book Review* 2(1), Autumn 1981: 21-26.
12. Naqvi, S.N.H. *Ethics and Economics: An Islamic Synthesis.* Leicester, U.K.: The Islamic Foundation, 1979.
13. – —— *Individual Freedom, Social Welfare and Islamic Economic Order.* Islamabad: Pakistan Institute of Development Economics, 1983.
14. Mirakhor, A. "Attempt to synthesize Islamic ethics and modern economics," *Crescent International,* 13(7), Ramadhan 16 - Shawwal 1, 1404 (June 16-30, 1984): 9,11.

15. Ishaque, K. Muhammad. "Private Property and Its Role in Islamic Social Order." In *ESI:* 19-54.
16. ——— "The Islamic Approach to Economic Activity and Development." In *MWFEO:* 74-100.
17. Sakr, Muhammad Ahmad. "The Role of State in the Economic System of Islam." In *INIEO:* 103-116.
18. Ibn Taymiya. *Public Duties in Islam: The Institution of the Hisba.* Translated by Mukhtar Holland , edited by K. Ahmad. Leicester, U.K.: The Islamic Foundation, 1982.
19. Khan,Muhammad Akram. "Al-Hisba and the Islamic Economy." In Ibn Taymiya, *op. cit.:* 135-151.
20. Awan, A.A. *Equality, Efficiency and Property Ownership in the Islamic Economic System.* Lanham, MD: University Press of America, 1983.

Microeconomic Theory of an Islamic Economy

1. Seoharwi, Muhammad Hifz-ur-Rehman. "Inferadi Ma'ishat" (Microeconomics). In *IKIN:* 61-67. (U)
2. Kelani, Abdul Rahman. *Islam mein Zabita-e-Tijarat* (Islamic Code of Business Ethics). Edited by A. Zubeidi and Abdul Wakeel Alvie. Lahore: Maktaba-tus-Salam, n.d. (U)
3. Mannan, Muhammad A. "Scarcity, Choice and Opportunity Cost: Their Dimensions in Islamic Perspective." *ICRIE,* Research Series in English, Paper No. 10, 1982. 35p.
4. Reference Nos. 18 and 19 in III.

Consumer Theory

1. Ariff, Mohammad. "Towards Establishing the Micro Foundations of Islamic Economics. A Contribution to the Consumer Behaviour in an Islamic Society." Paper presented at the 12th Annual Conference of the Association of Muslim Social Scientists, November 1983. 29pp.
2. Kahf, M. "The Theory of Consumption." In TIE: Chapter 11, 15-25.
3. ——— "A Contribution to the Theory of Consumer Behaviour in Islamic Economy." In *SIE:* 19-36.

Theory of Firm

1. Siddiqi, Muhammad Nejatullah. "Ends of Economic Enterprise." In EEI: Chapter One, 1-34.
2. ——— "Justice and Benevolence as the Bases of Entrepreneurial Behavior." In *EEI:* Chapter Two, 35-73.
3. ——— "Muslim Entrepreneur and the Economy." In *EEI:* 139-152.
4. Kahf, M. "The Theory of Production." In *TIE:* Chapter IV, 41-56.
4. Mannan, Muhammad A. "Islamic Perspectives on Market Prices and Allocation." *ICRIE,* Research Series in English, Paper No. 5, 1982. 31pp.
5. ——— "All Efficiency, Decision and Welfare Criteria in an Interest-Free Islamic Economy. A Comparative Policy Approach." In *MFEI:* 43-73.
6. Reference Nos. 18 and 19 III.

Basic Macroeconomic Themes in Islamic Economics

1. Kahf, M. "A Contribution to the Theory of Consumer Behaviour in an Islamic Society." In *SIE:* 19-36.
2. Khan, Muhammad Fahim. "Macro Consumption Function in an Islamic Framework." *JRIE* 1(2), Winter 1984: 1-24.

Investment

1. Kahf, M. "Saving and Investment Functions in a Two-Sector Islamic Economy." In *MFEI:* 107-123.
2. Zarqa, Muhammad A. "An Islamic Perspective on the Economics of Discounting in Project Evaluation." In *FPRAI:* 203-252.
3. Choudhry, M.A. "The Rate of Capitalization in Valuation Models in an Islamic Economy." In *FPRAI:* 287-313.
4. Naqvi, S.N.H. "Interest Rate and Intertemporal Allocative Efficiency in an Islamic Economy." In *MFEI:* 75-106

Money Banking and Monetary Policy in an Islamic Economy

1. Siddiqi, Muhammad Nejatullh, "Islamic Approach to Money, Banking and Monetary Policy." In *MFEI:* 25-42, or more recent version of the same in IIBSP. 15-50.
2. Ariff, Mohammad. "Introduction." In *MFEI:* 1-23.

3. Ahmad, Z. Iqbal, M. and Khan, Muhammad Fahim. "Introduction." In *MBI:* 1-25.

Nature of Money and Interest: The Western View and the Islamic Viewpoint

1. Saud, M.A. "Money, Interest and Qirad." In *SIE:* 59-84.
2. Ahmad, Z. "The Theory of Riba." *Islamic Studies* 17(4), Winter 1978: 171-85.
3. Shafi', Mufti Muhammad. *Mas'ala-e-Sud* (The Problem of Interest). Karachi: Dar al-Asha'at, 1979. (U)
4. Ahmad, M. "Semantics of Theory of Interest." *Islamic Studies* 6(2), June 1967: 171-96.

Alternatives to Interest in an Islamic Economy

1. Council of Islamic Ideology. "Report on the Elimination of Interest from the Economy." (Along with "Interim Report of the Panel of Economists and Bankers on the Elimination of Interest.) In *MBI:* 103-257.
2. Ali, M. "Mudarabah and Shirakat as a Basis of Interest-Free Economy." In *IFBP:* 127-41.
3. Siddiqi, *Muhammad Nejatullah Shirkat aur Mudabarat kay Shar'i Usul* (Principles of Shirakah and Mudarabah in Shariah). Lahore: Islamic Publication Ltd, 1969. (U)
4. ——— "Business of the Bank." In *BWI:* Chapter 2, 19-38.
5. ——— "The Bank and the Owners of Capital." In *BWI:* Chapter 3, 39-52.
6. ——— "Banking in an Islamic Framework." In *IIBSP:* 51-65.
7. ——— "Rationale of Islamic Banking." In *IIBSP:* 67-96.
8. ——— "The Process of Credit Creation." In *BWI:* Chapter 5, 73-96.
9. ——— "Monetary Theory of Islamic Economics." In *IIBSP:* 125-131.
10. ——— "Some Clarification." In *BWI:* Chapter 9, 167-176.
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A Glossary of Abbreviations

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EEI Siddiqi, Muhammad Nejatullah. *The Economic Enterprise in Islam*. Lahore: Islamic Publication Ltd., 1979.

ESI Economic System of Islam. (Proceedings of a seminar organized by The National Bank of Pakistan in April 1979.) Karachi: The National Bank of Pakistan, 1980.

FPRAI Ahmad, Z., M. Iqbal, and Muhammad Fahim Khan (eds.). *Fiscal Policy and Resource Allocation in Islam*. Islamabad: Institute of Policy Studies, 1983.

ICRIE International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia.

IFBP *Interest-Free Banking in Pakistan*. (Proceedings of the seminar on "Islamization of Banking" in 1980.) Karachi: The Institute of Bankers in Pakistan, n.d.

IIBSP Siddiqi, Muhammad Nejatullah. *Issues in Islamic Banking, Selected Papers*. Leicester, U.K.: The Islamic Foundation, 1983. (Also Muhammad A. Mannan's Review in *J.R.I.E.* 1(2), Summer 1983: 69-72.

IKIN Seoharwi, Muhammad Hafiz-ur-Rehman. *Islam ka Iqtesadi Nizam* (Economic System of Islam). Lahore: Adara-e-Islamiyat, 1981. (U)

INIEO *Islam and a New International Economic Order: The Social Dimension*. (Proceedings of the symposium held, on the same theme, in Geneva, 7-10, January, 1980.) Geneva: International Institute for Labour Studies, 1980.

JRIE *Journal of Research in Islamic Economics.*

MBI Ahmad, Z., M. Iqbal, and Muhammad Fahim Khan (eds.). *Money and Banking in Islam.* Islamabad: Institute of Policy Studies, 1983.

MFEI Ariff, Mohammad (ed.). *Monetary and Fiscal Economics of Islam.*Jeddah: International Centre for Research in Islamic Economics, 1982.

MI Mawdudi, S.A.A. *Ma'ashiyat-e-Islam* (Economics of Islam). Edited by K. Ahmad. Lahore: Islamic Publications Ltd., 1969. (U)

MWFEO *The Muslim World and the Future Economic Order.* (Proceedings of the conference held, on the same theme, in London during July 4-9, 1977). London: Islamic Council of Europe, 1979.

SIE Ahmad, K. (ed.). *Studies in Islamic Economics.* Leicester, U.K.: The Islamic Foundation, 1980.

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(U) The title is in Urdu.

2ICIE The Second International Conference on Islamic Economics held during March 19-23, 1983 at the Islamic University, Islamabad.

Appendix C
List of Topics Covered in Senior Officers Training Programme in Islamic Economic Doctrines And Their Practical Application Conducted by the International Institute of Islamic Economics at the International Islamic University, Islamabad, Pakistan (IIIE)

Sequence No.	Topics	Remarks
1	Main Components of the Universal Islamic Message	
2	Islamic Approach Towards Life	
3	Ejaz ul Qur'an	
4	Introduction to Hadith Literature	
5	Economics of Qur'an	
6	The Concept of al Adl Wa al Ihsan	
7	Maqasid al Shariah	
8	Idiological Basis for Pakistan Movement	
9	Applicability of Islamic Shariah in the Context of Modern World Conditions	
10	Extension Lecture on "Concept of Credit & Its Application	Evening lecture "Modern World"
11	History of Islamic Economic Thought	
12	Contribution of Islam of World Civilization	
13	Economic System of Islam	
14	Islamic Economic System	
15	Islamic Viewpoint on Distribution of Income and Wealth	
16	Islam's Distribution System	
17	Concept of Ownership & Property Relationships in Islam	
18	The Prophet (PBUH) ka Mo'ashi Inqila'ab	
19	Land Tenure System and Land Reforms in an Islamic State	
20	Worker-Employer Relationships in Islam	
21	"Source of Islamic Law"	Evening Lecture
22	Social Justice in Islam	
23	Riba in the Light of Qur'an and Sunnah	
24	Economic Rationale of the Prohibition of Interest and Virtues of an Interest-Free Economy	
25	Seminar on "Business Practices in Islamic Shariah"	
26	Islamization of Commercial Banking in Pakistan	
27	Role of Ijtehad in Meeting the Challenges of Modern World	

28	Worker-Employer Relationships in Islam	
29	Commercial Banking Based on Islamic Principles	
30	Elimination of Interest from Government Transactions (Including Islamic Viewpoint on Deficit Financing)	
31	General Discussion	
32	"The Present State of Islamic Finance Movement"	Evening Lecture
33	Resource Allocation and Project Evaluation in an Islamic Economy	
34	Principles of Public Expenditure in an Islamic Economy	
35	System of Zakah and Ushr in Operation in Pakistan: A Description	
36	Some Misgivings about Islamic Interest-Free Banking	
37	Islam and Insurance	
38	Central Banking and Monetary Policy in an Islamic Economy	
39	Recommendations of the Council of Islamic Ideology on Economic Issues	
40	Extension Lecture on "Islamisation of Commercial Banking in Pakistan	Evening Lecture
41	Development Finance Institutions and Instruments in an Islamic Economy	
42	Taxation, PLS System and Islamization	
43	Islamic Theory of Public Finance and Principles of Taxation in an Islamic Economy	
44	Role of Awqaf	
45	"Islamization Process in Pakistan"	Evening Lecture

Comments on "Teaching Programs in Islamic Economics: A Comparative Study"*

Abdul Rahman Yusri

In "Teaching Programs in Islamic Economics: A Comparative Study," Iqbal introduces excellent ideas that demonstrate his knowledge of both Islamic economics and the problems of teaching it. He exposes the hiatus between secular social sciences and traditional education in Muslim societies by following the usual interpretation; that is, describing the rift within the educational system between 'traditional' education which is devoted to the religious sciences while ignoring the modern sciences, and secular education which is devoted to modern sciences, accepting it in blind faith, while showing no interest in the religious sciences. However, within the educational institutions there exists a more fundamental problem.

Many Muslim countries such as Egypt have introduced modern sciences into the curriculum of institutions of traditional education. For example, al-Azhar University restructured itself, mixing traditional shari'ah education with the modern sciences. Even so, the gap between the two systems did not disappear, rather, it became even more pronounced. Iqbal indicates his awareness of the problem but does not express it as succinctly and clearly as he should. The gap between traditional and modern education in our societies is reflected in the hearts and minds of our teachers, educators, and intellectuals who believe that integration does injustice to one or the other educational system. A deep-seated belief among some religious leaders is that modern science contains the seeds of evil thought and that the introduction of modern sciences into traditional Islamic education will have a negative effect on the faith. Clearly, mixing the modern and the Islamic sciences alone will not solve the problem facing our schools and universities. Rather, the problem will only be solved when educators expand the traditional curriculum so that it absorbs new branches of knowledge, while at the same time, establishes a

* Translated from Arabic by the editor.

discriminating filter to sift out what is not in accord with Islam. Only when we have developed a methodology to ascertain whether a modern scientific development is in line with the values inherent in our shari'ah will the blind imitation of the West stop. The moment Muslim intellectuals attain this is the moment the imaginary hiatus between the two systems vanishs. Vital to teaching Islamic economics is the knowledge that the real gap to be bridged is the one between the knowledge based on true faith revealed to our Prophet, the Seal of the Prophets, blessings and peace be upon him, and the sciences that do not pay attention to such faith, and may even run counter to it.

The early steps taken by some Muslim educational institutions to establish specialized departments with full curricula for the teaching of Islamic economics encountered the question of balance between shari'ah and secular sciences. The problem was not only how much of each to give the students but also who among the faculties was qualified to teach these subjects. The professors of fiqh saw themselves as the most qualified to teach Islamic economics as well modern economics. On the other hand, the professors who studied economics in the West or in the Muslim countries whose universities followed Western standards and were unconvinced of the relevance of Islamic economics, understood the problem of teaching Islamic economics as no more than modifying the economic theory within ordinary secular economics courses to accord with Islamic ethics and values. What concerned most professors of economics was how to analyse problems and pass them through theoretical studies within a general framework of basic assumptions deduced from the shari'ah and the ethics of Islamic societies. Economics professors concentrated on learning the details of some rather general principles of the shari'ah or considered the shari'ah outside their field of competence. Evidence of this situation was revealed in conferences, seminars, and workshops conducted in many countries since 1971, and is reflected in the curricula of many Islamic universities.

Iqbal analyses the curricula of four leading Islamic Universities, highlighting the balance between the shari'ah and modern economics in each. He finds traditional shari'ah subjects are prominent and receive higher intensity in Muhammad bin Saud and al Imam Sadiq Universities; whereas he finds modern economics more dominant in the curriculum of the International Islamic University in Malaysia. Iqbal does not explain the reasons behind the curricula differences. I may safely say that the differences in the curricula lie in the fact that at those universities where the shari'ah specialists had the upper hand, the shari'ah subjects dominated the curriculum and vice-versa. At the International Islamic University in Islamabad he found a more balanced curriculum. And reflecting his wide experience at the University of Islamabad, we find that Iqbal, in his proposed curriculum, judiciously mixes shari'ah science and modern economics to produce a balanced curriculum at the undergraduate level.

With care, Iqbal addresses the question of what is the proper mixture of shari'ah and modern economics in the university curriculum. Certainly, the question is not easy to answer and may not be answered until Islamic economics is well established in Muslim countries. Professors of shari'ah, and *fuqahā* in particular, are not economists. This fact does not reduce in any way their prestige—Islamic scientific methodology was developed centuries before the Western system. The Islamic system respects specialization. Professors of modern economics in Muslim universities have to begin economic analysis within the Islamic perspective. Of course, this will need more than a general knowledge of shari'ah principles, it will take a deep and searching exploration of the shari'ah, Islamic economic history, and the contribution of Muslim scholars to economics.

But the problem is not merely deciding the proper mixture of shari'ah and modern economics courses, the problem is how to facilitate the amalgamation of shari'ah and modern economics. The amalgam will not occur unless the hearts and minds of the teachers of both shari'ah and modern economics change. Then and only then will we have a unified concept of Islamic economics and no longer need to divide our courses into shari'ah and otherwise.

Iqbal's work is excellent as is the program he presents as a B.A. degree in Islamic Economics. Those who have studied modern economics and then devoted their time and energy to research in the field of Islamic economics are in complete agreement with him. However, even though a large portion of Iqbal's proposed curriculum contains study of the shari'ah, his proposal will still not be acceptable to most shari'ah specialists.

The fundamental question is how to eliminate the existing gap in the hearts and minds of those who teach. I suspect that, for a long time, there are going to be graduates from our leading universities who have B.A. degrees in Islamic economics but who have different backgrounds. Some will be well-versed in shari'ah principles and codes with little training in economics while others will be well-trained in modern economics but possess very superficial knowledge of the shari'ah.

In Iqbal's examination of Islamic universities, he ignores developments in three leading Islamic universities—al Azhar in Egypt, Um al Qura in Saudi Arabia and Omdurman in Sudan. Neglecting to mention these universities is unfortunate for they are instructive examples. In particular, al-Azhar, which has ambitiously pursued the integration of modern sciences with traditional religious teachings has been a target of criticism from different quarters. Al Azhar is worth evaluating and should have been included in this paper. The other two universities have identical programs of teaching Islamic economics. In these programs, there is a clear attempt to integrate modern economics and the shari'ah. There seems to be no particular reason why these universities were not included in this paper.

From my own experience at Um al Qura University, I know that within two years it is possible to present a substantial portion of the shari'ah of economics to graduate students from secular universities. At the same time, it is also possible to present a substantial portion of modern economics to graduates of shari'ah institutions. Within this program, a student who has passed his preparatory studies is in a position to choose his Master or Ph.D. thesis under the supervision of two professors, one specializing in the shari'ah and the other in modern economics. The program has resulted in important research and the completion of many theses in different branches of Islamic economics.

Some of the students who finished their Ph.D.s became part of the teaching staff at the university and will have an important role in furthering research in Islamic economics. They are well prepared for the task. They went through a program of balanced education in both economics and shari'ah. Some may wonder how it is possible to develop postgraduate programs where there is no undergraduate teaching of the subject? We should not forget that Islamic economics is not a new science. Its roots extend into history and we are only reintroducing it in the modern context.

The last point which I would like to raise is the importance of offering complementary subjects to students of Islamic economics. The job market is not yet ready to offer employment opportunities to its graduates. In fact, society may demand skills and training not developed by its courses but by the complementary courses. The complementary subjects such as accounting, business administration, foreign language, and quantitative studies, though not part of the study of Islamic economics, will enhance the opportunities of its graduates. This is very important, especially in the beginning. Certainly, students will not specialize in this science if there are no jobs for them.

Economic Development in Muslim Countries: A Strategy for Development in the Light of Islamic Teachings*

M. Umar Chapra**

*Revised version of a paper presented to the Seminar on Islamic Economics held in Cairo from 6-9 September 1988 under the auspices of the International Institute of Islamic Thought, Washington, USA, and the Al-Azhar University.

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The Questions

All Muslim countries fall within the category of developing countries, even though some of them are relatively rich. Most of these countries, particularly the poorer ones, are, like other developing countries, beset with a number of extremely difficult macroeconomic imbalances, which are reflected in high rates of unemployment and inflation, excessive balance of payment deficits, continued exchange rate depreciation, and heavy debt burdens. They are also experiencing extreme inequalities of income and wealth. The basic needs of a considerable portion of the population remain unsatisfied; the rich and the upper middle classes live in great affluence, corroding the social fabric and causing sociopolitical instability.

The Islamic revival, which is gaining momentum in almost all Muslim countries, forces us to pose two basic questions. The first is What is the quality of development that Islam stands for? And the second is What can Islamic teachings provide to aid in the development of this quality within each country's existing resource constraints such that their macroeconomic imbalances are reduced?

The quality of development is automatically defined by the objectives of the shari'ah (*maqāṣid al shari'ah*). They imply that, while economic growth is essential, it is not sufficient for attaining real human wellbeing (*falāh*); it must be accompanied by a rise in mental peace and a decline in crime and social tensions. This is not possible without spiritual health at the core of human consciousness, and justice and fair play at all levels of human interaction. Accordingly, the shari'ah accords a high priority to spiritual uplift, brotherhood, and socioeconomic justice. But these will remain an unrealized dream unless the scarce resources at the disposal of Muslim countries are utilized for the wellbeing of all its people through the removal of poverty and the reduction of economic inequalities.[1] Since Islam discourages begging and makes it a personal obligation on every physically and mentally fit person to support himself and his family, the goal of 'need fulfillment' needs to be realized through the development of individual ability and the expansion of both self-employment and employment opportunities.

Because there is no significant controversy among Muslims about the objectives of the shari'ah, this paper will be concerned mainly with formulating a strategy to realize the kind of development that Islam stands for. To lay the discussion groundwork, the paper

[1] The fulfillment of basic needs is now quite widely accepted as a strategy for development (See Paul Streeten's "A Basic Needs Approach to Economic Development" in Kenneth P. Jameson and Charles K. Wilber, eds., *Directions in Economic Development*, [Notre Dame, IN: W. Notre Dame University Press, 1973]; and Frances Stewart, *Basic Needs in Developing Countries* [Baltimore, Maryland: John Hopkins University Press, 1985].) A number of other authors have also written over the last decade on the concept of basic needs and its implications for development.

The stress on need fulfillment in Islam should, however, not be construed as an afterthought arising out of the recent Western discussion of the subject. It has received an important place in the fiqh and other Islamic literature throughout Muslim history. The jurists have unanimously held the view that it is the collective duty (*farḍ kifāyah*) of the Muslim society to take care of the basic needs of the poor. (See, for example, Abu Muhammad 'Ali Ibn Hazm, *Al Muhallā,* Beirut: Al Maktab al Tijāri, n.d., vol. 6, p. 156:725.) In fact, according to Shatibi, this is the *raison d'etre,* of society itself (abu Ishāq al-Shatibi, *Al Muwāfiqāt fi Usul al Shari'ah,* ed., Abdallah Daraz, Cairo: Al Maktabah al Tijāriyyah al Kubrā, n.d., vol. 2, p. 177). All modern writers, including Mawdudi, Sayyid Qutb, Mustafā al Sabā'i, Abu Zaharah, Bāqir al Sadr, M. al Mubarak, and al Qardāwi, unanimously agree on this point. (See for a brief introduction, M.N. Siddiqi, "Guarantee of a Minimum Level of Living in Islamic State", in Munawwar Iqbal, *Distributive Justice and Need Fulfilment in an Islamic Economy* (Islamabad: International Institute of Islamic Economics, 1986), pp. 249 301; 'Abd al Salām al Abbādi, *Al Milkiyyah fi al Shari'ah al Islāmiyyah* (Amman, Jordan: Maktabah al Aqsā, 1975), vol. 3, pp. 81-95; Ibrahim Ahmad Ibrahim, *Nizam al Nafaqāt fi al Shari'ah al Islamiyyah* (Cairo: Al Matba'ah al Salafiyyah, 1349 A. H.); and M. Anas Zarqa, "Nahwa Nazariyyah Islāmiyyah Mi'yariyyah li al-Tawzi'," a paper presented to the Second Islamic Economics Conference at the International Institute of Islamic Economics in Islamabad).

starts with a brief discussion of capitalist and socialist strategies and exposes the fact that continued pursuance of these strategies will either frustrate the efforts of Muslim countries to realize the objectives of the shari'ah or lead to an accentuation of their macroeconomic and external imbalances. The paper then discusses the main ingredients of a strategy in the light of Islamic teachings—a strategy that will enable the poorer Muslim countries to accelerate economic development, giving it the meaning and color that Islam visualizes, and reduce the severity of their macroeconomic imbalances.

Failure of the Borrowed Strategies

If resources were unlimited there would be no difficulty in realizing the objectives of the shari'ah. However, the bitter fact is that resources are limited. This makes it necessary that the claims on these resources be reduced and that they be allocated and distributed in such an efficient and equitable manner that an optimum rate of economic growth is attained (efficiency) and the objectives of the shari'ah are realized (equity) without generating macroeconomic imbalances. It is not possible to accomplish these goals in a vacuum and, therefore, it is necessary to have an underlying philosophy consistent with the goals.

Every economic system has such an underlying philosophy even though, like the foundation of a building, it is not visible. This philosophy helps the system develop its own strategy, consisting of: (a) a filter mechanism to enable individuals to discriminate and choose among the unlimited uses of resources in such a way that the aggregate claims do not exceed supply and socioeconomic goals of the society are realized; (b) a motivating mechanism to induce individuals to contribute their best in conformity with the dictates of such a filter mechanism irrespective of whether this serves their own interest or the interest of society; and (c) a transfer mechanism to bring about resource allocation and distribution that is in harmony with social goals. Unless the underlying philosophy of the system is consistent with its professed goals, a proper strategy cannot be developed and the goals will not be realized.

Muslim countries have tried to pursue development strategies conceived within the secularist and 'this-worldly' perspective of either capitalism or socialism. However, their problems have become aggravated and they have moved farther and farther away from the realization of the objectives of the shari'ah. The fundamental reason is that the strategies they have adopted have been borrowed from societies whose professed goals may be the same as those of Islam but whose underlying philosophy and strategy are in conflict with the realization of these goals.

Capitalism regards self-interest as the primary motivation behind individual initiative and enterprise. It thus assigns primary value to everything that serves self-interest, such as maximum individual freedom, unlimited rights to accumulate private property, market determined prices, and profit maximization. Freedom is also conceived within the framework of unhindered opportunity to pursue this self-interest. The willingness of the sovereign consumers to pay the price in accordance with their individual preferences will interact with the cost schedules of passive suppliers and determine not only the production of that configuration of goods and services which is socially most preferred but also the incomes earned by different factors of production in return for their contribution to output and revenue. The serving of self-interest by everyone in a free and competitive market environment will thus serve the social interest by leading to a most efficient and equitable allocation and distribution. Prices will serve as the filter mechanism in determining necessary from unnecessary and equitable from inequitable. Trying to do this in any other way requires value judgements which are an anathema. Capitalism thus sidesteps the crucial issues of ethics and socioeconomic justice by asserting that market forces will be sufficient to keep self-interest within the bounds of social wellbeing. Government intervention is accordingly considered undesirable except when it is necessary to ensure the prevalence of orderly markets.

A number of assumptions are implicitly made in the above reasoning. However, usually they are not spelled out clearly in the literature. First, it is assumed that everything that needs to be done in social interest is also in self-interest, with no possibility of conflict between the two. This is a false assumption; for example, a substantial reduction in luxury consumption of the rich is in the interest of increased savings and investment and of general need-fulfillment, but may not necessarily be in the immediate interest of the rich. Similarly, eliminating the pollution in a country's rivers is in social interest but need not necessarily satisfy the immediate, this-worldly self-interest of an individual because it raises costs and reduces profits; thus, market forces would tend to benefit those who avoid such costs.

Second, it is assumed that background conditions that are necessary to bring about a harmony between self-interest and social well-being in a secularist environment are fulfilled. Two of the most important of these are: perfect competition (many buyers, many sellers, no barriers to entry, and perfect knowledge) and equal distribution of wealth, talents, education, and power. However, none of these two tacitly assumed conditions is fulfilled in any of the market economies around the world. Samuel Brittan has rightly observed that "No real world market is likely to be even approximately satisfactory in all the background conditions."[2] Hence, while market forces may be able to raise efficiency, they cannot, by themselves, be expected to bring about equity. Rather, they will enable the rich and the powerful to tilt the allocation of resources in their favor. Accordingly, as Samuelson has rightly indicated, market forces will only lead to "starving couples; to malnourished children who grow up to produce malnourished children; to perpetuation of Lorenz curves of great inequality of incomes and wealth for generations or forever."[3]

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[2] Samuel Brittan, *Two Cheers for Self-Interest* (London: The Institute of Economic Affairs, for the Wincott Foundation, 1985), p. 17.

[3] Paul Samuelson, *Economics* (New York: McGraw Hill, 1980, 11th ed.), p. 591.

Third, it is assumed that even in a secularist system committed to utilitarianism, the preferences of utility maximizing sovereign consumers would reflect social priorities. This is also not true. Without the restraint that commitment to moral values promotes in the use of resources, votes cast in the market place cannot reflect social priorities. Why would the rich abstain from diverting scarce resources from need fulfillment to the satisfaction of their preferences, whatever they be.

Given the prevailing inequalities of income and wealth and the lack of commitment to agreed social values, the price system could not but effectively contribute to social Darwinism in resource allocation and distribution. The situation is worsened by value-free advertising to promote the sales of status symbols and the relatively easy access of the rich to the enormous financial resources of the banking system through credit. The result is that in secularist market economies, the rich are able, by the sheer weight of their purchasing power, to get scarce national resources diverted to the production or import of luxuries and false symbols of prestige which do not fall within the category of needs. Thus, as indicated by Tawney, a "part of the goods which are annually produced, and which are called wealth is, strictly speaking, waste because it consists of articles which, though reckoned as part of the income of the nation, either should not have been produced until other articles had been produced in sufficient abundance or should not have been produced at all."[4] Nevertheless, every competitive equilibrium is declared to be a Pareto optimum, irrespective of whether the configuration of goods and services produced and the income distribution brought about is in conflict with the professed goals of society.

Therefore, the only policy alternatives left for removing poverty and satisfying needs within the capitalist framework are accelerated growth and government 'welfare' spending. However, two decades of unprecedented growth have failed to remove poverty and fulfill needs even in the world's richest countries. In fact, as Adelman and

[4] R.H. Tawney, *The Acquisitive Society* (New York: Harcourt and Brace, 1948), p. 12.

Morris have convincingly shown on the basis of a cross-section of data, "development is accompanied by an absolute as well as a relative decline in the average income of the poor."[5] Moreover, growth has now faltered and there seems to be no hope of faster growth in the near future without rekindling inflation or accentuating external imbalances. Welfare spending, undertaken within the framework of value neutrality, has also helped the rich more than the poor because of their larger purchases and their greater access to facilities.[6] Thus, while the single-minded pursuit of growth and welfare spending led to an avalanche of claims satisfied through deficit financing, credit expansion, and external borrowing, it did not help accomplish the desired goals; rather, it led to macroeconomic imbalances which have acquired cancerous proportions in some countries. Within the constraints of neoclassical orthodoxy, being championed by the World Bank and the International Monetary Fund (IMF), the cure lies in a greater resort to the market mechanism. This implies a package of liberalization policies including removal of price controls and subsidies, real exchange rate depreciation, and a general reduction in all forms of market intervention. While these are no doubt essential, their use within the secularist framework of value neutrality not only slows down growth but actually squeezes the poor unduly, leading to riots and socio-political instability.

Socialism, which is equally if not more secularist in its outlook towards life, has an implicit distrust in the ability of human beings to act in the interest of society. Hence, there arises the need to curb freedom and eliminate private property as well as the profit motive through state ownership of all means of production and central planning to promote efficiency and equity in resource use. The removal of profit as a direct reward for individual effort, however, erodes initiative and efficiency, both of which are indispensable for growth. Centralized decision making also makes the transfer of resources

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[5] Adelman and C.T. Morris, *Economic Growth and Social Equity in Developing Countries* (Stanford, California: Stanford University Press, 1973), p. 189.

[6] See Richard Titmus, Commitment of Welfare (London: George Allen and Unwin, 2nd ed., 1976), p. 196.

slow and cumbersome and makes the whole economic machinery inefficient.[7] Thus, the emergence of perestroika in almost all socialist countries—a move to reintroduce private profit, realistic prices, and some other elements of the market system for greater efficiency in resource allocation.

Nevertheless, the basic question that remains is, If individual human beings cannot be trusted to manage their private businesses within the overall constraint of social wellbeing, how can they manage the whole nation's means of production for this purpose? Will not the government officials come out of the same people who cannot be trusted? If so, what is the guarantee that they will not exploit the tremendous power exercised by them through the placing of all means of production at their command. Moreover, even the central planning officials need a philosophy of life and a filter mechanism of values to manage the means of production for actualizing socio-economic justice. Who will provide these values? If they themselves try to develop all values and rules, even the fundamentals, wouldn't there be arbitrariness in their decisions and a conflict of interest, particularly in a system which has dialectics (the counterpart of social Darwinism) as an essential part of its world view? Who will check them and correct them if necessary?

The logical flaws in the reasoning of both capitalism and socialism are also borne out by facts. The experience of capitalist countries indicates that even the richest and most advanced ones have not been able to remove poverty in spite of decades of development and their enormous wealth. In fact, inequalities of income and wealth have risen and unemployment has become a chronic, long-term problem. Some of these countries are also facing chronic macroeconomic and external imbalances that they are finding hard to remove. The record of the socialist countries is no different in either fulfilling needs or in reducing socio-economic inequalities, in spite of their enormous resources. Their economies have stagnated due to lack of motivation among workers as well as executives, and the inability of the system

[7] For the experience with socialism in some Muslim countries see, Helen Desfosses and Jacques Levesque, *Socialism in the Third World* (New York: Praeger, 1975).

to respond to changing realities. The external debt of some of these countries has also risen steeply like that of a number of developing countries. The adoption of market solutions, which perestroika envisages, within the framework of the diehard secularism of these societies is bound to get them engulfed in the problems of inflation, unemployment, and other macroeconomic imbalances that capitalist societies are themselves experiencing.

Thus, both systems have failed to realize their professed goals. This is because their fundamental philosophy of life and the strategy derived from it are not in harmony with their professed goals. The goals are humanitarian but the strategies are conflict-oriented, based on social Darwinism or dialectics rather than on the concepts of brotherhood, trust, and accountability before the Supreme Being. Within the frame of reference of their world view and strategy they are unable to introduce the radical structural changes that are needed to realize professed goals without accentuating macroeconomic imbalances. Systems which have themselves failed to realize their goals cannot serve as examples for Muslim countries. Hence, Muslim countries must turn inward and see whether Islam can provide an allocation and distribution strategy that is different from those of both capitalism and socialism, while at the same time is in conformity with the objectives of the shari'ah.

The Islamic Strategy

Realization of the objectives of the shari'ah requires resources and, in view of the already existing heavy pressure on resources, it is not possible to muster resources for this purpose without reducing the flow for other purposes or, to use the proper economic terminology, reallocation. In the absence of reallocation there is bound to be an excessive resort to deficit financing, credit expansion and external debt. These exacerbate inflationary pressures, balance of payments deficits, currency depreciation, and debt-servicing burdens.

The kind of resource reallocation needed for realizing the objectives of the shari'ah cannot be brought about merely by the operation of market forces or central planning. It is necessary to have a socially agreed upon filter mechanism of values, which only a moral system can provide. Islam is no doubt such a moral system with values that no sincere Muslim would be willing to challenge. However, values, even if they are accepted by everyone, may be ineffective unless they are acted upon. This requires a strong motivating mechanism, particularly when there is a conflict between self-interest and social interest. Islam provides such a mechanism through a set of interlinked beliefs. The human being is the vicegerent (*khalīfah*) of the One Almighty God, the Creator of this universe and everything in it. As God's *khalīfah*, he is accountable to Him for how he uses the resources provided. He is duty-bound to look after his wellbeing and dignity in this world . But this world is not the end of his life. There is a life after death and his self-interest lies in safeguarding his interest in this world as well as in the Hereafter. Islam thus gives self-interest a spiritual, long-term direction by extending the span of self-interest beyond the confines of this life. His wellbeing in the Hereafter is ensured only by behaving in a way that does not hurt the interests of others in this world. This is because he is not the only *khalīfah* of God, there are millions of others like him who are his equals and brothers and whose needs must be satisfied through a fair share in God-given resources.

Thus the contribution that self-interest and the desire for profit can make towards individual initiative, drive, efficiency and entrepreneurship are recognized by Islam. However, the evils of greed and the unscrupulous disregard for the rights and needs of others that the secularist, this-worldly perspective of both capitalism and socialism can promote are overcome through the internal self-regulating mechanism of Islam, with its unrelenting emphasis on belief in God, accountability before Him, moral values, brotherhood and socioeconomic justice. This accountability serves as a strong motivating force in preventing individuals from pursuing self-interest beyond the limits of social health and wellbeing. Competition and market forces are essential for playing a complementary role but are not adequate to ensure the interest and wellbeing of all because self-interest can tend to be blind and find different ways of restraining competition and thwarting the operation of market forces, particularly when wealth and power are unequally distributed.

However, even in a morally charged environment, values may be violated and accountability before God ignored, individuals may tend to be oblivious to the problems of scarcity and to social priorities in resource allocation. They may simply be unaware of the urgent and unsatisfied needs of others and, if they are well-to-do, they may unconsciously divert scarce resources to the satisfaction of their relatively less urgent wants. Therefore, a certain degree of economic restructuring is indispensable if the objectives of the shari'ah are to be realized by Muslim countries without exceeding the limits of their resources and engulfing themselves in perplexing macroeconomic imbalances. The restructuring must address itself to the following:

a. Transforming the human factor in development to enable it to play an active and constructive role;
b. Reducing the existing concentration in ownership of means of production;
c. Eliminating or minimizing all wasteful and unnecessary consumption at the private as well as the public level to release resources for actualizing social goals;
d. Reorganizing investment to enable the production system to fulfill the demands of a need-based economy, increase opportunities for self-employment and employment, and expand the export surplus; and
e. Reforming the financial system in the light of Islamic teachings to enable it to play a complementary and enabling role in the realization of the objectives of the shari'ah.

Such restructuring is not possible without the government playing a positive, active economic role. Totalitarianism, as envisaged by socialism, does not permit such a role. Islam, on the other hand, takes a complementary role, not through excessive controls, unnecessary violation of individual freedom, and abolition of property rights, but rather through the creation of a healthy environment and development of proper enabling institutions. Islam's four dimensional approach (i.e., providing a filter mechanism of values, motivating the individual, socio-economic restructuring, and positive role of the government) should prove to be more effective in ensuring the well-being of all within society than the single dimensional capitalist or socialist approach of putting the whole burden on the shoulders of either self-interest and market forces or collectivization and central planning.

In general, the governments of poorer Muslim countries have been inwardly (though perhaps not outwardly) secularist, in step with their colonial heritage and the 'conventional' wisdom. They have not formulated a consistent development philosophy to realize the objectives of the shari'ah. Hence, their policies have lacked a firm direction and have oscillated on the waves of socialism and free enterprise, controls and decontrols that have been in vogue in development literature over the last four decades.[8] This lack of firm direction, combined with fluctuations and inconsistencies in policies, has generated uncertainties and caused immense harm to the developmental process. Whatever development has been attained has been at a high cost in terms of macroeconomic imbalances, increased inequalities of incomes and wealth, and social tensions.

While formulating policies for Muslim countries within the framework of such an integrated approach, it is not necessary to find a precedent for all of these in early Islamic history. Although the shari'ah has prescribed the essential elements of a basic strategy, it has not spelled out detailed policy measures. These have to be developed. It may be possible to emulate the experience of other countries with respect to specific policies. However, while doing so, it is necessary to ensure that the policy measures being considered for adoption fulfill two criteria—that they make a positive contribution towards the realization of the objectives of the shari'ah without creating a conflict with the shari'ah, and that they do not lead to an

[8] For some relevant details on the changing moods in develoment literature, see, Gerald M. Meier, ed., *Pioneers in Developments* (published for the World Bank by the Oxford University Press, 1987), in particular the "Introduction" by Meier himself. See also, Gustav Ranis and Poul Schult, eds., *The State of Development Economics* (Oxford: Blackwell, 1987).

excessive increase in claims on resources. The second criterion should not be fulfilled within the framework of Pareto optimality. A strategy that talks of increasing resources for a specific purpose without effectively reducing its availability for other purposes, cannot but lead to frustrations and imbalances. Hence, value neutrality must be set aside. Policies must be passed through the filter mechanism of Islamic values. This will also help in the public acceptance of these policies, particularly policies which do not satisfy the criterion of Pareto optimality.

In general, the policy measures suggested below may be familiar to those well-versed in development literature. No originality is claimed for most of these. What is important is the integrated approach within the framework of the Islamic world view and strategy to realize the objectives of the shari'ah without putting excessive pressure on the limited resources available.

The Human Factor: Motivation and Ability

Allocating resources efficiently and equitably, and removing imbalances requires a number of essential qualities in the people themselves, qualities that enable them to serve their individual self-interest and qualities that ensure social wellbeing. They must be willing and able to render their best by working hard and efficiently with integrity, conscientiousness, and discipline and must also be willing to sacrifice their personal comfort to overcome obstacles in the path of development. They must also change their consumption, savings, and investment behavior so that it is in conformity with what is needed for realizing the objectives of the shari'ah. This requires proper motivation and ability.

Motivation

Unless individuals are properly motivated, no system can realize either efficiency in resource use or equity in distribution. The present-day Muslim socioeconomic environment has become so inherently unjust that it is unable to motivate people to render their best, either in their own interest or in the interest of society. Therefore, it is necessary to adopt policies that will help ensure both.

To make people work in their self-interest, they need to have an assurance that their self-interest is served by their hard work, creativity and contribution to output. There must, in other words, be socioeconomic justice—a quid pro quo relationship between the quantity and quality of output and reward.

If individuals, irrespective of whether they are employees, savers, investors or exporters, do not share equitably in the fruits of their contribution to output through a reciprocal reward, they become apathetic and their initiative and efficiency suffer considerably. In most Muslim countries material rewards are inequitable due to biases and lack of realism in official policies. Wealth and power is concentrated in the hands of the few in both rural and urban areas. Biases and lack of realism have distorted key prices which have unconsciously lowered the incomes of tenant farmers, small microenterprises (SMEs), and workers, reducing their demand for needs and creating a misallocation of resources against need fulfillment. The concentration of wealth and power, also due partly to official policies and partly to the exploitative economic system that has prevailed for centuries, has restricted competition, generated widespread collusion and created a climate conducive to the misery of the masses. This has reduced the willingness and ability of the individuals in the Muslim countries to do their best.

The bias against agriculture and SMEs in government policies has retarded the development of human, physical, and financial infrastructure in rural areas, thus not only reducing the rewards for the efforts of tenant farmers and workers in rural areas but also lowering their ability to invest in better seeds, fertilizers and equipment in SMEs to supplement their incomes from agriculture. This has led to an influx of labor in urban areas, thereby depressing wages and living conditions there. The bias in favor of urban development and large-scale businesses and industries, has also raised, along with heavy tariff protection, concessionary financing and subsidized inputs, along with profit rates among favored urban SMEs, further increasing the concentration of wealth and power. While high tax evasion prevents the governments from reaping the benefit of their urban bias, urban congestion results in low wages and salaries and prevents urban employees from getting rewarded appropriately for their contribution to urban prosperity. However, while it is necessary to remove the bias of official policies against agriculture and SMEs, it is also necessary to remove other policy biases that reduce the real income of workers, savers, investors and exporters, particularly of those who are poor.

Minimum real wages in an Islamic society, not necessarily legally stipulated, should be such that a laborer is able to fulfill all his and his family's essential needs in a humane manner.[9] In sharp contrast to this, wages in most Muslim countries are so low that, in spite of nearly 10-14 hours of hard work, a laborer is unable to fulfill his and his family's basic needs. This is due to the exploitation that results from inappropriate official policies, concentration of wealth and power, poverty, and lack of training facilities for workers and their children. Unless this pathetic situation is remedied it may not be possible to motivate workers to work conscientiously and efficiently.

The prescription of minimum wages may not, nevertheless, be the immediate solution. It would be difficult to enforce and, if enforced, may tend to exacerbate the prevailing high level of unemployment. Rather, it is better to resort to an entirely different package of policies—policies that raise the ability of workers to earn more through training and finance and also that restructure the entire economy in favor of need fulfillment and a more equitable distribution of incomes and wealth. Profit sharing and the employee stock ownership plan (ESOP) should also be made as widespread as possible.

Every firm should be required to establish a profit-sharing scheme for the employees. A certain agreed proportion of the firm's net profit should be distributed among the employees as profit-sharing bonuses and as a means to provide training facilities and improve working conditions, as well as to grant medical benefits, educational

[9] For discussion, see M. U. Chapra, *Objectives of the Islamic Economic Order* (Leicester, U.K., The Islamic Foundation, 1979), pp. 14-16.

allowances to children, housing facilities, and food subsidies. Linking the increase in income and benefits of employees beyond a certain basic level to their firm's profitability and combining this with a more humanitarian treatment should have a number of benefits, including: (a) boosting employees' morale, thus leading to increased efficiency and productivity; (b) improving labor/management relations and promoting solidarity and the sense of worker participation that should be the characteristic of an Islamic society; (c) keeping the employees' earnings flexible and responsive to the health of the national economy and the performance of their firms—employees sharing in their firm's prosperity when profits are good but not burdening it when profits are low or the firm is suffering losses; (d) reducing tax evasion (provided that the tax system is reformed), because the employees, in their own self-interest, would keep an eye on the firm's actual profits with respect to which they are currently indifferent; and (e) maintaining the competitiveness of the economy and the firms, thus improving the general climate for investment and the macroeconomic performance of the economy.

The introduction of ESOP could also go a long way in benefiting workers and reducing concentration of wealth and power. It will enable workers to become equity owners, thus increasing their stake in the firm's success. It will raise savings, discourage the unproductive alternative of gold hoarding and help raise their social status in the company and society. When ESOP has been adopted even in some capitalist countries like France, the United Kingdom, and the United States, there is no reason why it should not receive enthusiastic support in Muslim countries.[10]

The low return on deposits paid by conventional banks because of administrative fiats hurt mainly the small savers; big businesses get a higher return and are, besides, alleged to keep most of their savings abroad to evade taxes, to protect themselves from the depreciation of their currency, and to get a higher international market-related return. However, for domestic investment, they borrow from local

[10] See, J. W. Middendorf II, "Employee Share Ownership: An ESOPs Moral for the Third World" *Financial Times*, 25 March 1987, p. 25.

banks and government financial organizations at lower prime- or concessionary-rates. This is not a plea in favor of higher interest rates, but rather a strong case in favor of equity financing in conformity with the shari'ah because of its more positive role in rendering greater justice to both savers and investors and in bringing about greater allocative efficiency, economic stability, and growth.[11]

Similarly, unrealistic exchange rates and unnecessary price controls hurt producers and exporters, while high protective tariffs hurt consumers. The claim that these measures are adopted in the interest of the common man and the country's development is usually a lie. They are not, rather, they serve the vested interest of the rich and powerful who have grown continually richer at the expense of the masses who have become more and more impoverished.

All measures that enrich a minority of the population at the expense of the majority cannot be defended in the light of the shari'ah. Nevertheless, since such practices have been in existence for a long time, it may not be advisable to remove them abruptly without taking measures to safeguard the interests of the poor. These measures may take the form of an increase in their incomes or relief payments, or an expansion in the supply of need-fulfilling goods and services, or a rise in income-earning opportunities. Among the needs that should be given priority are education and training, nutrition, the water supply, housing, sanitation, medical facilities, and public transportation.

Although a quid pro quo relationship between work and reward is necessary for hard and efficient work, it is not necessarily sufficient for inducing integrity and conscientiousness. It is also not adequate to motivate people to change their consumption, savings and investment behavior to be in conformity with the objectives of the shari'ah. Secularism, which has tacitly been the philosophy of most of the power elite in the Muslim world, regardless of whether their leaning is towards socialism or capitalism, has neither the filter mechanism necessary to serve social goals, nor the charisma to

[11] For a discussion of this, see M. U. Chapra, *Towards a Just Monetary System* (Leicester, U.K.: The Islamic Foundation, 1985), pp. 107-125.

inspire people and to motivate them to make the sacrifices required. Islam however carries a great potential for creating the desired qualities in people and for making them identify the social interest with their personal interest. Islam not only demands these characteristics in its followers, it also commands the necessary charisma and motivation to inspire and change them.[12] However, due to several centuries of degeneration and foreign domination, Muslims have lost touch with the inner core of their faith. Muslim countries could accelerate development substantially by improving the quality of the human factor through a reform program based on Islamic values. If they do not undertake such a reform, the erosion in morals will continue and contribute to a further degeneration in the quality of people, accompanied by its adverse impact on development and sociopolitical stability.

Ability

While socioeconomic justice and moral consciousness are both necessary to motivate people they are not enough for realizing efficiency and equity. Two persons may be equally motivated, yet they may be unable to contribute equally to the realization of the objectives of the shari'ah. The difference lies in ability, which is not only inborn but also acquired, partly through education and training and partly through access to finance. Hence, expansion of educational and training facilities, and the poor's access to finance are indispensable.

The invaluable contribution that appropriate education and training can make towards improvement in the quality of human beings, greater socioeconomic justice and faster growth is now universally recognized. Education opens the door to opportunity and has been rightly considered to be the great equalizer of the human condition. Nevertheless, Muslim governments have been grossly guilty of

[12] For a more detailed discussion of the moral characteristics required in Muslims see, Sayyid Abul A'la Mawdudi, *The Islamic Movement: the Dynamics of Values, Power and Change,* tr. and ed. by K. Murad (Leicester, U.K.: The Islamic Foundation, 1984), in particular pp. 93-132. See also, Marwan Ibrahim al Kaysi, *Morals and Manners in Islam: a Guide to Islamic Adab* (Leicester, U.K.: The Islamic Foundation, 1986), see particularly the "Introduction," pp. 13-53.

neglecting this important sector in their resource allocation policies. Even literacy, which is the first step on the path of education, has not become universal in Muslim countries. Such a neglect cannot continue for long without ruining the fabric of Muslim society.

The primary stress of education has to be on creating a 'good' Muslim. He must be educated about the qualities of a true Muslim and strongly motivated to create those qualities in himself. But this is not sufficient. It is also necessary to teach him the skills in demand and the most efficient production, management, and marketing techniques available.

The secular educational system in Muslim countries has failed to make its students better human beings and it has also failed to make them more productive. While qualified young men are unable to get admission into vocational training institutes and engineering and medical colleges due to a shortage of facilities, the universities, following loyally the blueprint set by their colonial masters, have been producing generations of secularized liberal arts majors for clerical and civil service jobs, which have now become more than fully saturated. There is thus a steep rise in the number of 'educated unemployed' in urban areas, in spite of a scarcity of trained manpower in several sectors of the economy. While the rich are easily able to get technical education for their children at home and abroad, the poor, who need it more acutely to raise their income and status, are unable to do so. This tends to widen the gulf between the rich and the poor, and to condemn the poor to a position of permanent misery. It is an obvious proof that the educational systems are not responding to the objectives of the shari'ah nor to the changing economic and political realities within Muslim countries.

Hence, there is need for a revolutionary change in educational curricula in order to impart Islamic values and the needed technical skills. It is also necessary to establish a widespread network of institutions such that even a poor man's child in rural areas or urban slums is able to have access to technical education and training facilities. This is an important way of removing one of the primary sources of iniquity and poverty and providing everyone a chance to push ahead on the basis of his innate ability and the training he has acquired.

The inability of the poor to have access to finance is undoubtedly the most crucial drawback in bringing about a broad-based ownership of businesses and industries and thereby realizing the egalitarian objectives of Islam. Unless effective measures are taken to remove this drawback, a better and widespread educational system will only help raise efficiency and incomes but be ineffective in reducing substantially the inequalities of wealth, thus making meaningless the talk of creating an egalitarian Islamic society. Fortunately, Islam has a clear advantage over both capitalism and socialism through a financial system which is built into its value system and which provides biting power to its objective of socioeconomic justice. This will be discussed later.

Reducing Concentration of Ownership

The most serious obstacle to the realization of the objectives of the shari'ah is the existing concentration in ownership of means of production in Muslim countries, as it is in all market economy countries. Unless this situation is corrected through special measures adopted in the light of the shari'ah, it may not be possible to make perceptible progress in realizing the egalitarian goals of Islam. The Islamic strategy in this case is in sharp contrast with that of socialism, which has reduced human beings to a permanent state of wage slavery through collectivisation of all means of production and centralization of decision making. Proliferation of ownership and decentralization of decision making, conform to the dignity and freedom that are associated with the concept of *khalīfah*. This proliferation must be brought about in both the rural and urban areas, as well as in agriculture, industry, and commerce.

Land Reforms and Rural Development

In most Muslim countries, a large proportion of the population is dependent on agriculture for income, employment, and general well-being. However, a constellation of historical and political forces has led to a socioeconomic structure that is inherently unjust and perpetrates exploitation and misery of the rural population. Nevertheless, this sector has failed to receive the priority it deserves in official policies in order to remove the prevailing iniquities and inefficiencies. Unless measures are adopted to make the agricultural sector more efficient and equitable, the poorer Muslim countries will find it difficult to remove poverty and inequalities or to accelerate development.

A small number of absentee landlords controls large tracts of land in rural areas and a substantial part of the farming population is either landless or has an uneconomic holding. This sets the stage for exploitation by both the landlord and the money lender and serves as one of the major sources of persistent economic and political inequalities. The poverty of tenant farmers and rural laborers prevents them from adopting better farming techniques, thus freezing them into a state of permanent poverty and depravity. It also kills the incentive of the rural population to put in their best and creates in them the characteristics of indolence, dishonesty, and apathy. It also drives the rural population to urban areas in search of work. There, they face unhealthy living conditions and remoteness from their loved ones. Social control declines and, combined with low wages and other frustrations, contributes to crime and social unrest.

Realizing the objectives of the shari'ah is not possible without making land reform the corner stone of all economic policies. However, land reform revolves around the issues of size of land holdings and terms of tenancy. Unless these are settled in conformity with the demands of socioeconomic justice, it will be difficult to make significant headway.

If land had been acquired through fair means and cultivated either by the owner himself or leased to tenant farmers on 'just' terms, and if the Islamic system of inheritance had also been faithfully applied, landholding would not have become concentrated in the hands of a few families. However, since land has been acquired for centuries through unfair means and the Islamic law of inheritance has been disregarded, landholding has become inequitably distributed, subjecting most of the rural population to lives of virtual slavery, poverty and misery. Given this highly unjust situation, it is important to set a ceiling on the maximum size of landholding and to distribute the surplus equitably among landless peasants.

The shari'ah does not visualize the setting of such limits on private wealth in normal circumstances.[13] Nevertheless, the shari'ah does authorize the state to take all measures that are necessary for realizing the objectives of the shari'ah, provided that they are not specifically prohibited by the shari'ah.[14] Since land ownership is concentrated in the hands of a few families, the existing exploitation, poverty, and inefficient use of land and labor will continue, and the goal of realizing an equitable distribution of wealth will remain permanently frustrated as long as the combined monopolistic and monopsomatic power of landlords is not broken by imposing certain reasonable limits on the maximum size of land held by one family. Even the enormity of the present rural population relative to the limited size of total available land necessitates the adoption of such a measure. Accordingly, a number of renowned scholars have argued in favor of such limits.[15] Since the shari'ah requires the payment of 'just' compensation to 'rightful' owners, the land needs not be given away to the peasants free. Rather, it should be given at a fair price, the entire value being realized by the government gradually over a number of years out of the peasants' earnings, and used partly to

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[13] See Abbādi *op. cit.*, vol. 2, p. 400.

[14] Ali al Khafif, *Al Milkīyah fi al Shari'ah al Islāmiyyah*, vol. 1, p. 93.

[15] See Muhammad Qutub, *Al Insān Bayna al Māddiyyah wa al Islām*, (Cairo: Isā al Bābi al Halabi, 4th ed., 1965), pp. 160-168 and 200-201; see also Mustafā al Sabā'i, *Ishtirākīyat al Islām* (Damascus; Mu'assasat al Maṭbu'āt al 'Arabiyah, 2nd ed., 1960), p. 62; and Abbādi, *op. cit.*, vol. 2, pp. 398-420. There are many others who have expressed similar opinions, for example, Ali al Khafif, Mahmud Abu Sa'ud, Muhammad Yusuf Musa, Wahbah al Zuhayli, Abd al Hamid Mitwalli, Muhammed Anis Ibrahim. Even Sayyid Abul A'la Mawdudi, who, in his early writings, held the opinion that no 'arbitrary' limits can be imposed on land ownership, recanted later and stated that, in the light of the existing unfair distribution of land, the Islamic state should impose certain desired limits as a temporary measure to remove the inequities. See, Abul A'la Mawdudi, *Mas'alah Milkīyat al Zamin* (Lahore: Islamic Publications, 3rd ed., 1969), p. 111.

compensate the 'rightful' (and only the 'rightful') owners and partly to meet some of the costs of rural development.

In addition to reducing the size of landholdings, it is important to reform the terms of tenancy. While the objective of establishing justice between the landlord and the tenant remains undisputed by the *fuqahā* of all schools of Muslim jurisprudence, the nature of land tenancy has been one of the most controversial issues in fiqh literature.[16] Some jurists (a small minority) permit neither sharecropping nor fixed-rent tenancy and require that a landowner himself should cultivate whatever land he can and grant the use of the balance to someone who can do so.[17] There are others (a greater minority) who allow share-cropping but prohibit fixed-rent tenancy.[18] Their contention is that although initially the Prophet, may the peace and blessings of Allah be on him, discouraged both sharecropping and fixed-rent tenancy, he later allowed sharecropping. This became a widespread practice among the Prophet's companions and their successors. A predominant majority of the jurists, however, allows both sharecropping and fixed-rent tenancy, this being consistent with the permissibility of both *muḍārabah* (partnership between one who has capital and one who has expertise) and leasing in the shari'ah. Their rationale is that the poverty of most Muslims in the early Madinese period had led the Prophet, may the peace and blessings of Allah be on him, to discourage both sharecropping and fixed-rent tenancy. However, later on when the economic condition of Muslims improved, he allowed both, and not just sharecropping as is argued

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[16] For a cogent summary see, Yusuf al-Qardawi, *Al Ḥalāl wa al Ḥarām fi al Islām* (Cairo: Dār al I'tisām, 8th ed., 1974), pp. 290-301; Abbādi, *op. cit.*, vol. 2, pp. 113-138; and M. Anas Zarqā "*Al Siyāsat al Iqtisādiyah aw al-Takhtit fi Iqtiṣād Islāmi*," unpublished paper, pp. 36-39.

[17] For a discussion in favor of this point of view see, Abdul Hamid Abu Sulayman, "The Theory of the Economics of Islam" in *Contemporary Aspects of Economic Thinking in Islam* (Bloomington, Indiana: The Muslim Students Association of U.S.A. and Canada, 1976), pp. 9-12.

[18] For a strong defense of this viewpoint see, Ibn Hazm, *op. cit.*, vol. 8, pp. 210-214; see also al Qardāwi, *op. cit.*, p. 295-299.

by the second group.[19] Nevertheless, Ibn Taymiyyah and a number of other jurists consider fixed-rent tenancy to be *makrūh* (undesirable).[20] According to them sharecropping is preferable because it is closer to justice; it requires both the landowner and the tenant to share in the reward as well as the risk of farming, in contrast with fixed-rent tenancy, which assures the landlord a fixed return even though the tenant may or may not be able to have any output. Hence, a number of jurists argue that since fixed-rent tenancy is undesirable, though not prohibited, it is within the competence of an Islamic state to prohibit it, at least temporarily, or to regulate it sufficiently, if it is considered necessary for realizing the objectives of the shari'ah and serving the interests of the people.[21]

Since the tenants and landless farmers are weak and powerless and are likely to remain so for some time in spite of the enforcement of a limit on the size of landholding, fixed-rent leasing of land may continue to be a source of injustice and poverty when the output continues to be uncertain. Hence, it would be desirable for Muslim governments to make sharecropping the general basis of land lease and to strive for a just sharing of the output between the landlord and the tenant. This should continue at least until the power base in rural areas has become sufficiently broadened and the exploitative edge of landholding families has been substantially curtailed.

The importance of land reforms for creating the egalitarian and democratic climate that Islam visualizes cannot be overstated. The creation of a rural sector of small, independent proprietary farmers would help provide a great boost to farmer incentives, thus raising agricultural output and accelerating development. Combined with the proliferation of SMEs (small micro enterprises), it would help reduce the migration of farm population to urban areas and the associated urban congestion, crime and violence. The reduction of

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[19] For a strong case in its favor, see Abu Yusuf Kitab al Kharāj, *op. cit.*, pp. 88-91 and Ibn Taymiyyah, *Al Ḥisbah fi al Islam*, ed., Abd al Aziz Rabāh (Damascus: Maktabah Dar al Bayan, 1967), pp. 28-31; see also Mawdudi, *op. cit.*

[20] Ibn Taymiyyah, *op. cit.*, p. 30.

[21] Abbādi, *op. cit.*, vol. 2, p. 128 and M. Anas Zarqā, p. 39.

inequalities of income and wealth would tend to strengthen democratic processes in these countries.

Given the flagrant iniquities that now exist, land reform is not an option which the governments may or may not consider seriously. If a meaningful land reform is not implemented, it will come ultimately through a violent revolution. Historical experience shows that when such revolutions take place, all ethical values get trampled. Landlords may, in this case, lose not only their lands through expropriation but also their lives. Therefore, it would be in their best interest to strive voluntarily for a just land reform.

Land reforms, though indispensable for reducing concentration of wealth, will not by themselves take the Muslim countries very far in realizing the objectives of the shari'ah unless there is a simultaneous effort to remove some of the other disadvantages from which the entire agricultural sector is suffering. The most serious disadvantage is the absence of an efficient infrastructure (roads, schools, electricity, and health facilities) due to neglect of the agricultural sector in government budgetary appropriations. Unlike the rich industrial countries, which encourage farmers through various incentives, including protection from imports, most developing countries discriminate against their farming sectors.[22] They try to offset the inflationary impact of government budgetary deficits through overvalued exchange rates and low administered food prices. Such policies have turned the terms of trade against agriculture and SMEs, lowered agricultural output, increased dependence on imports, reduced exports, and depressed rural incomes. The depressed rural incomes, combined with the inequitable land tenure system, does not leave an adequate surplus to enable tenant farmers to undertake the necessary investments in agriculture and SMEs. This accentuates rural unemployment and underemployment. Thus, there is a vicious circle of poverty, paucity of investments, lower output, and unemployment. The pressure of population in urban areas has also consequently risen, leading to a decline in urban wages and the creation of slums. Hence, the hub of the problem in rural areas, as the authors of *Poverty and*

[22] IBRD, *World Development Report, 1986*, pp. 85-109.

Hunger have indicated, is income distribution rather than agricultural technique.[23]

Another serious disadvantage faced by the agricultural sector is the lack of availability of financing to small farmers and microenterprises. "Constant indebtedness to traders, informal money lenders, loan sharks, or relatives perpetuates the poverty of poor people."[24] The result is that small farmers do not have the financing to purchase better quality agricultural inputs and to operate microenterprises to raise their incomes and to keep themselves fully occupied. Hence, an equitable distribution of landholdings would by itself not lead very far unless suitable arrangements are also made to provide adequate financing, not only for agriculture but also for small enterprises in rural areas.[25] This should naturally be done within the framework of the alternative to the interest-based financial system provided by Islam.[26] However, it may not be possible unless the governments and

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[23] IBRD, *Poverty and Hunger: Issues and Options for Food Security in Developing Countries, 1986*; see also "Can Better Farming Feed the World", *Economist*, 5 July 1986, p. 73.

[24] *Banking for the Poor: Alleviating Poverty through Credit Assistance to the Poorest Micro-entrepreneurs in Developing Countries*, Report of the Select Committee on Hunger, U.S. House of Representatives (Washington: U.S. Government Printing Office, May 1986), p. 1.

[25] In Japan, three out of four farming households now get most of their income from outside agriculture. See "When the Salt of the Earth Loses its Savour," *Economist* 20 February 1988, pp. 43-44.

[26] The alternative arrangement, in which cooperative societies, commercial banks and government sponsored financial institutions will have to play an important role, must avoid interest and be based on risk/reward sharing (*muḍārabah* or *mushārakah), murābahah* (cost-plus financing), leasing, or *bay' al salam*. (*Bay' al salam* refers to a sale where full payment is made in advance against an obligation to deliver the specified fungible goods at an agreed future date. This is not the same as a speculative forward sale because a full, not a marginal payment is required. Under this arrangement the farmer may be able to secure the needed financing by making an advance sale of only a part of his expected output. This will not get him into delivery problems if output falls due to unforeseen circumstances. For details on *bay' al salam* see Abd al Rahman al Jaziri, *Kitāb al Fiqh 'alā al Madhāhib al Arba'ah* (Cairo: Al Maktabah al Tijariyyah al Kubrā, 1938), vol. 3, pp. 3 20 and vol. 2 pp. 302-318.

commercial banks, who have subsidized large urban enterprises for decades through concessionary or prime-rate financing, now tilt the balance in favor of agriculture. How this may be done will be discussed later.

Land reforms supported by other measures to liberate the peasants from the iniquities and inefficiencies they are suffering from, should not only help expand considerably the productivity of the agricultural sector but also dim the attraction of the bright city lights, thus helping reverse the shift of population from rural to urban areas. Nevertheless, it would be necessary to bring about a change in the attitudes and work habits in rural areas. This may be attained faster if Islam is used as a mechanism for social change and motivation. The mosque plays an important role in rural life and its proper use could open up an effective way of inculcating the desired characteristics in the rural population.

Proliferation of Small and Micro Enterprises

The counterpart of rural land reforms in the industrial and business sectors is the proliferation of efficient SMEs in rural as well as urban areas. This would complement land reforms in reducing the prevailing concentration of wealth and power in Muslim countries. It also has other advantages which occupy a place of high priority in the Islamic value frame.

It will enable man, the *khalifah* of God, to have an independent means of livelihood, thus rendering to him greater dignity and self respect, not possible in the state of wage slavery. In the capitalist world small businessmen, farmers and artists have increasingly lost their independence and bargaining power. In the United States, the proportion of population dependent on wages and salaries has risen steeply over the last two centuries from 20 percent in 1780 to 84 percent in 1970. Accordingly, the proportion of those who are self-employed or those who work as managers and officers has declined from 80 percent to 16 percent over this period.[27]

[27] Michael Reich, "The Evolution of the U.S. Labour Force," *The Capitalist System* (Englewood Cliffs, N. J.: Prentice Hall, 1972); Edward S. Greenberg,

Large businesses dominate the economic and political scene in the capitalist world and the trend is decidedly in favor of even bigger businesses and farms. Competition, which was the predominant form of market relations in the 19th century in the capitalist world, has ceased to occupy that position.[28] Socialism sought to solve this problem through collectivisation, which increased wage slavery and alienation, while at the same time eliminating competition, worker incentive, and efficiency. Hence, the change of emphasis in Muslim countries in favor of a proliferation of SMEs should help create a healthier climate for competition and also be more conducive to the realization of greater efficiency and equity.

Wider Ownership and Control of Corporations

Nevertheless, it must be admitted that small business units, although preferable, may not be feasible for all types of economic activity. Hence, large business units cannot be avoided. Preferably, their form should be that of a corporation because of its ability to proliferate ownership. However, the corporation as it exists in the West is a primary cause of wealth and power concentration.[29] Even though it constitutes the dominant sector of the economy, it does not reflect the political democracy of the West in its decision-making. The corporation operates as an autocratic institution; the holding of controlling stock by a few families makes it possible for a few people to have control over all policies.[30] They exercise an immense power to make

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Serving the Few: Corporate Capitalism and the Bias of Government Policy (New York: John Wiley, 1974), p. 244.

[28] See Paul A. Baran & Paul M. Sweezy, *Monopoly Capital: An Essay on the American Economic and Social Order* (New York: Modern Reader Paperback, 1966), p. 6.

[29] See C. Wright Mills, *The Power Elite* (New York: Oxford University Press, 1959), p. 117.

[30] One percent of all tax filers in 1960 owned 48 percent of all stock held by individuals (Reagan, "What 17 million shareholders share," p. 102 cited by Greenberg, *op. cit.*, p. 45). "In the 150 Companies on the current Fortune 500 list, controlling ownership rests in the hands of an individual or of the members of a family," (Robert Sheehan, "Proprietors in the World of Big Business," *Fortune*, 15 June 1967, p. 179).

basic product, price, and investment decisions that affect the entire nation and, in fact, the world.[31]

The Western corporation does not, therefore, provide a model for Muslim countries. It must be reformed drastically to reduce the concentration of power. The abolition of interest and the introduction of equity financing in place of borrowing will help remove the inverted pyramid of corporate power. The requirement to raise financing through the issue of shares rather than borrowing will enable broad-based ownership of corporate shares and set the stage for wider distribution of power. Since this may still not solve the problem of wealth and power concentration because most shareholders do not participate in board meetings, other reforms will also be needed to reduce the sweeping powers of directors.

Activation of Zakah and Inheritance Systems

The above measures for reducing inequalities of income and wealth would be more successful if they were further strengthened by the activation of Islamic zakah and inheritance systems. Unfortunately, even though the implementation of both these systems is an essential part of a Muslim's obligations, and indispensable for the realization of the objectives of the shari'ah, they have remained dormant for ages.

Islam requires every Muslim having resources in excess of a certain basic amount to pay zakah as a given proportion of his or her net worth or agricultural output, mainly for the benefit of the very poor and destitute. What could be a stronger rationale for making the needed sacrifice to meet one's social obligations than the belief that all resources are a trust from God and must be used for the wellbeing of all human beings who belong to the one human family of the One God, before whom account has to be given about how resources are utilized. This system of social self-reliance should, along with other measures discussed in this paper, enable the Muslim society to meet the needs of all without putting the entire burden on the public exchequer as socialism and the welfare state have unwittingly done.

[31] See Gabriel Kolko, *Wealth and Power in America: An Analysis of Social Class and Income Distribution* (New York: Praeger, 1964), pp. 68 and 127.

Since it is the obligation of a Muslim to earn his livelihood, it has been considered desirable by the *fuqahā* to give priority in zakah disbursements to the objective of enabling the poor to stand on their own feet. Zakah should become a permanent income supplement of only those who cannot be enabled to earn enough through their own effort. This requirement, implemented in a socioeconomic environment which encourages SMEs, should make a valuable contribution toward the reduction of inequalities.

The distribution of a deceased person's estate in accordance with Islamic injunctions should also help reduce the skewness in wealth distribution. If necessary, the enforcement of inheritance laws should be in such a way that it does not lead to a rise in unnecessary consumption but, rather, to an increase in investment and a proliferation in the ownership of means of production.

Restructuring the Financial System

The interest-based financial system, which Muslim countries have borrowed from the capitalist countries, is one of the primary sources of the concentration of wealth and power.[32] Therefore, the Muslim countries may find it difficult to bring about a reduction in equalities and a proliferation of SMEs unless the entire financial system is restructured in the light of Islamic teachings. This subject is discussed later.

Economic Restructuring

Actualization of the objectives of the shari'ah without accentuating macroeconomic imbalances requires resources and, given the scarcity of resources, it may not be possible to allocate additional resources for this purpose without reducing their use elsewhere. Such a reallocation of resources is not feasible without a total restructuring of the economy in accordance with the Islamic world view and strategy. Such a restructuring would inevitably cover all aspects of the economy, including private consumption, government finances, capital for-

[32] M. U. Chapra, *Towards a Just Monetary System* (Leicester, U.K.: The Islamic Foundation), pp. 110 and 140.

mation and production. Some of the relevant aspects of these are discussed below.

Restructuring Consumer Preferences

Since an accelerated rise in capital formation is indispensable for realizing the objectives of the shari'ah, it is necessary to increase savings by squeezing consumption. This objective poses a dilemma. The unequivocal Islamic emphasis on brotherhood and social equality requires that a reduction in consumption be brought about in such a way that the standard of need satisfaction of the poor is not only not worsened but in fact improved. It is not possible to resolve this dilemma without making a revolutionary change in the prevailing life-styles, particularly of the rich, knowing fully well that the inability of society to fulfill needs is not necessarily the result of an absolute lack of resources but rather of the failure to achieve a consumption pattern which is in conformity with its resources and ideals. If the needs of all are to be met within the constraint of scarce resources and if this is also to be accompanied by a rise in capital formation, then an offsetting reduction has to be made by holding consumption within the range of what the society can afford. Consumption cannot then be allowed to become the sole end of an individual's life as it has become under capitalism.

For decades, Muslim countries have been following a consumption pattern that has been copied from the Western consumer culture which measures a person's worth by the extravagance of his living and the frequency of his purchases. Accordingly, expensive lifestyles, which even some of the rich industrial countries can hardly afford, have become a prestige symbol in the poorer Muslim countries. The bandwagon effect of this, along with a number of unIslamic customs and ceremonies, extending from childbirth to marriage and death, have led to an unrealistic consumption pattern which is unwarranted in the light of their values as well as their resources. The victims of this competition are forced to live beyond their means. Aggregate consumption has accordingly risen, savings have lagged behind, and capital formation based on domestic savings remains inadequate. Moreover, since most luxury goods and services carrying a snob appeal are of foreign origin, the pressure on foreign exchange resources has risen steeply. The resources gap has had to be filled by external borrowings, contributing to a higher debt servicing burden and further squeezing of resources.

The crux of the problem is how to distinguish 'necessary' from 'unnecessary' claims on resources and how to induce everyone to abstain from making 'unnecessary' claims? It is necessary to have a filter mechanism and a motivating system. The price system operating in a secular, value-free economy cannot provide either an effective filter mechanism or a complete motivating system.

Though prices are important for regulating consumer demand and generating efficiency in the use of resources, they are inadequate to realize equity, particularly if the background conditions are not satisfied. Reliance on prices alone enables the rich to buy what they want of the luxuries and status symbols, no matter how high their prices. If one family has them others consider them indispensable. Those who cannot afford them try to acquire them through suppression of need satisfaction, corruption, evading tariffs and taxes, and smuggling. In developing countries with their inefficient and corrupt tax administration, it is possible to avoid or evade high tariffs and taxes by means of under-invoicing, bribing and smuggling; however, the higher prices resulting from such tariffs and taxes yield higher profit margins and promote not only larger imports (through official and unofficial channels) but also greater domestic production of such goods. This leads to an unintentional diversion of resources into status symbols and unwittingly squeezes their availability for need satisfaction, thus making their prices higher.

This does not imply that higher taxes and tariffs should not be imposed. It does, however, mean that the effort to check unnecessary consumption merely by means of higher prices cannot be effective. It must also be reinforced by changing the preference scale of consumers by means of another layer of filter based on socially agreed values. If this is done, a substantial chunk of aggregate demand is eliminated even before it gets expressed in the market. A new equilibrium between aggregate supply and aggregate claims on resources is then established at a lower level of general prices. This should help need fulfillment and improve the living conditions of the poor.

In central planning, the absence of a filter mechanism as well as consumer 'sovereignty' makes resource allocation subject to the whims and vested interests of the politburo members and other power elite. Moreover, the absence of realistic market determined prices removes even the secular motivation for 'efficiency' in the use of resources. However, if realistic prices and consumer 'sovereignty' are bracketed with central planning, as is now intended to be done in many socialist countries, then the absence of a filter mechanism, along with arbitrary decision making and vested interest of the high-salaried power elite, would lead to a resource allocation and price structure that are little different from capitalism.

Hence, as long as the Muslim countries continue to use the capitalist and socialist strategies, they will not be able, like the capitalist and socialist countries themselves, to prevent the use of scarce resources for inessential purposes. They will thus fail to realize the objectives of the shari'ah in spite of their increasing wealth. What the Muslim countries need to do is to distinguish the 'necessary' from the 'unnecessary' by dividing all goods and services into three categories: those that fulfill a need or reduce a hardship and thus make a real difference in human wellbeing; those that make no difference in a person's wellbeing and, being needed mainly for their snob appeal could be classified as luxuries and status symbols; and those that lie within the borders of the two and, there being a difference of opinion about their 'need', a clear-cut decision is not possible and a leeway is considered desirable.

The filter mechanism necessary for such a classification is available within the Islamic value system. There is substantial discussion in the fiqh literature about necessities (*darūrīyāt*), conveniences (*ḥājiyāt*) and refinements (*taḥsiniyāt*). All of these, as defined by the *fuqahā* (jurists), simply fall within the range of what is understood to represent needs (necessities and comforts) in modern economics and do not include luxuries or status symbols. Anything that goes beyond needs has been treated by the *fuqahā* as prodigality and self-indulgence and is strongly disapproved of.[33] The Islamic consumption norms could thus be of great assistance in defining 'unnecessary' claims on resources.

It is important to bear in mind that since Islam is not an ascetic religion, the classification of goods and services into the three categories given above, need not remain constant through time and place. Since Islam allows a person to satisfy all his needs and to partake of those comforts that increase his efficiency and wellbeing, and since the classification of goods and services into the three categories takes into account the development of technology and the shared increase in the standard of living, the definition of need is bound to undergo a change over time. In fact, most Muslim countries are richer today and can afford a higher standard of need fulfillment than previous Muslim societies. What is, however, indispensable is the satisfaction of all basic needs of all human beings in a Muslim society in conformity with their position as *khulafā* (vicegerents of God) and members of His family. This goal cannot be realized unless the differences in consumption levels which have been allowed in conformity with the status and income of individuals do not go beyond what the economy's resources can bear. They should not reflect snobbery or lead to wide social gaps that could only weaken the bonds of Islamic brotherhood. The objective should not be to create a monotonous uniformity and drabness in Muslim society. Simplicity in life-styles can be attained along side creativity and diversity. The criteria for classifying a need into one of the three categories should be based upon norms defined by Islam (i.e., the impact of its consumption on brotherhood and social equality) as well as upon availability of resources.

[33] For the definition of these terms within the perspective of fiqh, see Shatibi, *op. cit.*, vol. 2, pp. 8-12; and Anas Zarqa, "Islamic Economics: An Approach to Human Welfare", in K. Ahmad, *Studies in Islamic Economics* (Leicester, U.K.: The Islamic Foundation, 1980), pp. 13-15. Ahmad al Najjar and Anas Zarqā have in fact argued that in the light of Islamic teachings nothing that a man uses (as a consumer or as a producer) is morally free, even if it is economically free. (See Ahmad al Najjar, *Al Madkhal ilā al Nazariyah al Iqtiṣādiyah fi al Islām*, Beirut: Dar al Fikr, 1973, pp. 32 ff; and Anas Zargā, *op. cit.*, p. 13).

'Liberalization' may hence be construed only within the framework of these three categories. Production, import and distribution of all goods and services falling within the first category should be liberalized. Market forces should be allowed to play their full role. The government should do all it can to ensure healthy competition and free interaction between a large number of buyers and sellers. The government should also provide all necessary incentives and facilities to increase the supply of goods and services falling within this category. Any indirect taxes that are considered necessary to impose on these goods and services should be modest and graduated inversely to their necessity. The consumption of goods falling within the third category should be discouraged through moral suasion, import restrictions, and relatively higher tariffs and taxes.

However, it would be necessary not to liberalize the use of resources for the second category of goods and services. The price system, as argued earlier, cannot by itself motivate people to use resources in a way that reflects social priorities. It is necessary to change consumer preferences through moral reform. If people understand their social obligations and their accountability before God, and realize that use of the economy's scarce resources by them for inessential purposes will deprive others of need fulfillment, they will tend to change their behavior voluntarily. However, moral exhortation may be ineffective when conspicuous consumption has become common and accepted over a long period of time. It is necessary to change the social mood. Individuals cannot change the direction of the tide and are constrained to conform. Hence, for greater effectiveness in creating the needed social environment, it would be desirable to campaign for simple living accompanied, at least initially, by an officially imposed ban on the third category of goods and services, including luxury imports, ostentatious ceremonies, unrealistic dowries and the display of status symbols. The elimination of 'unnecessary' claims on resources brought about in this manner, would release resources for greater supply of needs, thus keeping their prices at a humane level without the use of force or controls. It will also help prevent the continued depreciation of the currency which is the obvious consequence of liberalization within a value-free framework as propagated by the IMF and the World Bank.

Efforts to reduce corruption are bound to fail unless the governments first strike at one of the major roots of corruption—ostentatious life-styles that now prevail in Muslim countries. Such life-styles almost force people to resort to unfair means of earning. Acquisitiveness and corruption may decline substantially once they realize that their effort to acquire greater prestige through conspicuous consumption only blemishes their reputation and raises questions about the source of their financing.

Responsible Government Spending

No doubt changing consumer preferences in favor of simple living will reduce private sector pressure on resources and raise the savings needed for investment and development. However it will not be enough. Governments in Muslim countries, as in other developing countries, are as blameworthy as, if not more than, the private sector for the excessive claims on resources. They have almost lost control over their public finances. The result is that, in spite of high rates of both direct and indirect taxes, they have had to resort to unhealthy levels of budgetary deficits. These deficits have been financed by monetary expansion and excessive levels of domestic and external borrowing. The high levels of inflation and the debt-servicing burden which have been generated will continue to plague them for a long time.[34]

In spite of their excessive spending, governments have neither laid down the minimum infrastructure necessary for a balanced and accelerated development nor adequately supplied the services indispensable for realizing the objectives of the shari'ah. Rural infrastructure and agricultural extension services, on which the wellbeing of a preponderant proportion of the population depends, have been neglected. Education, which should constitute the foundation stone of an Islamic society, has also received inadequate attention. Health expenditure has been concentrated mainly in the major cities, in large

[34] See IMF, *Survey*, 6 April 1987, pp. 98-99.

capital intensive hospitals and on curative medicine. Yet the majority of the population lives in the countryside, needs a network of simple clinics and paramedical personnel, control of epidemic diseases, and, above all, the provision of clean water supplies, sanitary services and eradication of malnutrition.[35] Housing for the poor has received hardly any public sector attention and slum areas without public utilities and sanitation have mushroomed. Development of an efficient public transport system has been grossly neglected causing great hardship to the poor who have no transport facilities of their own. At the same time considerable lip service is paid to Islam and its imperative of socioeconomic justice. This sorry state of affairs is bound to perpetuate slower growth and economic inequalities, thus accentuating social tensions and unrest. It is therefore necessary for Muslim governments to restructure their spending so that they are able not only to reduce their overall spending levels but also reallocate spending to concentrate more on projects that will help accelerate development and realization of the objectives of the shari'ah.

The absence of a serious effort on the part of governments to utilize their limited resources more efficiently has a number of reasons. First, there is a lack of realization that the resources at their disposal are a trust from God. This failing, along with the expensive life style of government officials, has contributed to corruption. Only a moral reform of the society along with a restructuring of people's life-styles can remove this shortcoming. Second, the absence of an indigenous development philosophy, prepared in conformity with the country's own resources and values, has led to the absence of well-established priorities. Without the establishment of such priorities it is impossible to set up agreed criteria for judging the 'essential' from the 'inessential' and the 'productive' from the 'wasteful' use of resources. Unless a long-term commitment is made to an Islamic development philosophy, it may not be possible to remove the existing confusion and conflict in policies. Third, the price system has not been used and resources, particularly foreign exchange resources, are

[35] See Thomas, McKeown, *The Role of Medicine: Dream, Mirage or Nemesis?* Princeton, N.J.: Princeton University Press, 1979,; and Alastair Gray, "Health and Society: Reflections on Policy," *IDS Bulletin*, October 1983, pp. 3-9.

acquired or sold by governments and public enterprises at less than their opportunity costs. This contributes to inefficient use of resources. Fourth, the absence of an elected parliament and a free press deprive the public of a forum for criticism of government policies. This problem cannot be cured without establishing democratic processes.

Commitment to Islamic values and the objectives of the shari'ah should help on all four counts. The objectives of the shari'ah will in particular help reduce the existing arbitrariness in government spending decisions by providing the criteria for establishing priorities. The objectives of the shari'ah could be further reinforced by adhering to the following six broad principles adapted from the legal maxims developed over the centuries by Muslim jurists to provide a rational and consistent basis for Islamic jurisprudence.[36]

1. The principal criterion for all expenditure allocations should be the wellbeing of the people (Article 58).
2. The removal of hardship and injury must take precedence over the provision of comfort (Articles 17, 19, 20, 30, 31, and 32).
3. The larger interest of the majority should take precedence over the narrower interest of a minority (Article 28).
4. A private sacrifice or loss may be inflicted to save a public sacrifice or loss and a greater sacrifice or loss may be averted by imposing a smaller sacrifice or loss (Articles 26, 27, and 28).
5. Whoever receives the benefit must bear the cost (Articles 87 and 88).

[36] *Majallah al Aḥkām al 'Adliyyah,* briefly known as the *Majallah,* states 100 maxims of jurisprudence (*al Qawa'id al fiqhiyyah*) in its preamble. An English translation of the *Majallah* by C.R. Tyser, *et. al.*, and entitled *The Mejelle* was published in 1967 by the All Pakistan Legal Decisions, Nabha Road, Lahore. Although the Majallah is a Hanafi compendium codified during the Ottoman period, the maxims of jurisprudence are almost universally used by jurists of all schools of Muslim jurisprudence. See also Mustafa A. al-Zarqā, *Al Fiqh al Islāmi fi Thawbihi al Jadid* (Damascus: Matābi' Ba' Alif Bā' Al Adib, 1967), vol. 2, pp. 945-1060. The numbers given within brackets after each principle refer to the articles of the *Majallah* from which the principle has been derived.)

Stabilization and Growth in an Open Islamic Economy*

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*An earlier version of this paper was presented in a seminar sponsored by the Islamic Development Bank and the International Institute of Islamic Economics in Islamabad, Pakistan, August 1987, and was published in the proceedings of that seminar. The authors would like to express their appreciation to the participants of the seminar and to Michael Dooley and Mohsin Khan for their comments and suggestions, without implicating them in any remaining shortcomings.

Abstract

Islam proposes the replacement of an interest-based financial system with one which operates on the basis of risk and profit sharing. Using a general equilibrium model, the paper investigates some open-economy implications of adopting Islamic banking for economic growth and stabilization. It analizes the long-run effects of Islamic banking on international capital flows and on the economy's capacity to adjust to disturbances. It concludes that monetary policy can be used effectively for stabilization purposes and that disturbances to asset positions are absorbed efficiently in an Islamic financial system.

Summary

A number of studies have shown that monetary policy can be used to stabilize an economy that adopts an Islamic financial system. Until now this conclusion has been based on a closed-economy model. This paper expands and extends the consideration of stabilization and growth questions to an open economy whose banking system operates on the basis of risk and profit sharing.

A simple general equilibrium model is developed to illustrate how and through what channels monetary policy alters rates of return on financial and real assets, thereby affecting investment, output, and the balance of payments. This exercise shows that although the authorities lose the ability to set directly financial rates of return, and monetary policy is constrained both by substitution possibilities among domestic assets and by offsetting international capital flows, the authorities can alter the rate of return on physical capital, thereby affecting investment and output.

The paper also investigates the long-run implications of adopting Islamic banking for international capital flows, and sheds some light on the capacity of an Islamic economy to adjust to certain macroeconomic disturbances. It concludes that, to the extent that borrowed external resources (through profit-and-risk-sharing models) are channelled into productive investments, such investments can be expected to generate a stream of returns at least sufficient to repay the foreign loans. Furthermore, an Islamic financial system has the capacity for better adjustment to macroeconomic disturbances that require the shifting of resources from the traded to the nontraded sector than does the conventional interest-based system.

I. Introduction

There has been a great deal of interest in recent years in the analysis of an Islamic economy. The purpose of this paper is to integrate and to expand upon the results of certain approaches which have been adopted to study the effects of stabilization policies in an Islamic economy. The possibility that monetary policy could be used to stabilize such an economy, characterized specifically by the strict prohibition against charging interest, has been demonstrated by Khan and Mirakhor (1987).[1] Employing a short-run macroeconomic model of a closed economy, they show that, in an Islamic economy, there is apparently no fundamental change in the way monetary policy affects economic variables. The authorities can achieve the same results through controlling the supply of profit-based bank lending as they can through varying the total money supply.[2] The present paper extends the analysis to an open economy. This endeavour, besides being of interest in itself, serves to clarify the relationship between the financial and real sectors in an open Islamic economy. More specifically, the analysis pinpoints the principal channels through which monetary policy alters rates of return on financial and real assets, thereby affecting investment spending, output, and the balance of payments.

The paper has the following plan. In the Section II, certain institutional and accounting features of an Islamic banking system are discussed. The intention is to demonstrate the similarities, as well as the differences between interest-based banking and Islamic banking. Section III discusses the general equilibrium approach to monetary theory and the 'q' theory of investment developed by Tobin and Brainard. The purpose is to systematically analyse, by way of intro-

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[1] See also Mohsin Khan, "Principles of Monetary Theory and Policy in an Islamic Framework," paper presented at the International Institute of Economics, Islamabad, Pakistan, September 1987.

[2] In most of the highly-developed countries in fact such rates are set indirectly through central bank actions, e.g., open market operations, reserve requirement changes, variations in discount rates, etc.

duction, the implications of the general equilibrium model, both in explaining the effectiveness of monetary policy when financial intermediaries are uncontrolled, and in providing a foundation for the analysis of monetary policy in an open economy without interest. Section IV presents a simple general equilibrium model for an open Islamic economy. The model is designed to illustrate how changes in government holdings of bank equities affect the various rates of return, and how the possibility of substitution amongst assets affects the outcome of monetary policy. Section V concentrates on the relationship, in an Islamic economy, between total investment and saving on the one hand and the current account deficit on the other. The purpose of this section is to shed some light on the issues concerning the sustainable level of external borrowing and whether adoption of an Islamic banking system will tend to increase or reduce the current account deficit. Finally, Section VI contains some concluding remarks.

At the risk of oversimplifying the analysis contained in this paper the main results that emerge can be summarized as follows. Since Islamic banking essentially transforms banking from an interest-based system to one that relies on profit and loss sharing, it becomes an equity-based system and, in the process, the authorities lose the ability to set directly financial rates of return. Although monetary policy is constrained by both substitution possibilities among domestic assets and by offsetting international capital flows, the authorities can alter the rate of return on physical capital, thereby affecting investment and output. Furthermore, it will be argued that replacing an interest-based system with Islamic banking will not necessarily lead to a reduction in savings and investment. If both savings and investment should increase, then the effect on the current account position is ambiguous. But even if the current account deficit is increased because of a larger increase in investment, it can be shown that given that certain conditions are met, the ensuing growth of output would make it feasible ultimately to close the gap between domestic saving and investment. The Islamic financial system also has advantages over the conventional interest-based system in terms of adjustment to certain types of macroeconomic disturbances.[3]

II. Islamic Financial System

In an Islamic financial system, banks perform the same essential functions as they do in the conventional banking system but are constrained to carry out their transactions in accordance with the rules of Islamic law, the shari'ah. They act as administrators of the economy's payment system and as financial intermediaries. The need for them in the Islamic system arises for the same reason as that in the conventional system, which is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On one side are the deficit financial units who wish to expand their holdings of real assets behind the limits of their net worth. On the other side are the surplus units, who wish to hold part of their net worth in liquid assets with small risk of default. The reasons a bank can accomplish these transformations are that it possesses administrative economy and expertise in negotiating, accounting, appraising, and collecting; it reduces risk by pooling of independent risks, with respect both to returns on assets and to deposit withdrawal; and government regulations and provisions are designed to assure their solvency and liquidity. Banks exploit the imperfections in the financial markets, including *inter alia,* imperfect divisibility of financial claims, and transaction costs of search in the acquisition and diversification of these claims by the surplus and deficit units. Just as their counterparts do in the conventional system, banks in the Islamic system can be expected to exhibit economies of scale in monitoring financial transactions. Because of these economies of scale and the banks specialized expertise, banks possess the ability to minimize the cost of transactions that convert current income optimal consumption and investment bundles. Banks alter yield relationships between surplus and deficit units, and provide lower costs to the deficit units and higher

[3] See also Khan (1986) for similar conclusion derived from the analysis of a closed-economy model.

returns to the surplus units than would be possible with direct finance. As in interest-based banking, Islamic banking transforms the liabilities of firms into a variety of obligations to suit the tastes and circumstances of the surplus units. Their liabilities consist of shares, which serve as the medium of exchange; and their assets consist mainly of primary financial securities in the capital market.

In disallowing interest but permitting profits, the shari'ah has developed two specific forms of business arrangements as means of earning profits without resorting to interest charges, namely, *muḍārabah* (commenda) and *mushārakah* (partnership).[4] In the case of *muḍārabah,* one party provides the necessary financial capital and the other party provides the human capital that is needed for the economic activity to be undertaken. *Mushārakah* is a form of business arrangement in which a number of partners pool their financial capital to undertake a particular activity within an enterprise—either whole-firm or project-specific oriented. *Muḍārabah* is traditionally applied to commercial activities of short duration, whereas *mushārakah* is applicable to production or commercial activities of long duration.

The expectation is that in the Islamic system, projects would be selected for funding through partnerships primarily on the basis of their expected profitability. This factor, together with the predominance of equity markets and the absence of debt markets, has led Muslim scholars to conclude that, potentially, in an Islamic system, there would be a greater number and variety of investment projects that would be seeking financing—a more cautious, selective, and perhaps more efficient project selection by the savers and investors—and a greater involvement by the public investment and entrepreneurial activities, particularly as private equity markets develop, than in the conventional fixed-interest-based system. In the Islamic profit-sharing arrangement, while the profit is shared on the basis of a predetermined share parameter between the agent-entrepreneur and the financial-capital owner, the loss is only borne by the owners of

[4] See Khan and Mirakhur (1987) for other forms of Islamic transactions.

the funds and not the entrepreneur. This affords human capital, which is representative of present work and effort, a status on par with financial capital, which is representative of monetized past labor and work. In this respect, the owner of financial capital risks the loss of his funds, whereas the agent-entrepreneur is recognized as risking his time, effort, and labor.

The efforts of Muslim scholars and economists in developing models of banking within the framework of Islamic requirements has led to a variety of proposals that can be categorized into two principal models. The first model, relying on the concept of profit-sharing, integrates the asset and liability sides of the financial sector on the basis of a principle called 'two-tier *muḍārabah*'.[5] This model envisages depositors entering into a contract with a banking firm to share the profits accruing to the bank. The bank, on its asset side, enters into another contract with an agent-entrepreneur, who is searching for investable funds and agrees to share his profit with the bank in accordance with a predetermined percentage that is stipulated in the contract. The bank's earnings from all its activities are pooled and then shared with its depositors and shareholders according to the terms of their contract. The profits earned by the depositors are a percentage of the total banking profits. According to this model, the banks are allowed to accept demand deposits that would not earn profits and instead may be subjected to a service charge. This model requires that demand deposits must be paid to the depositors on demand, and has no specific reserve requirement.

The second model divides the liability side of the bank balance sheet into two windows, one for demand deposits, which serve as transaction balances and the other for investment balances.[6] The choice of which window to use is left to the depositors. This model stipulates a 100 percent reserve requirement for the demand deposits but no reserve requirement for investment balances. Proponents of this model argue that demand deposits are placed as *amānah* (safe-

[5] Iqbal and Mirakhor (1987).

[6] Khan (1986).

keeping) and must be backed by 100 percent reserve, because these balances belong to the depositors and do not carry with them the right for the bank to use them as the basis for lending and money creation through fractional reserves. Money deposited in investment accounts, on the other hand, is placed with the depositor's full knowledge that the deposit will be invested in riskbearing projects, therefore no guarantee is justified. In this model, too, the bank may charge a service fee for providing safekeeping services.

III. Monetary Policy, Investment And the Balance of Payments

The effectiveness of using monetary policy to influence macroeconomic conditions is a controversial and widely debated topic. On the one hand, some economists contend that if domestic labor and product markets respond slowly to shifts in the economic environment, giving rise to disequilibrium situations in which supply and demand are not always equal, there is scope for monetary policy to stabilize the economy. On the other hand, other economists argue that a counter cyclical monetary policy cannot be effective in influencing employment and output, based on models in which economic agents are rational and do not make systematic errors in anticipating the behavior of the monetary authorities. A key issue in this debate is whether prices are free to adjust rapidly so that markets clear continuously as economic participants respond to whatever changes in monetary policies they come to anticipate.

In addition to focusing on the effectiveness of monetary policy in the context of rational expectations, developments in monetary theory have also focused on the issue of international capital mobility and its implications for active monetary policy. The effectiveness of monetary policy depends crucially on whether money 'spills out' directly and rapidly through the capital account of the balance of payments, and on the strength of the effects on the current account from changes in both the relative price of traded and nontraded goods and aggregate domestic demand.

In the analysis of the open-economy aspects of monetary policy, exchange rates and the balance of payments are sometimes discussed as a separate compartment of monetary policy. 'International' financial policy is taken to be concerned with capital flows in the balance of payments, with official intervention in exchange markets, with holdings by the government of international reserve assets, and with the choice between a fixed- or flexible-exchange rate regime. 'Domestic' monetary policy is considered independently of international complications and is taken to be concerned with, for example, interest rate changes, open-market operations, and the supply of commercial bank reserve. However, as the monetary approach to the balance of payments has emphasized, there is no valid way to segregate the 'external' and 'domestic' aspects of national monetary policy for separate analysis.

The monetary approach to the balance of payments (MABP) uses the money-supply process and the money-demand function as the central theoretical relationships around which to organize the analysis of the balance of payments.[7] In the framework of the monetary approach, the balance of payments position of a country is considered to be a reflection of decisions by the residents to accumulate or to run down their stocks of money balances. For a small country, in which income is exogenous, which has prices given from abroad, and which adheres to a fixed exchange rate, the money supply is endogenous and increases in the domestic supply of money beyond the level demanded will leak out in the balance of payments. In essence, MABP argues that international money flows are a consequence of stock disequilibria differences between desired and actual stocks of international money and, as such, are inherently transitory and self-correcting. A nonzero official settlements balance allows the money stock to change until the demand for and supply of money are equalized and when the money market is in equilibrium, the official settlements balance returns to zero.

[7] Two useful anthologies of the monetary approach to the balance of payments are Frenkel and Johnson (1976) and the International Monetary Fund (1977).

Another important subject that has been emphasized in recent years in macroeconomic theory has been the variation in the pace of capital accumulation and the sensitivity of investment to rates of return in financial markets. Tobin (1969), Tobin and Brainard (1968, 1977), and others, have attributed much of this variation in investment to changes in the relative attraction for wealth-owners to hold physical capital, on the one hand, and money or obligations to pay money, on the other. In this approach, monetary assets are part of a list of assets and the commercial banking system is one sector, but not the only one, whose balance sheet behavior must be specified. The Tobin-Brainard model of the economy's capital account specifies the assets (and liabilities) that appear in portfolios and balance sheets, the factors that determine the demands and supplies of the various assets, and the conditions under which asset prices and rates of return clear these interrelated markets. Equilibrium in these models is an equilibrium of stock and balance sheets, that is, a situation in which both the private sector and the financial institutions are content with their portfolios of assets and liabilities, and the demand to hold each assets is equal to the stock supply. Proponents of this general equilibrium approach to monetary theory argue that the monetary operations of a central bank can bring about changes in the 'q' ratio—the ratio of the market value of firms to the replacement cost of their physical capital—and that this ratio is the principal link between the financial and real sectors of the economy.

A change in the quantity of money disturbs asset market equilibrium and sets off a chain of portfolio substitutions. Currency, deposits in banks and other financial intermediaries, equities, etc., are important substitutes for each other and other assets in the portfolios of investors. The central bank operates in the first instance on the rate of return of some financial instrument that it holds in its portfolio by buying or selling it in the market. The monetary operations are then transmitted to equity yields as portfolio substitutions are affected by the current levels of the rates of return and expectations of their future paths. Thus, changes in the stock of money alter 'q' and thereby alter private investment expenditures, real output, and prices. The rate of investment is a positive function of 'q,' and an increase in the money stock increases 'q'. In a competitive economy with constant returns to scale, the equilibrium value of 'q' sustains capital replacement and expansion at the natural growth rate of the economy. If there are no adjustment costs, the firm will continue to increase or decrease the capital stock until 'q' is equal to unity. In the short-run, disturbances, expectations, and policy changes cause movements in 'q,' which in turn changes incentives for real investment.

Tobin and Brainard (1963) address the question whether the existence of uncontrolled financial intermediaries diminishes the effectiveness of monetary control. Their method is to set up models of general equilibrium in financial and capital markets and to trace, in these models, the effects of monetary controls when structural changes, such as abolishing ceilings on rates which commercial banks pay on deposits, occur. Tobin and Brainard note that introducing nonbank financial intermediaries, uncontrolled or controlled, into a system in which banks are under effective monetary control presents essentially the same issues as introducing commercial banks as an intermediary, controlled or uncontrolled, into a system in which the government's control is the supply of its own currency. Their analysis, therefore, focuses on the effects of financial intermediation by banks, the consequences of leaving their operations unregulated, and the effects of regulating them in various ways. In their model, a monetary action is considered expansionary if it lowers the rate of return on the ownership of real capital that the community requires to induce it to hold a given stock of capital, and deflationary if it raises that rate of return. In equilibrium, this rate of return equals the expected marginal productivity of the capital stock, which in turn depends on the size of the capital stock relative to expected levels of output. If a monetary action lowers the rate of return on capital at which owners of wealth are content to absorb the given stock of capital into their portfolios or balance sheets along with other assets and liabilities, then it becomes easier for the economy to accumulate capital.

The Tobin-Brainard analysis shows that the presence of an uncontrolled financial intermediary does not imply the ineffectiveness of monetary policy to alter the required rate of return on physical capital. Although a reduction in the supply of currency will raise the financial intermediary's rates, the substitution of the intermediary's liabilities for currency will not offset the monetary contraction completely so long as the intermediary's liabilities are an imperfect substitute for currency. Substitutions of this kind imply that a given change in the supply of currency and bank reserves would have more effect on the economy if such substitutions were prevented, but this does not imply a one-for-one offset to enforced reductions in the supply of controlled monetary assets.

> Whether it is important that monetary controls be more effective in this sense is another question. . . . When a given remedial effect can be achieved either by a small dose of strong medicine or a large dose of weak medicine, it is not obvious that the small dose is preferable. Increasing the responsiveness of the system to instruments of control may also increase its sensitivity to random exogenous shocks. Furthermore, extension of controls over financial intermediaries and markets involves considerations beyond those of economic stabilization; it raises also questions of equity, allocative efficiency, and the scope of governmental authority.[8]

IV. A Model of Monetary Policy In an Open Islamic Economy

The key insights from the general equilibrium approach to monetary theory and the 'q' theory of investment, as they bear on the subject of Islamic banking, are that the principal way in which monetary policy affects aggregate demand is by changing the valuations of physical assets relative to their replacement costs, and that monetary policy can accomplish such changes even in the presence of uncontrolled financial intermediaries. The transformation of banking from an

[8] Tobin and Brainard (1963).

interest-based system to one that relies on profit and loss sharing makes an Islamic banking system essentially an equity-based system. The authorities cannot set directly financial rates of return, so the financial system is more market oriented in an Islamic economy than in an economy with fixed-interest rates. In this respect, the Tobin-Brainard models, particularly the model for analyzing the effect of an uncontrolled financial intermediary on the effectiveness of monetary control, are relevant. In this section, we present a variant of the Tobin-Brainard model for the purpose of studying monetary policy in an open Islamic economy. As the model is for an open economy, monetary policy is constrained by substitution possibilities among domestic assets and by offsetting international capital flows. The model below bears a close resemblance to models developed by Branson (1976, 1979), Miller (1973), and Tobin and de Macedo (1980). The purpose is to develop the simplest possible fundamental model which yields the basic behavior of the general equilibrium approach to monetary theory in an open Islamic economy, particularly, the movements in the rate of return on physical capital and offsetting international capital flows following shifts in monetary policy.

The model consists of the following assumptions. There are three financial assets and one real asset, and the set of excess demand equations for these assets determines the rates on the assets, given the values of the various exogenous variables. Table 1 gives definitions of the symbols used. The domestic private sector allocates its wealth between currency, bank deposits, bank equities, and physical capital. The banking sector holds currency, bank equities, and loans. The foreign sector holds deposits in the domestic banking sector and also holds equity capital.

The model represented by equations (1) through (7) is presented in Table 2. The first four equations are the excess demand equations for bank equity, bank loans, physical capital, and currency, respectively. The assets-holders demand functions for the four imperfectly substitutable assets are functions of the rates of return that are relevant for the particular sector. It is assumed that the assets are all gross

Table 1
Symbols Used

Symbol	Definition
D	Bank's liabilities to domestic residents (as a fraction of private sector wealth)
D*	Bank's liabilities to foreign sector (as a fraction of private sector wealth)
H	Supply of bank equities (as a fraction of private sector wealth)
G	Government holdings of bank equities (as a fraction of private sector wealth)
K	Physical capital (as a fraction of private sector wealth)
C	Currency (as a fraction of private sector wealth)
c	Required reserve ratio for banks
ê	The rate of change of the exchange rate, where the exchange rate is expressed as the domestic currency price of a unit of foreign currency
rd	Rate on bank deposits
rl	Rate on bank loans
rh	Rate on bank equities
rk	Return on physical capital
rf	Return on foreign assets

substitutes in the portfolios of each sector, which implies that a rise in the rate on any asset will lead to substitution into that asset out of other assets in the portfolio. In other words, the partial derivative of the asset demand function with respect to the own rate is positive, while with respect to an alternative rate, negative or zero. Equation (5) describes the private sector's demand function for bank deposits, whereas equation (6) is the foreign sector's demand for domestic bank deposits. Equation (7) describes the relationship between the bank loan rate and the deposit rate.

Table 2
Islamic Financial System Model

Symbol Number	Equation
(1)	$b^h(rh,rl)(1-c)(D+D^*) + p^h(rh,rd,rk) + G-H=0$
(2)	$b^l(rh,rl)(1-c)(D + D^*)-p^l(rk,rl) = 0$
(3)	$p^k(rh,rd,rk,rl) + f^k(rk-rf-e)-K = 0; \quad f^k > 0$
(4)	$cb^d(rh,rd) + p^c(rh,rd,rk)-C = 0$
(5)	$D = p^d(rh,rd,rk)$
(6)	$D^* = f^d(rd-rf-\acute{e}); \quad f^d > 0$
(7)	$rd = r(rl); \quad r > 0$

Commercial banks offer investment deposits to the private sector, *D*, and to the foreign sector, *D**, which are not guaranteed by the banks and do not yield a predetermined rate of return. The banks are assumed to pay depositors a rate of return, *rd*, that is based on profits from their operations, as postulated in equation (7). These deposits are shared between the depositors and the banks in mutually agreed-upon proportions determined prior to the transaction, so that, should the banks incur losses, the rate of return to the depositor would be negative and the nominal value of the deposits would be reduced accordingly.[9] Unlike the commercial banks in the interest-based banking system, commercial banks in the Islamic system cannot borrow from the central bank through the customary mechanism of rediscounting at a given official discount rate. It is assumed that banks can borrow from the central bank only on an equity-participation basis, and the central bank purchases equity in the banks when it wishes to expand reserves in the system, and vice-versa. Therefore, an additional source of funds for the commercial banks is the rate of equity shares to the central bank, and the public also participates in this market. As in the case of investment deposits, the rate of return on equity shares, *rh*, depends on the overall profit position of banks, so that in contrast to the official discount rate, it is not determined directly by the central bank.

On the lending side, banks engage in only risk-return sharing *muḍārabah* arrangements with the private sector. *Muḍārabah* financing in this case is assumed to subsume all other types of similar arrangements, such as *mushārakah* financing. As in the case of investment deposits, the profits earned from the projects financed by the banks are shared between the bank and the entrepreneur on a pre-arranged basis specified in the contract between the two before the financing is provided. Banks are also required to hold a certain proportion, *c*, of their liabilities to the private and foreign sectors in the form of reserves with the central bank.

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[9] See Khan and Mirakhor (1987).

The foreign sector holds investment deposits in the banking system and physical capital. The foreign demand for investment deposits, f^d, is a function of the rate of return on investment deposits, *rd,* less foreign or world interest rate, *rf,* and the expected depreciation of the domestic currency, $\hat{e}$. The derivative of $f^{d'}$, is positive.

The central bank's liabilities consist of reserves of commercial banks and currency held by the public. As mentioned earlier, the central bank holds equity shares of commercial banks, and the rate of return on these is market determined. The supply of reserves is changed by the central bank through variations in its stock of bank equity shares, *dG,* which in turn alters the cost of borrowing for the banks.

The four excess demand equations for the assets are constrained by the balance sheet, so they contain three independent equations determining *rh, rl,* and *rk,* for given values of the exogenous variables. Dropping equation (4) and substituting for *D, D** and *rd,* leaves three equations to determine the three endogenous rates of return. To derive a result for the direction of movement of one of the rates, we can take the total differentials of the three excess demand equations. Total differential of equations (1) through (3), after suitable substitution, yields equation (8), which determines *drh, drl* and *drk* as functions of changes in *G, c, H, K, rf,* and $\hat{e}$.

(8) $$\mathrm{AdY} + \mathrm{BdX} = 0 \text{ or } \mathrm{AdY} = -\mathrm{BdX}$$

with

$$\mathrm{dy} = \begin{bmatrix} \mathrm{drh} \\ \mathrm{drs} \\ \mathrm{drk} \end{bmatrix} \qquad \mathrm{dx} = \begin{bmatrix} \mathrm{dg} \\ \mathrm{dc} \\ \mathrm{dh} \\ \mathrm{dk} \\ \mathrm{drf} \\ \mathrm{d\acute{e}} \end{bmatrix}$$

and the coefficient of the matrices *A* and *-B* are given in the Appendix. The solution is

(9) $$\mathrm{dY} = -\mathrm{A}^{-1}\mathrm{BdX}.$$

The matrix *A*, with elements a_{ij}, is a matrix of partial derivatives of the excess demand functions with respect to the endogenous rates of return, and *B* is defined analogously with respect to the exogenous variables. The assumption of gross substitutability ensures the following:

(i) $a_{ii} > 0$ for all i;

(ii) $a_{ij} < 0$ for all i, j and i · j;

(iii) a_{ij} 0 for all j; and

(iv) det $A > 0$.

The determinant of matrix is positive because condition (iii) implies that *A* has dominant diagonals by column, which is sufficient for the characteristic roots to have positive real parts. An important result for matrices of this kind is that all cofactors are nonnegative and the inverse of *A* is composed entirely of nonnegative elements.

Next, we discuss the effect of changes in central bank holdings of commercial bank equities, *dG*, on the endogenous rates of return. From equation (9) the entries for change in government holdings of bank equities on the endogenous rates of return are given in equations 10 through 12:

(10) $drh/dG = (1/|a|)\ [-(a_{22}a_{33}) + (a_{23}a_{32})]$;

(11) $drl/dG = (1/|a|)\ [-(a_{23}a_{31}) + (a_{21}a_{33})]$; and

(12) $drk/dG = (1/|a|)\ [(-a_{21}a_{32}) + (a_{22}a_{31})]$.

Given the assumptions on matrix *A*, all three endogenous rates decline in response to an increase in the central bank's holding of bank equities. Intuitively, the results can be explained by noting that the increase in the central bank's holding of bank equities adds immediately to the supply of funds banks have for lending purposes. As banks seek out more projects for *muḍārabah* financing, they accept projects with lower expected rates of return than previously. The lower earnings on *muḍārabah* financing will be reflected in lower returns on *muḍārabah* deposits. Given the decline in *muḍārabah* deposit rates, there is substitution into the market for physical capital, and the increased demand for capital lowers the required rate of return on capital. As discussed earlier in terms of the 'q' theory of investment, this monetary action is expansionary because it lowers the required rate of return on capital and makes it easier for the economy to accumulate physical capital.

It needs to be mentioned, however, that because deposit rates are flexible and not controlled by the central bank in Islamic banking, there will be partial offsets to the monetary action. As returns on *muḍārabah* deposits decline, the private sector will not only substitute into physical capital but also into currency, thereby dampening the expansion of bank intermediation. Furthermore, the foreign sector will reduce its holdings of domestic assets, both *muḍārabah* deposits and physical capital, because their rates of return decline. These offsetting international capital flows will depend on the elasticities of the foreign asset demand functions with respect to the rates of return. Thus, the move to greater flexibility in the setting of deposit rates is likely to increase the extent to which capital flows offset monetary policy. But as long as the assets are imperfect substitutes, the offset is only partial. Although the greater flexibility in the rates of return increases the short-run international capital flows offset to monetary policy, this does not at all mean that the adoption of Islamic banking will lead to sustained medium- or long term capital outflows. The model is presented for the purpose of analyzing short-run effects of monetary policy. To study the long-run implications of Islamic banking for international capital flows, one needs to look at the likely effects that interest-free banking would have on domestic saving and investment. This issue is discussed in the next section.

V. Saving, Investment, Growth And External Borrowing

The foregoing discussion has concentrated on the relationship between monetary policy and the rates of return in an Islamic economy, and how changes in the rates of return affect investment spending. This section focuses on the relationship between domestic saving and investment, on the one hand, and the current account deficit, on the other, in order to shed some light on the external debt servicing capacity issue for an Islamic economy. In the national income accounts identity, gross national product (GNP) is measured both by expenditure on final product and by the way in which the income that is generated in production is used. As is shown in equation 13.

$$(13) \qquad C+I_p+I_g+G+(X-M) = GNP = C+S+T+R_f.$$

The left-hand side of the identity indicates that expenditure on *GNP* is divided among private consumption C, gross private sector investment I_p, gross government investment I_g, government spending for consumption-type goods and services G, and net exports X-M. The right-hand side of the equation indicates that the income earned in production is used up in private consumption C, saving by consumers and businesses S, net tax payment T, and transfer payments to foreigners by private citizens R_f. Subtracting private consumption C from both sides of the identity and rearranging we have equation 14:

$$(14) \qquad (M-X)+R_f = (I_p-S)+(I_g+G-T).$$

In other words, the current account deficit equals the sum of the excess of private sector investment over private sector saving and the budget deficit of government. This implies that the higher the current account deficit, the greater is the accumulation of capital, the smaller is the accumulation of private wealth, and the larger is the budget deficit. But a deficit in the current account means a transfer of resources to the country, in the sense that some of the goods and services brought into the country are not paid for by an equivalent claims on the country. In total, the current account deficit must be reflected by changes in the net asset position, irrespective of whether these take place through a reduction in foreign assets (including international reserves) or through borrowing. If a current account deficit results from increased investment, then the economy is trading one asset, the debt instrument, for another, the claim to physical capital. To the extent that borrowed resources have been channeled into productive investments, such investments could be expected – given prudent management of the economy and maintenance of the competitiveness of the external sector—to generate a stream of returns at least sufficient to repay the associated loans. If, on the other hand, the resources were used, directly or indirectly, to sustain consumption, repayment of the indebtedness must be, at least to some extent, at the expense of future levels of consumption, a far more onerous prospect. It is, therefore, of considerable interest to know whether the adoption of an Islamic banking system would lead to increased investment or increased consumption, i.e., whether a stream of real resources is likely to be generated which will permit the eventual repayment of the foreign liabilities.

It could be argued that in an Islamic economic system, particularly with its emphasis upon work and moderation in consumption, saving would be enhanced. Nevertheless, concerns have been expressed that the adoption of an Islamic financial system may lead to a reduction of savings and retardation of financial intermediation and development. One argument suggests that since savings receive no reward (i.e., interest rate is zero) there is no incentive for individuals to save. Another argument asserts that savings will decrease because of increased uncertainty of future prospects in the Islamic system.

The first argument stems from a misunderstanding regarding Islam's prohibition against interest. Those advancing this argument consider the prohibition against interest to be tantamount to an imposition of a zero rate of return on investment and capital. This view reflects a confusion between rate of return and rate of interest. While the latter is forbidden in Islam, the former is not only permitted but is, in fact, encouraged. The second argument is based on the proposition that increased uncertainty in the rate of return affects savings adversely. Recently this issue has been subjected to rigorous theoretical analysis with conflicting results. The few studies that have considered this question within the context of Islamic framework have tended to neglect the risk return tradeoff aspects of the question.[10] That is, the effects on savings of a fixed and certain rate of return are compared with effects on savings when only uncertainty is taken into account, and the obvious result is a reduction in savings in the latter case. If the expected value of return is kept constant while its vari-

[10] See Haque and Mirakhor (1987).

ance is increased, i.e, when increased risk is not compensated by higher returns, savings will be adversely effected. This conclusion, however, is far from obvious when both risk and return are allowed to vary. The theoretical conclusion of an analysis in which risk and return variability have both been taken into account depends on assumptions regarding the form of the utility function and its risk properties; e.g., the degree and the extent of risk aversion, the presence and the degree to which the future is discounted, whether or not increased risk is compensated by higher return, and finally, the income and substitution effects of increased uncertainty.

Haque and Mirakhor (1987) have argued that the structural changes accompanying the adoption of an Islamic financial system may produce favorable effects on the rate of return on savings. The increased rate of return could compensate for the increased level of uncertainty that may result from the elimination of the risk-free asset, thereby leaving the overall level of savings unchanged or perhaps even leading to an increase in savings. They also note that the move to an Islamic banking system cannot be analyzed as an *a priori* increase in uncertainty in the environment in which the consumer is operating. Theoretically, any asset whose return is not *ex ante* fixed and tied to the amount of money invested can be admitted into the menu of assets available in an Islamic financial system. Given the availability of assets with a variety of risk characteristics, the saver can organize a diversified asset portfolio which can enable him to minimize risk in the Islamic financial system as in its counterpart.

In the companion paper to the one just mentioned, Haque and Mirakhor (1987) analyze investment behavior in an interest-free Islamic economy, and their analysis indicated that there is no strong theoretical reason to support the assertion that investment levels would decline if an Islamic profit-sharing system were adopted. Their analysis demonstrates that in the case of perfect certainty and full information, whether investment decisions are based on profit sharing or on a fixed rate of return has no real consequences for the economy. But when uncertainty is introduced, the level of investment may actually increase under certain conditions. Intuitively, the result can be explained by noting that when a fixed-interest rate is replaced by profit sharing, both the owners of the firm and the lenders to the firm would be residual income earners and a fixed cost for capital would not be required as part of the firm's profit calculations. Therefore, the marginal product of capital could be taken up to the point where maximum profits would be obtained, as the firm does not face the constraint of meeting a fixed cost of capital.

The question of what will happen to the level of savings and investment following the adoption of Islamic banking will ultimately be an empirical one. However, some insights regarding the effect on the current account deficit can be obtained from examining the various possibilities with regards to the movements in savings and investment.

The propositions that follow from the above discussion are that savings and investment are unlikely to decline in an Islamic economy. If both savings and investments rise, then the effect on the current account deficit is ambiguous. Other things being equal, if the increase in saving is greater than the increase in investment, then the current account deficit will be lower. But even if the current account deficit is increased because of a larger increase in investment, the ensuing growth of output would make it feasible ultimately to close the gap between domestic saving and investment to repay the external loans. This statement needs to be qualified to allow that high saving and investment rates by themselves do not imply immunity against difficulties in external debt management. For example, a number of developing countries that apparently devoted the proceeds of external borrowing to investment have, nevertheless, encountered serious debt-servicing problems. The reasons for this are complex, and include both global economic developments—weakness of international trade, protectionist practices in industrial countries, high international interest rates—and policies in the developing countries, especially with regards to fiscal deficits, exchange rates and pricing policies, that lowered the efficiency of investment. While a full analysis of these issues is beyond the scope of this paper, two aspects of investment spending in a capital importing economy may be discussed, insofar as the discussion serves to show that disturbances to asset positions are absorbed more efficiently in an Islamic financial system and capital inflows are less likely to be affected by sudden and uniform shifts in the perception of the country's creditworthiness in Islamic banking than in the conventional form of international bank lending.

The first point we discuss is the well-known result that a high level of capital inflows into a country, which reflects not only a strong demand for external capital but also the absence of substantial credit rationing constraints on its supply, will lead to an appreciation of the real exchange rate. The increased inflows cause an increase in domestic expenditures relative to output. The supply of traded goods required by the increased demand will be met by some combination of increased imports and decreased exports, with the resulting increase in the current account deficit equal to the capital inflow. However, the increased demand for nontraded goods can only be met from domestic supply, and if the supply of nontraded goods is unchanged, their relative price will rise. If one makes the small country assumption that the foreign currency price of traded goods is not affected by developments in the domestic economy, then the rise in the relative price of nontraded goods occurs through either a rise in the domestic currency price of nontraded goods or an appreciation of the nominal exchange rate. The rise in the relative price of nontraded goods results in the drawing of labor out of the traded goods sector because the real wage rate in terms of nontraded goods declines. However, the wage rate measured in terms of traded goods and the real wage rate (that is, in terms of all goods consumed) both rise because of the resource movement effect. This increase in the cost of labor has an adverse effect on external competitiveness. A sudden reduction in the level of capital inflows, either because borrowers are frozen out of the markets by the credit rationing phenomenon or because they cease borrowing voluntarily in the face of high interest rates in world financial markets, will require a fall in the real exchange rate to restore equilibrium and may involve substantial short-run adjustment costs, in terms of foregone output and under-employed resources, if resources cannot be shifted back quickly to the traded goods sector.

These types of adjustment problems will be less severe in an Islamic financial system, both because the fluctuations in capital inflows are dampened and because the transfer of resources from the nontraded goods sector to the traded goods sector is facilitated by Islamic banking. Muslim scholars have little doubt that a financial system based on an Islamic framework of profit sharing would be more efficient in allocating resources and more stable as compared to a conventional interest-based system.[11] It is argued that allocational improvements would occur because investment alternatives are, to one another, based strictly on their productivity and rates of return, and better quality investment projects will be undertaken because the saver becomes an entrepreneur sharing in the profits earned. As payment commitments of firms and financial institutions are mostly dividends that will have to be paid only if profits are received, the decline in the profitability in the nontraded goods sector of the sort discussed above will be reflected quickly in the returns earned by investors on the nontraded goods sector, thereby encouraging the investors to switch their resources to firms or financial institutions that are active in the traded goods sector.

The second aspect of financial intermediation and investment spending in a capital importing country is the case where existing debt constrains the flow of new credits and domestic investment. The argument as presented in Dooley (1987) is that when a country experiences an exogenous reversal in its economic prospects, a wedge can become established between the contractual and market value of debt. The contractual value of debt can be defined as the present value of the stream of payments set out in the initial contract between the debtor and the creditor on the assumption that such payments will be made with certainty. The market valuation of that contract is the present value of the market's expectation of the stream of payments

[11] It must be pointed out that external borrowing in an Islamic economy will also have to be based on a profit-and-risk-sharing basis.

that will actually be made under the contract. Whereas the contractual value is generally above the market valuation to cover the possibility that the contractual obligations may not be carried out. Circumstances can arise where uncertainty among new investors as to whether or not they will be forced to share an expected loss on existing unprofitable investments through increased taxation, exchange rate depreciation, and other means that the government may employ, causes a sharp slowdown of new investment in the capital-importing country.

In this regard, an important difference between interest-based international bank lending and Islamic modes of financing is that, whereas in the former, interest payments are due irrespective of the uses to which original borrowing had been put, payments in the latter are closely linked to the returns on the underlying investment.[12,13] Due to the prohibition against charging interest and the fact that banks will have to rely primarily on profit-sharing, Islamic banks will have to offer their asset portfolios of primary securities in the form of risky, open-ended, mutual-fund type packages for sale to the investor depositors, as opposed to the conventional bank practice of keeping title to the portfolios they originate. In the Islamic system, there will also be greater interdependence and closer relationship between investment deposit yields because banks can primarily accept investment deposits on the basis of profit sharing and can provide funds to the enterprises on the same basis. Due to the fact that the return to lia-

[12] See Khan (1986) and Mirakhor (1986).

[13] There is a marked shift from nondebt-creating flows—official transfers and private direct investment to debt-creating and interest-sensitive borrowing by developing countries in world capital markets. During the 1986's, the main form of international bank lending was short-term trade credit. During the 1970s, however, institutional developments in the domestic banking systems of the industrial countries lowered the risk on deposit liabilities of the money-center banks, which enabled the major banks to become the largest recipients of international loanable funds. Furthermore, financial innovations—notably the growth of syndicated loans and the increased use of cross-default clauses—reduced perceived levels of risk in lending to developing country borrowers, resulting in a significant rise in the volume of private bank lending.

bilities will be a direct function of the return to asset portfolios and also because assets are created in response to investment opportunities in the real sector, the return to financing is removed from the cost side and relegated to the profit side, thereby allowing the rate of return to financing to be determined by productivity in the real sector. It will be the real sector that determines the rate of return to the financial sector in the Islamic financial system, rather than the other way round. For these reasons, Islamic banking tends to reduce the vulnerability of the capital importing country to fluctuations in the level of capital inflows and sharp slowdown of new investment due to uncertainty among investors.

This can be further explained in terms of the 'q' theory of investment that was discussed in Section III. One way to look at 'q' is that it represents the comparison between the marginal efficiency of capital and the financial cost of capital. The marginal efficiency of capital is the internal rate of return on investment at its cost in the commodity markets, whereas the financial cost of capital is the rate at which investors discount future returns from investment. The reason new investment does not take place when a wedge becomes established between the contractual and market value of debt is not primarily because marginal productivity of capital is reduced but, more importantly, because investors discount future returns from new investment on the basis of a very high discount rate, which reflects their expectations that proceeds from their investments will be used to service the existing large external debt. The problem of high discount rates on new investments will not arise in the Islamic financial system because the liabilities of each economic unit are composed of equities, are fully amortized with an underlying future income flow, and no debt refinancing can take place. If there is any refinancing, it must be based on the sharing of future income expected from assets.

VI. Concluding Remarks

The aim of this paper has been to extend the analysis of monetary policy to the case of an open Islamic economy. A general equilibrium model for analyzing investment and external balance was presented. The model should not be taken too literally; rather, it should be regarded as an exploration of monetary policy in an Islamic economy when there are offsetting international capital flows. While the strong qualitative results that emerge from this paper hinge on the specific assumptions used, the basic conclusions are of general interest. Without denying the constraint imposed upon monetary policy by substitution possibilities among domestic and foreign assets, the paper argues that monetary policy can be used to affect output in an open Islamic economy. The rate of return on equity shares of commercial banks is market determined, but the supply of reserves is changed by the central bank through variations in its stock of bank equity shares, which in turn alters the cost of borrowing for the banks. While an increase in the supply of bank reserves will lower the deposit rates, the substitution of currency and foreign assets for domestic bank deposits will not offset the monetary expansion completely so long as the assets are imperfect substitutes.

Although the move to greater flexibility in the setting of deposit rates is likely to increase the extent to which international capital flows offset monetary policy, this does not imply that Islamic banking will lead to sustained medium- or long-term capital outflows. To study the long-run implications of Islamic banking for international capital flows, the paper discussed the effects that interest-free banking would have on domestic saving and investment. It was argued that savings and investment are likely to increase in an Islamic economy so that the effect on the current account position is ambiguous. However, to the extent that borrowed resources are channelled into productive investments, such investments could be expected to generate a stream of returns at least sufficient to repay the associated loans. Furthermore, the Islamic system has some advantages over the conventional interest-based system in terms of adjustment to certain types of macroeconomic disturbances because the liabilities of each economic unit are composed of equities and, therefore, fluctuations in international capital flows on domestic investment are dampened.

Appendix

Coefficient Matrices

$$
A = \begin{matrix}
b^h_{rh}(1-c)(\dot{D}+D^*)+b^h(1-c)p^d_{rh} & b^h_{rl}(1-c)(D+D^*)+b^h(1-c)(p^d_{rd}+f^d)\dot{r}+r'+\dot{r}\,p^h_{rd} & b^h(1-c)p^d_{rk}+p^h_{rk} \\
b^l_{rh}(1-c)(D+D^*)+b^l(1-c)p^d_{rh} & b^l_{rl}(1-c)(D+D^*)+b^l(1-c)(p^d_{rd}+f^d)\dot{r}-p^l_{rl} & b^l(1-c)p^d_{rk}+p^l_{rk} \\
p^k_{rh} & p^k_{rl}+p^k_{rd}\,\dot{r} & f^k_{rk}+p^k_{rk}
\end{matrix}
$$

$$
-B = \begin{matrix}
-1 & b^h(D+D^*) & 1 & 0 & b^h(1-c)f^{\dot{d}} & b^h(1-c)f^{\dot{d}} \\
0 & b^l(D+D^*) & 0 & 0 & b^l(1-c)f^{\dot{d}} & b^l(1-c)f^{\dot{d}} \\
0 & 0 & 0 & 1 & f^{\dot{k}} & f^{\dot{k}}
\end{matrix}
$$

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

Medhat Hassanein

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;

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

= 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.

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 conventional 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 assert, 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 assests. 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 agrument 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 *muḍārabah* or *mushārakah,* 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 assests 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.

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Muslim countries are facing serious problems in managing their economic life. Their inherited colonial way of achieving economic aims are in basic contradiction to certain aspects of Islamic values and intended economic goals.

Thus, it is imperative for Muslim countries endeavoring to escape underdevelopment and social injustice to turn to Islamic teaching and the Islamic way of harnessing human potentials to improve economic conditions and ascertain the necessary requirement for effective economic development.

Islamic economics, as developed by Muslim jurists and social scientists *(fuqahā')*, needs to be recast in modern terms and developed further to deal with complex realities of the modern society.

This book is one step on the long march to Islamizing the science of economics. It contains a selection of papers from the proceedings of an economic conference held in Cairo in 1988. The papers that appear in this selection contribute to the cause of modernizing Islamic economics.