Economic Perspective of Islamic Business and Financing Techniques

Muhammad Ayub

Abstract

Islamic law of contracts has suggested many modes and techniques for financial intermediation. These techniques pass through some prohibitions mandated in Islamic commercial law and have different shades of application. The modes are generally categorized into debt creating and profit-loss sharing techniques. The sale and leasing based modes create debt that has to be paid in full whether the client earns a profit or incurves a loss in the activity performed based on financing. In non-debt creating modes, the user pays according to the benefit taken in the form of asset's ownership, or the usufruct. All modes have different implications for both finance providers and users. This paper discusses micro and macro aspects of both categories of techniques. The aspects discussed include the role in financial intermediation, the impact on consumption and savings choice of consumers, decision making by firms regarding investment and the impact on the parties to the contracts, and macroeconomic implications. It also discusses the current Islamic banking practices. The paper concludes that both categories of techniques have an economic value different from that of the interest based system provided the processes as suggested in Islamic law of contracts are applied in their true spirit. Islamic banks are also required to move to value-based and social finance focusing in line with the emerging trend for meeting UN's SDGs-2030.

Keywords: Islamic finance, Financial and social inclusion, VBI, Macro and micro implications of Islamic contracts

JEL classification: D01, E44, G20, Z12

1. Introduction

The Islamic concept of financial intermediation and business is quite different from conventional concepts based on *ribā* and *gharar*. The latter has helped capital users to become richer while depriving the financial providers (savers). The global and national economies are facing increasing inequality, development for a few at the cost of the majority leading to anxiety for all, and therefore, exposed to dangers (Siddiqi, 2021; Krichene, 2021).

The modern capitalist system has led to serious financial crises in the last two centuries and recently in 2007-2008 (Krichene, 2021; Rajan, 2012). This system is incompatible with Islamic teaching, and the current Islamic banks' operations are also embedded with the shortcomings of this system (Wilson, 2021). The Islamic banks evolved with the idea of facilitating broad-based growth and just and fair distribution of resources among the stakeholders. But the gap between theoretical Islamic finance and actual practice had widened (Siddiqi, 2021).

The micro and macro-economic implications of the Islamic modes of financing need to be studied both for the finance providers and the users. In this article, an effort has been made to discuss the micro and macroeconomic implications of Islamic modes of financing. It first gives the background and objective of the study, then the methodology used and the problem statement. That is followed by the literature review and then a discussion on the economic role that various Islamic finance techniques can play in an economy at both micro and macro levels.

Although economists have been arguing that financial markets create economic growth and lead to economic prosperity and human wellbeing; there is hardly any empirical evidence to prove that the present-day financial markets have helped developing countries to put their economies on the path of economic development. Most countries are facing problems like that of extreme poverty and idle human resources with low per capita income, and this is due to some built-in features of conventional finance, e.g. the risk-free return on financial capital, short selling, creating and trading risk resulting in uncertainty about the major elements of contracts like the subject matter, price and delivery and delinking finance from the real economy and businesses.

Islamic financial principles and tools, on the other hand, facilitate the finance providers and the users by channeling the resources for real economic activity simply because money earning money without business risk-taking and value addition (ribā), and creating and trading in risk (gharar) are prohibited (Sadiq & Black, 2012). Unlike conventional markets, in Islamic finance, both the finance providers and users get benefits as it is based on risk/profit-loss sharing, and every transaction has to be linked to any production or real business activities.

The Islamic banking and non-banking financial institutions hereinafter referred to as the IBFIs, adopted generally some stratagems to ‘Islamize’ the conventional products and services using technicalities of jurisprudence. They have not learned the lesson of avoiding interest-based finance products that led to instability, injustice, and crises in global financial markets. Therefore, they may not lead to adding to the Islamic economic policies and their impact on the welfare of the masses. The policymakers, regulators, and practitioners have not taken into account the economic implications of the Islamic tools of business and contracts.

In the above perspective, the potential role of all major categories of Islamic modes of business and contracts must be presented concisely to enable the policymakers and regulators in Islamic economics and finance to operationalize the system for realizing the objective of shared growth and broad-based welfare. This paper sets out to discuss the comparative economics of Islamic financing techniques viz-à-viz interest as well as markup rate, so it could be helpful while discussing activities without involvement of ribā and gharar. It is also to elaborate upon the priorities or preferences given to various categories of products by the scholars and the practitioners and the implications of the same in terms of economic role. Finally, it discusses the basic functions of the Islamic banks and non-banking financial institutions (IBFIs) and their role in enhancing social and financial intermediation in an Islamic economy.

This paper is based on interpretive approach that is used by the researchers for socially constructed theories (Eriksson & Kovalainen, 2008). Being a qualitative study, it uses the descriptive and analytical methodology based on the available information and data. Secondary data have been gathered from the available literature on Islamic law of contracts as could be used by the IBFIs to undertake business in line with the principles of Shariah. For analyzing the economic implications, it discusses the operational aspects of business techniques. Such qualitative research uses inductive reasoning and explores the potential of business tools in depth to discuss the research area (Creswell, 1998). The problem statement under the research areas as indicated above is:

> *"Exploring the potential role of different categories and tools of Islamic modes of business and finance in determining earning, consumption and investment behavior at the micro level and implications for shared growth and development at the macro level. It is to facilitate the policymakers, regulators, and the practitioners in Islamic finance to realign their strategies and processes to realize the higher purposes of Shariah".*

2. Literature Review

Literature on the subject pertains to the prohibitions and their impact on the business of IBFIs, investors, and the business community. Researchers have also written on features of Islamic modes of financing in terms of their comparative economic impact, the priority of some modes over others, and the linkage of money and finance with the real economy for balanced growth, The economists discussing finance have also explored the possible impact of Islamic modes in terms of socio-economic justice and sustainable development. Lately, some papers have been published on value-based intermediation (VBI), responsible and ethics-based finance, and Islamic social finance.

Haniffa and Hudaib (2007) argue that Islam permits economic activities for earning of profits or yield from any business activity while remaining within the limits of the Shariah. The phrase '*maqāṣid'* has been used in several contexts like the objectives, goals, and final objectives of Islamic law (Auda, 2013). Sadiq and Black (2012) indicated the features of Islamic finance as below:

> "The ban on interest, the ban on uncertainty or speculation, the ban on financing certain economic sectors, the profit-and loss- sharing principle and the asset-backing principle".

The other main features indicated by Sadiq and Black (2012) are the principle of risk and reward sharing based on the profit and loss (PLS) system and that of financing with the asset-backing. This is the original narrative of Islamic finance. Pakistan's Council of Islamic Ideology (CII), in its Report (1980) evaluated the techniques of Islamic financing as alternatives to conventional finance and declared the PLS as the best mode for business by the

IBFIs. It also discussed macro aspects of other possible business contracts including Murabaha, salam, istisnā and leasing. However, the CII did not discuss the impact of Islamic financing modes regarding microeconomic aspects. Some studies have been conducted to discuss the system based on *mudārabah* and *mushārakah* [(Siddiqi (1988), Habibi (1987), Chaudhury (1974), and Khan (1985). Of course, neither a thorough comparison has been made between the PLS and the debt-creating techniques, nor the implications of debt-creating modes on both macro and micro aspects have been discussed in detail.

Kahf (2011) indicates that finance can be provided through the sale and lease-based techniques, and by way of venture capital. Lending cannot be a technique to do business and charge on the amount given as a loan (Kahf, 2011). For the borrower, *Sharī'ah* discourages incurring debt except in cases of dire (basic) needs or when one is fairly sure of using the funds so received in any successful business adding value. But uncertainties implicit in the real sector businesses make such surety impossible. Debt could be created through trade transactions, but cannot be sold, discounted, securitized to generate further debt, or multiplied. Money creation, monetary base, or high-powered money largely depend on the debt markets rather than the investment markets (Al-Jarhi, 2013). In Islamic finance, therefore, debt cannot be created beyond the limits of actual or potential real sector development in goods and services.

Siddiqi (2021) argues that the focus of *fiqh* scholars has been on freeing the system from interest, but with little attention being given to the role of created money, and how money is created and managed. He argues that the role of debt needs to be drastically reduced, and that of PLS encouraged in finance and management of money. Wilson (2021) noted that the writers on Islamic economics largely neglected the discussion on money transmission mechanisms (in Islamic financing techniques).

All Islamic finance operations need to be linked to the real sector. Accordingly, there is a system of money creation and destruction, and credit multiplication (Krichene, 2021). The issue of money and credit creation has been discussed in the Chicago Plan suggested by a group of renowned Chicago professors in 1933. The 'Chicago Plan' suggested a monopoly for the government for issuing currency. It also suggested 100 percent reserves against checking deposits and prohibited the banks to create money (Krichene, 2021). "*The essence of the 100% plan is to make money independent of loans; that is to divorce the process of creating and destroying money from the business of banking….*": Krichene quoted Irving Fisher (1936).

There is controversy regarding the adoption or preference of various modes. According to the early authors, PLS modes should primarily be used by the IBFIs (CII, 1980; Siddiqi, 1973, p. 9). This debate is based on the two underlying aspects namely: the essential features of these modes, their possible role in decision making at the micro level and their macroeconomic implication about the impact on growth and development, stability, price level, employment, equity and income distribution (Ayub, 2020).

Ayub (2020) discussed all Islamic modes of business by dividing them into three categories and concluded that all are valid from the Sharī´ah perspective and the IBFIs could use them as per nature of the business and clients' requirements. Of course, IBFIs will have to do the real business - either purchase and sell (*murābaḥah*, *salam* or *istisna'a*) or give on rent, or become active partner (*mushārakah*) or passive partner (*mudārabah*) with their clients/entrepreneurs. These three categories are i) intermediation modes (*muḍārabah*, *mushārakah*, *qarḍ*, *wakālah* and service based modes; ii) investment modes like *muḍārabah, mushārakah*, and PLS based instrument, and iii) the financing modes (credit and forward sales and leasing as per Sharī´ah principles.

Lately, in Pakistan, there has been the use of mushārakah both by the banks (for working capital finance to the corporate sector) and 'Special Musharaka Certificates' (SMCs) for taking deposits at targeted rates and in the capital market for investment through commercial papers. But it is not the real mushārakah and in 100% of cases, a fixed predetermined charge is made by the banks or the financiers and paid to the SMC depositors. One such excessively used technique in Pakistan is 'Running Mushārakah' (RM) which involves fixed return charged by the banks just like the debts and, hence, cannot be considered as *mushārakah* based financing in real term (Tahir and Khan, 2016, Mansuri, 2020, Akram, 2019).

Lately, after the global financial crisis (GFC) of 2008, researchers have been suggesting that Islamic social finance and the moral economy are in line with the *maqāṣid al-sharī'ah* and corporate social responsibility (CSR) based financial services (Mergaliyev, Asutay, Avdukic & Karbhari, 2019). It is argued that Islamic finance refers to ethics and values-based system and as such, it has its specific impact in terms of growth, discipline and sustainability. The malpractices like lack of proper disclosure, black-marketing, hoarding, monopoly, short weighing and measuring, adulteration, false oaths, misrepresentation, deception, etc. are disliked in all value-based systems.

Few systematic studies have been conducted on comparative economics of various Islamic financing techniques discussing both micro and macro aspects. Some authors discussed the business of conventional financial institutions and some Islamic modes of business[1]. However, the area of comparative economics of various Islamic business and finance techniques has not been sufficiently explored. This paper tries to fill the gap and discuss the economics of Islamic financing techniques viz-à-viz interest so that the economists could guide the practitioners for a useful link between finance and the economy, economic growth and its impact on various groups in a society.

3. The Business Contracts and their Economic Features

The business contracts in Islamic law can generally be divided into (i) *Qard al hassan* which has to be returned without any increase; (ii) Partnership based modes of investment and financing, including *mushārakah*, *mudārabah* and their variants like equity in joint stock companies; (iii) Sale based modes like credit and forward sales allowing banks to purchase/sell goods while charging profit;

[1]. See Attia (1985), Mannan (1986) and Ahmad (1987).

and (iv) Rental-based modes. All above are the contracts that when executed create rights for and liabilities of the contracting parties.

Markup-based credit sales and *bai' salam* are debt creating modes, and debt so created has to be fully paid irrespective of the impact of the use of debts . While in in *ijarah* (of non-consumable assets), the rent is paid by the client, in PLS modes of financing, the fund user pays according to the end-result / product of the project finance by the IBFIs[2]. In that sense, *ijarah* can also be included in the category of non-debt financing techniques. The non-commutative contracts like loans & debts (*qard* & *dayn*), gifts, *kafālah* (guarantee) and *hawalah* (assignment of debts) are also useful tools in Islamic finance.

The nature of business transactions undertaken by the IBFIs determines the nature of return – valid or invalid. Any income sought on loans and debts is ribā and therefore prohibited. Banks, therefore, cannot adopt lending as a mode of business for earnings. Profits in credit or forward sales (*muajjal, salam*, *istisna'a* and *joala* contracts), and rent in *ijarah* are valid. Further, short selling that gives one invalid return/property without actual exchange, or any return taken without taking the business risk and established value addition are prohibited for the IBFIs (Ayub, 2007). Table 1 below shows the features of the main five Islamic modes of financing.

3.1 Micro and Macro Level Impacts of Financing Techniques

Discussion regarding economic role of Islamic modes of financing could broadly cover the areas as we discuss below:

3.1.1 Household Consumption-Savings Choice

While discussing the debt based financial system in comparison with the PLS system, some scholars are of the view that PLS techniques make the 'lender' i.e., the saver, worse off (Habibi, 1987; Rafi Khan (1984). This argument is based on the Shylockian behavior and considers only the 'lender's welfare, and not the other sections of the society. Further, this argument assumes that the PLS system means zero return for the savers, while Islamic finance does not mean zero return on savings (Ayub, 2007).

The fund user could be a little better off in the case of ijarah based financing compared to murabaha or *salam* based financing because of lesser repayment problems in ijarah than in trade in case the fund user suffers a loss in his project. The sale and rental based modes of financing have an advantage over PLS modes for the finance user. These can be utilized for meeting household consumption needs, unlike the *mushārakah* and *mudārabah*.

---

[2] This paper generally uses masculine pronouns etc. like he or his or him. But the theory is not
gender specific. It applies equally to men and women.

Table 1: Features of Islamic Modes of Financing

TECHNIQUES					
Techniques / **Features**	***Mudarabah***	***Musharakah***	**Leasing (Ijarah)**	***Bai'al Salam***	***Murabahah* (markup)**
Nature of financing	Investment based	Investment based	Rental based	Combination of debt and trading	Combination of debt and trading
Role of the capital provider in the management of Funds	Nil	Full control	Full control on the use of the funds	Nil	Full control on the use of the finance
Risk bearing by the capital provider	i) To the full extent of the capital as well as of the opportunity cost of capital. ii) For the entire period of the contract.	Same as in Mudarabah	i) To the full extent of the capital as well as of the opportunity cost of capital. ii) Until the asset completes its life or is finally disposed of.	i) To the full extent of the capital as well as of the opportunity cost of capital ii) Even after the expiry of the contract until the goods are finally disposed of.	i) To the full extent of the capital ii) Only for a short period until the goods are purchased and taken over by the finance user .
Uncertainty of rate of return	Complete uncertainty	Complete uncertainty	Complete uncertainty	Complete uncertainty	Uncertainty only for a short period of the contract
Cost of Capital	Uncertain ex-ante	Uncertain ex-ante	Fixed and predetermined	Uncertain ex- ante	Fixed and Predetermined
Relationship between the cost of capital and the rate of return on capital	Perfect correlation	Perfect correlation	Week Correlation	No correlation	Strong correlation but not perfect

Source: Author's own.

3.1.2 Firms' Investment Decision Making

In PLS modes the capital owner must share the profit according to the realized productivity, and bear the loss if any, as per the ratio of a partner in the joint capital. Accordingly, the possible return will play role in the allocation of funds for investment.

In corporate finance, the interest rate might not necessarily be determining the cut-off point for the selection of investment. Investment is made if the expected rate of return is greater than or equal to the actual rate of return in similar avenues. Modigliani and Miller (1980; pp. 30, 31) proved the irrelevance of interest rates in the context of corporate finance. In *mushārakah,* unlike in *mudārabah*, the fund provider can take part in the management of the business. Hence, the problems related to moral hazards can be controlled. In the case of *mudārabah,* the financier has the right to check the financial statements only.

The role of sales and lease based modes in investment decisions is like that of interest based financing. The fund user knows the amount that he is required to pay as the cost of using capital. For the financier, the investment decision depends on the rate of return that will be different from the cost of capital to be paid by the fund user, because the financier has to make an allowance for the uncertainties and related things. Therefore, there could be a divergence in the supply price and demand price of capital. The fixed amount of mark up or rent is not related to the profitability of the enterprise, Therefore, sale and *ijarah* based modes may not have a primary role in investment decision making, as *mudārabah* and mushārakah could have.

The argument that *mudārabah* financing entails an infinitely elastic demand for financing (Habibi, 1987) might not be very important unless we also consider the supply of funds under *mudārabah* and the simultaneity in the determination of supply and demand. This argument of infinitely elastic demand is due to the potential moral hazard, or the misconception that cost of capital under *mudārabah* is zero. The supply of *mudārabah* based financing will depend on the profit share of the financier provider. It will also depend on the expertise and skill of *mudārib*. Better the professional expertise, the higher would be the amount that the financier would be willing to invest with a *mudārib*. The profit sharing ratio (PSR) will depend on the risks involved in the project for which finance is being demanded, and the expected revenue. An equilibrium will be determined by the interaction of supply and demand of the capital.

The PSR will increasingly depend on the supply of capital because the risks of giving more funds to a single *mudārib* would be increasing at a higher rate. It may reflect the diminishing marginal entrepreneurship of an entrepreneur. As the productivity of the enterprise increases at a declining rate, as more and more capital is invested, a *mudārib* might demand financing to the extent where his income is maximum.

This rationale is also applicable to *mushārakah*. Since the financier also has right to take part in management of joint business, the supply of capital for a given expected rate of return on capital would be higher in *mushārakah* than in the case of *mudārabah*.

Regarding the debt creating modes, Ijarah based techniques are more advantageous to the capital user, vis-à-vis the sales-based modes because the asset is in the ownership of the financier and the user is responsible only for the payment of rentals and not for the capital asset itself.[3]

In the interest based system, investment decision-making requires that the last unit of investment brings a return at least equal to the rate of interest. It might be assumed that the PLS modes mean zero interest; and therefore, investment can be made until its marginal productivity becomes zero. It is not a correct approach as Islamic law of contracts does not imply that the opportunity cost of capital is zero; a firm will continue investing until the marginal productivity of capital becomes equal to the opportunity cost of capital, without taking into account the interest rate. In case the capital is scarce, the opportunity cost of capital in the Islamic framework, would be represented by the rate of return on alternate opportunities for investment of similar nature.

3.1.3 Role of Islamic Modes of Financing in Financial Intermediation

Financial intermediaries like banks and non-banking finance institutions play a crucial role in modern economies for enhancing efficiency. Islam also promotes efficiency and emphasizes doing any economic or production activity in the best possible way, of course within the Sharī´ah parameters. Producing goods for use and rendering services for benefit of the mankind and other creatures are considered commendable activities for Muslims. Below, we discuss the economic role of Islamic modes of business and finance, particularly regarding their role in financial intermediation.

To mobilize deposits and financial capital by any IBFIs, the most important technique is mudārabah (Ayub & Ibrahim, 2013). Practically, however, some deviation has been witnessed, and even organized tawarruq is used for booking fixed profit to the depositors in advance (Ayub, 2020). The bank, in the case of *mudārabah,* agrees with the depositors to share, in a certain ratio, the profits it makes, by using the funds of the depositors.

Banks offer different types of deposits to clients who choose any type of accounts category based on their risk taking profile. All *mudārabah* based deposits are exposed to risk, even in case of Current Accounts if entitled to get some return as currently IBIs in Pakistan are offering to the business community. Banks adopt different measures to minimize the risk by proper pool management and allocation of funds to different deposit pools based on depositors' risk profiles. Banks also spread investments to different sectors and a large number of clients on the assets

---

[3]. The finance provide may also prefer leasing over the marked-up techniques as the return in leasing (rental) could be kept variable, flexible and even floating over the period of lease; unlike the marked-up techniques, in which the profit margin once added to the price at the time of execution of the contract would finally determine the amount of profit for the financier.

side. Similarly, the nature of financing and assets determine the risk level – lower in the case of financing through debt creating modes, than in PLS-based financing or investments.

For financing and investments by the IBFIs, the researchers have generally been in favour of PLS modes as suitable techniques for business, mainly to achieve the objective of equitable distribution of wealth (CII, 1981; Chapra, 2008; Ayub, 2007). As the clients on the assets side would like to continue financial relations with the bank (as discussed earlier), banks would be able to find some such clients with which they might face a lesser degree of moral hazard implying that they may not be involved in management thus performing mainly the financial intermediation function.

In trade and lease based financing, of course, banks will involve in business by deviating from their conventional function. They are required to purchase the goods and assets for sale and/or leasing and bear all ownership related risks. In leasing, they need to keep assets in their ownership and risk for entitlement to rentals as they cannot charge rent if the asset is not in useable condition according to the market norm.

The mark-up based Islamic modes of financing could be more attractive to banks over leasing mainly because all ownership related risks are transferred to the clients as soon as the sale contract like *murabaha* is executed. The bank knows its profit as soon as the contract is executed, even though the bank's investment has not been fully recovered. However, the trading business is more than mere financial intermediation as in the case of conventional banking. But, this is an added discipline for sustainable business as a financial intermediary by avoiding overexposures as it happens in conventional finance leading to 'bubble &burst' scenarios.

In *salam*, the exact profit could be known only after the goods are received and sold in the market. The bank will only be forecasting the future market and prices. Further, the clients may not avail *salam* based financing in case they feel that the banks might be exploiting them by giving lower prices than the market prices at the time of delivery of goods.

Regarding liquidity of banks, the PLS modes would be limiting the short run liquidity levels unless time-bound equity instruments like participation term certificates (PTCs) and equity sukuk, tradable in the secondary market are made available. Leasing might create liquidity related problems more than the PLS modes because it generally entails higher returns in case of lengthier leasing period. However, securitization of assets under a lease is suitable for liquidity management by the banks as the leasing based sukuk can be exchanged in the secondary market.

Murabaha based short-term financing is better for the banks, vis-à-vis the partnership or leasing based modes, in terms of liquidity management. In case the *salam sukuk* are issued by the *salam* seller for delivery of the goods in the short run, it could be better for liquidity management than in the case of *ijarah* based financing. Still, the *salam* would be less useful than the *murābaha* financing due to the time lag involved in the delivery of goods as agreed between the parties in the *salam* contract.

3.2 Macroeconomic Implications of Islamic Financing Techniques

The macroeconomic implication of Islamic financing modes can be discussed briefly about the growth of economy and development, the impact on inflation, employment opportunities, poverty alleviation, the pattern of income distribution in the economy, justice concerning return to various factors of production, and sustainability.

3.2.1 Growth and Development

In terms of the modern concepts of financial intermediation and resource mobilization for growth, banks mobilize saving from household and corporate sectors for financing the commodity producing and business sectors. The institution of ribā/interest is performing the function of savings mobilization, but it is also channelizing the resources to such activities that might be non-productive, or injurious to the economy and the society. It may also be facilitating the holders of financial capital in earning money from money without involving in any real sector business, and production activity. It also leads to consumerism in the economy with many socio-economic implications.

The Islamic finance intermediaries need to focus primarily on the financing of production, not consumption. For this purpose, the PLS techniques are suitable for providing the risk-bearing capital for productive activities in the economy. These techniques are suitable for entrepreneurs who may provide skill sets and services for production and growth with the finance of surplus families and corporate entities in the economy. The availability of risk-bearing capital could be an engine of growth and development (Siddiqi, 1973 and 1983; Khan, 1986 and Mannan, 1984). Of course, the liquidity related problems in PLS modes, as discussed above, may not allow the risk based funds to be invested for the long term projects.

PLS techniques might not be leading to the formation of fixed assets and infrastructural development in case these are used in trading activity. A clear case in this regard is that of running *mushārakah* (RM) as being used in Pakistan for financing the corporate sector for working capital needs. In RM a bank gets a fixed charge and hence it cannot be considered mushārakah in real terms. Rather, it is a complete replica of the interest based 'Over Draft' facility (Mansuri, 2000; Akram, 2019). Hence, its impact is like that of interest.

Ijarah could be useful in capital formation in the economy, but the banks and the NBFIs might be using it primarily for financing the consumption of durable goods. Hence, leasing would require purposeful regulatory instructions to make it a source of capital formation. Further, leasing is conducive for medium and long-term investment by way of *ijarah sukuk* for financing the installation of plants, and projects like energy creation, roads, dams, and railways. *Murabaha* and *salam* are less conducive to capital formation in an economy vis-à-vis *istisna'a*.

3.2.2 Islamic Financing Techniques and Inflation

Mudārabah and *mushārakah* used for financing production-oriented activities would not be causing demand-pull inflation as they would be adding to the available goods in the economy. Any modes and techniques that are used for financing consumption might be generating inflation due to increased demand for such goods. Leasing and to some extent trade-based modes can generate cost-push inflation due to higher demand for consumption goods.

3.2.3 Equity, Income Distribution, and Poverty Alleviation

Financial capital and institutions in the interest-based framework have increased their share vis-a`-vis the non-financial sources and institutions also including human resources. The human resources who do not have funds or do not have access to finance from the financial intermediaries have no option but to work as wage earners. The entrepreneurial activities leading to increased employment opportunities and production cannot flourish because of the lack of access to capital due to the involvement of interest, particularly in an Islamic economy, and that of collateral demanded by the banks. Lack of capital at affordable rates, and the terms not conforming to Islamic principles keep many potential entrepreneurs, particularly the female population, away from cottage industry and SMEs. If the human resources belonging to these categories are provided finance, they could play a crucial role in employment opportunities and the production of goods for export and internal use in any economy. Accordingly, Islamic financing techniques can be used not only for self-employment in trade, handicrafts and cottage industry, software industry, etc. but also for offering employment to others. The following could be implications of Islamic modes of financing in enhancing the income of the poor and middle classes in any economy through promoting entrepreneurship:

a) *Mudārabah* is the best technique for financing those who have entrepreneurial capabilities but do not have finance. *Mudārabah* for trade business would be suitable for traders enabling them to earn their livelihood and also contribute to the growth of the economy by way of an efficient exchange system.
b) *Mushārakah* would serve the same purpose for those who may have some capital, insufficient for any useful project.
c) Both *mudārabah and mushārakah* could lead to the broader circulation of wealth and hence provide better opportunities for potential entrepreneurs lacking capital.
d) *Ijarah* and sale based modes can be useful in providing earning opportunities to traders and producers. However, the low-income groups may not be able to afford the fixed cost of capital involved in these modes, particularly in the early stage of the business. Leasing-based contracts can especially have a good impact on enabling entrepreneurs to do business. They pay a fixed amount of rent and keep the business proceeds. Since trading-based financing creates debt,

which has to be paid irrespective of what the business would earn, such financing may not be as fruitful as *PLS based* and leasing-based modes in reducing income inequalities where the labor supply is abundant, and capital is extremely scarce.

3.2.4 Islamic Financing Techniques and Economic Stability

The application of *mudārabah* or *mushārakah* for mobilizing deposits by Islamic banks renders the banking system stable (Khan, 1987). As the deposits are taken mainly on *mudārabah* basis, any problem on the financing side may not create crisis in the short run. Pricing of financial capital on PLS basis would help maintain equilibrium in the supply and demand of capital for the entrepreneurs.

The profit sharing ratio in PLS modes of financing would serve as a policy variable for maintaining stability and growth momentum. While the rate of interest may not affect investment decisions, sharing based rate of return will certainly have effective.

The debt creating techniques, particularly the markup-based sales, are closer to interest-based financing for the user of the funds. Therefore, these might not lead to the results in respect of stability, similar to the impact of PLS based system.

4 Islamic Finance Techniques and Money (Credit Creation)

The creation and exchange of money in any economy have crucial implications for the rights and liabilities of parties to exchange and various stakeholders in that economy. In this perspective, the Islamic system of finance provides such built-in rules ensuring that money and credit in any economy do not become a cause of concern. In principle, the intermediation based *mudarabah* and *musharakah* may lead to lesser monetary expansion than the debt finance might create (Siddiqui, 1992),

Money must not be created except for exchanging the goods available in an economy or economy's potential based on the principles of valid forward exchange (*salam, istisnā and joāla)*. Any amount of money created beyond that limit, if needed, must belong to the whole nation, and not to the banks. The application of Islamic principles in letter and spirit could help in disciplining the system of money and credit.

A crucial step to be taken in this context is to adopt a law that money cannot earn a return without its involvement in real business activities based on the law of property (*māl*) and its exchange. It requires that all money and finance transactions must take the genuine business risk and add value for parties to exchange and the economy. As all civilized communities and nations believe in good ethics, justice, fair play, and harmony, adoption of such law should not be a problem. For Islamic banks and financial institutions, money must not be created except for exchanging the goods available in an economy or economy's potential based on the principles of *salam*. It is up to the regulators, however, as to how they implement this crucial policy principle.

5 Economic Role of Islamic Finance Techniques as Currently Practiced

Regarding Islamic finance as being practiced, financing by Islamic banks is based generally on sales contracts only formally. As indicated by Nienhaus (2018), the contracting parties, particularly the IBFIs do not have any substantial interest in the physical delivery of the subject matter of trade.

Against the claims made in theory that PLS techniques are superior and the real modes of financing, Islamic banks consider the sales and *ijarah* based modes as the most suitable for financing activities. Lately, Islamic banks in Pakistan have started using RM for working capital finance to the corporate sector. But, as indicated earlier, RM cannot be considered *mushārakah* based financing in real terms (Mansuri, 2020; Tahir & Khan, 2016,).

To economists generally, the problem of minimal use of PLS modes is due to informational asymmetry and the information cost that might be involved particularly in *mudārabah*. This presumption, however, does not take into account the root cause of the problem. Conventional finance does not require much information due to the collateral and, therefore, there is no information cost in interest based financing (Green, 1987). Therefore, the issue of information cost has to be resolved by comparing the benefits of PLS techniques with the costs of the system as a whole. In a bank-client relationship where any client would not like to have only a one-time relationship with the bank, this issue would not be as significant. Further, in a competitive situation where many clients might be wishing to get scarce risk-bearing financing, the problem would not be as important as credibility and integrity. Accordingly, the market can also take care of the problem of informational asymmetry.

Some loss can be attributed to a degree of informational asymmetry in almost all transactions. We observe that even then the transactions take place in the market because the benefits could be more than the cost. For the sake of a continued relationship with the bank for getting finance for the business in a competitive market, the informational asymmetry would be much less than in many similar cases. The existence of the market for lemons (Akerlof, 1970) and that of the used cars establishes that only the informational asymmetry might not be a hindrance in the use of PLS modes of finance.

5.1 Availability of Risk-Free Finance – A Cause of Non-Adoption of Equity Finance

The availability of risk-free avenues of investment and financing in a mixed system could be one major factor behind the banks' avoidance from the PLS-based financing. Therefore, banks have avoided the real *mushārakah* even by doing RM for working capital finance to the corporate sector.

Certain rules and institutions have to be there in every market to minimize the fraud chances arising from information asymmetry. Therefore, the rules, regulations and institutions have to be introduced and effectively implemented to restrict the possibility of fraud (Flath, 1980). There could also be an incentive system to persuade the clients to disclose all required information.

5.2 Need for moving to Value-based finance

All functions relating to the recently emerging value-based finance and CSR are the objective of Islamic finance as well. Therefore, the IBFIs must turn to social welfare in general and value-based intermediation (VBI) and CSR in particular. Their Sharī´ah boards must avoid dependence on jurisprudential technicalities to replicate the conventional finance products. It would enhance the economic implications of banks' financial services and provide opportunities for sustainable growth (Refinitiv, 2019; ICD-Refinitiv, 2019, Ayub, 2015).

The "*Global Alliance for Banking on Values*" [GABV] has also recommended the VBI principles targeting at serving the real economy, long-term relationships with clients, resilience to outside disruptions, and transparent and inclusive governance (Refinitiv, 2019).

6 Summary and Conclusion

The article discusses the economic implication of all major Islamic modes of financing. However, it does not discuss the macroeconomic modeling. The philosophy behind the prohibitions of *ribā*, *gharar*, and short selling is to discipline the market, enable the establishment of justice, and eliminate exploitation of any of the parties to the contracts, or the members of society. It refers to the ethical foundations of the Islamic financial system which can facilitate achieving prosperity and fair distribution of income and wealth among the society by way of enhancing financial and social inclusion (Ali, 2017; Ayub, 2015). It requires that all contracts of the IBFIs must have economic substance, in addition to Shariah compliance in the letter.

Many types of modes and techniques are available for providing finance by involvement in the production and business process. It provides flexibility to investors and fund users to manage according to their requirements as the bank can provide financing by way of trading, leasing, and equity based modes and instruments.

Islamic countries' economies like other present-day economies are operating under an interest-based financial system with the same intermediaries and instruments as being globally operated. However, many IBFIs are operating in almost all areas of the world. They have experienced considerable growth worldwide in terms of deposits and assets over the last 50 years, but the system shows little signs of achieving maturity and achieving the objectives of the Islamic economic system.

The philosophy of Islamic financing techniques requires a responsible and ethical approach, which is currently taken in global finance as a way of sustainable resource management as could be observed in the UN's SDGs agenda for 2030. But the issue is that Islamic finance, conceptually based on social and ethical concepts, deviated practically from its theory and paradigm.

IBFIs are required to link finance with the business through any of the valid modes. It could be by ways of trading and lease based modes or the perpetual and time-bound equity (sukuk and Participation Term Certificates). An issue, however, is that Islamic banks are increasingly adopting gray area products that "*result from determined refusal to adhere to the decisions of the International Islamic Fiqh Academy*" (Al-Jarhi, 2013).

Financial markets attract households to provide their savings that are used by private and public enterprises as capital. The Islamic financial market helps the finance providers as well as users by collecting and disbursing funds that are used in real economic activity. Unlike conventional markets, in Islamic finance, the finance providers and users both get benefits as it is based on risk and reward sharing, and every transaction must be linked to any production or real business activities. This approach fits into the philosophical foundations of Islamic finance to realize the objective of achieving financial and social inclusion, justice, and equity.

References

Abdullah, D. V; & Mirakhor, A. (2012). Moral foundation of collective action against economic crime; paper presented at 30th International Symposium on Economic Crime; KL; September 3.

Akerlof, G. A. (1970). The market for lemons: quality uncertainty and the market. *Quarterly Journal of Economics. MIT Press*. *84* (3): 488–500.

Akram, M. (2019). Running mushārakah-based working capital finance; Case study from Pakistan. *Journal of Islamic Financial Accountancy (JOIFA), 3*(1), 46-55.

Ali, S. N. (2017). Moving towards community driven Islamic finance. *Journal of Islamic Business and Management*, *7*(1), 11-27.

Al-Jarhi, Mabid Ali (2013). Gaps in the theory and practice of islamic economics; JKAU: Islamic Econ., 26(1), 243-254 (2013 A.D./1434 A.H.) DOI: 10.4197 / Islec. 26-1.11

Anwar, M. (1987). *Modelling Interest-Free Economy: A Study in Macroeconomic and Development*, Washington D.C.: The International Institute of Islamic Thought.

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

Assa, J. (2012). Financialization and its consequences: the OECD experience, *Finance Research*, 1(1), 35-39

Attia, G. (1985), *Financial Instruments used by Islamic Banks*, paper presented at the Islamic Banking and Finance Conference, London.

Ayub, M. (2007). Understanding Islamic Finance; John Wiley and Sons, London.

Ayub, M. & Ibrahim, S. H. M., 2013. Profit and loss distribution and pool management framework for IBIs in Pakistan: Progress, issues and implications. *Journal of Islamic Business and Management,* 3(1), 51-70.

Ayub, M. (2015). Financial inclusion: Social inclusion with its true paradigm to be the target! *Journal of Islamic Business and Management, 5*(1), 2-13.

Ayub, M. (2016). Running Mushārakah' by Islamic banks in Pakistan: Running from mushārakah or moving back to square One. *Journal of Islamic Business and Management, 6*(1), 7-18.

Ayub, M. (2019). Islamic finance crossing the 40-years milestone – the way forward; Intellectual Discourse, IIUM, 26:2 (2018) 463–484.

Ayub, M. (2020). Issues in theory and practice of Islamic finance and the reform agenda. *Journal of King Abdulaziz University Islamic Economics (JKAU-IE), 33*(2), 87-98.

Chapra, M. U. (1985). *Towards a Just Monetary System*, Leicester, U.K.: The Islamic Foundation.

Chaudhury, M. A. (1974). A Mathematical Formulation of Mudārabah and Profit-sharing in Islam. Proceedings of the Third Regional Conference of Muslim Social Scientists of the US and Canada, Muslim Trust, Indiana.

Creswell, J. W. (1998). *Qualitative inquiry and research design: Choosing among five traditions.* Sage Publications.

Council of Islamic Ideology (1980). *Report on the Elimination of Interest from the Economy*, Islamabad, Pakistan;

Eriksson, P. & Kovalainen, A. (2008). *Qualitative methods in business research.* Sage.

Fisher, I. (1936). 100% Money and the Public Debt, New York: Adelphi Company

Flath, D. (1980). The Economics of Short-term Leasing, *Economic Inquiry*, Vol. XVIII

Green, T. L. (1987). *Corporate Finance*, New York: Putnam.

Habibi, N. (1987). *The Economic Consequences of the Interest-Free Islamic*

Haq, N & Mirakhor, A. (1985). Optimal Profit Sharing Contracts and Investments in an Interest-Free Economy Banks. Paper presented at the Islamic Banking and Finance Conference, London.

Haniffa, R., & Hudaib, M. (2007). Exploring the ethical identity of Islamic banks via communication in annual reports. *Journal of Business Ethics, 76*(1), 97-116.

ICD-Rifinitiv (2019); Islamic Finance Development Report, Shifting Dynamics. https://icd-ps.org/uploads/files/IFDI%202019%20DEF%20digital1574605094_7214.pdf

Khan, M. S. (1987), "Islamic Interest-Free Banking: A Theoretical Analysis" in Mohsin Khan and Abbas Mirakhor (1987).

Khan, M . F. (1987). *Discounting for Time Value of Money in Islamic Finance*

Khan, M. A. "Capital Pricing and General Equilibrium in Islamic Framework", paper presented in the International Seminar on Monetary and Fiscal Economics of Islam held in Islamabad in 1981 under the auspices of Planning and Development Division, Government of Pakistan.

Khan, M. F. (1986). *Development Strategy in an Islamic Framework*, paper presented in the International Seminar on Fiscal Policy and Development Planning held under the auspices of International Institute of Islamic Economics, Islamabad.

Khan, S. R. R. (1984). An economic analysis of a PLS model for the financial sector, *Pakistan Journal of Applied Economics*, 3, 89-1.05

Khan, W. M. (1985), *Towards an interest free economic system*, Leicester: The Islamic Foundation and International Association for Islamic Economics.

Krichene, N. (2021). Islamic economics: Where from, where to? Comments and reflections, JKAU: Islamic Econ., Vol. 27 No. 2, pp: 93-107 (2014A.D./1435A.H.) DOI: 10.4197 / Islec. 27-2.6

Latif, B. (1987). Inflation caused by monetary functions in both Islamic (Interest-Free) and non-Islamic (Interest Based) banking system, paper presented at special seminar on Islamic Finance and Banking. The International University of Japan, Tokyo, (November).

Mannan, M. A. (1984). Mobilizing Mudārabah's Other Half, " *Arabia*, July 1984.

Mansuri, M. T. (2020b). *Maqāṣid al* Shari’ah: A valid paradigm for Shari’ah opinions in Islamic finance. *Journal of Islamic Finance Accountancy*, 5(1), 40-53.

Mergaliyev, A., Asutay, M., Avdukic, A., & Karbhari, Y. (2019). Higher ethical objective (maqasid al-shari’ah) augmented framework for Islamic banks: Assessing ethical performance and exploring its determinants. Journal of Business Ethics. Retrieved from: https://bit.ly/3jrvcWY

Modigliani, F. & M.H. Miller (1980). The cost of capital, corporate finance and the theory of investment, in A. Abdel (ed. (*The Theory of Finance and Other Essays* ,Vol. 3, Cambridge: The MIT Press.

Nienhaus, V. (1983). Profitability of Islamic PLS banks competing with interest banks: Problems and prospects, *Journal of Research in Islamic Economics*, 1(1), 37-47.

Nienhaus, V. (1985). Principles, problems and prospects of islamic banking, *Islamic Perspective*, Islamabad: International Institute of Islamic Economics.

Nienhaus, V. (2018). International regulatory standards for islamic banking, *Yearbook of Islamic and Middle Eastern Law Online*, *20*(1), 141-162. DOI: https://doi.org/10.1163/22112987_02001008

Rajan, R. (2012). Fault lines-how hidden fractures still threaten the world economy; Princeton University Press, Princeton, and Oxford.

Refinitiv (2019). Islamic finance ESG outlook 2019: Shared Values; https://www.refinitiv.com/content/dam/marketing/en_us/documents/reports/islamic-finance-esg-outlook-2019-report.pdf

Siddiqi, M. N. (1973). *Banking Without Interest* ,Lahore: Islamic Publications.

Siddiqi, M. N. (1988). Islamic Banking: Theory and Practice, in M. Ariff (ed ,(.*The Muslims of South-East Asia* , Singapore: Institute of South-East Asian Studies.

Siddiqi, M. N. (2007). *Economics of tawarruq: How its Mafasid overwhelm the Masalih;* Workshop paper held in Feb. 2007: http://www.siddiqi.com/mns/ Economics _of _*Tawarruq*.pdf

Tahir, S. & Khan, A. (2016). Islamic banking: Why not mushārakah financing? *Journal of Islamic Business and Management,* 6 (1), 61-74.

Wilson, R. (2011). *The Determinants of Islāmic Financial Development and the Constraints on its Growth*", IFSB 4th lecture on financial policy and stability.

Wilson, R. (2021); Islamic Economics: Where from, where to? JKAU: *Islamic Economics*, 27(2), 77-83 (2014A.D./1435A.H.) DOI: 10.4197 / Islec. 27-2.4

World Bank and Islamic Development Bank Group (WB-IDB, 2016); *Global Report on Islamic Finance: Islamic Finance: A Catalyst for Shared Prosperity.* Washington, DC: World Bank. doi:10.1596/978-1-4648-0926-2

Zarqa, M. A. (1983). Stability in an Interest free economy: A note, *Pakistan Journal of Applied Economics,* 2(2), 181-88.