Islamic Finance

Money, credit and the rate of interest: how today's global financial architecture blocks Islamic Finance

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The notes from a lecture to The Oxford Centre for Islamic Studies in November 2014, the author discusses usury, interest rates, and the creation of money - and how Keynesian monetary theory and policy could embed a Koranic model of finance.

Introduction

It is timely to be addressing an issue that is a matter of great importance in Islam: riba. But first, while I want to begin by referencing riba, I must explain that my qualifications for discussing this aspect of Islam are questionable (to put it mildly). I am not a scholar of Islam or of Islamic banking, but I have for a long time admired the way in which Islam has upheld the principle of riba – even while it may be watered down and diluted by Islamic Finance practitioners.

So as someone who is only an observer of, not a student of Islamic Finance – may I beg your forbearance as I plunge into a subject at the heart of my work: rates of interest. I have a deep interest in the nature and pricing of money and of credit, and therefore of debt – and have spent many years studying, writing and campaigning on the subject of debt and interest. At the heart of both is the issue of social and economic justice – not to mention moral obligations and religious principles. This is why it is important to pay attention to credit, interest and debt.

I spend much time thinking and writing about the *economics* of money, credit and interest, and that is what I want to major on today. Frederick Soddy, a chemist by profession, had this to say about debt way back in 1920:

> "Debts are subject to the laws of mathematics rather than physics. Unlike wealth, which is subject to the laws of thermodynamics, debts do not rot with old age and are not consumed in the process of living…
>
> "On the contrary (debts) grow at so much per cent per annum, by the well-known mathematical laws of simple and compound interest... The process of compound interest is physically impossible, though the process of compound decrement is common enough... the former (increment) leads to infinity, which like minus one is a mathematical not a physical quantity... whereas the latter (decrement) leads to zero... the lower limit of physical quantities."
>
> Frederick Soddy (1877- 1956) From "Science and Life" 1920

Interest rates on payday loans recently hit the British headlines, as the Financial Conduct Authority belatedly announced a cap of 0.8% per day on amounts borrowed from payday lenders such as Wonga.

An "Alice in Wongaland Economy"

Back in June 2013 I found myself inadvertently launching a campaign when, while interviewed on the Today Programme I mentioned that Britain was being transformed into an 'Alice in Wongaland economy'. The phrase struck a nerve and went viral. The Wonga CEO's office approached me and sought a meeting. The invitation was declined but my researcher visited their offices to find out more. They ended the meeting by making a polite request that we refrain from using the phrase: "Alice in Wongaland economy".

We refused, for good reason. Back then, in June, 2013, Wonga's updated representative APR rate on its loans was 5,853% p.a. Just a reminder: the *Annual Percentage Rate* takes into account not only the interest rate charged on a loan, but also other charges or fees. "*Representative Annual Percentage Rate*" means 51% of successful applicants will be given the advertised interest rate. The rest will most likely get a higher rate.

This rate – 5,853% - is not unusual for payday lenders. According to some sources payday loans (before this week's FCA announcement) ranged from 1,000% to 6,000% Average Percentage Rate per annum.

A simple way of thinking about this rate is by imagining how many pence would be paid in interest, over a year, for every £1 borrowed. A 60% APR would mean that for every £1 borrowed, 60p in interest would be owed per annum. A 600% APR means that for every £1 borrowed, £6 would be owed in interest. The borrower would have to repay £6 for the initial £1. At 6,000% APR (effectively, WONGA's rate) the borrower would have to repay £60 per annum for every £1 borrowed.

While most Wonga borrowers to do not borrow for as long as a year, that interest rate is usury, plain and simple – and explains why Wonga has been so astonishingly profitable.

The principle of "Sabbath economics"

My interest and study of these aspects of the economy arose from my involvement in the design and implementation of the Jubilee 2000 campaign – a global civil society social movement that resulted in about $100bn (in nominal terms) of sovereign debt being cancelled for 35 countries between 2000 and 2005. Later I advised the Nigerian government on its debt negotiations at the Paris Club in 2005, which resulted in $30bn of Nigeria's debt being cleared – which the finance minister argued would lead to savings of $47bn for Nigeria over the following years.

The guiding principles of the Jubilee 2000 campaign – and the principles that guide my own work (and indeed that of Adam Smith and many other economists) were grounded in Judaic and Christian law – based on biblical

ethics relating to human rights, debt forgiveness, opposition to usury, and the need for periodic corrections to imbalances – the Sabbath and Jubilee principles.

I was personally unfamiliar with the biblical laws and principles underpinning the concept of Jubilee before launching into the campaign. I had always taken Jubilee to refer to a celebration of e.g. the Queen's fiftieth wedding anniversary. Instead the principle arises from what the theologian Ched Myers has called Sabbath economics. That is, the biblical laws and prescriptions that underpin periodic correction to imbalances.

Every seventh day of the week, as outlined in Leviticus 25, both*, labour a*nd the *land* – in the broadest senses – were – and are to be rested. There is to be no exploitation of either land or labour on that day, according to the law of the Sabbath.

Every seven years, *the land* is to be rested – so that it can recover. According to scriptural practice as outlined in Exodus 23:10-11, there is to be no pruning or planting in the Sabbath year, no attempt to kill insects… the fruit have to remain in the field, except for what passersby, servants, the poor or owners can pluck to eat.

Violation of the Sabbatical Year's land rest is considered such a serious transgression that it is specifically listed as one of the sins that led to the Israelites being conquered and expelled to the land of Egypt.

The concept of the seven year Sabbath should be extended to all forms of labour but today it applies mainly if not exclusively to just one group: academia. The biblical principle and application of *the sabbatical* is alive and well in universities – ironic given that most academics disdain religious doctrine.

Every seven times seven years, in the 49th year, slaves were to be freed, land restored to its rightful owner and debts written off - so that a new beginning could be forged – and balance restored. This new balance was to be celebrated – "Sound the Trumpet of Jubilee!" - in the fiftieth year, the Jubilee Year. The Jubilee principle has always inspired those rising up against colonisers, slavers and slavery. Philadephia's "Liberty Bell" has an inscription from Leviticus 25:10: which refers to the Jubilee:

"Proclaim Liberty thro' all the Land to all the Inhabitants thereof"

The Jubilee 2000 campaign drew on what Ched Myers called the

> "Hebrew Bible's vision of Sabbath economics (which) contends that a theology of abundant grace and a communal ethic of redistribution is the only way out of our slavery to the debt system, with its theology of meritocracy and private ethic of wealth concentration".[1]

The principles and ethics underpinning the Jubilee 2000 campaign resonated with Muslims and other peoples of faith and with those of no faith at all. Because of the Jubilee 2000 campaign, worldwide opposition was mobilised against a modern form of usury – operated at an international level - which effectively traps innocent citizens and whole nations in debt bondage to foreign creditors.

It is because of my work in sovereign debt, and how interest can amplify and compound debt, that I have come to admire the work of the Islamic finance sector in trying to uphold Koranic opposition to the practice of usury. These efforts are particularly commendable given that they are undertaken within the framework of today's 'liberalised' and as a consequence, 'financialised' global economy.

Usury and Today's Masters of the Universe

It is my view that society is confronted daily by usurious practices that are on a historically unprecedented scale. The Medicis, in my view, would have envied the freedom enjoyed by today's Masters of the Universe - financiers, bankers and payday lenders to the world, whose "liquid" finances roam the world, largely unfettered by regulation or law.

As Michael Hudson and Derek Bezemer argue in a recent paper:

> "In the real world most credit today is spent to buy assets already in place, not to create new productive capacity. Some 80 percent of bank loans in the English-speaking world are real estate mortgages, and much of the balance is lent against stocks and bonds already issued.
>
> The share of bank lending that goes to the 'Finance, Insurance and Real Estate' (FIRE) sector, aka the nonbank financial sector… has quadrupled since the 1950s. The contrast is with lending to the real sector, which has remained about constant relative to GDP. This is how our debt burden has grown.

[1] In Sojourners magazine: July-August 1998 – "Jesus' New Economy of Grace – the biblical vision of Sabbath economics"". Second of two parts.

> Extending credit to purchase assets already in place bids up their price. Prospective homebuyers need to take on larger mortgages to obtain a home. The effect is to turn property rents into a flow of mortgage interest. These payments divert the revenue of consumers and businesses from being spent on consumption or new capital investment. The effect is deflationary for the economy's product markets, and hence consumer prices and employment, and therefore wages. This is why we had a long period of low cpi inflation but skyrocketing asset price inflation. The two trends are linked."[2]

While there is considerable unease within society and between societies; while there is an understanding that those operating in the FIRE sector, or on what Peter Kellner of YouGov has called Planet Croesus [3] are reckless; while we understand that these players are beyond the reach of governments and regulators – not to mention priests, archbishops and Popes; while there is a sense that things are not right, that our world is unbalanced and unfair - nevertheless the reality of usury – and *the scale* of usury - remains concealed from the wider public. It is hidden by modern finance's deliberate masking and obfuscation of its activities, often in collusion with governments that are willing to play the role of liberalizer, and tax haven. The complexity, opacity and volatility of modern finance is the thing that enables the self-proclaimed Masters of the Financial Universe to amass capital gains on an unprecedented scale. It also enables financial speculators to periodically pose systemic threats to society, the economy and the ecosystem.

This makes the principles and ambition behind Islamic finance all the more relevant, in my view, to the restoration of financial stability and social justice.

As a result of this pursuit, I have been invited to share platforms with many Islamic Finance practitioners over the past few years, and have learned more about the challenges faced by the sector.

Islamic Finance is a system of banking operating within *a liberalized, de-regulated economic framework* that is entirely hostile to the values and principles of, for example stakeholder engagement and responsibility, upon which Islamic banks have been established. As a result, Islamic financial institutions find themselves unable to compete with western financial institutions that do not operate under similar ethical principles, or the prohibition against usury. Indeed usury is positively encouraged under today's liberalized and globalized economic framework.

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[2] *Incorporating the Rentier Sectors into a Financial Model*, by Michael Hudson, University of Missouri at Kansas City & Levy Institute, USA and Dirk Bezemer, University of Groningen, Netherlands. World Economic Review Vol 1: 1-12, 2012. file:///Users/annpettifor/Dropbox/Hudson-and-Bezemer%20Rentierism2012.pdf

[3] In the YouGov Cambridge University *Public Trust in Banking Report,* published 17 April, 2013 and found here: http://yougov.co.uk/news/2013/04/17/special-report-public-trust-banking/

If Islamic finance or banking is to be made to work, then its practitioners will have to help in the creation or re-creation of an alternative economic framework, within which Islamic finance could operate safely and even profitably - One which honours and safeguards stakeholder finance (with both lender and borrower sharing risk); and low or zero rates of interest as the price of borrowing funds.

The flawed understanding of money and credit

Most orthodox, classical or neoliberal economists would have us believe that banks and bankers are mere 'intermediaries' between borrowers and savers. Most would have us believe that *savings* are needed for (and prior to) investment, that loans are made from deposits and that the price of money – defined as the '*natural rate of interest*' – is a function of the supply and demand for money.

Many have known since before the founding of the Bank of England in 1694 that none of this true. This includes economists such as John Law (1671 – 21 March 1729), John Maynard Keynes (1883 – 1946), Josef Schumpeter (1883 – 8 1950), JK Galbraith (1908 – 2006). But also contemporary economists such as Victoria Chick, Geoff Tily and Cullen Roche; and prominent sociologists (such as Geoffrey Ingham), central bankers, commercial bankers, presidents and politicians.

Private bankers are *not mere intermediaries*. Savings are not needed for deposits. Savings are *not needed* for investment. Bankers do not lend the deposits of their customers on to borrowers. Bankers do not use their reserves 'parked' in central banks to lend on. Reserves occur *as a consequence* of a bank making a loan. The money for a loan is not in the bank when a borrower applies for a loan. It is the application for a loan – by many hundreds of thousands of borrowers – that creates new money, expands the money supply and with it purchasing power and economic activity. And by the same logic, it is the reluctance to apply for loans that *contracts* the money supply, and limits purchasing power and economic activity.

Bank credit-money is produced out of nothing more than the promise of repayment. Bank money issued as credit does not exist *as a result* of economic activity. Instead, bank money *creates* economic activity. Credit creates purchasing power. Private bank loans issued by commercial bankers (by a stroke of the computer keyboard) *create deposits*.

It is the loan application together with the borrower's promise of both collateral and repayment over a specified period of time that creates deposits – as Paul Sheard, the chief economist of Standard and Poor's, explains:

> "Banks lend by simultaneously creating a loan asset and a deposit liability on their balance sheet. That is why it is called credit "creation"-- credit is created literally out of thin air (or with the stroke of a keyboard). The loan is not created out of reserves. And the loan is not created out of deposits: Loans create deposits, not the other way around."[4] Paul Sheard

After a risk assessment, credit or money or finance is created by simply entering a number into a computer, and charging the sum to the borrower's account. (In bygone days this bank transfer was made using a fountain pen or quill to make an entry into a ledger. It was then known as 'fountain pen money'.)

Of course, the loan is underpinned by the legal system, the criminal justice system, the system of accounting or double-entry bookkeeping and the monetary system. The borrower offers collateral, signs a contract, and promises to repay over a term, at a particular rate of interest.

The overwhelming bulk of credit so created is 'bank money' and exists as nothing more than a promise to repay over an agreed period of time. At the most tangible, it is the quantities expressed on a bank statement.

> In the Eurosystem, money is primarily created through the extension of bank credit… The commercial banks can create money themselves.[5] Bundesbank

> The Euro's introduction in the form of notes and coins dated from 2002, but it existed as a means of setting prices, contracting debts & a means of payment for over a year before embodied in these media of exchange.[6] Geoffrey Ingham

Think of your credit card. There is no money in most credit card accounts before a user begins to spend. All that exists is a contract with the bank to repay the debt created by the spending at a certain rate of interest, and over a specified time. Your spending 'out of thin air' (on e.g. an appliance) gives you purchasing power and creates economic activity, in the sense that it creates demand for that product, and encourages the manufacturer to employ more people, to create more products.

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4 *Repeat After Me: Banks Cannot And Do Not "Lend Out" Reserves*. Paul Sheard New York Standard and Poor's 13 August, 2013. Online: http://www.standardandpoors.com/spf/upload/Ratings_US/Repeat_After_Me_8_14_13.pdf [accessed 3/10/2013, 12:57 GMT].

5 *The Chicago Plan Revisited.* Jaromir Benes and Michael Kumhof: International Monetary Fund/Bank of England presentation March 7, 2013. Online: http://www.bankofengland.co.uk/research/Documents/ccbs/Workshop2013/Presentation_Kumhof.pdf [accessed 15/09/2013, 12:34 GMT].

6: *The Nature of Money.* Geoffrey Ingham Cambridge Polity Press 2004, p.6.

In other words, money has been created out of thin air, which has enabled you to spend; but also to stimulate and create economic activity. Money's quality, its acceptability and validity is simply *due to its being able to facilitate transactions* - as the genius and Scottish economist, John Law, was first to fully recognise:

> "Money is not the Value *for* which Goods are exchanged, but the Value *by* which they are exchanged".
>
> Joseph Schumpeter, *History of Economic Analysis*, attributes this quote to John Law.[7]

When we spend on our credit card, the card is not the value for which goods are exchanged, but the value *by* which we exchange goods for money. The credit card, after all, goes back into our purse or pocket. We do not hand it to the retailer.

What Law grasped, before many others back in about the year 1700, is that money is simply a measure, *by* which we assess a) the value of goods we wish to buy or exchange; or b) the risk of holding money liquid, or investing/lending it over time.

The delusion of 'fractional reserve banking'

Those who grasp this much still sometimes fall into another popular misconception, the idea that commercial banks can only create credit or lend on the basis of a fraction of 'reserves'. In other words, so it is said, to lend £1000, banks need a reserve or *capital requirement* of £100 in their vaults, or in the vaults of the central bank. The reality is exactly the opposite. *Reserves are created as a result of, and to support lending*. (However, if the bank has borrowed *on its own account*, against very little collateral, it may be required by the authorities to increase the equity or capital requirement needed to protect against its own speculation and risk-taking.)

Private banks obtain reserves from the central bank when they make a loan. They keep reserves in the central bank, in reserve. Reserves are funds banks need on a day-to-day basis to settle or "clear" accounts with other banks, as part of the cheque-clearing process: - for no other reason.

Now as Marx noted,

> "The development of the credit system takes place as a reaction against usury. This violent fight against usury… on the one hand robs usurer's capital of its monopoly by concentrating all fallow

7 *History of Economic Analysis.* Joseph Schumpeter: Oxford University Press 1954, p. 322.

money reserves and throwing them on the money-market, and on the other hand limits the monopoly of the precious metals themselves by creating credit-money."[8] Karl Marx

Before the development of the western banking system, borrowers relied on the 'Robber Barons' of their day for their loans. These were the rich and powerful, the Masters of the Universe who, by fair means or foul, had built up a surplus of capital and held this surplus in their vaults as *savings.*

To gain access to these savings, poor borrowers had to beg. Money was lent arbitrarily at very high, real rates of interest – or rent. However, the power of Robber Barons of older times was considerably diminished by the development of banking, and the credit system. The banking and credit system "*robbed usurer's capital of its monopoly*" - as Marx noted.

That was an important civilizational development, and one that has enabled humanity to achieve great change. Which is why bank or credit money should on the one hand be celebrated and recognised as highly important to human advances. In countries without a developed monetary system – a central bank, the rule of law, a criminal justice system etc. - there literally is no money.

However, as Geoffrey Ingham explains in his book, *The Nature of Money*, the monetary system can be captured. He writes that money has a dual nature: it is 'not only infrastructural power, it is also despotic power'. [9] It is the fate of the British economy presently to be in the grip of a small, wealthy elite who effectively wield 'despotic power' over society as a whole.

Wrenching that power away and ensuring the monetary system serves not only the private interests of the wealthy but all of society, including the public sector, is a vital challenge to our democracy. Ensuring that the financial system is the servant, not master, of the economy cannot be achieved on the basis of flawed monetary and economic theory. Nor can a more democratic allocation of finance be achieved by centralising the creation of money in the hands of a small, unaccountable committee of men and women – as proposed by the NGO, Positive Money, and by Martin Wolf in his book, *Shocks and Shifts*.

So how do bankers create credit?

Credit creates deposits. Deposits are created when a banker, having received an application for a loan, having made a risk assessment of the borrower, and having confirmed by legal contract *the promise* to repay, backed by *collateral* (e.g. property) at *a rate of interest* and *over a fixed period of time*; and having

8: Capital Vol. III pt. 2 Karl Marx. New York International Publishers 1894, pp.704 and 708-9.
9 Ingham G (2004) The Nature of Money, London: Polity Press, p4.

obtained the cash proportion of the loan from the central bank, then enters numbers into a ledger or computer. After entering the amount of the agreed loan into the computer, the banker credits the funds to the account of the borrower.

When the loan created by entering numbers into a keyboard is drawn down by the borrower, the payment goes either to the same bank, or to another, either through interbank settlements, or by withdrawing cash from bank A and depositing it in bank B.

In accounting terms, these deposits are liabilities for the bank that issued the loan. The reason for this is that claims can immediately be made on deposits, for both the tangible notes and coins and for the intangible bank money element of the loan. Bank A will have to 'clear' this payment with Bank B. The loan itself, however, becomes an asset. The reason for this is that the bank expects to earn interest, or a rate of return on the loan.

Once the loan is drawn down, the bank proceeds to draw interest from the borrower - In other words, to drain a share of the borrower's income as repayment. By these means, commercial banks (in tandem with borrowers) *create* the overwhelming bulk of the money supply and effortlessly earn rent on that money.

Ben Bernanke, US Federal Reserve Governor, was interviewed on CBS's 60 Minutes Show on the 15 March 2009, soon after the Fed had made $160 billion available to AIG. The journalist asked where the money had come from? Was it tax money? Bernanke replied:

> "It's not tax money. The banks have accounts with the Fed, much the same way that you have an account in a commercial bank."
>
> "So, to lend to a bank, we simply use the computer to mark up the size of the account that they have with the Fed."

$160 billion dollars!

The question that Keynes asked, and that arises from this is this: if banks can create credit so easily, why should they charge a fee for it? Or deny any reasonable request for a loan?

Let us assume that the bank has made a sound risk assessment of whether the loan will generate income and therefore be repayable without bankrupting the borrower. Let us then begin with the rate of interest charged.

The rate of interest

First, the macroeconomic picture: the rate of interest on credit is fundamental to the health and stability of an economy, *The level of employment and activity in an economy depends critically on the rate of interest*, as John Maynard Keynes argued so firmly. Too high a rate stifles enterprise and initiative and renders debts unpayable. I take it as a given that *the moral dimension* to the application of interest rates to credit are understood as abhorrence towards earnings from effectively *effortless activities* – unearned income.

As well as being vital to the health of an economy, a low rate is also fundamental to the health of *the ecosystem*. A high rate demands both ever-rising extraction of labour's contribution, but also of the earth's assets: both need to generate resources for repayment. If high rates bleed the working community of incomes and livelihoods, the outcome is invariably social and political unrest – which harms the wider social, political and ecological environments. If high rates demand ever-rising extraction of nature's assets, too many fish are fished from the sea, forests are stripped of trees, our finite atmosphere is polluted, land is farmed relentlessly, weakening its structure. Much of this extraction is undertaken in order to repay exponentially rising debts. No surprise then that under the current economic system, society has begun to hit the ecosystem's limits.

The two dominant rates of interest

Below, I discuss the two dominant forms of interest rate. First, the rate set by central banks – the 'base' or 'policy' rate – at which the financial system alone can borrow, and which often bears little relation to rates applied across the full spectrum of private lending by commercial bankers.

Second, the complex of interest rates for all kinds of borrowing, long and short, real, safe and risky; rates that are today determined by modern 'robber barons' - private, commercial bankers and financiers.

As outlined above, the intangible nature of bank money means that the extension of credit is simply a 'book' transaction. The only consideration on the part of the bank is the borrower's riskiness on the one hand, and the need for *tangible* notes and coins on the other.

Private banks cannot issue notes and coins. Only the central bank can. To obtain notes and coins, the private bank effectively pays a fee to the central bank. However, today, notes and coins are a declining portion of bank money in mature economies. Here in the UK, only 3% of the money in circulation is in the tangible form of notes and coins.

The central bank provides to private banks - on demand - any cash a borrower requires from their bank, as part of the application for a loan. In other words, the central bank provides all that the private bank needs to provide a loan, and does so on demand.

In other words, the central bank does not set any limit to the volume of credit and debt that can be created by private, commercial banks, and provides on demand the share of cash provided when banks create loans, and make deposits.

In the past (during the 'golden age' 1945-1971) central banks 'guided' private banks in the creation of credit and insisted that it be aimed at largely productive purposes. Credit for speculative purposes was frowned upon. In the Anglo-American world, this is no longer the case.)

If there is no necessary limit to the volume of credit/debt that can be created, then it is essentially *a free good* – not subject to finitude, or the market forces of supply and demand.

From this it follows, as Keynes argued in his Treatise on Money, that:

> "... if the banks can create credit, (why) should they refuse any reasonable request for it? And why should they charge a fee for what costs them little or nothing?"[10]

Keynes recognised that, once the system of bank money evolved, society no longer needed to rely on existing wealth holders for finance. The owners of a surplus of capital were no longer sole providers of loan finance to the rest of the economy. Savings were no longer needed for investment. The powers exercised by the owners of wealth could be subordinated to society's wider interests. Credit creation by banks could provide investors, entrepreneurs and innovators with the finance needed for investment.

The rate of interest on this bank-created money is determine, argued Keynes, in ways quite different to that in which the price of (say) tomatoes or a smartphone or a pair of shoes is fixed. And the reason it is different, and cannot be subject to the forces of 'supply and demand' is because of the very nature of bank money, and of the way in which it is 'created'.

To manufacture a product such as, for example, a smartphone, requires investors, designers or manufacturers to engage with, first, the land – in the broadest sense of the word. Minerals and crucial elements for the phone have to be extracted from the earth, and then transported to manufacturing sites. The extraction, supply and transport of these minerals are subject to both

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10 The Collected Writings Vol. VI. John Maynard Keynes: Cambridge University Press 2012, p. 196.

geological and geographical, but also geopolitical, constraints. Second, the manufacturers of the smartphone have to engage with labour – in the broadest sense of the word. Labour has to be found and trained; wages have to be negotiated; and sometimes disputes have to be managed.

The creator of credit faces none of these challenges. The banker engages with neither the land nor labour (in the broadest senses) in the creation of his financial product. (However, as outlined above the repayment of debt does require exploitation of both labour and the land.)

Sound commercial banking requires good judgment, a conscience, and accounting skills. But the mere act of credit creation is effortless in the way that the manufacture of, say, a mobile phone, no matter how slapdash or obsolete, is not.

For these reasons, credit is essentially a 'free good' and the rate of interest must necessarily be low. However, while society is no longer dependent on private wealth for loanable funds, the holders of wealth can still exercise influence over the "price" of finance, or rate of interest. They can influence financial markets and the price of money by *hoarding* their money or surplus, or *by the act of parting with it.*

Keynes on how rates of interest are determined: liquidity preference theory

Rates on loans of different *maturities* are the reward, argued Keynes, to the lender for parting with *the liquidity* of his or her savings, or stocks of wealth. In other words the 'price' of money, or rate of interest is the reward lenders or creditors demand for tying up, or parting with, their money for a period of time.

The rate of interest is not, as orthodox economists would have us believe, the reward for *saving*. The decision to *part* with savings is made *after* savings are made. A lender or creditor's decision about where to place, and for how long to hold her savings, is determined first by the *transactional* motive - the need for *cash*, for immediate use in purchasing goods and services. Second, by the *precautionary* motive: the desire for *security* as to the future equivalent of her cash. And third, by the *speculative* motive: the desire to secure *gains* by knowing better than the market what the future will bring.

The rate of interest, Keynes concluded is therefore determined by the supply of, and demand for, assets into which holdings of (stocks) of wealth can be placed for different motives and for different periods of time – to suit the liquidity preferences of the investors.

Keynes argued that central bankers could influence rates of interest across the spectrum of private bank borrowing; namely rates on short and long-term loans, safe and risky loans and rates in real terms. They could do this by

offering *a range of assets* to the markets that would satisfy the needs of savers to part with their savings for short, medium or lengthy periods of time, for safe or riskier investments. By offering such a range of assets, central bankers could play a dominant role in setting interest rates across the full spectrum of liquidity.

This understanding of how rates of interest are, or can be determined by central banks was perhaps Keynes's greatest insight – one lost to academia and society today.

His liquidity preference theory led Keynes to argue that central banks working with government debt management offices could offer investors a wide range of assets (bonds) of different maturity rates, to suit their liquidity preferences. This theory formed the basis of Keynes's advice to both the Bank of England and the UK Treasury from 1933 onwards. The theory, and subsequent policies demonstrated that rates of interest – for the full spectrum of commercial loans: safe, risky, short & long-term loans - are quantities that can be influenced and even controlled by the policies of central banks and democratically elected governments.

Interest rates are not, or need not be the 'natural' prices that result from market forces, and a demand for *savings.*

Determining a sustainable rate of interest

Keynes, in my view, is the only economist to satisfactorily explain how interest rates are determined, and how rates across the spectrum of lending can therefore be *managed* by central banks and governments, and kept low and affordable.

Keynes's *liquidity preference theory* provided central bankers and governments with not just an understanding of how interest rates are determined but also with policies for managing, and keeping rates of interest low across the full spectrum of lending during World War II, and beyond.[11] This was a time when Britain's government borrowed more than it had ever borrowed before, and public debt peaked at 250% of GDP.

Geoff Tily argues in his book, *Keynes Betrayed* that liquidity preference theory:

> "led [Keynes] to conclusions of the most profound importance. Ultimately, the theory turned classical analysis on its head. The rate of interest was *the cause*, not the passive consequence, of the level of economic activity"

11: Keynes´s monetary theory of interest. Geoff Tily Bank of International Settlements Papers No. 65. Online: http://www.bis.org/publ/bppdf/bispap65c_rh.pdf [accessed 3/10/2013, 18:53 GMT]

… and in particular, of the level of employment. Yet this revolutionary monetary theory is largely ignored by the economics profession, and forgotten by regulators and policy-makers.

Central to Keynes's theory is an understanding of bank money as *a social relationship* - "I promise to pay or repay" – and not as a quantifiable commodity.

Keynes argued that once a system of bank money evolved, society no longer needed to rely on the holders of wealth, the "robber barons" of old. The existence of bank money means that those fortunate enough to own a surplus of capital *are no longer sole providers of loan finance* to the rest of the economy.

Second, under a well-managed banking system (managed in the interests of society as a whole) *finance capital need no longer determine the rate of interest for lending.* Instead, within a bank money system, finance capital can be held at bay, and forced to play a more passive role in the economy.

In this way interest rates can be managed and kept very low. It is only in such a macroeconomic environment, in my view, that Islamic Finance banking can hope to compete and survive.

Controlling mobile capital: the international dimension

Just as a well managed banking system ends society's dependence on 'robber barons' at home, so a well-developed and sound banking system should end society and the economy's reliance on international capital. With a managed banking system, operated in the interests of both Industry and Labour, both government, Industry and Labour need not depend on, or fear 'bond vigilantes' or 'global capital markets'.

However, management of the financial system and of interest rates in particular will be subverted if capital is mobile and lenders in international markets offer higher or lower rates beyond a country's border – rates not appropriate to the economic conditions in-country. Keynes advocated controls (taxes) over the mobility of capital. (Note that taxes on flows of capital – capital controls – are not the same as exchange controls, controls over the amounts of currency that can be taken abroad.) Keynes argued that "the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this", he wrote in this letter to R. F. Harrod:

> "Freedom of capital movements is an essential part of the old laissez-faire system and assumes that it is right and desirable to have an equalisation of interest rates in all parts of the world. It assumes, that is to say, that if the rate of interest

> which promotes full employment in Great Britain is lower than the appropriate rate in Australia, there is no reason why this should not be allowed to lead to a situation in which the whole of British savings are invested in Australia, subject only to different estimations of risk, until the equilibrium rate in Australia has been brought down to the British rate." [12]

Keynes understood that under a bank money system, not only was reliance on foreign capital ended, but that in order to manage the economy, countries should actually close their borders to footloose, mobile international capital. To do so he advocated capital control: the taxing of cross-border capital flows. (Capital controls are taxes, and differ from exchange controls. The latter place limits on the amount of a nation's currency that can be taken abroad. The Financial Transaction Tax (or Robin Hood Tax) is a form of capital control, a tax or 'sand in the wheels' of capital flows.)

Professor Jagdish Bhagwati has argued persuasively that China and Japan:

> "different in politics and sociology as well as historical experience, have registered remarkable growth without capital account convertibility. Western Europe's return to prosperity was also achieved without capital account convertibility... In short when we penetrate the fog of implausible assertions that surrounds the case for free capital mobility we realize that the idea and the ideology of free trade and its benefit ... have been used to bamboozle us into celebrating the new world of trillions of dollars moving daily in a borderless world..." [13] (my emphasis)

Removing finance's control over a nation's currency

Keynes also understood that the modern-day practice of using the rate of interest to manage the exchange rate of the currency would hurt the domestic economy, because central bankers are obliged to focus on the interests of the 'robber barons' - international capital markets - instead of the interests of 'the makers' and exporters of the domestic economy. He argued that instead, central banks should manage exchange rates over a specified range by buying and selling currency rather than by manipulating and ratcheting up interest rates to attract foreign capital. This would both allow interest rate policy to be focussed on domestic interests and at the same time ensure stability and transparency in exchange rate arrangements.

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[12] Keynes to R. F. Harrod 19 April 1942 in John Maynard Keynes: Collected Writings, Vol. XXV. Cambridge University Press 2012, pp. 148-9

[13] Professor Jagdish Bhagwati: *The capital myth: The difference between trade in widgets and dollars*. Foreign Affairs; May/Jun 1998. http://web.cenet.org.cn/upfile/57122.pdf

Conclusion

A key principle of Islamic finance is the provision of finance for entrepreneurs at zero rates of interest. If practised on the basis of this principle, Islamic finance effectively becomes a form of stakeholder finance, in which both the lender and borrower share the risk of gains, but also losses. Under the usurious system of western capitalism the risk is not so equally shared. Unless the borrower is bankrupted ("the warehouse burns down") the creditor does not make losses, when the entrepreneur makes losses. Indeed the creditor can gain from such losses by imposing compound interest on unpaid debts.

It is vital therefore - for the health of society, the economy and the ecosystem - that the principles governing Islamic finance should not only be upheld in mosques and religious institutions; but should also be far more widely practiced. However, in my conversations with Islamic Finance bankers, I have been made aware of the difficulties they face when operating within an economic environment in which western banks are able to offer and compete on much higher rates of interests for savers.

It is not that western bankers are "bad apples". It is simply that "the barrel" or framework within which they operate encourages speculative lending at high rates of interest, which can generate spectacular returns for what are simply forms of gambling. It's therefore time to change the "barrel" – the global economy - into one much more conducive to low or even zero rates of interest.

This great transformation can only happen if we, the people, equip ourselves with a full and proper understanding of money-creation, bank money and interest rates – and then begin to demand the reform and restoration of a just monetary system, one that makes finance a servant to the economy, and removes it from its current role as master.

*Cover Image: *Iranian Glazed Ceramic Tile Work*, Province of Fars, Iran. Pentocelo, April 2008

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