

Chapter IV: Keynesian paradigm

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1. Introduction

Theories of business cycles explain fluctuations in business activity, and attempt to find ways of stabilising it. A theory of business cycles thus needs not only to *describe* economic activity, but also to *prescribe* responses when things do not work out in line with expectations.

Theoretical analysis invariably rests a range of assumptions. If any of the basic assumptions turn out to be false or problematic in some sense, it will be difficult for the theory to deliver results, and offer viable responses to any problems that may arise in a given system.

Thus, a theory is as reliable as the underlying assumptions on which it rests. If any of its assumptions turn out to be problematic, the theory cannot be expected to provide a sound basis for analysing problems as and when they arise. For a flawed theory will provide flawed results.

The prime reason for the inability of contemporary economic theory to generate credible responses to major economic problems is that mainstream analysis contains precisely such a flaw (anomaly).

This flaw is the assumption that interest as an incentive for productive activity and allocating resources efficiently is no different from profit. A closer look at interest, however, shows that this is far from the case.

The results of this analytical *faux pas* include a flawed economic theory, but also a range of burdens imposed on society in various forms. Thus, the assumption that interest is no different from profit needs to be looked at. The challenge is as much theoretical as it is practical. Economic theory will have to be reconstructed to bring it in line with reality.

Despite evidence to the contrary, mainstream economic theory continues to maintain that interest-based financing channels resources *efficiently*. In the meantime, government stabilisation policies continue to meet with limited success in overcoming economic problems.

These problems impose significant social and personal costs on society. These “costs” include an inefficient allocation of resources, indebtedness, inflation, unemployment, cyclical instability, stagnating growth, and a growing gap between rich and poor. In light of the analysis presented here, this hardly comes as a surprise.

Mainstream stabilisation policies have met with limited success. The main reason is that they are based on flawed economic analysis, the Keynesian paradigm. A closer look indicates that this theory is deeply *flawed*. The primary flaw in this model is the assumption that interest is little different from profit as an incentive to ensure an efficient allocation of resources.

2. Counter-cyclical policies

In his theory of business cycles John Maynard Keynes explained fluctuations in economic growth as being caused changes in aggregate demand.¹ He assumed that the relationship between aggregate demand and aggregate supply, demand was the

“independent” while supply served as the “dependent” variable.² Thus, he recommended countercyclical government spending (fiscal policy) as a way of overcoming recessions. This requires the government to spend more during periods of economic slowdown, and to spend less during periods of expansion.

A closer look, however, shows that much instability remains even after the administration of Keynesian stabilisation policies. The reason is that Keynes assumes that debt may be traded the way real assets are traded. In the Keynesian universe of discourse, money itself becomes an asset, and subject to trade. Money is traded at a price known as “interest.” Moreover, the ‘price’ of money is determined by the interaction between the demand and supply of money, in ways comparable to those in which the prices of goods, services and resources are determined. This price is known as the market or “equilibrium” price, which is a price at which the demand for money equals to its supply.

What Keynes did not appreciate is that interest rates are not determined by the demand for and the supply of money, because interest rates do not fluctuate up and down with market forces. Rather, *interest rates are fixed, in the sense that they are set by central banks.*

Secondly, while the Keynesian model acknowledges that equilibrium takes place when investment and savings become equal, it overlooks the fact that this takes place only when the ‘price’ of money falls to zero. In other words, investment can become equal to savings *only in an interest-free economy*. The reason is that *only* at this ‘price’ will all surplus funds (savings) remain in the real sector.³ When the price

of money falls to zero, even marginally profitable businesses will be able to attract some funds.⁴

Fixing the interest rate at a level higher than zero is tantamount to imposing a minimum price of money (price floor). However, a minimum 'price' of capital will cause a surplus in the money markets (financial institutions) just as a minimum wage will cause a surplus of workers (unemployment) in the labour market. Thus, whenever the interest rates are higher than zero, some funds will remain within the financial institutions.

Surplus funds will remain there due to the fact that parties averse to risk will prefer to earn a lower rate of return from a financial institution rather than take a risk in the real sector, even with a prospect of better returns. Surplus funds will also remain in the financial institutions because they are too expensive for some (the marginally profitable) businesses to borrow.

As long as parties with surplus capital have the option to "earn" guaranteed returns in the form of interest, they will have an incentive to keep their funds in the financial institutions, rather than invest them in the real sector. The opportunity to gain interest income will reduce the amount of savings flowing into the real sector (share markets) for the purpose of investment.

In the absence of the possibility of "earning" guaranteed interest income in financial institutions, parties with surplus funds will be compelled to channel them into the real sector, even if the profits were to appear relatively slim. Put differently, were depositors able to invest directly in the businesses that currently borrow to finance investment, without the costly intermediation of financial institutions,

businesses should be able to obtain funds at rates as low as those that financial institutions currently pay on savings accounts to depositors or even lower.

For the same reason, former depositors turned investors should be able to obtain rates of return on their investments as high or higher than the rates currently obtained by financial institutions on their loans to businesses. In other words, eliminating the proverbial “middleman” would increase transactional efficiency: it would increase the returns for investors and at the same time it would reduce the “cost of funds” to businesses.

Suppose that the rate of interest paid by financial institutions to depositors is 3 per cent, and the rate charged to borrowers is 8 per cent. The difference between the lending and savings rates or the interest “spread” in this example is 5 per cent. It is the difference between what a financial institution obtains from borrowers and what it pays to depositors. This is the amount that the financial institution retains for itself from the amount charged to borrowers.

Were savers to invest directly in businesses on the basis of risk sharing, they could claim not only the 3 per cent they currently receive in the form of interest from financial institutions, but also the remaining 5 per cent that the financial institutions currently retain for themselves. Thus, the returns to savers would rise by at least the amount that the financial institutions currently gain for their shareholders. This extra gain for savers constitutes a compelling reason to switch to risk sharing modes of financing rather than continuing to rely on loan financing. There are other advantages of equity financing over borrowing at interest.

All businesses whose profits over a given period of time fall short of the amount needed to repay loans over the same period of time will be disqualified from obtaining loan financing, as their income will be insufficient to repay the loans. Since periodic repayments of loans include not only the payment of interest but also the repayment of the principal amount borrowed, the amount of profit that a firm using loan financing needs to earn to repay loans has to be higher than the percentage of interest the firm has to pay for the loan.

Even earning profits sufficiently high to repay loans, however, does not yet guarantee obtaining loan financing, as firms are also required to post acceptable collateral. Any firm unable to post acceptable collateral will remain without loan financing, even if it makes profits sufficiently high to repay the loan.

This would include a substantial number of businesses, in particular the SMEs. These business, due to the highly competitive conditions in which they operate, tend to have the slimmest profit margins. For the same reason, they are also the most efficient businesses. Moreover, it is well known that SMEs also provide the highest number of jobs. Thus, in a regime where capital comes at a “cost,” the most efficient business, the same businesses that contribute to social welfare most by providing the highest number of jobs will remain without financing due to its prohibitively high “cost.”

In the Keynesian universe, disequilibrium between savings (S) and investment (I) resulting from a deficit of private spending (in particular investment) is not achieved – as it should be – by bringing the “cost of funds” to zero. Rather, it is resolved by increasing government spending in a process known as *countercyclical fiscal policy*.

This is in keeping with the (Keynesian) idea that when private sector investment is low, governments need to step in and take up the slack. But this is hardly a satisfactory response, because it amounts to solving one problem by creating another. Disequilibrium (surplus of goods and services) in the private sector is overcome by creating a disequilibrium (deficit) in the public sector.

Moreover, apart from displacing (crowding out) private investment, public sector deficit spending adds to the national debt. For example, as a result of deficit spending the public (government) debt in the US has grown from \$2.4 trillion in 1987 to \$20 trillion by 2016. Higher taxes necessary to repay debts in turn reduce private spending, and further slowdown economic growth. Thus, the solution to this problem is not palpably better than the problem.

As a result of its lack of awareness of the harmful effects of interest-based financing on economic activity, the conventional (Keynesian) analysis has been unable to provide responses for addressing the major problems confronting present-day economies, in particular inflation and unemployment, as well as their co-existence in the form of “stagflation.” In so far as both inflation and unemployment are directly caused by the fact that capital comes at a “cost,” it follows that phasing out interest-based financing should contribute to overcoming both problems at the same time.

In the conventional analysis, inflation and unemployment constitute a “trade-off,” exemplified by the “Phillips curve.” The trade-off between inflation and unemployment (the Phillips curve) means that stable prices and full employment cannot be realised at the same time. In other words, the economy can never reach

its full potential.⁵ This is certainly the case, but only in a regime where capital itself is traded: in an interest-based financial system.

The Phillips curve implies that unemployment can be reduced only if society is prepared to tolerate more inflation. Similarly, it conveys the idea that unemployment can be reduced if society is willing to accept a higher rate of inflation. In other words, standard neo-Keynesian economic theory takes the alleged trade-off between inflation and unemployment as a given. Thus, public policy based on this model can only recommend moving from one point on the Phillips curve to another. But this amounts merely to substituting one kind of inefficiency with another.

In mainstream economic theory the trade-off between unemployment and inflation is presented as *inevitable*. But it is not inevitable. The reason is that this trade-off is a direct consequence of interest-based finance. In an interest-free system, the trade-off between inflation and unemployment does not arise on the first place.

The supply side model, tried by the Thatcher as well as the Reagan administrations, has not been more successful in eliminating the problems of unemployment and inflation. Significant stagflation prevailed even during the Reagan-Thatcher years. This hardly comes as a surprise. The supply-side model, like its Keynesian counterpart, shows little awareness of the harmful effects of financing spending by borrowing at interest.

Another difficulty in the Keynesian model is that it assumes the possibility of equilibrium in the “money markets.” However, no equilibrium ever takes place in the money markets. The reason is that equilibrium invariably can only take place at *one*

price. However, the market for money is *not a single market*; it comprises *two* markets.

The first is a market for *savings*, while the second is a market for *loans*. The fact that there are two markets is confirmed by the fact that there are also two prices in the markets for credit: a lending rate and a savings rate. The first is charged to “buyers” (borrowers) while the other is paid to the “lenders” (savers). The financial institutions effectively “borrow” from depositors, and use the money thus “borrowed” to make loans of their own. What explains this co-existence of the two markets in the credit sector?

The reason why there are two markets is that savers do not interact directly with parties that need financing. The two markets arise directly from the fact that financial institutions position themselves between savers and users of capital. The financial institutions to make an income from the difference between the price they pay to savers and the price they obtain from borrowers.

This arrangement, however, *prevents the money market from ever reaching equilibrium*. As long as financial institutions play the role of “intermediaries,” they will charge one (a higher) ‘price’ to borrowers, and pay another (lower) ‘price’ to lenders (savers).

While a single ‘price’ may be unattainable under interest-based financing, a single ‘price’ could be achieved under risk sharing. Here the ‘price’ of financing would take the form of an *average rate of profit*. The reason why a single price could be attained is that risk sharing dispenses with the need for costly intermediaries

between the suppliers and the end users of capital, intermediaries that add to the cost of financing without, however, adding value.

In an arrangement that would allow the suppliers of capital to interact directly with the users of capital, the money that borrowers currently pay to financial institutions in the form of interest would be paid directly to the suppliers of capital (the savers) in the form of profit. Under such conditions, all surplus funds could be channelled into investment, and even marginally profitable businesses would attract some capital. The reason is that there would be no opportunity to place funds in financial institutions to earn “guaranteed” interest income that might be higher than any profits earned in the real sector.

Moreover, by sharing risk, investors could expect to earn higher returns than the rates paid by financial institutions on savings accounts. It is well known that over the longer term equity investments outperform bond markets by approximately 5 to 6 per cent. At the same time, entrepreneurs (former borrowers) would not have to pay predetermined rewards to the suppliers of capital (former lenders).

Were interest to be phased out, the equilibrium ‘price’ of money would of necessity have to be zero. It is at this ‘price’ and only at this ‘price’ that not only stability but even efficiency become realistic goals. The solution to the chronic problem presented by financial crises is to abandon the interest-based economic system, and adopt an interest-free alternative. This will ensure that profitable firms will be able to attract investment funds, in proportion to their profitability. Additional benefits may be expected to follow. These include better growth, lower unemployment and greater price stability.

The problem of inefficiency in the form of inflation and unemployment will persist as long as businesses, consumers and even governments continue to utilise interest-based loan financing in preference to risk sharing. The implementation of risk sharing can contribute to the realisation of three major economic objectives: growth, full employment and stable prices. In an interest-free economy, all parties with excess savings wishing to earn a return would be obliged to invest in the real sector. They could invest in the share market or the market for sukuk. Indeed, they could earn higher returns in the real sector markets than in the markets for fixed income securities.

Investors would not lose by investing in equities. Some of the greatest fortunes were made in the equity markets. The fact that the returns on equity investments over the longer term outperform conventional bonds is well documented. Since WWII, common stock in the US, for example, yielded a real (after inflation) average annual return (dividend payments and capital appreciation) that was 6% higher than the real return on government-issued Treasuries.

Moreover, the fact that all savers would invest their surplus funds – with the exception of balances held for transaction purposes – would ensure equilibrium (equality) between savings and investment. This would have a stabilising effect on economic activity. All excess savings would be channelled directly back into the real sector, without having to rely on intermediation by financial institutions, whose ability to recycle funds into the real sector is reduced by the need to charge a “minimum price” (interest) for any funds loaned.

In an interest-free system, all surplus savings would be recycled in the real sector. This would take place because there would be no need to pay for the cost of investment funds. Moreover, the government would be relieved of the responsibility to maintain high levels of employment. This would reduce the national debt and bring fiscal discipline to government spending and enable it to balance its budget. Effectively, market forces would bring about the results that have so far proven elusive for governments.

3. Efficiency

A market is a mechanism for buying and selling. There are as many markets as there are products, services or resources. Markets include producer, consumer and capital markets. In exchange for the payment of taxes, various ministries provide public services, such as transportation, education, welfare and health care.

Markets enable the exchange of goods, services and resources in an organised manner. Resource markets comprise human, natural resource and capital markets. The latter comprise equity and bond (credit) markets. Assets in the form of company shares are traded in the stock markets, while liabilities (loans) are traded in the bond markets. Equity markets comprise share (stock) and Islamic sukuk markets.

Efficiency is an attribute of workers, businesses or entire economies. Efficiency is *productivity*. Thus, an efficient worker is a *productive* worker. Similarly, an efficient business is a *productive* business. An efficient economic system is a *productive* system.

In macroeconomics, the leading measure of productivity is national income or the GDP (Gross Domestic Product).⁶ The efficiency in the use of human resources is reflected in the employment rate.⁷ At the microeconomic (business) level, leading measures of efficiency include output per unit of input, cost per unit of output, and profitability.⁸

The term “efficiency” is also used to characterise economic systems. Some systems (such as the free market system) are seen as “more efficient” than others (for example a socialist or command system). If resources are allocated without generating any lasting *shortages of surpluses*, they are said to be allocated *efficiently*. If resources are allocated in ways that cause either shortages or surpluses, they are said to be allocated *inefficiently*. In a free market system, markets help allocate resources efficiently. They do this by means of the price mechanism.

Markets help allocate resources efficiently by identifying industries or sectors where prices are rising and higher profits may be earned. Other factors being constant, changes in prices signal changes in profitability. Rising prices indicate rising profits while falling prices indicate declining profits.

When the price of a given product declines, the profits of its producers fall in tandem. As prices and profits fall, businesses shift their resources out of the production of goods whose prices are falling and into the production of goods whose prices are rising.

Variations in profitability are also reflected in the prices of company shares. The prices of the shares of business firms whose profits are rising are also likely to rise, assuming other factors remain constant. Conversely, the prices of the shares of

companies whose profits are declining are likely to fall. A shift of (capital) resources takes place whenever investors sell the shares of companies whose profits are falling, and invest instead in the shares of companies whose profits are rising.

Excessive regulation of markets, for example by means of price controls, *reduces* efficiency. In order for markets to allocate resources efficiently, prices must be free to go up or down, to reflect changing market conditions accurately. If prices are not “free” to change, resources will not be allocated efficiently. Whenever prices are regulated (fixed), shortages or surpluses develop, signifying a reduction in efficiency.⁹

A surplus indicates inefficiency in that it shows that too many resources are being allocated to the production of a given good, at least in the short term. A shortage, on the other hand, shows that not enough resources are being channelled into the production of the good of which there is a shortage.

Under ideal (competitive) conditions, surpluses and shortages are overcome automatically by changes in prices, without any intervention by regulatory authorities. *A change in the price of the product, service or resource* is followed by changes in production levels and a reallocation of resources. In the case of surpluses, prices fall, freeing resources for alternative uses. In the case of shortages, prices rise, engaging additional resources in the production of goods and services for which demand appears to be rising.

When a surplus or shortage is overcome, equilibrium or the balance between the demand and supply of the product is re-established. At this point, the adjustment process comes to an end. Since the balance between demand and supply

(market equilibrium) indicates an absence of shortage or surplus, whenever equilibrium prevails in a given market, resources are allocated efficiently. They are allocated efficiently because just the right amount of a product is being produced: neither too much (causing a surplus) nor too little (causing a shortage). In this way, markets can be said to contribute to an *efficient allocation of resources*.

However, markets are also understood to be “efficient” in one *other* sense, the sense in which this term is used *in finance*. For in finance the term “efficiency” is used in a way that differs profoundly from the way this term is used in economics. In economics, efficiency is seen as an attribute of the *market system*, rather than of any particular market or markets.

In finance, by contrast, markets are understood as “efficient” not on account of the way they *allocate resources*, but on account of the way they *affect prices*. More specifically, in finance markets are viewed as efficient when they determine prices, in particular the prices of securities, *accurately*.

In other words, the meaning of efficiency in the discourse of finance reflects a shift of focus *from resources to prices*. One might say that the perspective of the economist gives way to the perspective of the trader. There are a number of problems with the view that markets are efficient in the sense in which term is understood in the discourse of finance.

The view that markets are efficient in that they determine prices of securities accurately was espoused by Eugene Fama in the 1960s.¹⁰ The view that “markets are efficient” is known as the *efficient market hypothesis* (EMH). Fama initially applied

his hypothesis to the share markets. Later he extended it to apply to the bond (credit) markets as well.

According to Fama, markets are able to provide accurate prices of securities, in particular the prices of stocks and bonds, because, over the longer term, market prices reflect all *information*. In practice this means that there can be no substantial difference between the price of a security and its “real” value, especially over the longer term.

However, one problem with this view is that the sweeping designation of markets as “efficient” obscures important differences between credit and real sector markets. For these two types of markets neither operate in the same way nor produce the same effects. Where real sector markets are efficient, credit markets are not.

In the absence of market or regulatory failure, real sector markets – including share markets – are efficient both in the sense in which this term is used in finance, as well as in the sense in which it is used in economics. They both determine prices *accurately* and allocate resources without causing long-term surpluses or shortages.

However, evidence shows that – unlike share markets – credit markets are efficient neither in the sense in which this term is used in economics, nor in the sense in which this term is used in finance. In other words, *credit markets neither allocate resources efficiently, nor determine prices accurately.*

The reason for this is that there are important differences between credit markets and share markets. These differences have profound implications on how well markets can achieve what is expected of them. Credit markets do not operate in

the same way as share markets, and therefore cannot be expected to produce the same results.

Assuming that credits markets operate in the same way as share markets can result in a misallocation of resources. The reason is that the allocation of resources in the real sector (share markets) depends to a large extent on how capital is allocated in the credit markets. If resources are misallocated in the credit markets, they will be misallocated in the real sector.

4. Financialisation

The view that markets are “efficient” emerged at a time known as “financialisation.”¹¹ Financialisation was part of a larger trend, *market liberalisation*. This trend finds its grounding in the ideology of *liberalism*, that views individual “freedom” as the most important feature of a well-governed system.¹² This view assumes that people and institutions are best left to regulate themselves.

Liberalisation of commercial activity was undertaken in the conviction that markets were capable of regulating themselves. In general, it was expected that deregulation would increase both productivity and growth. It was believed that freer markets would enable a more efficient allocation of resources.

It appears that the argument that markets should be left to “regulate themselves” found favour among the regulatory authorities. Later events, however, would throw a different light on the experiment with the wholesale deregulation of financial markets that took place in the years leading up to the most recent (2007) financial crisis.¹³

The first consequence of deregulation was an increase in *speculation*. One perception that fuelled the rise of speculation was the perception – alleged or real – that higher returns could be earned in the financial sector than in the real sector. The difference between a businessman and a speculator is that while a businessperson is willing to invest over the longer term, the speculator seeks short-term gains.

While benefiting some companies in the short term – financial institutions in particular – overall deregulation had an adverse long-term impact on economic activity. This was evident in the build-up of indebtedness and threats to the stability of the financial system as a whole.¹⁴

A significant amount of resources was diverted from the real sector, where production takes place, to the financial sector, where speculation is the dominant activity. This “transformation” was facilitated by changes in the law. The changes invariably favoured the banking sector over the real sector.¹⁵

As a consequence of financialisation, the proportion of loans compared to equity financing in the capital structure of corporations increased dramatically. In the developed world, approximately two thirds of corporate financing takes place by means of *loans*.

The view that credit markets are efficient in the finance sense of the term – in that they indicate prices accurately – was proven false by the unexpected and dramatic collapse of the prices of the CDOs or collateralised debt obligations, which lay at the heart of the recent global financial crisis. In other words, credit markets

have proven themselves to be inefficient not only in the way they allocate resources but also in the way they determine prices.

That credit markets are inefficient also in the way they allocate resources was confirmed by the large surplus of empty homes whose construction was financed by subprime mortgages. Millions of people had to vacate their homes due to repossessions by creditors during the subprime crisis, in which credit markets channelled vast sums of money into the construction of subprime houses. This was a waste of resources on a large scale.

After being repossessed by financial institutions due to defaults by house buyers, these surplus properties subsequently had to be demolished due to dilapidation.¹⁶ Similarly, overinvestment also took place in the property market in Dubai, using similar, debt-like instruments of financing. In other words, credit financing did not ensure an efficient allocation of resources.

The amount of waste caused by interest-based lending can be ascertained by identifying the total amount of interest paid out to all lenders in a given year by all borrowers. In a typical developed country, the amount of interest paid as a component of national income ranges from 8 to 11% of total GDP.

It goes without saying that in any economic system where it would be illegal to gain interest income, and where income could only be earned in the form of wages, rents and profits, the real GDP could be expected to increase approximately by the amount of money currently paid out to lenders by borrowers, in other words by approximately 8 to 11% per annum.

To eliminate the inefficiencies spawned by financing investment by lending at interest, an alternative – interest-free – mode of financing needs to be utilised. This mode of financing needs to ensure that rewards to the providers of capital depend directly on the performance of the productive assets they finance. Financing on the basis of risk sharing provides just such a method of financing.

In order to prevent waste in future, and thereby enhance the efficiency of the allocation of resources, it needs to be recognised that credit markets do not operate in the same way as other markets, in particular real sector markets. The prime reason is that activity in the two types of markets is driven by radically different incentives, *interest* on the one hand, and *profit* on the other.

One incentive – profit – is conducive for ensuring that resources will be allocated efficiently. The other – interest – is not. The reason is simple. The magnitude of dividend payments to investors in the real sector depends on the efficiency of the enterprises they finance. As profits in a particular sector increase, so does production. The magnitude of interest payments to creditors, by contrast, does not.

It follows, therefore, that the realisation of efficiency requires more than free markets. The efficient allocation of resources requires a legal framework in which it is legal to earn profit and illegal to gain interest. Only when suitable incentives are in place, can resources be allocated efficiently. Putting these incentives into effect requires suitable regulation and even legislation.

This includes the need to restructure the system of incentives. In particular, there is a need to implement a regulatory framework and a system of incentives that

reward real investment (production of wealth) rather than speculation (transfer of wealth) such as takes place in the trading of bonds in the debt markets.

One might say that having free markets constitutes a necessary but not a sufficient condition for the efficient allocation of resources. To realise efficiency in the macroeconomic sense there needs to be a structure of *incentives* that rewards productive activity.

Put differently, in order to realise efficiency, markets need to be free in one sense and regulated in another. For example, prices need to be free to fluctuate. And markets need to be regulated in the sense that income may legally be earned only in the form of wages, profit, and rents, but not in the form of interest.

When markets are free to determine prices, and regulated to allow the earning of profit but not of interest, they can be expected to allocate resources in ways that meet the needs of society, that is efficiently in the broad or macroeconomic sense of the term.

To ensure efficient allocation of resources, the decisions on how to allocate resources need to be made in the real sector (share markets) rather than in the credit (bond) markets. This can be achieved by gradually supplanting interest-based (credit) financing with financing on the basis of risk sharing.

Phasing out interest-based financing will ensure that decisions on how to allocate resources will always be made in the real sector, where investors are required to take risk. The need to take risk is a powerful incentive for ensuring that only convincing business proposals will qualify for financing.

The greater efficiency of the real sector in the allocation of resources, as compared to the credit sector, constitutes a compelling reason for adopting equity over loan financing.

When risk sharing takes the place of lending at interest, one can expect reductions in the levels of debt, the freeing of government resources for spending on social services, higher employment, lower inflation, higher growth, a fairer distribution of wealth, and greater systemic stability – *at the same time*.

Thus the *problem of interest*, however, needs to be addressed first. Interest constitutes an aberration within economic practice. Thus, what is required is a *paradigm shift*, away from an interest-based to an interest-free economy.¹⁷

5. Conclusions

What the law permits and prohibits has a significant impact on society. First and foremost, the law needs to realise justice. The widespread use of interest-based financing has impacted society in a number of different ways. Interest-based lending causes inefficiency, inflation, unemployment, indebtedness, as well as instability. It also reduces economic growth over the long term and causes excessively uneven distribution of wealth. These constitute compelling reasons for phasing out interest-based financing and replacing it with risk sharing.

The harmful effects of interest-based financing appeared in the indebtedness of nations, businesses and individuals. It is only a matter of time that unsustainable levels of debt will make it necessary to switch to an alternative mode of financing. In principle, it is better to be proactive rather than wait until a crisis forces change.

The fact that interest-based financing has been entrenched for centuries need not deter reforms. Slavery was likewise entrenched for centuries, until it was finally abolished. The fact that many nations are facing bankruptcy should add a degree of urgency to the much-needed reform of the financial system.

Reform will require financial institutions to re-invent themselves as investment companies that, due to the prohibition of “earning” interest, will be required to earn income in the real sector. It will also require the central bank itself to adopt a way to exercise monetary policy that does not depend on the buying and selling of debt (bonds). This requires regulatory changes.

Implementing an interest-free financial system will require phasing out the fractional reserve, interest-based system and its replacement with an interest-free financial system, where financing takes place on the basis of risk sharing. This will ensure that all money will remain within the real sector at all times and not be withdrawn from it at any stage.

It will also ensure that businesses, households and even governments will not be able to spend beyond their means. This should help reduce excessive spending caused by cheap credit, and insufficient spending caused by expensive credit. In all cases, it will also bring about an environment where only interest-free loans can be made.

Financing investment on the basis of risk sharing brings many advantages. It produces indebtedness neither for the private sector nor for the government. Neither does it cause inflation arising from the expenditure of borrowed funds.

Equity financing is more conducive to maintaining systemic stability and a fairer distribution of wealth than financing by debt.¹⁸

Thus, it is advisable to restructure the financial system to ensure that it will operate in the real sector. In such a system, parties with surplus capital will not be able to earn income in the form of interest by lending. They will only be able to earn profit or rent. Because the financial institutions will no longer be able to lend at interest, they will be compelled to earn their income exclusively in the real sector.

Socialism declined in part because of the injustice implied in its failure to reward and motivate people in proportion to their efforts. This was a direct consequence of severing the link between reward and productivity, caused by the prohibition of private enterprise, the right to own private property, and the collective ownership of productive resources.

As a result, incentives to work were lacking. Disincentives for not working were likewise lacking. Those that were abler than others could not expect greater rewards. Those that did not exert themselves earned as much reward as those who did. Such a stance can hardly be in accord with justice.

Like socialism, interest-based financing severs the link between reward and performance. The increasing financialisation of economic activity is draining valuable resources away from the real sector into largely unproductive speculation in the credit sector. The interest-based system may collapse as a result of the debt arising from lending at interest. The poor are especially vulnerable.¹⁹

In the series of crises since the Great Depression, each crisis has been more severe than the one that preceded it. It is clear that financing by way of lending at

interest is neither sustainable nor viable over the longer term. The fact that interest-based financing has been entrenched for centuries need not deter reforms. The fact that many nations are facing bankruptcy should add a degree of urgency to the much-needed reform of the financial system.

In order to achieve a fuller utilisation of resources, it is necessary to ensure that investors take responsibility for the outcome of the enterprises they finance. The opportunity to obtain guaranteed income without effort or taking risk should not be tolerated in any well-governed society as a matter of principle.

Deregulation is not a panacea for economic problems. Economic activity needs to be regulated for the benefit of the participants and to ensure fair competition. Practices that privilege the wealthy at the expense of the poor need to be abandoned. Economic activity needs to be regulated in ways that promote an efficient allocation of resources rather than hinder it. Incentives need to be in place to reward real contributions to production. Above all, the opportunities for rent seeking in the form of income for which no meaningful counter value needs to be given up, need to be eliminated. Moreover, tax advantages currently granted to the interest-based financial sector need to be withdrawn, and granted instead to the real sector. What is required is the political will to set the modern financial system on the right footing.

Awareness needs to be created that interest-based financing is not only inefficient in the way it allocates resources, but also an unethical way of “earning” income. The destabilising effects of interest-based financing need to be highlighted, in particular, the link between this mode of financing and cyclical instability.

Economic theory has to be reformed in a way that will dispense with interest-based financing. Law reform needs to be initiated to facilitate the replacement of interest-based financing with risk sharing. Incentives (in the form of tax breaks and regulatory changes) need to be provided to encourage financing on the basis of risk sharing. At the same time, disincentives (taxes as well as regulatory requirements) need to be implemented to facilitate the gradual phasing out of interest-based financing. Public education is required to facilitate the conversion of debt-based to asset-backed or equity-type financing. It is necessary to explain the advantages of financing on the basis of risk sharing.

Endnotes

¹ The role of the spending “multiplier” in magnifying the effects of spending constitutes a particularly valuable insight.

² This would apply to all markets, at both the microeconomic as well as the macroeconomic level. In relation to the economy as a whole, this principle is expressed by the equation $AS = f(AD)$, which states that “aggregate supply is a function of aggregate demand.” This notion was turned upside down in the early 1980s by “supply side economics,” which became popular during the Reagan/Thatcher years, and which postulated that supply determined demand or $AD = f(AS)$. Supply side economics was a throwback to the theory known as “Say’s law,” proposed by J.B. Say, according to whom “supply creates its own demand.” The significance of this change from the point of view of public policy is that any government stabilisation policies would have to begin on the supply side of markets. These would take the form of reducing government regulations and eliminating or reducing taxes.

³ Assuming that all savers are willing to take at least some risk.

⁴ It is not unknown that even loss-making businesses can attract tremendous shareholder interest, in the basis of excellent future prospects. Google is a case in point.

⁵ This claim is highly problematic and, as we seek to show, the simultaneous occurrence of inflation and unemployment is in reality largely due to the fact that capital comes at a cost, in other words, to interest-based financing. The Congressional Budget Office (CBO) of the US estimates that the US economy has been operating at approximately 7% below its potential (full employment) capacity over the last several decades. It hardly comes as a surprise that this figure is roughly equal to the average rate of unemployment in the US.

⁶ National income is “earned” in the process of generating the “national product.” Thus, “national income” is the monetary value of national production, normally calculated from the income tax receipts over a period of one year.

⁷ The unemployment rate would be a measure of *inefficiency* in the use of human resources.

⁸ The first two are monetary while the third is a non-monetary measure of efficiency.

⁹ Disequilibrium is a condition of inequality between the demand and supply of a given product. A surplus or a shortage in turn signifies a condition of instability or disequilibrium. According to classical theory, all disequilibria are temporary. The reason why it is temporary is that there are natural market forces that will re-establish equilibrium, without any need for outside (regulatory) assistance.

¹⁰ Fama, Eugene F. and French, Kenneth R. “Common Risk Factors in the Returns on Stocks and Bonds,” *Journal of Financial Economics* Vol. 33 (1), pp. 3–56, 1993.

¹¹ Foster, John Bellamy “The Financialization of Capitalism,” *Monthly Review*, Issue 11 (April), Volume 58, 2007. Available online at:

<<http://monthlyreview.org/2007/04/01/the-financialization-of-capitalism>>

¹² While freedom is necessary to protect the dignity of the individual, freedom is not without limits. This is recognised by the fact that even the freest nations impose restrictions on freedom in various ways.

Some restrictions thus need to be placed on freedom, if for no other reason than to prevent abuses. Life with dignity itself is hardly possible without differentiating acts that contribute to well-being from those that undermine it. The prohibition of interest is a case in point.

Seen in a broader context, the legalisation of interest was part of a liberal trend that swept Europe during the sixteenth and seventeenth centuries. It was also to a degree a result of a new confidence, perhaps not entirely warranted, in the power of human reason to legislate in the area of ethics, traditionally a preserve of religion.

The legalisation of interest was a part of a *moral revolution*, which took place in part by drifting away from revelation as a source of guidance. During this upheaval, individual autonomy became more prominent and the state was expected to protect it.

The liberation of modern man from the restraints “traditionally” imposed on human initiative by the need to conform to the requirements of religion was justified by appealing to the doctrine of human rights. However, it appears that in the haste to recognise and protect *human rights*, the need to maintain consciousness of *human obligations* appeared to have taken a back seat.

¹³ Rogoff, Kenneth S. & Carmen M. Reinhart *This Time Is Different*, Princeton University Press, 2009, p. 208.

¹⁴ See Roubini, Nouriel and Stephen Mihm *Crisis Economics*, Penguin Books, New York, 2010.

¹⁵ Financialisation is a global phenomenon. According to the World Bank, the global volume of financial transactions is approximately 15 to 20 times greater than what is required to finance world trade. Kennedy, Margrit, *Interest and Inflation Free Money*, Seva International, 1995, p. 10. Available online at:

<<http://userpage.fu-berlin.de/~roehrigw/kennedy/english/Interest-and-inflation-free-money.pdf>>

¹⁶ “Since 2007, banks have foreclosed around eight million homes. It is estimated that another eight to ten million homes will be foreclosed before the financial crisis is over.” Currently there are 18.6 million unoccupied houses in the US. That is approximately 6 houses for each of the 3.5 million homeless persons. The National Economic and Social Rights Initiative, *The Mind Unleashed*, 2014. Available online at:

<<http://themindunleashed.org/2014/02/18600000-vacant-homes-united-states-enough-every-homeless-person-six.html>>

¹⁷ One may note in passing that in the discourse on sustainable development, little attention is being accorded to ensuring that financing of development itself will be sustainable.

This is especially worrying in light of the fact that estimates show that anywhere from 3.5 to 5 trillion dollars per year will be required to finance development over the next fifteen years. The need to pay attention to the sustainability of finance shows up dramatically in the issue of indebtedness, especially by poorer nations.

Hopefully “development” will be sustainable not only in terms of the impact on the environment, but also from the financial point of view, in terms of the impact on the people that will, in the final analysis, have to pay for it.

¹⁸ Minsky, Hyman P. “The Financial Instability Hypothesis,” working paper No. 74, Levy Economics Institute, 1992, pp. 7-8;

<<http://www.levyinstitute.org/pubs/wp74.pdf>>

¹⁹ Salleh, Murizah Osman, Aziz Jaafar, M Shahid Ebrahim, “The inhibition of usury (*riba an-nasi’ah*) and the economic underdevelopment of the Muslim world,” *Bangor Business School Working Paper*, Bangor Business School, Bangor University, BBSWP/11/002, October 2011, p. 17, accessed online on 15 April 2013;

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