Interest, Usury and its Impact on the Economy

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Abstract

The element of interest or 'Riba' is an inseparable part of the economic activities in today's world. And perhaps it is one of the causes of the business cycles and fluctuations and a hurdle in the way of economic development especially in the third world countries. It is the rate of interest due to which money is treated as a commodity leading to the concentration of wealth in a few hands; and as a consequence, the whole economy then suffers. Allah Almighty has clearly prohibited the element of interest or riba in the Holy Qur'an. The Shariah of Islam makes no distinction between interest and usury. Islam treats money as a medium of exchange and not a commodity. Therefore, taking interest is forbidden on loans for consumption as well as loans for productive purposes. Islam wants to eliminate all forms of exploitation from the economy. It wants to establish justice between the financier and the borrower; the capitalist and entrepreneur in order to establish and maintain an egalitarian society in the world.

Keywords: Capital, Debt Servicing, Exploitation, Interest, Riba, Usury

Introduction

The economic structure of almost all the economies today is based on interest. The element of interest plays a significant role in our today's life which affects all the aspects of man's life and this is the reason that Almighty Allah did not leave especially the economic aspect of man's life to be determined only by the reason, experience and by the intellect of the human beings. He gives importance to this aspect of man's life by stating various commandments and directives in the Holy Qur'an because Allah, Who without any doubt, is the Creator of human beings, wants a happy, prosperous and a dignified life of His creature in both the worlds – this mortal world and the hereafter. Therefore, if man lives his life according to the commandments laid down in the Shariah of Islam will undoubtedly lead a successful and happy life in both the worlds.

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This paper takes into consideration the definition of the term 'interest' or 'riba'; views about interest in different religions; the difference between interest and usury; loans for consumption and for productive purposes; and finally the impact of interest on the economy.

The definition and meaning of Riba

Riba is an Arabic word which literally means increase, addition, growth or augmentation. However, every increase, addition or growth cannot be termed as riba which is basically prohibited by the Holy Qur'an in surah al-Baqara. There is no ambiguity in the Holy Qur'an regarding the concept and definition of the term riba. The Holy Qur'an unequivocally condemns and forbids any claim in excess of the principal amount of money lent to a borrower for any purpose. Allah clearly prohibited interest in the Holy Qur'an by stating that: "*Whereas Allah permitted trading and forbideth usury*"[1]. And Allah directed the believers to give up the practice of taking interest from the people. "*O ye who believe! Observe your duty to Allah, and give up what remaineth (due to you) from usury, if you are (in truth) believers*"[2]. Technically riba refers to the amount of extra money that must be paid by the borrower to the lender of money along with the principal amount as a condition for the loan or for an extension in its maturity period.[3] There are three conditions, according to Khan[4], for the extra payment by the borrower to be termed as riba. These three conditions are: (i) the predetermined rate (ii) which has a relation to the principal amount of money, and (iii) while calculating, period of use of the principal amount of money is taken into consideration, shall be considered as riba. Patinkin[5], as quoted by Ahmad[6] in his book, tries to define the term 'riba' or interest that interest usually originates in the payment for a loan of money over a period of time – although it can also arise from a loan in kind. Interest is essentially measured by the difference between the amount that the borrower repays and the amount that he originally received from the lender. Keynes, a leading economist, has also the same views about the term 'interest'. According to Keynes[7], interest denotes the price of or rent paid on money in exchange for the use of a sum of money, the premium obtained on current cash over deferred cash. From the definitions, it is unambiguously clear that the differential between the amount of money received by the borrower and the amount of money paid by him/her is called riba or interest.

Interest in various Religions

There is no doubt that the Holy Qur'an and prophet Muhammad (peace be upon him) explicitly prohibit the giving and taking of riba and there is complete unanimity among all schools of thought (Hanbali, Shaafi'i, Maliki and Hanafi) in Islam that the term riba stands for interest in all types and forms.[8] However, other religions and prominent philosophers have also the same opinion about the term interest and they all are against the charging of interest on the principal amount of money lent.

The two most prominent Greek philosophers Plato (427-347 BC) and Aristotle (384-322 BC) were also against the charging of interest on the principal amount of money lent to the borrower. They openly condemned and criticized the practice of taking interest from the borrowers. They were of the opinion that charging the amount of money in excess of the principal amount of money is against the law of nature and justice.[9] Aristotle compared money to a barren hen which laid no eggs.[10] Al-Ghazali, a great Muslim Philosopher, is of the opinion that trade in money for earning some interest makes money an end objective (like a commodity) which is zulm (oppression).[11] The main purpose and objective of money, according to him, is to solve the problem of exchange and valuation. Money, no doubt, is a factor of production but money cannot produce money without the application of man's labor. Moreover, its reward cannot be predetermined.

Likewise the Christianity was also against the charging of interest and prohibited all such transactions in which the element of interest was involved. Islahi[12] presents some passages from the Old Testament and the New Testament regarding the prohibition of interest. Deuteronomy 23:19: 'Thou shall not lend upon usury to thy brother.' Likewise in the New Testament we find the words of Jesus: 'lend freely hoping nothing thereby,' Luke 6:35 imply that charging of interest is against the spirit of Christianity and is therefore, prohibited.[13] Though transactions were mainly based on interest through out the Christendom and the world over, the Christian Church was openly against this practice.

Interest and Usury

According to Ahmad:

> *"Historically interest and usury always treated as one and the same thing. It was only in the post-Christian, post-renaissance period of European history that the term interest was used as a substitute for usury to wriggle out of the religion and moral prohibition".*[14]

Historically, all the world religions including Christianity were against the charging of interest over the principal amount of money lent to the borrower and it was considered unethical, illegal, unjust and exploitation of the borrower. However, with the passage of time and development in commerce and trade especially in Europe undermined the influence of the stand of the Christian church regarding the charging of interest on the amount of money borrowed. And also we see a change in the definition of the term interest from the previous version. According to encyclopedia Britannica:

> *"In old English law, the taking of any compensation whatsoever was termed usury. With the expansion of trade in the 13th century however, the demand for credit increased, necessitating a modification in the definition of the term. Usury then applied to exorbitant or unconscionable interest rate. In 1545 England fixed a legal maximum interest; any amount in excess of the maximum was usury. The practice of setting a legal maximum on interest rate was later followed by most states of the United States and most other Western nations."*[15]

It was basically the expansion in commerce and trade which needed credit and secondly the Churchmen themselves too became the owners of large estates and wealth which persuaded them to redefine and reinterpret the laws related to the term interest.[16] And so a distinction was made between interest and usury. Charging of a high rate of interest, above the legal fixed maximum was termed as usury and considered illegal. The Oxford dictionary defines the term usury as the practice of lending money at exorbitant interest especially at higher interest than is allowed by law. Now the question is, what is an exorbitant rate of interest which may be called usury and what mechanism may be adopted for its fixation? An exorbitant rate of interest today may not be an exorbitant rate of interest tomorrow or a reasonable rate of interest today will not be a reasonable rate tomorrow or in near future. Therefore, we see a wide range of variations in the rate of interest from as low as 10 percent to as high as 300 percent. The differentiation between usury and interest is almost impossible. According to Chapra:

> *"The rate of interest, if it is market determined, is high or low in a country depending on the demand for and supply of, loanable funds, the nature and extent of the risk involved, and the rate of inflation. Hence, if interest is accepted then its market determined rate must also be accepted irrespective of whether it is high or low. Usury cannot be condemned."*[17]

Loans for Consumption and Production

The basic cause of a deliberate distinction between interest and usury was a high demand for credit in order to meet the increasing needs of the commerce and trade sectors in Europe. Some Muslim scholars who had no depth in Islamic Fiqh were also influenced by the new interpretation and distinction between interest and usury. For instance, in the context of sub-continent, Sir Sayyid Ahmad Khan, the proponent of the 'Two Nations Theory', was the first person who advocated this distinction between usury and interest. They made such distinction on the basis of loans for consumption purposes and loans for productive purposes. According to them, Islam prohibited usury and not interest. The Holy Qur'an, according to them, prohibited interest on loans for consumption purposes and not on investment purposes. They are of the opinion that the Qur'anic injunction regarding the prohibition of interest refers only to the interest on non-productive/consumption loans which prevailed in the pre-Islamic period when people were not familiar with productive loans.[18] This is only an assumption but not true. There are some documentary proofs available in the researches done by many researchers and scholars which contradict this claim. These researches show that loans were given for both consumption and for productive purposes even during the lifetime of the prophet Muhammad (peace be upon him).[19] Abu Zahrah, a prominent Muslim scholar is also of the opinion that there is no evidence available in the history to support the view that interest or riba in the pre-Islamic era was on consumption loan and not on loans for investment purposes.[20] He further says that the circumstances of Arabs, the position of Makkah and the trade of Quraysh, all lend support to the claim that the loans were for both production and investment purposes. Islam came to the people who were basically traders and businessmen and therefore, when interest was prohibited by Islam, its followers stopped immediately the practice of interest.[21]

Islam prohibited all kinds of pre-determined rates of interest whether the loan is for consumption or for productive purposes. Islam says that the principal amount of loan should be protected and any amount other than the principal is strictly prohibited. The lender has no legal and moral right to claim a fixed rate of interest on loans advanced even for productive purposes. When a loan is given without sharing the risk, any additional payment, small or large, in excess of the principal amount of the loan, constitute interest/riba and as such is prohibited by the Holy Qur'an.[22]

The Holy Qur'an makes it clear in verses 276, 277 and 279 of surah al-Baqarah that it is not only the compound rate of interest which is prohibited but also all types of interest. It is quite obvious from these verses that you have your principal amount and not anything above the principal amount of loan. The Pakistan Council of Islamic Ideology (CII) clearly expressed this view in 1980 in its report on the elimination of riba from the economy of Pakistan. The report says:

> *"The term riba encompasses interest in its all manifestations irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are for a personal nature or of a commercial type, whether the borrower is a government, a private individual or a concern, and whether the rate of interest is high or low."*[23]

The Impact of Interest on the Economy

According to the classical economists, there is a reward for the amount of saving in the shape of interest. The higher is the rate of interest the larger the premium for savings and vice versa. They then tried to link saving and investment. An increase in savings means an increase in the volume of investment in a country, they argued. But they ignored that an increase in the rate of interest means an increase in the cost of investment which will adversely affect the total investment in the country. Rather, there is direct relationship between saving and income (Y) of the people because savings (S) and consumption (C) as well as induced investment (I) depends on income. If income increases savings increases. Keynes also objected to the classical economists and is of the opinion that an increase in the rate of interest will decrease investment and as a result the whole economy will be badly affected.

If there is no interest, the amount of savings will be available for investment with zero cost and the rate of investment will increase and the economy will take off based on Musharakah and Mudarabah modes of finance both. It is basically the rate of investment that influences positively the total income of the people which ultimately enhances the ability of the people to save more. This is how one can explain the enormous increase in savings during the present century in-spite of a steep fall in the rate of interest.

Another adverse impact of interest on the economy may be in the shape of increase in debt and debt servicing in the country concerned. It is generally agreed upon that foreign loans play a crucial role in the economic development of the recipient country. However, it should also to be kept in mind that a loan taken by the poor country on a high price (high rate of interest) will rather increase the total amount of loan and will make difficult the repayment of installments of the debt. It is the repayment of the foreign loans that pose some of the most difficult problems to the poor countries like Pakistan. The debt service ratio is steadily increasing in terms of export earnings, percentage of GDP ratio and percentage of current total expenditure of the country.

The table 1 shows the external debt servicing as a percentage of GDP, debt servicing in total current expenditure of the country and debt servicing as a percentage of export earnings in Pakistan. It shows that how the actual debt and the payment of interest badly impact the life of a common citizen by setting aside a significant portion of the GDP to pay for the installments. In other words, it affects the poor Pakistanis in two ways. First, as debt servicing obligations increases, a large amount of personal income would be taken away by the government in form of taxes to repay both the outstanding debt and the amount of interest. Second, due to the inability of the government to meet the rising debt servicing obligations in the face of insufficient foreign exchange earnings, the government would request the donor countries for concessions which would inevitably influence the socio-political and economic policies of the recipient country. And as a consequence, the government of Pakistan is supposed to adopt policies that are dictated by the donor countries but are not necessarily in the national interest.

Table 1 Debt Servicing in Pakistan since 1949-50

Year	Debt Servicing as %age of GDP	Debt Servicing in Total Current Expenditure	Debt Servicing as %age of Export Earnings
1949-50	0.2	3.6	-
1954-55	0.4	8.2	1.3
1959-60	0.7	11.3	6.9
1964-65	1.1	18	25.9
1969-70	1.8	19.6	52.1
1974-75	2.2	18.4	23.9
1979-80	5	35.5	24.7
1984-85	6	34.4	31.6
1989-90	8.9	44.6	24.9
1994-95	8.3	46.9	25.1
1997-98	10.7	31.9	27.9
1998-99	11.7	34	19.7

1999-2000	9.7	37	17.6
2000-01	8.3	34.7	18.7
2001-02	10	33.1	14.3
2002-03	6.3	26.2	14.4
2003-04	5.4	24.1	25.8
2004-05	4.7	19.7	12
2005-06	4.8	-	12.9
2006-07	-	-	12.2
2007-08	-	-	10.2
2008-09	-	39.6	18
2009-10	4.4	35.2	15.7
2010-11 (Jul-Mar)	0.8		9.9

Sources: Economic Survey (2009-10, 1995-96); GoP (2011) Pakistan Debt Policy Statement (2009-10 and 2010-11, table 4, p. 12).

The interest free loans and aids, on the other hand, stimulates positively the investment base, increases production, productivity, and mainly the ability of the poor country to enhance the potential of her exportability which ultimately enhances the standard of life of a common man and encourages the development of the economy as a whole.

The institution of interest makes the capitalist and wealthy people greedy and lazy too. They earn easy money by advancing their extra money based on interest while doing nothing in concrete. They remain unconcerned whether the receivers of the loans earn profit or make loss. The whole burden lies on the borrower. He/she has to pay the lender the principal amount of loan plus a fixed percentage as a reward for his/her money. This makes the lender lazy and greedy and this is the attitude which hampers the process of development and progress. Islam is deeply concerned with the life of man both in this mortal world and the life hereafter, therefore, Islam prohibited interest altogether. Islam encourages trade and profit instead of interest. The capitalist or lender becomes involved and concerned with the use of the fund by the borrower or entrepreneur from the very beginning. In this case, the experience of the entrepreneur and the acumen of the capitalist or lender becomes united and one which ultimately benefits the whole society by increasing the total volume of production and employment in the country.

Capitalism treats capital as a factor of production and interest as reward for capital. Interest as a reward for capital remains fixed without knowing the profitability of investment in advance. This makes investment very risky and hampers the growth of the process of production in a country. Several resources of production become unemployed which ultimately reduces the total amount of commodities in the country. Another effect of charging the rate of interest is an increase in the prices of commodities by increasing the cost of production. Two main adverse impacts follow: first, the consumers have to pay high prices for all types of commodities produced in an interest based economy and secondly, due to high rate of interest, quite a sizable portion of the labor force becomes unemployed.

People keep their surplus money in banks for various reasons. One of the reasons is to earn money in the shape of interest. People as well as banks divert their deposits for the purchase of bonds and securities etc for speculative purposes, and so, quite a large amount of liquid assets is set aside for just unproductive activity. Yes, it promotes trade and investment, however, charging interest on them increases the price of goods produced. Moreover, banks also keep certain percentage of their deposits with other banks and financial institutions with higher rate of interest without investing these deposits in productive investment purposes. So, the money and savings available for productive investment becomes scarce. The capital when becomes scarce and limited it raises the interest rate due to a positive relationship between the two. More funds will be diverted to banks and speculation. Further reduction in real investment, a further reduction in employment opportunities, further reduction in income of the people, further reduction in the purchasing power of the people, further increase in the prices of commodities due to disequilibrium between supply and demand for commodities, and as a result, increase in poverty and a low standard of life of the masses.

Some developed countries like USA, sometimes intentionally destroy their surplus production and throw it into the sea. This is because the supply of the product is greater than the demand for the product. The price of the product in question decreases to an extent which does not even cover the marginal cost of the product. Two remedial measures can be taken to correct this situation. One, to increase in the purchasing power of the consumers which will enable them to purchase more of the product and second, reduction in the marginal cost of the commodity which is possible by eliminating the element of interest. The marginal cost of the commodity in question will be decreased and as a result the purchasing power of more and more people will be increased thereby enabling them to use the commodity.

One of the social evils of interest is that it inculcates selfishness, miserliness, inhumanity and financial greed in the minds of the people. They become careless about the needs of their fellow citizens. Individualism takes place and society suffers. The same happens to the international relations. One nation finds its benefits from the needs and miseries of the other. After World War Second, England requested its ally in the war America for interest free loan. America did not honor the request on the pretext that it is not a practical business and provided the loan to England on a certain rate of interest. After signing this contract with America, J. M. Keynes, a great economist, delivered a speech in the House of Lords. He said that he will not be able to forget this event during his life time that America did not provide us interest free loans.[24]

Conclusion

The element of interest creates hurdles in the smooth running of the economy and one of the main factors which brings about economic crisis. Locke, a great political philosopher, is of the opinion that high rate of interest decays trade.[25] Most of the prevailing economic problems in today's under-developing countries stemmed to the element of interest in one way or another. Irshad comments that:

> *"Interest has been responsible for the destruction of many powers and causes of misery of many societies. The collapse of Wall Street Finance Market in the early 30's in USA brought an earthquake in the economic structure of the world. The economy of the world has shaken and shattered and many thinkers began to wonder about the soundness of such an economy based on interest. This followed the control of credit and interest by the central banks in almost all the countries of the world. Since then the central banks are fighting with the rate of interest whereas the problems of inflation, deflation and trade crises continues, and the bankers as well as the economists are facing a new problem every day all over the world."*[26]

The Almighty Allah has prohibited all forms of interest because the Creator wants a happier and prosperous life of His creature in both the worlds. The verses regarding interest in the Holy Qura'an wants to establish an economic system where there is no exploitation at all. Islam wants to establish a financial system wherein equal opportunities for ensuring a decent living are provided. However, it doesn't want to militate against the difference in individual talents & it is this talent which leads to difference in the out-put. It eliminates all forms of exploitation. It establishes justice between the lender and the borrower; the capitalist and the entrepreneur which leads to brotherhood, fraternity, economic progress and a better standard of life for all.

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