

An interest-free economy?

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THE recent decision by the Federal Shariat Court, directing the government to ensure an interest-free economy by 2027, raises questions about whether it is achievable. What follows is a short, non-technical discussion of a complex issue about which whole tracts have been written.

It should be noted, however, that this article has nothing to do with theology or the religious aspect of this issue. I am only going to delve into the socio-economic aspects and some ground realities relevant to this matter.

To begin with, a zero-interest economy is not a mirage. In fact, post-2007 recession, central bank determined interest rates (nominal) in industrialised nations remained close to zero for quite some time, giving rise to economics of the Zero Lower Bound (ZLB).

Second, Pakistan has had its fair share of attempts at 'Islamisation' of its economy, most notably under Ziaul Haq. For example financial institutions like the National Investment Trust (NIT) started operating on interest-free basis. Interest-bearing securities were replaced by Participation Term Certificates (PTCs). HBFC advanced loans based on rent-sharing basis. In January 1981, commercial banks opened interest-free counters besides accepting deposits on profit and loss sharing basis. For agriculture, 'Taccavi' loans, carrying a rate less than half of official rates, were initiated.

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And third, we tend to underestimate the extent of interest-free credit that is already prevalent in Pakistan. It is difficult to come across a person in Pakistan who has not taken or given an interest-free loan to a friend or a relative. It's just that we don't have a count of its extent. Additionally, there are institutions like Akhuwat that advance interest-free loans.

But none of these attempts succeeded in upending the interest-rate economy. Delving into the nature and causes of this issue, though, would help us understand its persistence.

Start by realising that money is something very valuable and extremely useful, the most liquid asset and a substantial part of total wealth. Such a valuable asset, in turn, commands a premium for its use. That premium can assume many names (like interest rate) and come in many forms, and is not subservient to any administrative endeavour or order. That is how credit has evolved throughout human history.

Also, in trying to force down the price of a useful commodity, we come up against an irrefutable law that has stood the test of time over thousands of years: it leads to that commodity's shortage, hoarding and expansion of informal/black market. That is what is likely to happen in case official interest rates are forced down to zero (or near zero): we will likely see a tremendous expansion in informal channels of lending (we already have quite a few), and formal lending

channels coming up with creative ways to either hoard or extract the required price for credit provision (readers should contemplate a bit on why, in the first few days of a month, ATMs are usually 'out of order', or why informal money lenders charge a premium on small denomination bills when Eid beckons).

Further, the use and pricing of credit is subservient to various socio-economic norms that affect the supply and demand of capital. For example, a government with a poor fiscal management record and poor finances (like Pakistan) is highly unlikely to get credit cheaply. Aside from being a competing, scarce resource in a society, the price of credit factors in other prevalent risks emanating from individuals, groups or various sectors of the economy.

Consider, for example, the poor judicial setup in the country which makes recovery of non-performing loans (NPLs) an excruciatingly painful task. This is besides the overall low level of trustworthiness in our society where fraud and deceit are common. In such a risky environment, a valuable resource like credit will always command a premium, whether it is named interest rate or given some other moniker.

In light of the above, is it possible to have a functioning economy that operates at a zero (or near zero) interest rate with benefits to the economy and society? Yes, theoretically at least. I gave the example of the post-2007 recession that saw nominal interest rates crashing to near-zero and remaining so for some time. But, as a policymaker, you really ought to stay clear of that predicament because it occurred based on aggregate demand's crash, inflicting immeasurable misery upon the populace.

In short, for near-zero rates to happen in Pakistan, the present order of things (economic and social) would need to change drastically. We would need to change from a heavily consumption-based economy to one that is savings-based. The overall productivity of both the private and the public sector will have to rise tremendously in order to get things done with lesser capital. Federal and provincial governments would have to become exceptionally good at getting more output of every rupee of input (technically speaking, marginal efficiency of capital would have to rise manifold), primarily because 60 to 70 per cent of credit (stock and flow) goes to the public sector, thus 'crowding out' the comparatively productive private sector and resulting in a lot of waste.

Similarly, the regulatory and NOC economy will have to give way to business-friendly laws and a supportive judicial infrastructure that would lead to increase in transactions. Moreover, the overall trust level in society would need to increase tremendously from its present poor state.

Put another way, the transition should be such that capital competes for best returns. Frankly, I don't see that happening anytime soon.

I will conclude by asserting again that this was just a very basic, rudimentary introduction to the issue of interest-free economics and the practical realities that stand in its way. Otherwise, if one were to probe deeply, this is quite a complex matter that involves challenging concepts like multiple equilibria in an economy and multiple interest rates operating alongside each other.

Above all, next time their lordships should perhaps return such petitions since interest-free economies can never be the outcome of legal and administrative injunctions.

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