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# Achieving the Objective of Interest-Free Economy: Challenges and Prospects

Rafi Amir-ud-Din<sup>1</sup>, Shazia Aziz<sup>2</sup>, and Sidra Rasool<sup>3</sup>

<sup>1</sup>*Department of Management Sciences, COMSATS Institute of Information Technology, Lahore*

<sup>2</sup>*Department of Humanities, COMSATS Institute of Information Technology, Lahore*

<sup>3</sup>*Sheikh Zayed Islamic Centre, University of the Punjab, Lahore*

## Abstract

Achieving the objective of the interest-free economy is critical for Islamic countries because interest is categorically prohibited in Islam. However, this objective has proved elusive partly because Islamic countries have to work within the capitalistic framework which crucially depends on interest to equilibrate debt and credit. Forces of globalization have made it hard for a country to exist in isolation in a world dominated by the capitalistic system. In this study, we have found that the legislative measures undertaken in Iran and Pakistan to outlaw Riba have not proved effective and have also opened backdoor to Riba. We have argued that a vibrant growth in the Islamic financial system is not enough per se unless some of the instruments at the disposal of Islamic financial institutions (IFIs) such as Murabaha and Ijarah are further reviewed to ensure strict compliance with the standards of Shariah. More importantly, the operations of the IFIs have to embody the spirit at the root of injunctions prohibiting Riba. It is argued that some space within the capitalistic system can be expeditiously used probationally such as maintaining zero interest rates and pursuing policy of interest free loans. However, achieving the objective of interest-free economy is not possible unless we develop effective institutions. We also highlighted the critical role of moral commitment to achieve the objective of Riba-free economy. Using data for the OIC countries, we found that the strong commitment at the mass level required to establish the vibrant Islamic economic and financial institutions is lacking.

**Keywords:** Interest-free economy, Zero-interest rate, Islamic Financial Institutions (IFIs)

## 1 Introduction

The Islamic world is facing a deeply disturbing and paradoxical situation. It has to operate in a world dominated by the capitalistic system. However, the core Islamic economic values fundamentally differ from the capitalist values. One of the essential features of Islamic economic system is the prohibition of Riba while it is the linchpin of the capitalistic system. Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offense) are companions of the Fire: They will abide therein (forever)" (Quran, 2:275). The Prophet Sallallahu Alaihi Wassallam was no less categorical in emphasizing the enormity of the sin involving Riba. Jabir b. Abdullah reports that the Prophet cursed the receiver of interest and the payer thereof, the one who records it and the two witnesses thereof. He said: "They are all alike in guilt" (Muslim, Tirmidhi, Ahmad). In another Hadith, the Prophet Sallallahu Alaihi Wassallam said, "Riba has 73 doors or 70 grades, least serious is equivalent to committing adultery with his own mother" (Ibn Majah).

Even if controversy rages on endlessly about what constitutes Riba, there is a compelling evidence to suggest that the adverse consequences of interest-based debts are well understood even in the capitalistic framework. Mian and Sufi (2015) pile up a huge evidence which points to the fact that interest-based debt leads to inequality by putting borrowers at a disadvantage, causes bubbles and boom and bust cycles, stalls recovery from crises, causes bank runs, promotes exhibitionist consumption and is often used as a strategic tool by non-state actors.

The challenge faced by the Islamic world is twofold: achieving the objective of a Riba-free economy and more ominously, doing this in a framework dominated by the capitalistic system which crucially depends on interest. Against this background, we have explored a set of options to achieve the objective of a Riba-free economy. In this study, we have briefly reviewed the history of legislative measures undertaken in Iran and

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**Corresponding Author:** Rafi Amir-ud-Din, e-mail: rafi.amiruddin@ciitlahore.edu.pk

Pakistan to outlaw Riba with a view to learn some useful lessons for future (Section 2). In Section 3, we have highlighted some of the issues central to the development of Islamic financial institutions (IFIs). In Section 4, we have explored the space available in the capitalistic system to pursue interest-free policies. Section 5 thoroughly analyzes the challenges in the way of abolishing Riba against a background where capitalistic system dominates the world and globalization process has made it nearly impossible for any nation to survive in isolation. This section also highlights the critical role of moral commitment to achieve the objective of a Riba-free economy. With the help of simple bi-variate analysis, we have done an empirical analysis in this section to show that in the absence of a strong will at the mass level, a Riba-free economy will remain a distinct dream.

## 2 Ending Riba: A gradualist approach

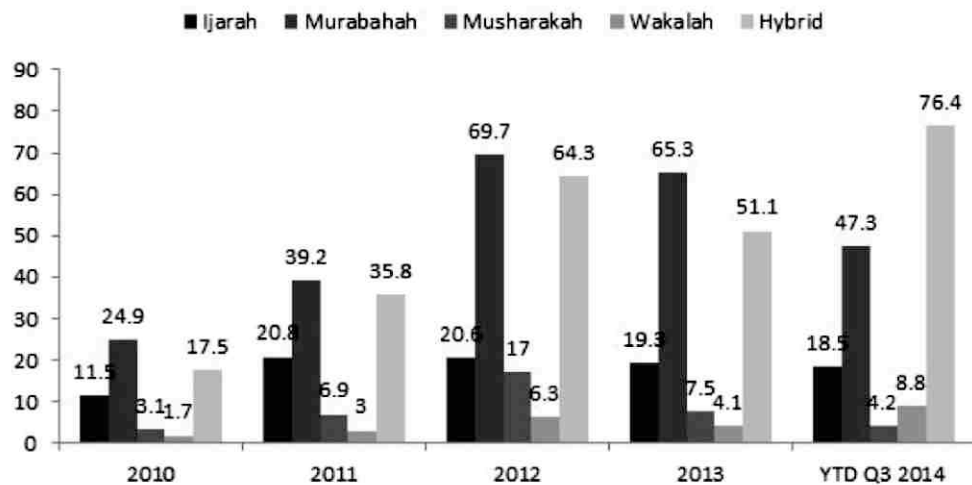
### 2.1 Legislative measures: lessons from Iran and Pakistan

While almost all the OIC countries have dual banking system based on Islamic and conventional models, only three countries claim to have applied Riba-free principles in their local banking transactions including Iran, Pakistan and Egypt. Both Iran and Pakistan banned Riba and put in place measures to make the financial sector Shariah compliant (Kuran, 1993; Noman, 2003). They used primarily two types of operational tools: profit loss sharing (PLS) and nonprofit loss sharing. Initially, both countries used profit loss sharing (PLS) investment mode. In the PLS system, customers of the banks share the profit on their investment, and in case of loss they also share it. The non-PLS based Murabaha and Ijarah are other widely used instruments by the banks. Murabaha is a mark-up based transaction. In this contract, the lender marks up the price of some object so that interest becomes the part of the price. Given that this transaction involves an element of interest, some Shariah scholars question its validity (Abdul-Khalik, 2014).

While Iran and Pakistan are similar to an extent that they have put a ban on Riba, there are some marked differences between these two countries. In Pakistan, the debate on what is the true definition of interest is still raging endlessly but there was no such debate on the definition of interest-rate in Iran. Iran followed rather more moderate approach to the definition of interest-rate but in Pakistan the more traditional and literal interpretation of interest was preferred (Noman, 2003, 2006).

**Figure 1: Sukuk instruments traded in the Islamic Financial Markets (US\$ Billion) Source: Thomson Reuters Sukuk Perceptions & Forecast 2015; Global Islamic Finance Forum, E&Y Reports, Zawya<sup>1</sup>**

It is perceived that there was an element of political expediency in abolishing Riba through constitutional measures in Iran and Pakistan (Gafoor, 1997). While both these countries are quite similar in that they used the issue of interest-rate for achieving political legitimacy and leverage, they stopped short of enforcing the Riba ban according to the strict interpretation of Quranic and Hadith literature. It should be a small wonder



that, Murabaha, which is a purchase and resale contract and includes marked up price, makes up a large chunk of the total transactions of the operations of the Islamic banks (Abdul-Khaliq, 2014; Haron, Ramli, Injas, & Injas, 2015). The Figure 1 below shows the historical trend of various Sukuk instruments used in the Islamic financial markets.

Pakistan's constitution is quite categorical that interest-rate should be abolished. However, the effort to abolish interest from the economy was undertaken in all earnestness by the military dictator General Zia-ul-Haq who ruled Pakistan from 1977 to 1988. The conventional banks were ordered to start operations on the profit loss sharing system basis. However, in practice, most of the banks shifted their interest-based operations to both profit loss sharing system and to the mark up based Murabaha system (Khan, 2008). These developments made many scholars question the validity of the Riba-free process put in place through legislative measures, and the situation was considered "a crisis of identity of the Islamic financial movement" (Iqbal & Molyneux, 2016; Siddiqi, 1983). In the wake of the turbulent Islamic revolution in Iran, the banks were nationalized in 1983. Parliament outlawed Riba through legislative measures except when they were dealing with the foreign countries. The Guardian Council however allowed interest-based transaction to the non-Muslims.

One of the most conspicuous lessons is that despite the legislative measures undertaken in Iran and Pakistan to abolish Riba from the economy, neither country has been able to successfully abolish Riba. On the contrary, the legal obligations only made banks look for the loopholes in the system and shift their operations to the Islamic transaction models such as Murabaha and Ijarah which are of questionable juristic validity. The reasons behind this is that when Islamic economic system has to operate within the bounds of the dominant capitalistic system, such failures should not be surprising. In Section 5, we shall discuss the implications of coexisting with capitalistic system.

### 3 Ridding Financial Sector of Riba

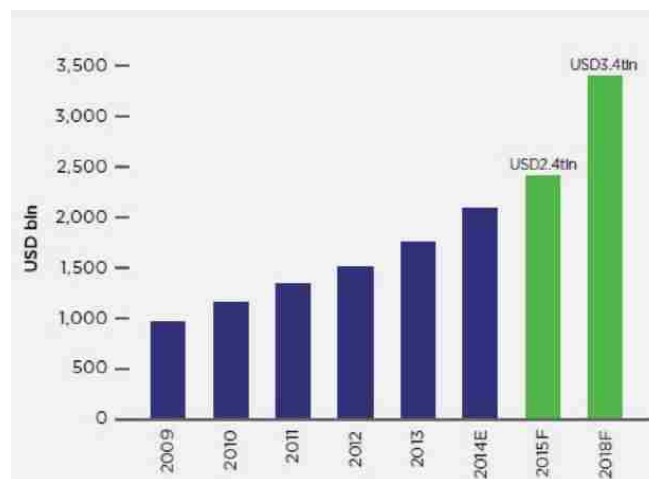
#### 3.1 Steep rise in Islamic banking and finance

Assets in the Islamic banking sector all over the world have grown remarkably from close to 200 US\$ 200 billion in 1990s to around US\$ 2000 and is projected to reach US\$ 3500 billion by 2018 (Figure 2 below).

Figure 2: Global Islamic assets (US\$ Billion)

Source: KFH research database

The growth of Islamic assets to around 17 times in this period is by no means a mean achievement. However, it

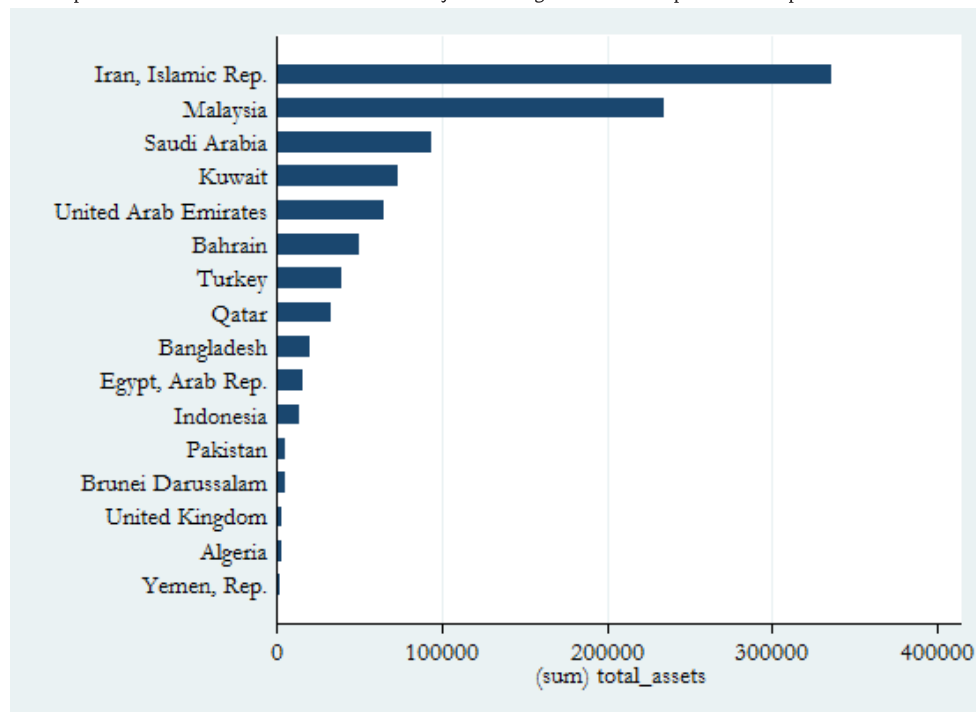


is important to note that the Shariah compliant Islamic assets are not equally distributed in the Islamic world. In the Figure 3 below, we see that it is Iran and Malaysia which lead the rest of Islamic countries by a wide margin in terms of the assets in their Islamic financial markets.

Figure 3: Total Assets of Islamic Financial Institutions (Million USD)

Source: Source: Global Financial Development Report 2014

A steep rise in the Islamic banks in Islamic societies, it is argued, is per se not a good thing unless it satisfies some important criteria. It is desirable if and only if it is aligned with the spirit behind prohibition of interest-



rate. The spirit behind prohibition of interest-rate is to end poverty and exploitation, reduce inequality and promote co-operation. One measure of judging as to what extent the deeper penetration of Islamic banks has been instrumental in achieving these goals is the reduction of inequalities and absolute poverty and promotion of cooperation among the people. When enough data becomes available on the Islamic assets and various components, it will be possible to analyze the impact of the Islamic banking and finance on the level of inequality and poverty in the Islamic countries and other societies where Islamic banking and finance is being practiced. Though some studies have theoretically analyzed the impact of micro-financing initiatives such as the operations of Akhuwat on poverty alleviation (Akhter, Akhtar, & Jaffri, 2009; Alam Choudhury & Wajdi Dusuki, 2008), most studies do not come close to providing reliable empirical evidence on the relationship between penetration of Islamic banking and finance and any significant change in the redistribution of resources.

### 3.2 Question of Shariah compliance

If a gradual approach is a preferred method to achieve the objective of Riba-free economy, it is crucial to rid the existing Islamic financial institutions of the anomalies which open a back door to interest and are liable to be used as legal trickery to gloss over interest in the transactions. Evidence suggests that majority of the instruments used by Islamic banks are, in their essence, no different from the debt-based and interest-based instruments used by the conventional banks. Instruments generally used by the Islamic banks such as Ijarah and Bai Salam, are the ones which are declared as exceptions according to some scholarly opinion. However, the instruments that are based on sharing the risk such as Musharka and Mudharba make only a small part of the operations of the Islamic banks (See Figure 1).

### 3.3 IFIs: Embodying spirit of riba-prohibition is critical

One of the reasons behind the prohibition of the interest rate is that it leads to inequality and exploitation.



Islamic economic system focuses on creating a just society where the people with adequate resources must come to the help of have-nots. "They ask thee how much they are to spend; Say: "What is beyond your needs." Thus doth Allah Make clear to you His Signs: In order that ye may consider" (Quran 2:219). Even if it is easy to expect the obvious differences between the spirit of devouring interest and the spirit of spending in the path of Allah, surprisingly the similarities between Islamic and conventional banks are telling. Profits offered by the Islamic banks on PLS accounts are roughly the same as are offered by the conventional banks. Many Islamic banks slap penalties if some customers fail to repay the loans within the stipulated time.

Banks need to be overly watchful when it comes to making investment decisions. There are clear guidelines as to where investment is permissible and where it is not permissible. One cannot do any business which is expressly prohibited in Islam such as the sale of wine or pork. However, there is widespread belief that Islamic banks are not adequately strict in the investment decisions. Islamic banks at times invest in the stock exchanges which involves speculation (gharar) which is clearly prohibited in Islam. On the other hand, Islamic banks have to make sure that they engage in a business activity which is beneficial for the society. Only those businesses need to be undertaken which generate real economic activity.

There is a lot of research to suggest that if we can create an economic activity in the financial sector only without any corresponding activity in the real sector, there would be huge bubbles and violent booms and busts in the economy (Allen & Gale, 2000; Semlali & Collyns, 2002)

Yet another salient feature of the Islamic businesses is the equity based transactions rather than debt based transactions. The preferred mode is risk sharing activities. Musharka and Mudharba need to be the essential mode of Islamic business model, while markup based leasing (Ijara) and Murabaha should be discouraged. In a nutshell, if the profit is the only business of the business, as Friedman (2007) famously put it, it is not possible for the Islamic banks to reflect the spirit which lies at the heart of Riba prohibition.

#### 4. Maneuvering within the capitalistic system

As we discussed earlier that the objective of abolishing the interest from the economy can be achieved only gradually. It may be expedient to use the space that is available in the capitalistic system. The Islamic world may adopt the risk-sharing business models in the developed world and replicate them in their conventional sector. Islamic world may also undertake the interest-free loans initiatives in the public sector and in private capacity. As is being done by many major banks in the developed world, arrangements may be put in place to ensure that the lenders and borrower may share the operations of the proposed venture. Micro-financing is another possibility and there are many institutions in the developed world that are providing interest-free micro-financing. For example, No Interest Loans Scheme (NILS) that has been operating in Australia has given interest free loans to 20,000 borrowers. Over 70% of the recipients were women and the elderly, while the repayment rate has been 93%. Interest-free societies with a focus on some specific target group have also flourished in the United States.

New York Hebrew Free-Loan Society has given interest free loans to nearly 1,000,000 people with a repayment rate of 99%. Interest-free loans to the students is yet another successful program (Beed & Beed, 2014).

##### 4.1 Zero interest rate

In recent years, the frequency of policy rates reaching zero percent or even in negative territory has increased in many parts of the world, especially after the 2008 financial crisis. Islamic countries may try to use their monetary policy tools to bring policy rates down to zero percent. Evidence suggests that many central banks have brought interest rates close to 0% after the 2008 global financial crisis (Honkapohja, 2016). In Japan, effective short-term interest rates have been zero since 1998 (Claus, Claus, & Krippner, 2016) and some other money and capital markets have gone down below zero interest rate (von Ruden, 2015). When the policy rate goes below certain rate, the monetary policy is sometimes found to become totally irrelevant (Apergis & Christou, 2015). The zero interest rate can give us a greater freedom to extensively use fiscal measures which are more consistent with the Islamic ethos. Fiscal policy stabilization is found to compensate for welfare losses caused by persistence of zero bound interest rates (Schmidt, 2013). Some studies have also found that in case of zero interest rates, the multiplier in fiscal policy can change by large magnitude (Ramamurthy & Sedgley, 2013). Even in some cases, exchange rate can be effectively used as an alternative to the monetary policy when the interest rates are close to zero (Iwata & Wu, 2012).

#### 4.2 Sharia's point of view

To what extent it is acceptable for the Islamic countries to maneuver within the capitalistic system and adapt from capitalistic system is a question of juristic debate and inquiry. One view is that corroborating interest rate in any circumstances is unacceptable. The Quran is very categorical when it says that believing in part of the book while rejecting the other part of the book has serious consequences. "Believe ye in part of the Scripture and disbelieve ye in part thereof? And what is the reward of those who do so save ignominy in the life of the world, and on the Day of Resurrection they will be consigned to the most grievous doom. For Allah is not unaware of what ye do" (Quran, 2:85). However, there are some attenuating circumstances. If there is utter necessity (iztiraar), it is acceptable to consume those things that are prohibited for bare survival only. "But if one is forced by necessity, without willful disobedience, or transgressing due limits; then is he guiltless" (Quran, 2:173). Similarly, when one is committed to fight back, a strategic retreat is also acceptable. "If anyone do turn his back to them on such a day - unless it be in a stratagem of war, or to retreat to a troop (of his own)- he draws on himself the wrath of Allah, and his abode is Hell— an evil refuge (indeed)!" (Quran, 8:16). There are many instances in which things from foreign cultures have been adapted only if they do not pose any challenge to the fundamentals of Islamic faith such as digging the trench and using cannon (minjnee) in the battles. Taking cue from these examples, it may be acceptable to adapt from the capitalistic system the models which are clearly consistent with Islamic way of life such as business models based on risk-sharing and interest-free loan schemes and zero interest rates through monetary policy manipulation.

### 5. Challenges in abolishing Riba

#### 5.1 Dominant capitalistic system

The objective of a Riba-free economy cannot be achieved in isolation. Currently we are living in a uni-polar world in which the dominant political system is the liberal democracy and the dominant economic system is capitalism. One shared characteristic of democracy and capitalism is that they divorce religion from the affairs of public life and relegate it to the position of a personal matter. Previously the world was divided into two blocs that ensured a balance of power. Following the defeat of the Communist bloc at the hands of Allied forces in the World War II, the Soviet Union represented a powerful symbol of the communism until its demise in the 1991. Thatcher's privatization and Reagan's deregulation policies had already represented sharp departures from the socialist policies of the major western European economies and Canada. The net result is that the dominant economic system after 1990s is capitalism and it has remained unchallenged so far.

The recent wave of globalization setting off some 20 years ago, has reinforced dependencies in the economic relations of the nation states. International institutions such as the World Bank and IMF have assumed a greater role in the working of the global economy. Against this background, the vulnerabilities of the developing countries have also been accentuated. The economies of most of the Islamic countries are dependent on the foreign aid that is based on interest-rate. Industrial sector of the Islamic countries is most conspicuously financed by state control financial institutions which are interest based and more importantly are linked with international financial institutions (Ayaz, 1984). So it is not easy to set an isolated interest-free economy of the country that is dependent on the developed world for its economic survival (Razi, 2014).

#### 5.2 Capitalistic system is antithetical to Islamic worldview

Islamic economic system and the capitalistic system are radically different from each other. Islamic system encourages a life of simplicity and moderation, while the capitalistic system favors spending on luxury goods and conspicuous consumption. When profit becomes the only justification of the economic activity, the culture of consumerism is the only expected result. In this culture of consumerism, the sooner a consumer disposes of his belongings the better it is. High GDP growth is not possible unless consumption increases. Often elaborate advertising campaigns are required to artificially create a demand for the things that may be unnecessary. Islamic economic system also differs from the capitalistic system in that the former focuses on generosity and the resulting circulation and distribution of wealth, while capitalistic system is focused on savings and investment and accumulation of the private wealth (Zaman, 2015b).

Love of money for its own sake has always remained a despicable moral quality. However, pursuit of wealth is the cardinal principle of capitalism. Weber believed that in the capitalistic system, pursuit of wealth for its own sake has reached a point of irrationality (Weber, Tawney, & Parsons, 1930). It is not possible to develop institutions to satisfy the desire for limitless production without legitimizing the love for money and greed. Keynes realized that a single-minded pursuit of wealth was an undesirable thing but, in a convoluted sense, it was necessary for the time being to pursue wealth. He wrote that the accumulation of wealth is the most

distasteful of human qualities (a mental disease). But he said that For at least another hundred years we must pretend to ourselves and to everyone that fair is foul and foul is fair; for foul is useful and fair is not. Avarice and usury and precaution must be our gods for a little longer still. For only they can lead us out of the tunnel of economic necessity into daylight" (Keynes, 1930) . Friedman said that in a business, a concern with anything except the profit is immoral because it is equivalent to destroying the money of the stakeholders (Friedman, 2007) .

In Islam, earning profit for its own sake is not encouraged and wealth can be earned legitimately if it has to be spent in the way of Allah. "O ye who believe! there are indeed many among the priests and anchorites, who in Falsehood devour the substance of men and hinder (them) from the way of Allah. And there are those who bury gold and silver and spend it not in the way of Allah: announce unto them a most grievous penalty" (Quran 9:34). The primary object of doing business is service and not the profit (Ibne Majah).

### 5.3 Dovetailing Islamic economic system with the capitalistic regime: adverse consequences

Capitalism and Islamic system are radically different from each other. A major difference between Islam and Capitalism system is that they provide different answers to the fundamental question of what to do with the surplus resources (Zaman, 2015a) . Islam emphasizes that excess resources need to be spent in the path of Allah, while capitalism encourages one to invest the savings to generate more wealth. So, some serious problems are bound to arise if we try to supplant the capitalistic financial institutions into the Islamic economic system.

Zaman (2016) says that a whole generation of Islamic economists found that the liberal democracy, capitalism and freedom were consistent with Islam and consequently, they began to look for Islamic analogues of Western financial institutions. The reality is that capitalistic institutions are alien to the spirit of Islam. Amanah or safekeeping and investment are two legitimate functions of the economic activity and date back to the times of the Prophet Mohammed (SAW). The problem with the modern banking is that it does not keep these two fundamental functions of the banks apart. In the wake of the global financial crisis of 2008, many investment bankers who had no knowledge of the Islamic economy came to the conclusion that we can ensure the stability of the banking system only if we keep these two functions apart.

Zaman (2016) gives the broad contours of an Islamic financial institution. According to him, Islamic economic system will engage only in the real activities and will strictly stay away from the financial activities which are out of sync with the real activities. There will be separate institutions for safe keeping and investment. In this situation, it is argued, Islamic monetary system could run at zero inflation. The design of the deposit should ensure that inflation is being hedged against. Investment banks will share profits but they will also share the losses and risks. The most important dimension of the Islamic economic institutions would be Awqaf because this is the institution which encourages generosity and spending in the way of Allah and is most consistent with the true spirit of Islam (Kahf, 2003) .

### 6. Strong moral commitment for phasing out interest: some empirical considerations

Abolishing the interest overnight is extremely difficult if not outright impossible. There are many reasons behind it, and the most conspicuous among which is that the collective will required to form desired interest-free institutions does not exist. What people want is crucial in shaping the form of institutions. Polanyi (1957) writes that Institutions are embodiments of human meaning and purpose. The implication of this statement is that the human will is required to form required institutions. However, if the will does not exist or is sagging, the process of the institution making will remain unrealized. Polanyi writes that Interests, however, like intents, necessarily remain platonic unless they are translated into politics by the means of some social instrumentality. The required human will is though not sufficient to materialize the goal of interest-free society, it is a necessary condition because it is through potent human will that institutions are formed which in turn realize the desired goal, which in this case, is the establishment of interest-free economy.

Some recent understanding also points to the fact that the moral commitment necessary to achieve the purpose of interest-free economy is nearly missing in the Islamic world today. Hasan (2015) says that, "Most of the writings in the area of Islamic economics and finance are oblivious to the fact that the moral element in economic actors is utterly non-functional today, if not non-existent. They present their postulates on the tacit assumption that people are reasonably committed to moral and ethical norms, which is unfortunately not the case. When confronted with the choice of reaping economic benefits or obeying religious imperatives, worldly concerns tend to outweigh the Hereafter consideration." It is argued that if we want to abolish the interest

completely, there has to be a strong desire at the mass level, otherwise a dual system of Islamic and conventional financial institutions would continue while Islamic financial system would be marred by financial engineering of questionable juristic validity.

It is important to analyze the claim made by Hasan (2015) that concern for economic benefits outweigh the religious imperatives because it will provide insights regarding the probability of achieving the goal of interest-free economy. Our hypothesis is that the countries where there is a high degree of religiosity will have less number of bank accounts in the conventional banking system, and the higher percentage of accounts in the Islamic banks. Since religiosity, or faith for that matter, is not observable, we can only use proxies. However, the problem with the use of these proxies is that they are very crude and are based on many implausible assumptions.

Currently available data is about the religiosity and financial inclusion at the OIC level. The religiosity data has been taken from Pew Research Centers Religion & Public Life Project<sup>2</sup>. The data on the financial inclusion is taken from the Global Financial Development Report 2014: Financial Inclusion (Group, 2013). The GFDR 2014 contains data on the financial inclusion as well as financial exclusion. The financially excluded group is the share of the 15 years and above population of the OIC countries which do not have a bank account because of religious reasons. We hypothesize that a high degree of religiosity is positively associated with the share of population which does not have bank accounts for religious reasons. Alternatively, when people do not hold a bank account in the conventional banks to avoid Riba, it will be construed as a strong will to establish an alternative Riba-free economy which will become instrumental in due course of time to establish Riba-free institutions.

There are some caveats in using this approach. The countries where there is a larger financial penetration in the conventional sector may not have developed adequate Islamic banking and financial services to match the demand for Islamic institutions. Another reason might be that even if Islamic banking and financial institutions are there, people lack trust in the standards of Shariah compliance of these banks. Very small financial penetration in the conventional system may also result from the religious commitments of the people as well as the small savings of people.

We have used simple correlations, scatter diagrams and regression analysis to see the association between commitment to Riba-free economy proxied by the variable "No account because of religious reasons" and other measures of religiosity such as "Salat", "Fasting", "Hajj", "Zakat" and "Importance of religion in life."

The pairwise correlation estimates (Table 1) show that only Zakat is significantly associated with no-account for religious reasons. While this result is according to our expectation that a higher percentage of Zakat-payers will have a higher number of those people who do not have a bank account for religious reasons (correlation coefficient = 0.27; P-value <0.10). Additionally, the negative sign of the category of non-payers of Zakat (correlation coefficient = -0.28; P-value <0.10) is also according to our expectation. The lack of statistical association between other measures of religiosity such as Salat, Hajj, Fasting and Importance of religion in our life and having no bank account for religious reasons points to the lack of strong commitment to Riba-free economy.

To test the hypothesis that religiosity and its various indicators such as prayer, fasting, Hajj and Zakat are inversely related with the penetration of conventional financial institutions, we used pairwise correlation and quadratic regressions and saw that only prayer is significantly associated with a bank account. The negative association between the share of population which says prayers five times a day and has account in the conventional bank (correlation coefficient = -0.32; P-value <0.05) rejects the hypothesis that economic benefits outweigh religious imperatives (Table 2).

A visual inspection of the association of the choice of bank account and the indicators of religiosity is even more revealing. Figure 4 below shows the relationship between prayer and financial penetration. Saying prayers multiple times a day is negatively associated with a bank account in the conventional banking system and is positively associated with having no account for religious reasons. But this is the type of trend that equally applies to a person who seldom says the prayer or does not pray at all. On the whole we do not see any statistically significant relationship between these two variables.

Fasting also does not show any strong association with the choice of bank account because of religious reasons. Though we see a negative association between fasting and having an account in the conventional bank and a positive association between fasting and having no account for religious reasons, the relationship is not significant. This lack of significance is explained by the fact that in many countries we see a large percentage of



Table 1: No account in the conventional bank for religious reason (% of population above 15 years of OIC countries)

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
(1) No Account	9.00	8.38	0.00	33.60	1.00																
(2) Zakat (Yes)	74.55	10.97	36.00	98.00	0.27 (0.07)	1.00															
(3) Zakat (No)	23.66	10.69	1.00	63.00	-0.28 (0.05)	-0.99	1.00														
(4) Prayer (Five)	37.34	22.54	0.00	76.00	-0.04 (0.80)	0.37 (0.01)	-0.35 (0.02)	1.00													
(5) Prayer (Juma)	20.17	8.14	1.00	38.00	-0.13 (0.37)	0.18 (0.24)	-0.15 (0.31)	0.35 (0.02)	1.00												
(6) Prayer (Month)	4.91	3.28	1.00	13.00	-0.09 (0.55)	-0.10 (0.51)	0.11 (0.45)	-0.61 (0.00)	0.09 (0.57)	1.00											
(7) Prayer (Eid)	7.49	4.82	1.00	21.00	-0.18 (0.22)	-0.41 (0.00)	0.41 (0.00)	-0.77 (0.04)	0.70 (0.00)	1.00											
(8) Prayer (Seldom)	8.79	6.37	1.00	28.00	0.10 (0.50)	-0.30 (0.04)	0.30 (0.04)	-0.70 (0.00)	-0.38 (0.01)	0.51 (0.00)	1.00										
(9) Prayer (Never)	20.15	18.52	1.00	71.00	0.13 (0.38)	-0.30 (0.04)	0.27 (0.07)	-0.82 (0.00)	-0.66 (0.00)	0.17 (0.24)	0.44 (0.00)	1.00									
(10) Fast (Yes)	85.26	16.50	30.00	100.00	0.13 (0.38)	0.73 (0.00)	-0.72 (0.00)	0.68 (0.00)	0.51 (0.00)	-0.28 (0.06)	-0.62 (0.00)	-0.47 (0.00)	1.00								
(11) Fast (No)	14.11	16.53	0.00	70.00	-0.12 (0.41)	-0.72 (0.00)	0.72 (0.00)	-0.69 (0.00)	-0.52 (0.00)	0.29 (0.05)	0.63 (0.00)	0.48 (0.00)	0.70 (0.00)	1.00							
(12) Hajj (Yes)	11.98	8.17	1.00	48.00	0.13 (0.39)	0.23 (0.12)	-0.21 (0.16)	0.53 (0.00)	0.32 (0.03)	-0.12 (0.43)	-0.32 (0.00)	-0.43 (0.00)	-0.53 (0.00)	0.39 (0.01)	1.00						
(13) Hajj (No)	87.36	8.67	49.00	99.00	-0.12 (0.44)	-0.21 (0.15)	0.20 (0.17)	-0.55 (0.00)	-0.31 (0.03)	0.15 (0.32)	0.35 (0.02)	0.45 (0.00)	0.54 (0.00)	-0.37 (0.01)	0.40 (0.00)	1.00					
(14) Religion (Very Important)	76.70	21.42	15.00	98.00	0.05 (0.75)	-0.64 (0.00)	-0.61 (0.00)	0.86 (0.00)	0.55 (0.00)	-0.38 (0.00)	-0.71 (0.01)	-0.62 (0.00)	-0.82 (0.00)	0.90 (0.00)	-0.91 (0.00)	0.46 (0.00)	-0.46 (0.00)				
(15) Religion (Somewhat Important)	16.68	13.96	1.00	57.00	-0.04 (0.77)	-0.57 (0.00)	0.54 (0.00)	-0.87 (0.00)	-0.47 (0.00)	0.44 (0.00)	0.66 (0.00)	0.55 (0.00)	0.83 (0.00)	-0.83 (0.00)	0.84 (0.00)	-0.44 (0.00)	0.45 (0.00)	-0.96 (0.00)	1.00		
(16) Religion (Not Too Important)	4.47	7.18	0.00	35.00	-0.08 (0.61)	-0.68 (0.00)	0.66 (0.00)	-0.73 (0.00)	-0.60 (0.12)	0.23 (0.00)	0.69 (0.00)	0.61 (0.00)	0.72 (0.00)	-0.91 (0.00)	0.91 (0.00)	-0.46 (0.00)	0.44 (0.00)	-0.53 (0.00)	0.81 (0.00)	1.00	
(17) Religion (Not At All Important)	1.11	1.67	0.00	10.00	0.01 (0.94)	-0.44 (0.00)	0.42 (0.00)	-0.53 (0.00)	-0.37 (0.01)	0.12 (0.40)	0.55 (0.00)	0.63 (0.00)	0.43 (0.00)	-0.59 (0.00)	0.59 (0.00)	-0.31 (0.03)	0.30 (0.04)	-0.68 (0.00)	0.50 (0.00)	0.80 (0.00)	1.00



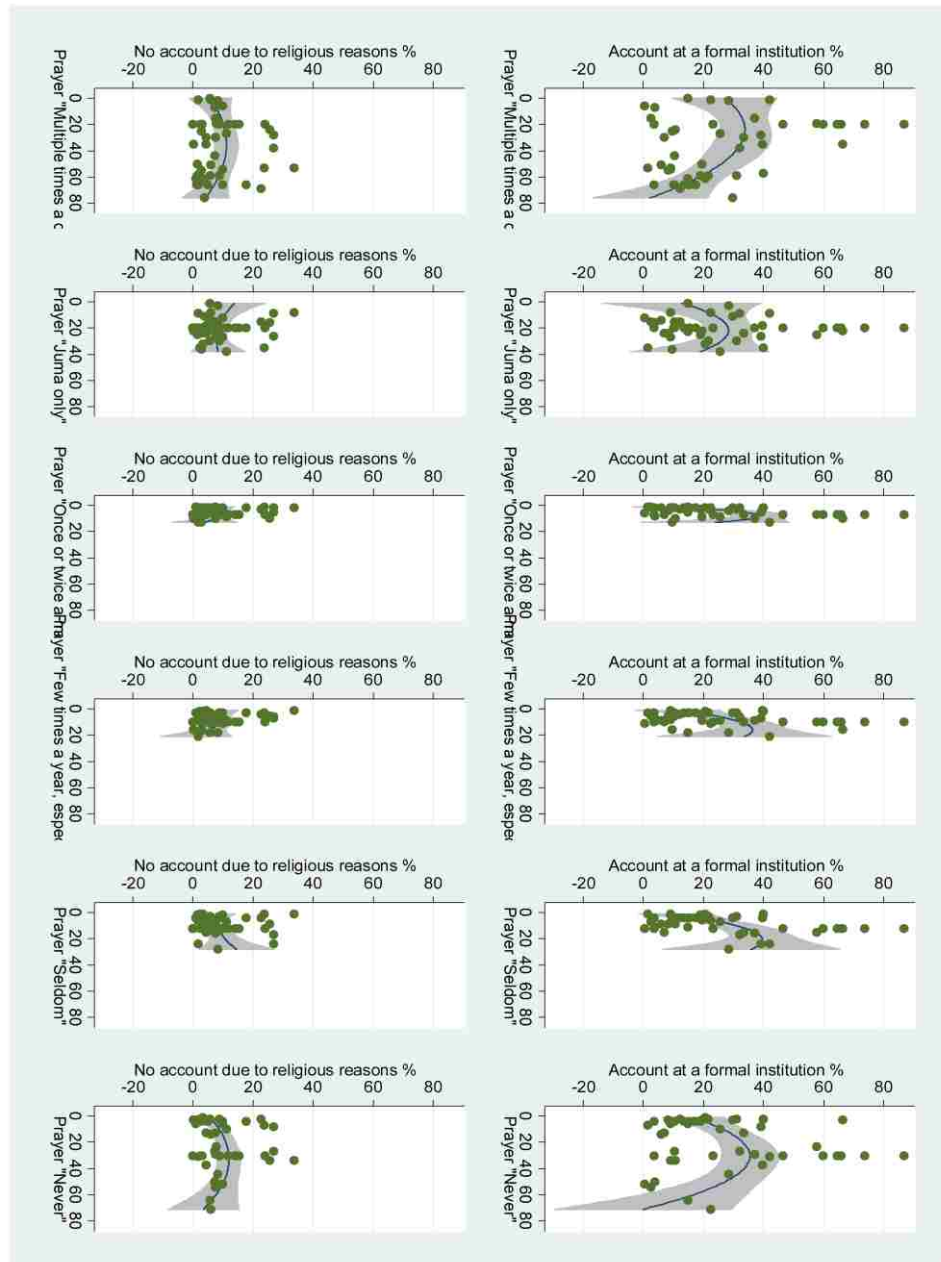
Table 2: Account in the conventional banks (% of population above 15 years of OIC countries)

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)
(1) Account	25.93	21.58	0.40	86.80	1.00																
(2) Zakat (Yes)	74.55	10.97	36.00	98.00	-0.04	1.00															
(3) Zakat (No)	23.66	10.69	1.00	63.00	0.05	-0.99	1.00														
(4) Prayer (Five)	37.34	22.54	0.00	76.00	-0.32	0.37	-0.35	1.00													
(5) Prayer (Juma)	20.17	8.14	1.00	38.00	0.04	0.18	-0.15	0.35	1.00												
(6) Prayer (Month)	4.91	3.28	1.00	13.00	0.37	-0.10	0.11	-0.61	0.09	1.00											
(7) Prayer (Eid)	7.49	4.82	1.00	21.00	0.32	-0.41	0.41	-0.77	-0.30	0.70	1.00										
(8) Prayer (Seldom)	8.79	6.37	1.00	28.00	0.39	-0.30	0.30	-0.70	-0.38	0.51	0.70	1.00									
(9) Prayer (Never)	20.15	18.52	1.00	71.00	0.09	-0.30	0.27	-0.82	-0.66	0.17	0.44	0.40	1.00								
(10) Fast (Yes)	85.26	16.50	30.00	100.00	0.56	0.04	0.07	0.00	0.00	0.24	0.00	0.00									
(11) Fast (No)	14.11	16.53	0.00	70.00	-0.08	0.73	-0.72	0.68	0.51	-0.28	-0.62	-0.47	-0.68	1.00							
(12) Hajj (Yes)	11.98	8.17	1.00	48.00	0.59	0.00	0.00	0.00	0.00	0.06	0.00	0.00	0.00								
(13) Hajj (No)	87.36	8.67	49.00	99.00	0.10	-0.72	0.72	-0.69	-0.52	0.29	0.63	0.48	0.70	-1.00	1.00						
(14) Religion (Very Important)	76.70	21.42	15.00	98.00	0.51	0.00	0.00	0.00	0.00	0.05	0.00	0.00	0.00								
(15) Religion (Somewhat Important)	16.68	13.96	1.00	57.00	-0.08	0.23	-0.21	0.53	0.32	-0.12	-0.32	-0.43	-0.53	0.39	-0.40	1.00					
(16) Religion (Not Too Important)	4.47	7.18	0.00	35.00	0.61	0.12	0.16	0.00	0.03	0.43	0.03	0.00	0.00	0.01	0.01						
(17) Religion (Not At All Important)	1.11	1.67	0.00	10.00	0.10	-0.21	0.20	-0.55	-0.31	0.15	0.35	0.45	0.54	-0.37	0.40	-0.98	1.00				
					0.50	0.15	0.17	0.00	0.03	0.32	0.02	0.00	0.00	0.01	0.01	0.01					
					-0.15	0.64	-0.61	0.86	0.55	-0.38	-0.71	-0.62	-0.82	0.90	-0.91	0.46	-0.46	1.00			
					0.33	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00					
					0.13	-0.57	0.54	-0.87	-0.47	0.44	0.66	0.55	0.83	-0.83	0.84	-0.44	0.45	-0.96	1.00		
					0.40	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
					0.12	-0.68	0.66	-0.73	-0.60	0.23	0.69	0.61	0.72	-0.91	0.91	-0.46	0.44	-0.93	0.81	1.00	
					0.41	0.00	0.00	0.00	0.00	0.12	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
					0.16	-0.44	0.42	-0.53	-0.37	0.12	0.55	0.63	0.43	-0.59	0.59	-0.31	0.30	-0.68	0.50	0.80	1.00
					0.28	0.00	0.00	0.00	0.01	0.40	0.00	0.00	0.00	0.00	0.00	0.03	0.04	0.00	0.00	0.00	0.00

population which fasts (as high as 80%) but here around 60% of the population or even a larger population maintains a bank account in the conventional banking industry.

Figure 4: Prayer vs (No) bank account

Figure 5: Fasting vs (No) bank account



Almost the same type of relationship holds in case Hajj as we saw in the case of Fasting (See Figure 5. The

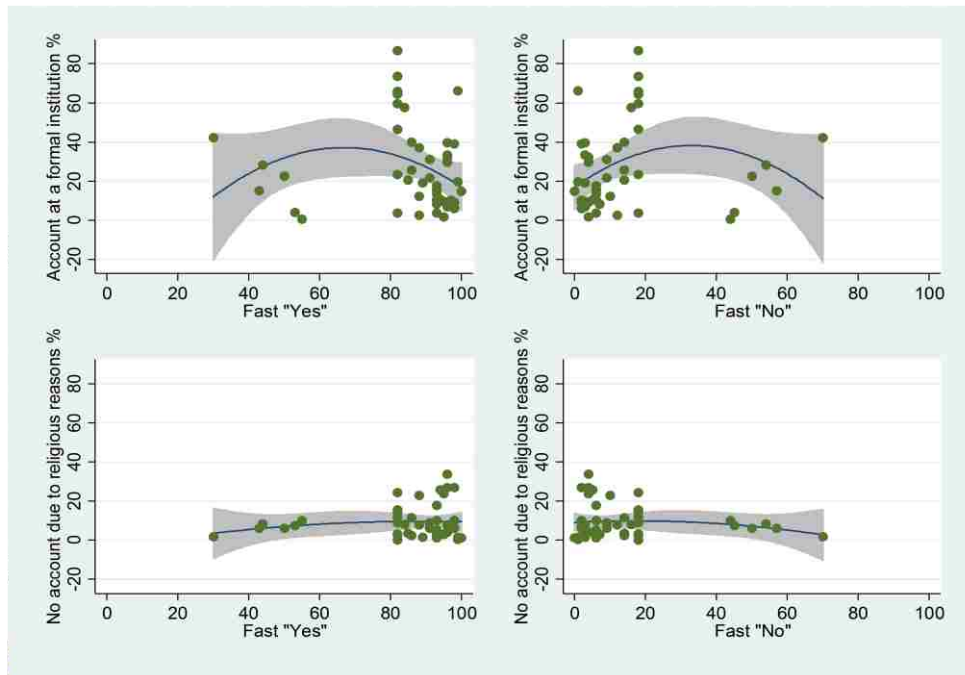
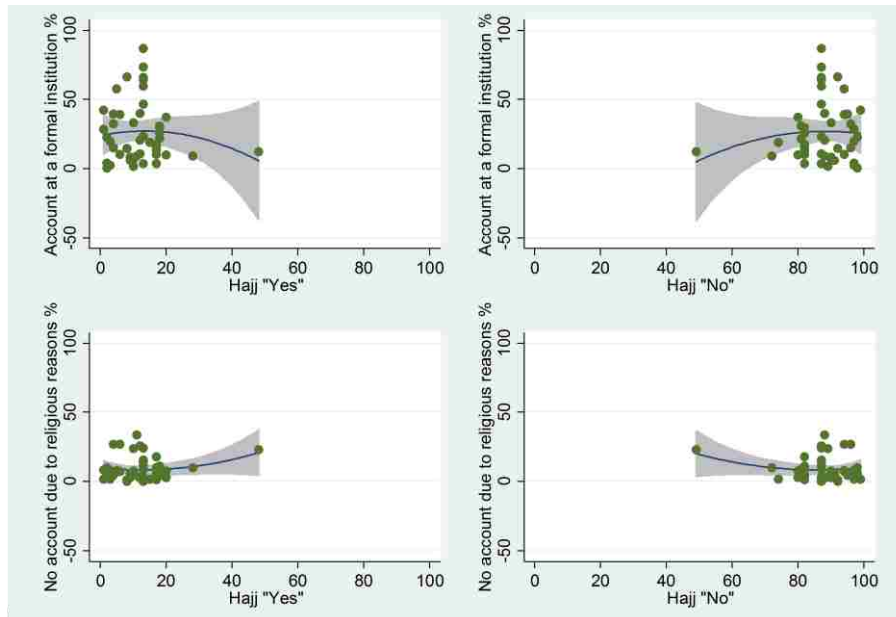


Figure 6: Hajj vs (No) bank account

Figure 6 below shows a slightly negative association between performing Hajj and having an account in the conventional bank and a positive association between performing Hajj and having no account because of



religious reasons.

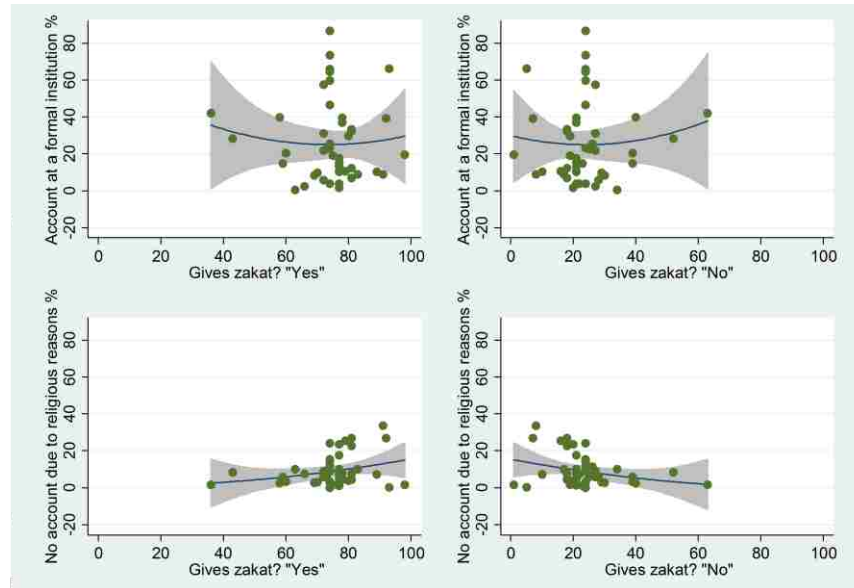
Though there is a positive and statistically significant relationship between paying Zakat and having no

account because of religious reasons as expected, we do not see any relationship between paying zakat and having a bank account in the conventional bank too (Figure 7).

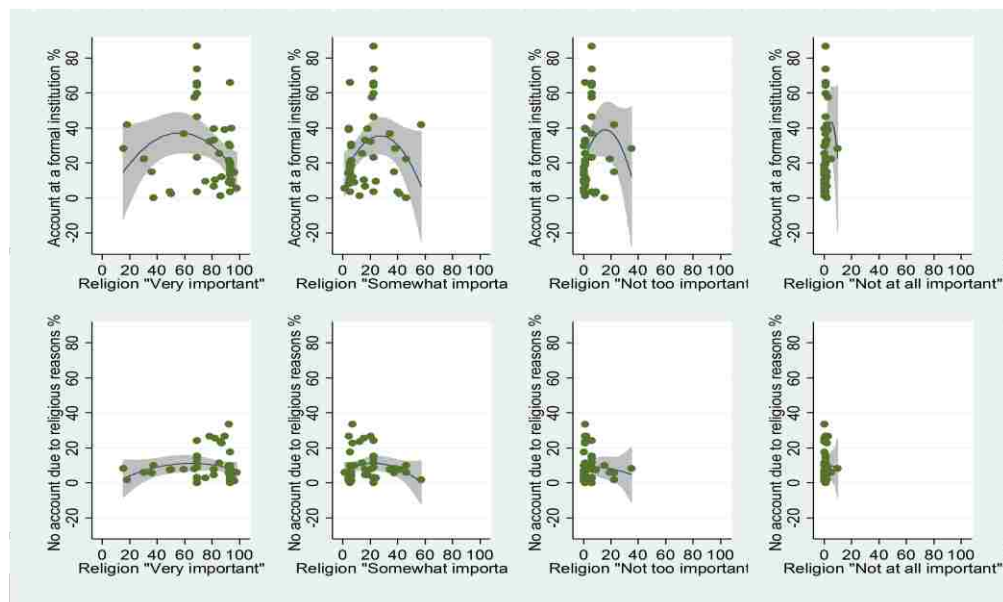
Figure 7: Zakat vs (No) bank account

Figure 8: Importance of religion vs (No) bank account

The importance of religion in life is also not a good predictor of the choice of bank account. Though we see a



positive and significant relationship between the decision to have no bank account for religious reasons and



considering religion as "very important in life", the same importance level of religion in life is not strongly

associated with the decision to have a bank account in the conventional banking sector (Figure 8).6.1

### Regression analysis

Keeping in view the limitation that pairwise correlations do not assume either the existence of causality, nor they assume the direction of causality, we model the choice of banking account as a function of religiosity and do a uni-variate regression analysis to see the causal link between the two variables. Eq. 1 sees the decision to have an account in the conventional bank as a function of various indicators of religiosity.

$$\text{Bank Account}_i = \alpha + \beta X_i + \varepsilon_i \quad (1)$$

The dependent variable  $\text{Account}_i$  refers to the bank account in the conventional bank. The independent variable  $X_i$  refers to the indicators of religiosity which include Prayer, Fasting, Hajj, Zakat and Importance of religion in life. The subscript  $i$  refers to any country among OIC group of nations.  $\varepsilon$  refers to the random error terms.

Eq. 2 links the decision to have no bank account in the conventional banking sector for religious reasons to the indicators of religiosity.

$$\text{No Bank Account}_i = \alpha + \beta X_i + \varepsilon_i \quad (2)$$

The dependent variable No Bank Account, in Eq. 2 refers to the percentage of population which has chosen not to open a bank account in the conventional bank because of religious reasons. The independent variable  $X_i$ , again refers to the indicators of religiosity which include Prayer, Fasting, Hajj, Zakat and Importance of religion in life.

Table 3 shows that among 16 different indicators of religiosity, only four indicators significantly predict the decision to have a bank account in the conventional bank. We see a negative and significant impact of prayers (multiple times in a day) on the decision to have an account in the conventional banks. However, we see that prayers once or twice a day, prayer only on Eid and prayer seldom offered exert a positive and significant impact on the decision to have an account in the conventional banks.

As regards the impact of various indicators of religiosity on the decision to have no account in the bank for religious reasons, we see that there is no significant impact of even a single indicator of religiosity (Table 4).



Table 3: Regression analysis: Account in the conventional banks (% of population above 15 years of OIC countries)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	est1	est2	est3	est4	est5	est6	est7	est8	est9	est10	est11	est12	est13	est14	est15	est16
Gives zakat? "Yes"	-0.0753 [-0.26]															
Gives zakat? "No"		0.0999 [0.33]														
Prayer "Multiple times a day"			-0.306 *													
Prayer "Juma only"				0.119 [0.30]												
Prayer "Once or twice a month"					2.462 ** [2.70]											
Prayer "Few times a year, especially Eid"						1.433 * [2.27]										
Prayer "Seldom"							1.316** [2.83]									
Prayer "Never"								0.102 [0.59]								
Fast "Yes"									-0.104 [-0.54]							
Fast "No"										0.130 [0.67]						
Hajj "Yes"											-0.203 [-0.52]					
Hajj "No"												0.252 [0.68]				
Religion "Very important"													-0.147 [-0.99]			
Religion "Somewhat important"														0.194 [0.85]		
Religion "Not too important"															0.373 [0.84]	
Religion "Not at all important"																2.061 [1.09]
Constant	31.55 [1.43]	23.57** [3.03]	37.35*** [6.35]	23.53** [2.74]	13.83* [2.58]	15.20** [2.71]	14.37** [2.86]	23.89*** [5.07]	34.83* [2.07]	24.10*** [5.77]	28.37*** [5.00]	3.884 [0.12]	37.23** [3.15]	22.69*** [4.58]	24.27*** [6.51]	23.65*** [6.26]
Observations	47	47	47	47	47	47	47	47	47	47	47	47	47	47	47	47
r <sup>2</sup>	0.00147	0.00245	0.102	0.00202	0.140	0.103	0.151	0.00762	0.00637	0.00990	0.00593	0.0103	0.0214	0.0158	0.0154	0.022
F	0.0661	0.110	5.112	0.0913	7.312	5.144	7.981	0.346	0.289	0.450	0.269	0.468	0.983	0.722	0.702	1.177
p	0.798	0.741	0.0286	0.764	0.00963	0.0282	0.00702	0.560	0.594	0.506	0.607	0.497	0.327	0.400	0.407	0.284

T statistics in brackets

\* p &lt; 0.05, \*\* p &lt; 0.01, \*\*\* p &lt; 0.001

Table 4: Regression analysis: No Account in the conventional banks for religious reasons (% of population above 15 years of OIC countries)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	est1	est2	est3	est4	est5	est6	est7	est8	est9	est10	est11	est12	est13	est14	est15	est16
Gives zakat? "Yes"	0.206 [1.88]															
Gives zakat? "No"		-0.222 [-1.98]														
Prayer "Multiple times a day"			-0.0140 [-0.25]													
Prayer "Juma only"				-0.138 [-0.91]												
Prayer "Once or twice a month"					-0.228 [-0.60]											
Prayer "Few times a year, especially Eid"						-0.317 [-1.24]										
Prayer "Seldom"							0.132 [0.68]									
Prayer "Never"								0.0597 [0.89]								
Fast "Yes"									0.0666 [0.89]							
Fast "No"										-0.0622 [-0.83]						
Hajj "Yes"											0.132 [0.87]					
Hajj "No"												-0.111 [-0.78]				
Religion "Very important"													0.0183 [0.32]			
Religion "Somewhat important"														-0.0262 [-0.29]		
Religion "Not too important"															-0.0885 [-0.51]	
Religion "Not at all important"																0.0560 [0.07]
Constant	-6.387 [-0.77]	14.26*** [4.91]	9.524*** [3.96]	11.78*** [3.57]	10.12*** [4.53]	11.37*** [5.03]	7.844*** [3.72]	7.799*** [4.28]	3.322 [0.51]	9.879*** [6.10]	7.419** [3.39]	18.72 [1.49]	7.595 [1.64]	9.439*** [4.88]	9.397*** [6.46]	8.940*** [6.01]
Observations	47	47	47	47	47	47	47	47	47	47	47	47	47	47	47	47
R <sup>2</sup>	0.0731	0.0804	0.00141	0.0179	0.00795	0.0332	0.0100	0.0174	0.0172	0.0151	0.0166	0.0133	0.00220	0.00190	0.00575	0.0001
F	3.548	3.935	0.0637	0.821	0.361	1.546	0.456	0.798	0.789	0.689	0.760	0.605	0.0993	0.0859	0.260	0.0056
p	0.0661	0.0534	0.802	0.370	0.551	0.220	0.503	0.376	0.379	0.411	0.368	0.441	0.754	0.771	0.613	0.941

t statistics in brackets

\* p &lt; 0.05, \*\* p &lt; 0.01, \*\*\* p &lt; 0.001

## 7. Conclusion

Keeping in view the perception that the legislative measures undertaken in Iran and Pakistan to outlaw Riba have not proved effective and have also opened many backdoors to Riba, it is argued that a vibrant growth in the Islamic financial system is not enough per se unless some of instruments such as Murabaha and Ijarah are reviewed to ensure strict compliance with the standards of Shariah. More importantly, the operations of the Islamic financial institutions have to embody the spirit that exists at the root of the injunctions prohibiting Riba. It is argued that some space within the capitalistic system can be expeditiously used as a stop-gap arrangement such as maintaining zero interest rates and expanding interest free loans. Given that Islamic economic system and capitalistic economic system are antithetical to each other in important ways, any effort of supplanting the capitalistic ideas within the Islamic financial systems will prove counterproductive.

This paper has highlighted the critical role of moral commitment to achieve the objective of Riba-free economy. Our empirical analysis shows that prayers five times a day negatively and significantly affect the choice to have a bank account in the conventional sector. However, there is no significant impact of any indicator of religiosity on the decision to have no account because of religious reasons. The implication of this finding is that the strong commitment at the mass level required to establish the vibrant Islamic economic and financial institutions exists among those who are more committed to discharge their religious obligations topped by saying prayers five times a day. However this commitment is less obvious (statistically it does not exist) when measured on the basis of other indicators of religiosity. The way out is to nurture that commitment which can be realized if we effectively discharge our religious duties and have a potent belief in the mortal effects of Riba in our societies.

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