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The Financial Pathology of the Postwar American Welfare State

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Abstract: Chronic inflation in the U.S. is a post World War II phenomenon. Particularly puzzling is the period of *accelerating* inflation after 1964 and the rapid *deceleration* after 1981. Arguably, inflation was employed to solve certain problems of finance faced by political authorities benefiting from the expanding welfare state. Those solutions depended on certain deceptions of the public, however. In particular, successful vote maximization through redistributive politics required (1) taxing and raising taxes surreptitiously through inflation to hide the costs of the subsidies, (2) covert inflationary repudiation of much of the accumulating federal debt that was also being employed to hide the costs of redistribution, and (3) the successful use of inflation to reduce the disemployment effects of pro-union laws and income transfers. Accomplishing these things required accelerating inflation. Inflation stopped accomplishing its intended functions over the 1970s, however, because the public's expectations of inflation became more accurate *despite* its acceleration, and certain costs of inflation rose. Thus the marginal benefits of inflationary policy to the governmental partisans of the welfare state fell below the marginal political costs, making a lower inflation rate optimal. This endogenous theory of monetary policy and inflation behavior may be termed the "political neutralization hypothesis".

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1 Introduction

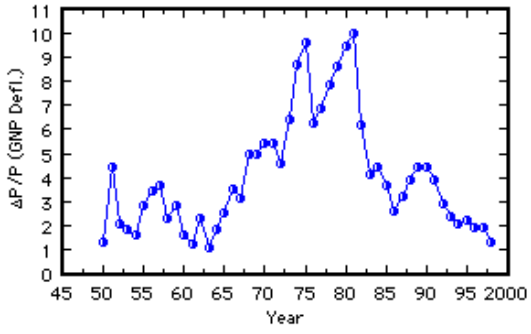
> ... By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate *arbitrarily;* and, while the process impoverishes many, it actually enriches some.
>
> John Maynard Keynes, *The Economic Consequences of the Peace* (1988, p. 235)

Most of us now breathing have lived with inflation – chronically rising prices yielding an ongoing decline in the value of money – all of our lives. Yet chronic peacetime inflation in the U.S. is an unusual historic experience, largely limited to the post World War II period. The United States was a developed, industrial nation long before World War II. Indeed, by 1910 it had already become the greatest industrial nation on earth despite experiencing nearly 35 years of *deflation* following the Civil War. So there is *nothing* inherent in a modern industrial society that requires ongoing diminishment in the value of money. Clearly some crucial determinants of the price level and value of money changed during or before World War II and have since acted to make price level behavior depart from previous U.S. experience. Not only does the existence of inflation in the post war period of the 20th century require explanation, so does its pattern, shown in Figure 1. The rate of inflation, measured there by the GNP Deflator index through 1990 and the GDP deflator after, was positive but relatively stable, even falling slightly into the mid 1960s. Then inflation accelerated over the period 1964-1981, known as the "Great Inflation", after which it *declined* rapidly for several years, before rising a bit in the late 1980s and then declining more slowly in the 1990s.

One prominent factor many analysts employ to explain much of the Great Inflation is the OPEC oil price increase associated with the Ramadan/Yom Kippur War of 1973. By raising the prices of everything made from crude oil, such as gasoline, plastics, and heating fuels, and by thus also raising transport costs and reducing supplies of nearly every good, this cost increase certainly pushed the price level up in a relatively short period. That accounts for the first of the *two* price spikes of the Great Inflation. Note, however, that the inflation rate had been rising for over seven years before the Yom Kippur War. Also note that such a unique supply shock, though it shows up as an increase in the inflation rate, only shows up as a *temporary* rise in

that *rate,* because it actually generates only a discrete jump in the price level. It would take a repeated sequence of such cost-pushes and supply declines to generate ongoing price increases. In fact, a sequence of negative sectoral supply shocks occurred which constitute part of the story, but they had nothing to do with oil. The effect of the oil price spike on inflation was completely gone by 1976, after which the inflation rate continued rising, actually slightly *below* its prior trend. The Great Inflation is not the story of the oil price shock, even if one adds in the second, smaller oil shock associated with the Iranian revolution of 1979. Something much more fundamental was occurring.

Figure 1: Annual Percent Inflation Rates, GNP and GDP Deflator Values, 1950-1998



Data Source: The Economic Report of the President, 2004, table B-3, and 1991, table B-3.

The basic nature of inflation has been understood for a long time. Inflation is a monetary phenomenon (Friedman, 1956 and 1970, Patinkin, 1965). In the long-run the rate of inflation (or deflation) will equal the *difference* between the growth rates of the nominal money stock and real balances demanded, though in the short-run significant deviations occur. Since the end of the gold standard in the Great Depression, and particularly since the 1951 Treasury accord releasing the Fed from Treasury department control, the Federal reserve has gained discretionary control over the monetary base, and hence (within certain short-term limits resulting from outside influences on the money multiplier) the level and growth of the nominal money stock (Timberlake, 1984). The basic question of why inflation has been chronic in the postwar period then becomes one of *what has motivated the monetary authorities to*

engage in chronic excess money growth. In particular we need to discover what motivated them to accelerate money growth and inflation from 1965 through the late '70s, and what changed to cause the subsequent rapid decline in inflation and its apparent stabilization at low levels.

Of course there has been no great lack of research into the causes of persistent inflation. The most influential theory currently was developed by Kydland and Prescott (1977). They were awarded the Nobel Prize in economics in 2004 for their work. Assuming the monetary authorities were altruistically concerned with keeping unemployment low, which required generating more rapid inflation than the public expects, and that the public preferred not being fooled, they explained chronic inflation – *without* lower than normal unemployment – as the suboptimal outcome of a "prisoner's dilemma" faced by the public and the Fed. While astute and insightful, their argument did not explain the accelerating pattern of inflation after 1964, nor predict or explain the deceleration that occurred after 1981. And while simplicity is often a virtue, their "social welfare function" approach ignored variables that might be crucial in explaining the behavior of the Fed and the consequent postwar inflation pattern, such as institutional incentives inherent in the structure of the Fed, self-interests that Fed decision makers may have, pressures from legislators and presidents to accommodate social policies, and changes in macroeconomic theory.

What Thomas Sargent (2003) calls the "Berkeley Story", developed by Delong (1997) and refined by Romer and Romer (2003), is that the inflation acceleration of 1964-1981 and subsequent disinflation was due to the Fed authorities having a correct macro model in the 1950s, forgetting or losing it in the 1960s and 1970s, with resulting inflationary policy, and regaining that knowledge in the 1980s. Though it contains important kernels of truth, there are obvious problems with this view. First, it provides *no* explanation for chronic post war inflation *at all,* merely for the acceleration after 1964. Second, its adherents have provided little, if any, explanation of why or how knowledge at the Fed was lost and regained. Third, the story assumes that Fed decision makers are reliably immune or insensitive to any political pressures or personal interests. This view of powerful government appointees in control of the nation's money and credit seems naive at best, and Arthur Burns, at least, admitted that it was not so.

Thomas Mayer (1998), who interviewed many members of the FOMC from the period, developed an explanation of the Great Inflation similar to the Berkeley Story. In his view various characteristics of FOMC behavior and decision making that he terms "cognitive errors" gave policy an inflationary bias. Some of these he claims to have been rooted in the nature of committee decision-making. Thus procrastination in the making of painful (i.e. anti-inflationary) decisions aided the rise of inflation rates. He says both Martin and Burns had no use for formal econometric models, and operated with vague conceptions of how changes in money and credit affected output and employment. Likewise, the FOMC overemphasized the short-run effects of policy actions, had little understanding of the difference between real and nominal interest rates, underestimated the lags in effects of policy on output and employment until well into the 1970s, and so on. Mayer's explanation of why these institutional and human problems had *more* inflationary effect *after* 1964 than before appears to be that they were aggravated by advice from economists based on Phillips curve reasoning (Mayer, 1998, pp. 95-104). As for political factors, Mayer specifically denies that pressures from the executive or legislative branches were crucial. In his view, it was all a result of cognitive mistakes by well-intended officials, repeated over and over for more than a dozen years.

In an early attempt to escape the social welfare function approach, Cukierman (1986), working with Allan Meltzer, formally recognized that the Fed receives pressures from the president, congress, and the financial community that affect its behavior. In their model, Fed preferences at the margin for economic stimulation versus inflation prevention shift randomly (though with some persistence) through time as the coalitions and relative strength of pressure groups change. This allowed Cukierman and Meltzer to explain many features of central bank behavior, including the existence of large swings in money growth and inflation. Note, however, that making the balance of Fed preferences for economic stimulation versus inflation prevention a random variable involves foregoing any effort to explain its value at any particular time in terms of the specific pressures existing at that time. It leaves unexplained the factors changing the composition of pressures on the Fed, *particularly in terms of the consequences of inflation itself.* It is precisely the explanation of such factors in the historic period under discussion at which the present, less formal paper, is aimed.

2 Redistributive Politics and Political Neutralization

That Fed independence gave it some institutional bias towards positive money growth can be seen by recognizing that all of its expenses, including the salaries and perquisites of its employees, are paid for by interest earned from loans it makes to and securities it purchases from the banking system, with base money it creates at zero cost. Such seignorage may *not* imply an *inflationary* bias in monetary policy, however, because growth in the money stock equal to the growth of real balances demanded in a growing economy would probably supply sufficient revenue to the Fed to satisfy the monetary authorities at zero inflation. Additional pressures must exist to account for chronic excess money growth and inflation.

While the Fed is a quasi-independent agency, it is certainly a governmental entity that receives pressures, both from presidents and from members of congress, to conduct monetary policy in ways they desire (Kane, 1982). Grier (1991, 1996) has shown statistically that the money growth rate over the period 1958-1984 was positively related to the degree of (welfare) liberalism of the relevant committee and subcommittee chairs in the Senate. The appointed monetary authorities in the Fed are more likely to bow to those political pressures the more uniform they are, in particular if *both* the president *and* congress want expansionary policy. They are also more likely to yield if the policy advice they get from economists reinforces the political pressures, as was often the case during the Great Inflation. Indeed, Mayer (1998) notes that by 1970 many members of the FOMC were *themselves* professional economists.

The first key argument of this paper is that *the pressures for excess money growth and inflation stemmed from motives and incentives of political authorities inherent in the rise and expansion of redistributive politics in the postwar period,* particularly, under Presidents Johnson, Nixon, Ford, and Carter. Inflation in America is thus the financial pathology of the welfare state, as Arthur Burns (1979, 12-16) clearly understood. However, inflation could aid the expansion of the welfare state only as long as the public underestimated the temporal rate of price increase. The Fed extended that period by causing the inflation rate to accelerate. Eventually, however, the inflation expectations of the public became more accurate despite its acceleration. The second key argument of this paper is that *this neutralized not only the economic effects*

of inflation, but also most of the political benefits to the architects of that policy tool. I term this the "political neutralization hypothesis".

One possible objection to the perspective of this paper is the similarity of the inflation patterns in other major democracies of the world in the post-war period, before, during, and since the great U.S. inflation, suggesting some broader, international force at work than just surreptitious finance of the expanding U.S. welfare state. In fact, though, there is no mystery here. The U.S. was the key currency country in the Bretton Woods system, so the U.S. dollar was held as international reserves by all central banks, and exchange rates were pegged by central bank intervention. When the U.S. began its accelerating monetary expansion after 1965 to finance its expanding War On Poverty income redistributions, and inflation accelerated, other nations had to buy dollars and expand their own money supplies at similar rates to maintain their agreed-upon exchange rate pegs. It is no exaggeration to say that our federal reserve was driving the monetary policies of the entire democratic world, a fact about which foreign politicians and central bankers (particularly the Germans and the French) complained bitterly and repeatedly at the time.

Perhaps they complained too much. After all, they too continued inflating into the floating rate period after 1972, when Nixon closed the Gold window at the Fed. Arthur Burns (1979, 14-15) has explained this well, however. The same ideological attitudes generating expanding welfare states, regulation, and other costly government interventions here were also operating in those nations, generating the same financial solutions and political pressures for monetary accommodation. To this insight it is only necessary to add, in explanation of the later correlated decline of inflation rates in the U.S. and other nations, that similar processes of government inflationary policy neutralization operated in virtually all democratic nations.

2.1 Inflationary Finance of Income Transfers

> Since time immemorial, the major source of inflation has been the sovereign's attempt to acquire resources to wage war, construct monuments, or for other purposes. Inflation has been irresistibly attractive to sovereigns because it is a hidden tax that at first appears painless or even pleasant, and above all, because

> it is a tax that can be imposed without specific legislation. It is truly taxation without representation.
>
> Milton Friedman, "Monetary Correction," (1978, p. 27)

Pubic choice theory has fairly well delineated the nature of politics in modern democratic states with wide franchises (Buchanan and Wagner, 1977). Politicians compete with each other to gain and retain office by offering alternative programs of expenditure and finance aimed at satisfying diverse constituencies and interest groups in such a way as to obtain the maximum number of votes possible. Since at least the Roosevelt administration, and particularly since Lyndon Johnson was elected in 1964, the expenditure side of electoral competition has increasingly involved offering programs of targeted income transfers. Those benefiting from such programs – including their administrative bureaucracies – engage in organized lobbying to support their continuance and expansion.

It is important to remember that in the U.S. most transfer payments shift income *sideways,* from unorganized to organized members of the middle class, rather than from rich to poor. Some is even redistributed upwards through business subsidies. Virtually all tax revenue is also extracted from the middle and upper classes. Because no gain can be made by anyone whose tax payment to provide such transfers equals or exceeds their subsidy, the recipients have an incentive to resist the taxation in an effort to insure that they are net beneficiaries. Those who are not recipients, and may even oppose such subsidies, have an even stronger incentive to oppose the taxation required to fund such programs.

As a consequence of the combination of strong, organized, and expanding demand for income transfers and persistent opposition to the explicit taxation required to fund them, the incentive faced by political agents has been to offer and vote for the expenditures, but not to vote for explicit tax increases (or at least for as few as possible). Instead, much of the revenue required to cover the expenditures came to be acquired through deficit finance, deferring the necessary taxation forward in time past the next election. That was only a short-term solution, however, since interest and principle on bonds must be paid. That implies future taxation, with its electoral costs. To avoid or at least minimize such costs, the authorities began pressuring the

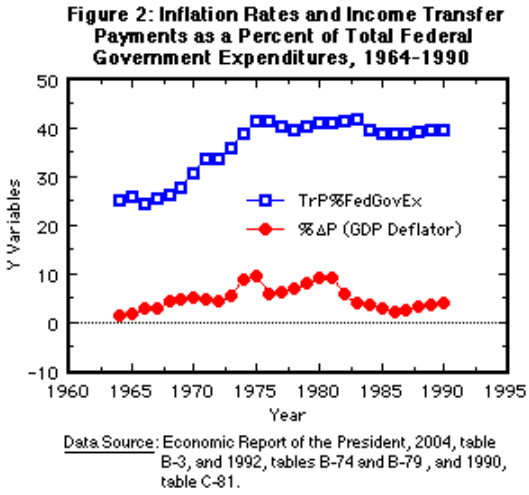
Fed to monetize debt and otherwise use monetary expansion and consequent inflation to tax and raise tax rates surreptitiously.[1]

Though the public is largely unaware of it, economists – and many federal politicians – have long understood that inflation is itself a tax on the cash balances people hold (Bailey, 1956, Johnson, 1967, Friedman, 1971). Money held loses purchasing power as prices rise. As members of the public forego some current purchases and add to their nominal cash balances in an effort to maintain their desired *real* balances, purchasing power is literally transferred from them to the government. Milton Friedman (1978) estimated that revenue generated for the government directly through money creation in 1973 amounted to $8 billion, equivalent to approximately 3.5 percent of its receipts that year.

Even better from the perspective of elected federal officials, absent an indexation provision in the progressive tax code, *inflation causes income tax rates to rise without a public vote, by causing nominal incomes to rise through the progressive tax brackets,* in a process commonly known as bracket creep. In addition, it generates artificial capital gains on financial assets on which taxes must be paid, and makes legally allowed depreciation allowances inadequate to replace business capital assets, thus decreasing real cash flow of firms while increasing real taxes paid (Edwards, 1991, pp. 376-377). Again, this happens without a legislative vote from which those in favor can be identified by the public.

These covert methods of taxing and raising taxes lowered the political costs of income transfers for leftist legislators. Friedman (1978) estimated that in 1973 inflation generated $13 billion in added revenue for the federal government from the corporate income tax alone. That was over 5.6 percent of receipts that year. He was apparently unable to obtain an estimate of personal income tax revenue added by bracket creep, but it must certainly have been many billions of dollars, so that the sum of revenue raised from seignorage, income tax bracket creep, taxation of phantom capital gains *and* understated business depreciation must have exceeded 10 percent of federal receipts that year.

[1] Thornton (1984) demonstrated empirically that the Federal Reserve monetized debt in this period, and found that it apparently stopped doing so when interest rate targeting ended and monetary targeting began in 1979. through money creation in 1973 amounted to $8 billion, equivalent to approximately 3.5 percent of its receipts that year.

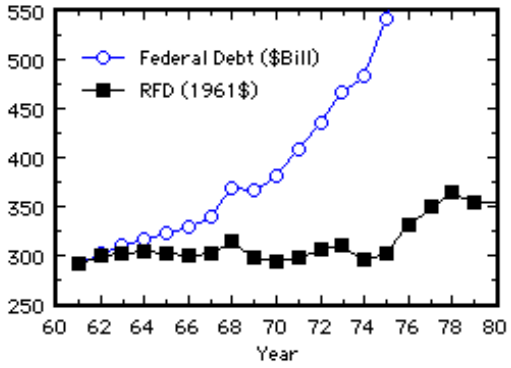


Given these political incentives it is no accident that, as the welfare state expanded in the 1960s and 1970s, the federal budget went into chronic, expanding deficits, rising even as a percent of gross domestic product, and the inflation rate rose. For the political authorities to gain and maintain public acceptance of the expanding welfare state required hiding its costs. Figure 2 shows, along with the inflation rate, income transfer payments as a percent of total federal expenditures (TrP%FedGovEx) from 1965 to 1990. It is easily seen that the periods of accelerating inflation rates and proportionately rising transfer payments correspond closely, and that when TrP%FedGovEx stopped rising, then began leveling off and drifting downward, so did inflation rates. It should also be added, to preempt an alternate hypothesis, that Vietnam War finance had nothing to do with the Great Inflation. *Military spending, as a fraction of either total federal spending or of GDP, began declining in the late 1960s and had a strongly inverse correlation with inflation rates over this entire period,* in stark contrast to TrP%FedGovEx.

The two processes for hiding the costs of compulsory income redistribution – federal deficits and inflation – were correlated in part because of the costs associated with the alternative mode of deficit finance. The government must borrow money to spend in excess of revenue it raises through open taxation, and it can do so by selling its bonds to private parties. In a period of rising deficits, however, the resulting increased competition for a limited supply of savings may raise interest rates, crowd out

some private sector investment and hurt the housing and capital goods industries. To avoid political fallout from this, the Treasury monetized a significant fraction of its current deficits (additions to the debt) by selling the bonds to the Federal Reserve. As the government spent the money and people deposited the checks this added to bank reserves, increasing the monetary base and the growth rate of money and credit. Such debt monetization, along with open market purchases by the Fed from the banking system, tended initially to cause interest rates to fall through the "liquidity effect", or at least to stay constant, instead of rising, as federal deficits and debt expanded.[2]

Figure 3: Nominal and Real Federal Debt in the 1960s and 1970s



Data Source: The Economic Report of the President 1991, table B-76 p. 375 for the nominal Federal debt values, and table B-3 p. 290 for the GNP Deflator values used to translate the nominal debt magnitudes into constant 1961 dollars.

Of course there were and are long-term counter effects, which the politicians and monetary authorities may not have initially recognized. Rising nominal income, resulting from the monetary expansion increases credit demand and pressures the nominal interest rate to rise again to its natural rate over time (Friedman, 1968). In addition, changes in expected rates of inflation motivate credit market transactors to

[2] The argument here may be thought to beg the question of Ricardian Equivalence, which would prevent interest rates from rising as the deficit increased (Barro, 1974). But if future tax obligations generated by current added debt in lieu of added current taxation are fully discounted, and seen by present taxpayers as having the same present value, it seems obvious that the political costs to the politicians would be the same, and they would have identical incentives to avoid those costs through debt monetization.

build compensating premiums into nominal interest rates (the Fisher Effect). Here again, expansionary monetary policy causes nominal interest rates to eventually *rise*. Due to interest rate ceilings the Fed had imposed on bank deposits in its regulatory capacity, however, and by the use of *accelerating* money growth, causing additional liquidity effects to offset the income and Fisher effects, the monetary and political authorities were able for some time to keep real interest rates artificially low, and pay government bondholders off in depreciated dollars. *Arguably, by this process the federal authorities surreptitiously repudiated virtually all of the added federal government debt, and thus redistributed income from federal bondholders to subsidy recipients.*

As figure 3 shows, real federal debt stayed almost constant for a decade and a half as inflation accelerated, even though both the annual budget deficits and the nominal national debt increased enormously. Milton Friedman's (1978) estimate for 1973 was that the federal government realized the equivalent of $5 billion in revenue from that source alone. That was just less than 2.2 percent of Federal receipts that year, raising the government's total revenue gains from inflation in 1973, at a *very* conservative estimate, to over 12 percent of its receipts.

2.2 Redistributive Labor Policy as an Inflation Motive

> If the Federal Reserve then sought to create a monetary environment that fell seriously short of accommodating the upward pressures on prices that were being released or reinforced by governmental action ... the Federal Reserve would be frustrating the will of Congress to which it was responsible – a Congress that was intent on providing additional services to the electorate and on assuring that jobs and incomes were maintained particularly in the short run.
>
> Arthur F. Burns, Chairman of the Federal Reserve Board, 1970-1979, in *The Anguish of Central Banking* (1979, p. 16)

A third important motive for the policy of chronic and accelerating inflation – in addition to surreptitious taxation and debt repudiation – has to do with the labor policy favored by the proponents of the welfare state. Not all redistributive political policy involves targeted income transfers. Many legislative programs aim at altering market

outcomes and redistributing income by other means. Because of certain widespread public attitudes about the supposedly superior bargaining power and exploitative character of employers, many political agents have found that large campaign contributions and bloc votes could be obtained through legislation to raise the minimum wage and increase the strength and bargaining power of unions. Such legislation, it should be noted, aims at redistributing incomes *directly* rather than through taxation and subsidies. It should also be noted that such legislation stems from the exact same ideological mindset as do policies of fiscal redistribution.

Unfortunately for those instituting such labor legislation, it has some harmful side effects. A major one is the *downward nominal wage and price rigidity that is created by minimum wage laws and widespread union contracts.* In a recession induced by, say, a discrete decline in the nominal money stock, a sufficient fall in the price level over time will raise the real money stock, thus restoring purchasing power, and tending to offset the contractionary effect on business activity. However, initially, such a price level decline will raise the aggregate *real* wage to unemployable levels, reducing employer profit margins and adding to the contraction (Bordo et al., 2000). With a lag, however, unemployment will cause nominal wage rates to fall, reducing the real wage back to employable levels and allowing the recession to end. When such downward nominal wage adjustments are prevented by bad governmental labor policy, however, *ongoing inflation becomes an absolutely necessary concomitant of such policy, because only through differences in the relative magnitudes of wage and price inflation* (and nominal money growth) *rates can the required, stabilizing adjustments in real wage rates and real money balances occur.* This third key argument may be termed *the first-difference hypothesis,* and regarded as the central explanation for chronic inflation in the post-war period.

A related though subsidiary reason redistributive labor policy led to inflation, however, has to do with its initial disemployment effects. While legislation and executive branch policies raising the minimum wage and/or increasing union strength may redistribute income from owners of firms to union employees and low wage workers retaining their employment, as intended, it also generates cost pushes which, partly passed on to prices, both hurt consumers and generate disemployment among the very employee groups the legislation intends to help, thus raising the natural rate

of unemployment.[3] In this situation, the temptation faced by political authorities unwilling to admit the cause of the added unemployment, and determined to avoid its occurrence, is to pressure the monetary authorities for monetary expansion to "validate" the cost pushes.

This was a significant factor in the "Great Inflation". Linneman and Wachter (1986) found large increases in union wage premiums resulting in significant declines in union employment between 1973 and 1984. Even earlier, in 1971, Arthur Burns made repeated public statements criticizing excessive union wage settlements (Schmidt, 1973, pp. 97-98). Burns also admitted, in the statement quoted above, not only both the existence of wage and welfare state financing pressures on prices, but that as Chairman of the Federal Reserve he had been unwilling, or at least unable, to resist monetarily accommodating such pressures.

The pressure on the monetary authorities, such as William McChesney Martin, and after him Arthur Burns and the other members of the FOMC, to accommodate the political authorities as they expanded income transfers through subsidies and labor legislation, was initially strengthened by the dominant Keynesian macroeconomics of the day. The Keynesian emphasis on aggregate demand management through fiscal and monetary policy was originally thought to show that unemployment could be kept minimal – even eliminated entirely – by sufficient aggregate demand without generating inflation. Specifically, the price level was assumed not to rise until full employment was reached (Keynes, 1936). When that turned out *not* to be true in the 1950s, and inflation, though low, became chronic, Keynesians adopted the Phillips curve argument, that some inflation was *beneficial* because the unemployment rate was an inverse function of the inflation rate (Samuelson and Solow, 1960). If true, unemployment could be set as low as desired by simply generating the required inflation rate. Indeed, the theory had significant empirical support as late as 1970. With a lag, this view heavily influenced the fiscal decision makers of administrations in the 1960s, as Romer and Romer (2003, pp. 20-22) have shown.

[3] Phillip Cagan (1979) estimated that unions and minimum wage laws accounted for about one-half of a percentage point out of the natural unemployment rate, or about 16 percent of total unemployment. In 1978, that would have amounted to approximately one million household providers.

2.3 The Welfare State and the Post War Inflation

> In this kind of perspective, the question is whether inflation will indeed become endemic and whether it will lead to basic social change... In the longer run it depends on the willingness of society to retreat from the welfare state towards less government taxation and expenditure and more private control over and private responsibility for the spending of income created by private effort.
>
> Harry Johnson "Living With Inflation," *The Banker* (August 1975, p. 864)

At this point an answer can be given to the initial question posed at the beginning of this paper: the chronic inflation of the postwar period has essentially been an outcome of the demand for and supply of income transfers through the democratic political system. The incentives for deficit finance and rapid money growth inherent in the provision of compulsory income transfers through democratic politics are a central element in this explanation, though public attitudinal changes should also be stressed. Before the Great Depression, widespread public and political elite acceptance of the classical liberal perspective on limited government, as well as of the Protestant ethic of frugality and personal responsibility, kept both the demand for and supply of public income transfers low.[4] Demand for income transfers increased from desperation during the Depression, and increased more during the 1960s, as many people accepted the perspective, propagated by the left intelligentsia, that corporate exploitation of workers is pervasive, and that it is a proper function of government to insure citizens against every imaginable detrimental contingency. This shift in opinion resulted in the election of President Lyndon Johnson in 1964, and the subsequent rapid expansion of income transfers.

Attitudinal changes also affected supply, and here is where the Berkeley story of the Fed losing and then regaining knowledge necessary for inflation control has at

[4] American leaders from James Madison in 1794 to Grover Cleveland in the 1890s made repeated statements denying both the constitutional authority of Congress to legislatively redistribute income (or wealth) and the morality of such acts. In Calder vs. Bull (1798) Justice Chase of the U.S. Supreme Court pronounced such laws "against reason and justice," and said, "the genius, the nature, and the spirit of our state governments, amount to a prohibition of such acts of legislation, and the general principles of law and reason forbid them." Attitudes changed, and state legislatures began undertaking such acts on a small scale in the late 19th century, particularly for the relief of widows. Until the Great Depression most poor relief was, however, provided by kin or by private charities.

least some relevance. The emerging dominance of redistributionist – and associated inflationist – views by the elites was aided by Keynesian economics, which removed the attitudinal constraints against both the budget deficits and the monetary expansion needed to fund income transfers (Buchanan and Wagner, 1977). In addition, with its presumption of downwardly inflexible wages and prices at output rates below full employment, such that the level of aggregate demand was all that determined the level of output and employment, Keynesianism led politicians and Federal Reserve officials to believe that any existing unemployment could be reduced without causing prices to rise by simply expanding aggregate demand. And when inflation became chronic despite unemployment, Phillips curve reasoning provided them with a rationale for continuing and even increasing excess money growth and inflation.

In the late 1960s and 1970s, the propagation of Monetarist doctrines by Milton Friedman and others began to threaten support for inflationary policies, however. Friedman's rejuvenation of the quantity theory of money had already made clear the monetary nature of inflation. Development by Bailey (1965), Johnson (1967), and Friedman (1971) of a clear concept of inflation as a tax on cash balances, literally shifting purchasing power from the public to the government without vote of elected representatives, threatened to remove public misconception on that score. Perhaps most important, Friedman's (1968) concept of the natural rate of unemployment, developed in his famous 1967 presidential address to the AEA, created doubts among economists and open minded political authorities about the power of monetary policy to manipulate unemployment (Friedman, 1968). His argument, in the same article, that inflation could only reduce unemployment below the natural rate by reducing the *real* wage, and then only until worker expectations adjusted to the higher inflation rate, began to spread recognition that inflationary reductions in unemployment might be temporary, not permanent, *and operated through deception of the public.*

The effect of these theoretical innovations on politicians and policy was initially limited, however. Many redistributionist politicians seem to have viewed the deceptions required by their policies as morally justified. The notion that people must be *forced* to do what is "in their own best interest" inheres in the welfare state philosophy. It is often employed in defense of compulsory social security, just to list one

prominent example (Tobin, 1988). This notion easily justified mere *deception* in the finance of such programs.[5] The egalitarian aspects of the welfare philosophy also easily justified the covert, inflationary expropriation of lenders, who were perceived as being wealthy.

Economists of the day, at the FOMC and in academia, were certainly aware of these effects. Indeed, when the author of this paper took his first course in Macroeconomics at the University of Utah in 1976, the Professor, a staunch Keynesian, not only clearly explained the distinction between real and nominal interest rates, but explained how inflationary reductions of real interest rates lowered the cost of government debt finance and redistributed income from government bondholders to subsidy recipients. Additionally, he made clear his *glee* at such policy action. Disregarding the questionable morality of this perspective, which was typical (though not universal) among the economists at that institution, his only intellectual error was in underestimating the intelligence of government bondholders and other private citizens while overestimating that of politicians and Federal Reserve authorities. That error was shared by the FOMC.

3 The Political Economy of the Disinflation

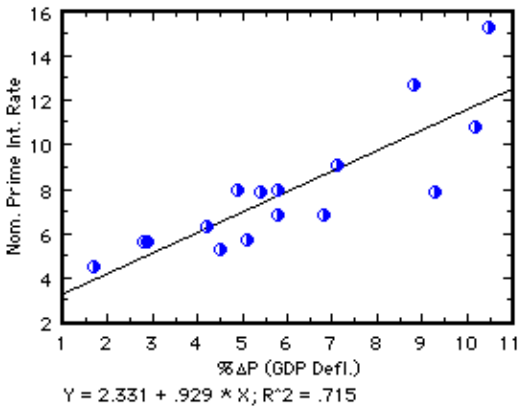
A political economy theory of inflation must provide insights not only into why a policy of enduring inflation has been followed in the postwar period, and why it accelerated after 1964, but also help explain why the inflation rate fell precipitously after 1980, eventually drifting down and stabilizing at comparatively low levels. One might attribute the rapid decline of inflation in the early 1980s to the anti-inflationary attitudes of the Reagan administration, and certainly that was a factor. Political disenchantment with inflationary policy began earlier, however, and came in the form of a change in the incentives faced by politicians relying on a policy based on deception. The crucial insight is that, in fundamental ways, critical elements of the public

[5] The term "deceptions" as used here has connotations both of the public miss-estimation of simple variables such as the inflation rate and what public choice economists have referred to as "fiscal illusions", i.e. voter underestimates of the costs of government due to such things as complex or hidden tax systems (the tax on cash balances being the quintessential example), to the extent that such errors have been deliberately induced by political authorities.

stopped being deceived, and/or responded to chronic, accelerating inflation in ways that diminished the political incentives for inflationary policy.

First, inflation could *only* be used to reduce real wages from excessive levels generated by legal minimum-wage increases, union violence, strike threats, and pro-union government interventions, and hence keep the unemployment rate down to politically acceptable levels, as long as workers were subject to money illusion (or at least underestimated the current and prospective inflation rates). Naive Keynesian Phillips curve theory implicitly assumed worker money illusion. Monetarists rejected this, and Friedman's famous presidential paper (1968) bravely predicted that worker expectations adjustments would, over time, make the long-run Phillips curve vertical.

Figure 4: Inflation Rates and Prime Bank Interest Rates, 1965-1980



Data Source: The Economic Report of the President, 2004, tables B-7 and B-73.

Some Monetarists, however, in a doctrine known as accelerationism, argued that, given adaptive expectations, the inflation expectation of the public would chronically lag the actual rate, and the government could peg unemployment below the natural rate if it was willing to cause inflation to accelerate continuously (Laidler, 1976).[6] Whether acting on this or more naive Phillips curve reasoning, public authorities faced in the late 1960s with the neutralization of their policy by expectations adjustment responded by causing excess money growth and inflation to accelerate. By the

[6] The accelerationists were not advocating unemployment rate pegging, however. Quite the opposite, their point was precisely to show that the costs of doing so would be excessive.

early 1970s, however, workers were able to anticipate even accelerating inflation and raise wage rates enough to compensate in advance. The inverse "Phillips Curve" relation between inflation and unemployment went away, just as Milton Friedman had predicted. Thus the 1970s were characterized by *both* high (and rising) inflation rates *and* high unemployment rates, contrary to the experience of the 1950s and '60s and contrary to both Keynesian *and* accelerationist theoretical predictions. *As a political tool for reducing the disemployment costs of redistributionist labor policies, inflation had stopped working.* Workers themselves sensed this, and their political allegiances began to shift marginally against redistributionist politicians. Previously strongly Democrat in their party affiliation, many blue collar workers voted for Ronald Reagan for president in 1980.

3.1 Neutralization of the Debt Repudiation Incentive

The story with debt repudiation through inflation is very similar to that of unemployment reduction. Inflation could only be used to reduce the real interest rate and repudiate debt as long as public inflation expectations lagged actual inflation rates, and transactors continued to suffer interest rate ceilings and confiscatory taxation on financial earnings. There is no reason to believe that sophisticated financial market transactors could be or were fooled much longer than workers. The operation of the Fisher effect, as such transactors built purchasing power premiums into nominal interest rates based on their inflation expectations, is shown in figure 4, which relates annual observations of GDP deflator inflation rates and prime bank lending rates from 1965 to 1980. A simple regression line is included which shows a slope coefficient of .929 on the inflation rate over the period, a virtually complete adjustment of the nominal rate to inflation. However, a regression over the 1965-1976 sub-period has a much lower slope coefficient on the inflation rate. Rising Inflation reduced the real interest rate substantially in that period.

The incomplete adjustment of the nominal rate to inflation over much of the period may *not* have been entirely due to a public underestimation of inflation, but also to the Fed's interest rate ceilings on time deposits. By the mid to late 1970s, however, those ceilings were causing significant distortions of the market. Banks were

experiencing heavy loss of deposits as customers faced with negative real interest rates on their deposits, made worse by federal and state taxation of their nominal interest earnings, sought alternate liquid financial instruments not subject to ceilings, and non-depository financial institutions supplied such instruments. This arbitrage, however, tended to bid up the prices on alternate financial assets and reduce their rates and yields also.

Even worse from the perspective of Federal Reserve officials, when, after 1973, the annual inflation rate exceeded six percent, the fixed nominal interest rates paid to member banks on their stock in the district Federal Reserve banks became negative in real terms, and many commercial banks began to leave the system, taking their reserve deposits with them. Astonishingly, DeLong (1997), Mayer (1998), and Romer and Romer (2003), in their discussions of and explanations for the inflation pattern of this period, *all ignore these events,* blotting this massive disintermediation completely from their historical narratives. They apparently believe it had no effect on the thinking or actions of the FOMC. In fact, the effect was enormous, on both the monetary and political officials.

In a near panic as the monetary authorities realized that the marginal cost *to them* of their inflationary policy had become much higher than they had previously anticipated, the FOMC, under the leadership of Paul Volker, just appointed Chairman of the Federal Reserve Board, raised its interest rate targets and started slowing money growth in October of 1979. In addition the Fed supported, and congress passed, the Depository Institutions Deregulation and Monetary Control Act of 1980. The Act removed regulation Q ceilings on bank deposit interest rates and forced all banks to hold reserve deposits with their regional Federal Reserve Bank (Timberlake, 1985). The capacity of the political and monetary authorities to suppress real interest rates and repudiate debt through inflation was gone, actually lost as early as 1977, as figure 3 shows. Gone with it was much of the political incentive for rapid and accelerating inflation.

3.2 Neutralization of the Seignorage Incentive

As with unemployment rate reduction and debt repudiation, the use of inflation to covertly tax and raise taxes also began reaching its limits in the mid to late 1970s. The

basic theoretical principle here, elaborated by the supply-side economists of the day, is that while the revenue from a tax is the product of the rate and the base, the base itself is negatively affected by the rate, *ceteris paribus*. As any tax rate rises from a low initial level, its effects on the base will be relatively small, and revenue will rise. But at a high level, the tax base will begin to diminish more than in proportion to the rise in the rate, so that revenue actually begins declining. For the tax on cash balances, the revenue is the product of the inflation rate and the quantity of real balances held. The inflation rate expected, however, negatively affects the demand for real balances, so that the quantity demanded falls as the estimated inflation rate rises.

Figure 5: Demand for Real Balances as a Function of Expected Inflation, and Inflation Tax Revenues

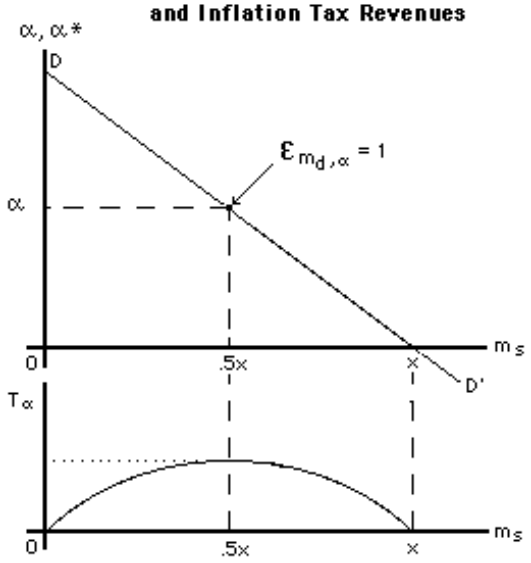


Figure 5 shows the "Laffer" (revenue) curve for the tax on cash balances, measuring real balances demanded and held on the horizontal axis, and the inflation rate and expected inflation (α and α*) on the vertical, *assuming expectations are correct*. Assuming for simplicity that the inverse relationship between inflation and real balances demanded is linear, there is a total revenue curve which rises as the tax (inflation) rate rises over the inelastic region of the demand function, reaches its maximum where the elasticity of demand for real balances with respect to inflation is unity at one-half the distance from zero to point x on the horizontal axis, and falls again as the

inflation rate continues rising over the elastic region of the demand function (Johnson, 1967). This is shown in the lower of the two graphs composing figure 5. The acceptance of such supply-side arguments by the Democrats in congress some years *before* their adoption by Republicans, is strong indication that something was forcing both economists and members of congress to recognize the existence of limits to their inflationary tax policy. Paul Craig Roberts (2002) has stressed the origins of supply-side analysis precisely in the stagflation of the Carter era.

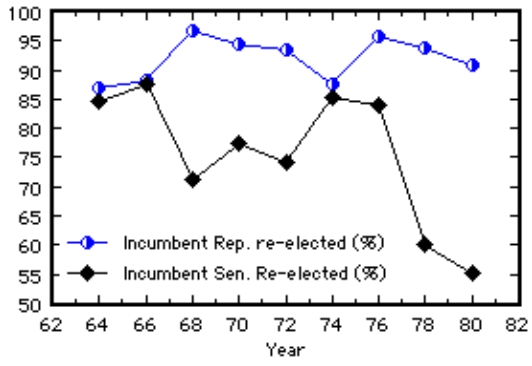
In years of inflation surprise, of course, real balances held and revenue from the tax on cash balances will both be larger than they would be with accurate expectations of the same inflation rate, and the opposite would hold when inflation is below expectations. In the late 1970s the first condition still held, as the determination of the authorities to finance expanding income transfers, keep interest rates low, and repudiate debt may have caused them to actually lose control of the money supply and price level in a Wicksellian cumulative process. The CPI increased 13.3 percent in 1979 and 12.5 percent in 1980. The GDP deflator rose 8.5 percent and 9.2 percent in those years. Inflation expectations of the public were beginning to adjust, however. The real money stock actually *fell* in 1978 and 1979, despite significant real economic growth in those years. Monetary velocity increased, adding its own impetus to inflation, as real balances demanded as a fraction of real GDP fell. The U.S. was headed for banana republic inflation rates, and voter panic began to generate significant pressure on the authorities to do something about it. Clearly the limits of inflation policy, both economic and political, were being reached.

3.3 Neutralization of Bracket Creep Incentives

Similar factors were operating to limit the capacity of the authorities to raise income tax rates and other tax rates through inflation. Voters may not have known which specific politicians to blame for bracket creep and rising property taxes on inflated land values, but they were not stupid. As for businessmen, they knew very well who to blame for capital consumption due to understated depreciation allowances in the tax code. Over time, the rising burdens of taxation and regulation and the consequent slowing of productivity and economic growth (Vedder, 1996) gradually created

a public backlash against taxes, which the redistributionist politicians had not anticipated. California voters began the revolt by passing proposition 13 reducing property tax rates in 1978. Many other states quickly followed. Politicians who opposed tax relief were threatened with electoral defeat, and more than a few were actually defeated, as shown in Figure 6. In 1980 Ronald Reagan was not only elected president on an explicit program of tax reduction, but the Republicans gained a slight majority in the U.S. Senate for the first time since 1956.

Figure 6: Percentages of Congressional Incumbents Re-elected, 1964-1980



Data Source: The Statistical Abstract of the United States, 1996, table no. 441, p. 279.

The inflation policy became unprofitable, then, because the marginal benefits of the policy to redistributionist politicians declined as the public learned to anticipate rising inflation rates, and because the marginal political costs of the policy increased, both in accordance with the political neutralization hypothesis. The politicians could no longer use inflation to reduce unemployment and interest rates, or hide the costs of an expanding welfare state through surreptitious taxation, deficit spending, and inflationary debt repudiation. Thus public political support began to shift marginally against the redistributionist and inflationist politicians, particularly in the U.S. Senate. Policies of income redistribution stopped growing and even declined slightly as a fraction of the budget, as shown in figure 2. At that point it became politically possible to significantly reduce the inflation rate, even at the cost of temporary added unemployment.

So, in Volker's "October Revolution" of 1979, the Fed raised the interest rate, and set monetary targets that began reducing the growth rate of the money stock. Nominal money growth fell below the growth in money demand, generating both an excess demand for money and, by Walras' Law, matching net excess supplies of the other economic goods, as people reduced their purchases in a futile effort to add to their money balances. Thus the U.S. experienced the large double dip recession of 1980-1982. The inflation rate then had to fall until it was enough below the growth in the nominal money stock that the *real* money stock could grow enough to satisfy real balances demanded and end the recession. As part of this process, since the fall in the price inflation rate below the rate of nominal wage inflation initially raised the real wage to unemployable levels, the rate of wage inflation had to eventually fall, reducing the real wage (adjusted for productivity) enough to restore more normal employment (Vedder and Gallaway, 1997, 235).

The final nail in the coffin of the inflation policy may have been the indexation of federal income tax brackets by President Reagan in his Economic Recovery Tax Act (ERTA) of 1981. Tying nominal income tax brackets, the zero bracket amount, and the personal exemptions to the consumer price index was an act of moral principle uncharacteristic of late 20th century politicians. That provision ended the congressional capacity to covertly raise income tax rates without an open and public vote, from which those in favor could be identified. This further reduced, by a large increment, the marginal benefits of inflation as a tool to redistributive politicians. The bitter congressional debate over the indexation provision should dispel all doubt concerning the deliberate, conscious use of inflation for surreptitious finance by such politicians. Opponents of indexation focused their arguments precisely on the revenue losses the government would suffer if indexation was included in the tax bill (Fessler, 1981). It is beyond dispute, as their own statements show, that they knew exactly what they had been doing, and what they were losing.

In a last gasp of Keynesian rationalization, some of its congressional opponents, including the *Republican* welfare statists John Chafee and Pete Dominici in the Senate, argued that indexation would actually make inflation worse. In their view, not only would it reduce the costs of inflation, and hence the incentive to fight it, but indexation would put more money in the hands of the public just when expenditure

restraint was needed (Fessler, 1981). So which view was correct? Did indexation decrease the incentives to *fight* inflation, or did it decrease (in combination with the expectations adjustments of citizens) the incentives of government and Federal Reserve officials to *generate* inflation? Indexation passed, and the matter was settled by the rapid disinflation that followed.

4 Recent Experience and Future Prospects

On the other hand, indexation may *not* have been the final nail. Since the rapid disinflation in the 1980s the inflation rate has largely stabilized at positive values in the two or three percent range. In part, this may be because some incentives for inflation on the part of political and monetary decision makers still exist. For one thing, revenue for the federal government can still be obtained through the tax on cash balances with little political cost. More important, even though the unionized fraction of the labor force has declined significantly since the 1950s, support for minimum wage laws and pro-union policies is still strong, and consequent downward *nominal* wage rigidity is still such that macroeconomically stabilizing real wage adjustments *must* largely occur through differential movements of wage and price inflation (the first-difference hypothesis).

In the near future, incentives for more rapid inflation may increase, and factors leading that way seem already to have begun. As the baby boomers retire in just a few years, and the social insurance programs begin to collapse (Edwards, 2003), pressures to "save" them through inflationary finance will almost certainly become irresistible. Add to that the debt monetization being used to help fund the recent huge Bush and Obama financial market bailouts, the current Federal Reserve open market purchases of worthless mortgage backed securities, and the necessity of financing the new health care initiatives and other added social programs forthcoming from the Obama administration, and higher inflation seems inevitable. As has been said, those who fail to learn from history are destined to repeat it.

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Monetary Reform – The Case for Button-Pushing

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JEL Classification: E50, P11, P21, P31

Abstract: In this paper I present a monetary reform plan that seeks to achieve a sound monetary system. I suggest the following three criteria of a good reform: it must be ethical, it must be based on sound economic theory and it must leave room for evolutionary processes. Based on these criteria and applying them to the monetary system, I argue for an immediate cancellation of all government intervention into the monetary realm.

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1 Introduction

In a previous paper (Bagus, 2008), I presented the proposals for monetary reform offered by the Austrian economists Ludwig Mises, Murray N. Rothbard, Jesús Huerta de Soto and Hans Sennholz. Their aim is a more stable monetary system that permits monetary freedom. Without questioning the aim, I set out to criticize the way that those outstanding economists proposed to get to their aim. In fact, Mises, Rothbard, Huerta de Soto and Sennholz offer plans of monetary reform that entail numerous state interventions into the economy, inconsistencies, arbitrariness, and tactical ambiguities. Their proposals contradict their own ethical and political principles, only partially resulting in monetary reform. All of these problems seem to stem from the authors' attempt to preserve the status quo and to avoid alleged chaos, their reliance on a problematic economic theory of deflation, or the attempt to gain acceptability by avoiding a deflation and its supposedly disastrous effects. In this paper, I will offer a monetary reform plan that does not entail the setbacks of the criticized plans.

I will proceed as follows. First, I will suggest the criteria a good reform must fulfill. Second, I will develop a reform based on those criteria and that can be called a "button-pushing" reform as it immediately abolishes all government interventions into the monetary sphere. Third, I will name the probable consequence such a reform will entail. Fourth, I will describe the advantage that can be derived from such a reform, mainly that it is in concordance with the criteria a good social reform must have. Fifth, I try to anticipate the most important objection that could be raised against such a proposal, concluding with a summary of the main results.

2 Requirements of a reform

After having critized the plans for monetary reform by Mises, Rothbard, Huerta de Soto and Sennholz for being too interventionists, too less laissez-faire, having too much fear of deflation, I will make a proposal for monetary reform that is in line with Huerta de Soto's theory of the compatibility of the three approximations towards the reality of human action.[1] The three approximations are, first, the development of

[1] See Huerta de Soto (2004, 105-109).

a formal ethical theory. Second, there is the study of economic theory and third the study of the "conjectural history," i.e. the interpretation of evolutionary processes and its results. According to Huerta de Soto these three levels of study are complementary and mutually enriching. Their careful and separated study is necessary. I would like to apply this approach to the concept of social reform. Social reforms should be in line with these three levels.

First, and most importantly, reforms should be ethical. This explains itself. A reform that is unjust, cannot be regarded as a good reform as every unjust action is something to be prevented. For example, the reform in itself should not imply violations of property rights nor willingly sanctify property rights violations ex post.[2]

Second, reforms should rely on a consistent, true, and value-free economic theory. Justifying this second criterion is also easy. Since if a reform is not based on a correct theory, the results and the costs incurred by the reform are different from those the proponents of the reform thought they would be. Therefore, the proponents do not actually know what results and costs they propose. They will aim at ends that they would not pursue if they would possess a correct theory. For instance, a monetary reform should not be based on a theory that claims the money supply must be adjusted to money demand in order to allow for an increase in production.

Third, there is the study of historic evolutionary processes. Of course, this cannot be applied one to one on a reform as a reform aims at the future and not at the past. However, one can demand that the reform makes possible and implies itself a spontaneous evolutionary process only determining the general abstract rules instead of imposing from above particular results. In other words, the reform should leave room for evolutionary processes to run their course, i. e. the reform should leave its exact results up to an dynamic entrepreneurial process.[3] This is very important to make use of innate entrepreneurial creativity of human beings. They know best how to solve their problems, coming up, if they are let to, with solutions that the proponents or planners of the reform would not have thought of. For example, it should not be determined a priori which kind of money is to be used and produced.

[2] Of course, we are relying here on an ethical theory that protects property rights.

[3] This criterion seems to be implied in the first requirement of being an ethical theory. However, there might exist ethical reform alternatives that leave different amounts of room for evolutionary processes.

If all three points are fulfilled, one can be sure that the reform is worth considering. However, if the reform fails on one of the three levels one might want to look at it in detail adjusting or discarding it. Therefore, in the following, I will develop a proposal for monetary reform in line with the three approximations.

The proposal is as simple as it is thorough. It consists of immediately abstaining from government intervention into the monetary realm. This is the strategy which was implicitly endorsed by Rothbard:

> Following the classical liberal Leonard Read, who advocated immediate and total abolition of price-wage controls after World War II, we might refer to this as the "button-pushing" criterion... The libertarian, then, should be a person who would push a button, if it existed, for the instantaneous abolition of all invasions of liberty... (1998, 259).

Everyone who subscribes to the idea of Rothbard to abolish government interventions immediately cannot at the same time subscribe to monetary reform not doing this and involving government actions. This person would always first propose a button-pushing reform in monetary affairs and at most as a second best option or compromise propose another reform in political negotiations.

3 Measures

So what would the "button-pushing" strategy mean for the monetary realm in the U.S.? First, and most importantly, all restriction for private money production must be removed in order to allow for free money competition. Then everyone is allowed to produce money. Legal tender laws, i. e. laws that determine that settlements of debts in the privileged currency must be accepted even though the contract was set in another currency, must be removed. Also all laws that imply restrictions of the buying, selling, loaning, borrowing, importing and exporting of competing monies are to be removed. Further, it must be possible to pay taxes in any currency at the prevailing market rates between the currencies. Moreover, the government institution Federal Deposit Insurance Corporation (FDIC) is to be abolished, because it gives an advantage to deposits in dollar paper money.

Second, the central bank, in the case of the United States, the Federal Reserve System is a quasi-governmental institution. It was created by the state with the 1913 Federal Reserve Act and was given the nationalized gold. Its board and chairman is appointed by the President and approved by the Senate. It holds the monopoly to issue federal reserve notes with the U.S. Treasury printing them. All this is to be removed.

Third, the gold that was nationalized and is held by the central bank is to be given back to the population. Who can prove that he was robbed or is an heir of such a person will get his property back. The gold that is not reclaimed in this way can be used as compensation and restitution for government interventions in the past. Former taxpayers, conscripted and expropriated citizens, can get restitution in gold in proportion to the harm they suffered.[4] That would imply that older people would tend to receive a higher part of the gold, because they tend to have been taxed more in the past. Further, interest will be considered in determining their compensation.[5]

Fourth, monetary and especially bank contracts must be enforced. If banks have committed fraud in issuing more titles to money than they have money proper or that have obfuscated "the difference between genuine (that is, 100 percent-covered) money titles and imperfectly redeemable IOUs,"[6] they should be held responsible.

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[4] Of course, this group includes only people that can prove that they have been net taxpayers and net expropriated people and have not earned the amounts taxed in virtue of some governmental privilege. In this sense, the distribution of the nationalized gold to state victims is not arbitrary but forms part of a restitutional process for government invasions of private property.

[5] Guido Hülsmann arguing for a libertarian monetary reform states that the unreclaimed property of the central bank should go to its users (1998, 115). The gold and foreign exchanges would go to the workers in the vault. In contrast, Hoppe claims that civil servants should not get public property, because they are not tax payers but tax receivers. (2001, 135-136). From a libertarian perspective it would be indeed strange that in a desocialization process President Bush would receive (parts of) the White House, limousine and Air Force One, all of which he uses. Or that Ben Bernanke receives any share of the unreclaimed gold in Fort Knox that he is using to back the state fiat currency. All employers of the central bank are to an extent part of a quasi-governmental institution and are collaborating in the financing of the government's activities. The same is true to a smaller extent though, for the bank owners and bank employers. (See Block, 2004 and 2006, for a theory of a libertarian punishment of statists and a libertarian Nuremberg Trial.) One could make the case that lower rank collaborators could homestead the buildings or printing press they are using. But it seems to be that these collaborators have a smaller claim on the nationalized gold and the foreign exchanges than tax payers. For a libertarian analysis of criminal possession, restitution and the burden of proof see Rothbard (1998, esp. Chaps. 9-11).

[6] Hülsmann (2003, 411). IOUs are certificates that banks issue in favor of a creditor who ususally receives interest from the bank.

4 (Probable) Consequences of the reform

With competition in the monetary production, private money producers will emerge and start competing with each other. Commodities like gold or silver in turn historically have a high cost of the material (of gold or silver) in comparison to their monetary value, due to their scarcity in relation to their industrial or luxury usages. The premium that the monetary value has on the material value is for gold and silver much smaller than for existing paper money. Therefore, it is more risky to accept paper money in daily exchanges, because its market value can drop considerably if people start abandoning it.

Thus, people would start using other monies than the fiat paper currency in their transactions. It will probably not be an instantaneous process and it is not so that entrepreneurs will stop quoting prices. Rather they will quote their prices in something else other than the fiat paper currency or in several media of exchange. Entrepreneurs will look at other entrepreneurs and chose the commodity or money they regard as most appropriate. At the same time, the most perspicacious (farsighted) entrepreneurs will pick up the business of money production, picking commodities of a high saleability. Other people will notice that some people are buying those commodities in order to resell them. As these commodities are easy to sell, people will imitate the innovators. As more people use those commodities, their saleability rises and it becomes ever more attractive to use them. In a self-enforcing process new monies arise.[7] One cannot know how fast and smooth this process will be. However, there is also no reason why it could not be fast and smooth.[8] Probably in the beginning, when the new money producers are just starting their production, people might start using foreign exchange. Yet, there already exists producers of gold and silver currencies[9] that might expand their business immediately when the restrictions on monetary competition are removed.[10] Furthermore, in the long run the foreign paper money is likely

[7] See Menger (1892, online: http://www.mises.org/web/2692) for the origin of money.

[8] R. A. Redford (1945) describes how in a prisoners of war camp in World War II cigarettes immiediately evolved as the general accepted medium of exchange.

[9] For example: http://www.e-gold.com/ or http://www.goldmoney.com/ .

[10] Note also that due to the denationalization of the central bank gold, most people will possess at least a small gold stock, which gives gold the headstart to emerge as one of the future monies. (According

to be driven out of the market by commodity money because, as pointed out before, commodity monies are less risky. It is important to notice that during the process of the evolution of new monies there is inflation (i.e. increase in the money supply) and deflation (i.e. decrease in the money supply) going on at the same time. This always happens when people start changing from one medium of exchange to another. The old money is abandoned, its supply shrinks and its material is used in other lines of production. At the same time new money emerges with an increasing supply. The German hyperinflation in 1923 serves as an example of this process.[11] While the hyperinflated paper money was abandoned and demonetized, i.e. not accepted as a medium of exchange anymore, new currencies backed by foreign exchange or gold emerged spontaneously.

As the monopoly to print federal reserve notes is removed, we face two possible alternatives. The first alternative is that people accept notes in daily exchange that are printed after the end of the monopoly. If this is the case, entrepreneurs would start printing fed notes freely, resulting in a hyperinflation and quick abandoning of the paper money.[12] The other possibility is that people only accept the old pre-reform notes. This seems to be more probable than the first alternative, especially when courts decide about contracts entered into before the reform. Why would a creditor that made a contract in the old fed notes accept the notes that a debtor just printed to repay the debt? The contract was set in terms of the old monopolized federal reserve notes. Why would someone accept a note that can be printed at no cost by everyone? Courts would probably decide in favor of creditors. If no new fed notes are accepted, the amount of fed notes would be fixed.[13] In this case, it is not hard to predict that

to wikipedia there are currently 147.000.000 ounces of gold in Fort Knox. That means on average half an ounce for every citizen of the U.S.)

[11] See Stucken (1953, 31-60, esp. 49).

[12] See for this scenario Hoppe (1994, 59). Walter Block (1991, 93-104) makes the case for a private counterfeiter under a fiat money regime. For good critiques of his view see Robert Murphy (2006) and Matteusz Machaj (2007). However, the whole scenario becomes different with the button-pushing reform. There the government monopoly is abolished, and people would be free to accept or no, old or new bank notes (printed after the monoply was abolished). Producers of new notes, pretending them to be old ones, would be considered counterfeiters.

[13] Probably the new owners (tax payers or homesteaders) of the old federal reserve printing press will try to print new notes and try to make people accept them. Yet, without the prestige of the state, the legal tender laws, etc. probably no one would accept these notes either. The antique federal reserve printing press becomes like every other printing press.

a price deflation would occur. It is probable that with the abolition of the Federal Reserve System and the FDIC bank runs would occur immediately. The confidence on which the system depends will be shaken. Some people might even call for runs on certain banks, an action that will be legal. Also, banks that committed fraud in obfuscating the distinction between money titles and IOUs or that issued more money titles than they have money, will be sued.[14] This also increases the possibility of a decrease in confidence and increases the likelihood of bank runs. As one bank run or bank failure undermines the confidence in other banks, all fractional reserve banks are likely to collapse in a domino effect. Even if there are no immediate bank runs, the system is very likely to eventually collapse. When the next recession, or political crisis looms, confidence will fall and a credit contraction will likewise occur. If people for some other reason want to have more cash, likewise a severe credit contraction ensues. This credit contraction in turn can lead to business bankruptcies, bad loans for banks and even less confidence in the fractional reserve banks, eventually leading to purging bank runs. The whole fractional reserve banking system will go bankrupt as they loose their cash and are sued for fraud. Their assets will be turned over to their creditors and depositors.[15]

[14] The exact legal status of fractional reserve banking is a historical contingency and must be decided case by case. It is not necessarily fraud, since people might voluntarily agree to an IOU with a redemption promise. See Hülsmann (2003, 402). Huerta de Soto (2006, 156) names seven possible legal classifications of a bank-deposit contract with a fractional reserve, one of them implying fraud. Beside the question of fraud there are two additional considerations. First, banks obtain a "de facto monopoly" (Hülsmann 2003, 415). One might consider the creation of new money through this privilege as a kind of "stealing." Second, there is the question of collaboration. In a libertarian Nuremberg trial banks would probably be sued for exploiting their monopoly and for financing the criminal activities of the state. It would of course be an extremely difficult exercise to find the main responsibles.

[15] Mateusz Machaj argues that, maybe, not all assets should be turned over to the depositors or creditors. The outstanding loans to private companies could simply be canceled or renegotiated, because capitalist entrepreneurs were in a bad position in a system that privileged banks. They had to borrow money from them in order to survive in the competition. Banks made contracts that are very beneficial to them and that were signed thanks to their privilege. When a price deflation occurs, they would have difficulties to repay their debts. Depositors do not only gain through the increase in purchasing power, but also by taking over the production facilities that were created by stolen money. Hence, debt should be renegotiated decentrally or cancelled. While this is an interesting argument, I do not agree with it. It is ethically just that the assets of bankrupt banks are turned over to their creditors and defrauded depositors. Also, debts must be repaid. If they cannot be repaid, there will be a change in the ownership from the former owners to the creditors. This poses no economic or ethical problems. No one was forced to cooperate with a privileged banking system.

5 Advantages of the reform

Let us first turn to the ethical, economic and evolutionary advantages of the proposed reform. First, the reform is ethical. It is in accordance with the libertarian non-aggression axiom.[16] It itself abstains from violations of property rights; it tries to compensate for past property right violations as much as possible and it enforces property rights.[17] It is a libertarian "button-pushing" reform.

Second, the reform does not want to avoid deflation, because there is a sound theory of deflation underlying it. It merely lets the free market run its course as a natural reaction to the government interventions into the monetary realms and does not aim at preventing monetary or price deflation. It recognizes that deflation purges efficiently and quickly malinvestments that were committed in a inflationary boom period. It is built upon a theory of entrepreneurship that shows that the reform is dynamically efficient in the economic sense that it does not inhibit the entrepreneurial function.[18]

Third, it does not inhibit the entrepreneurial function and the reform leaves room for evolutionary developments. And this is an important addition to the ethical requirement. Only considering ethics, one might argue that it would be a restoration of property rights to introduce a gold standard, 100 per cent or not. However, the money that would evolve out of voluntary decisions of market participants might be very different from gold and silver, now. Therefore, it is important that a gold or silver standard is not imposed from above. Also in different regions people might prefer different monies. In a dynamic, decentralized, competitive process the best money will be chosen by market participants. It is even likely that there might be several monies used in everyday life. For example, silver might be used for small purchases

[16] For a natural rights approach to libertarian ethics see Rothbard (1998). Note also that the proposed reform in contrast to other reforms is argumentatively justifiable. One cannot even coherently argue for other monetary reforms that imply a violation of property rights. This is so, because every argumentation in favor of reforms that imply violations of property rights or amnesty for past violations of property, imply a contradiction. The attempt to engage with someone and convince him in an argumentation (of a reform) implies the abstention of violence and requires the acknowledgment of property rights. Hence, one cannot consistently argue in favor for a reform that violated property rights.

[17] See Hoppe (2006, 305-338).

[18] For the concept of dynamic efficiency see Huerta de Soto (2003, 231-254).

and gold for larger ones. There is also room for innovations in monetary substitutes like credit cards, etc.

In addition to the evolutionary, economical and ethical advantages there exist some minor additional advantages of the proposed reform. First, there are some practical advantages. The reform itself is fast and uncomplicated. The managing or planning costs of the reform are very limited. Second, there is a unique opportunity to reduce the welfare state. The government bonds held by the central bank and bankrupt fractional reserve banks can be defaulted which reduces the national debt burden. Also the financing of the welfare state by inflation will become impossible. Another interesting feature of the reform is that the denationalized gold will primarily go the older and retired persons. That allows for reduced tensions that the abolition of a public pension system could cause.

Fourth, there will be public pressure to make the economy more flexible and reduce state interventions. For example, during the reform there will be a price deflation which could result in pressure from the involuntarily unemployed to break union power and abolish minimum wage laws.

Fifth, one has to put emphasis on the results of the reform. There will be a totally free monetary system, with competing moneys whose success results from the choices of economic agents. The inflationary redistribution that entails a fiat paper money system backed by a central bank immediately ends when the reform is put into practice. Also recurring business cycles induced by the credit expansion of fractional banks are put to an end. The implied misallocation of resources and impoverishment of the population ends with it. A stable, sound monetary system can develop as fast as is possible with freely interacting individuals.

Sixth, it is very difficult to reverse this reform. It does not leave in place state institutions or laws in the monetary sphere, and it does allow for a dynamic system. Moreover, people will not have the impression that the government provided them with their newly emerged system, because they experience that government is not necessary to provide for a monetary system or reform. Actually, there is not a single case of monetary reform managed by the government that changed the trend toward a fiat paper money system controlled by a central bank. For instance, the German mon-

etary reforms in 1924 and 1948 were conducted by the government (Stucken, 1953). Instead of permitting the already emerging alternative media of exchange to compete, the government stayed involved in the monetary system. Even though Germany got back to the gold standard in 1924, this was only for a short intermediate time. By introducing a foreign exchange control the German government efectively introduced a fiat paper money standard in 1931 again. The monetary break-down after World War II could have been used for a thorough monetary reform. However, the monetary reform from 1948 just changed the name of the currency and the institutional framework. Even though the Bank Deutscher Länder engaged in restrictive monetary policy in the beginning (Erhardt, 1968, 34), the new D-Mark was also just another fiat paper money currency.

Furthermore, the collapse of the old monetary system is also an educational advantage in showing that the former monetary system was inherently unstable and bankrupt. Rothbard´s hope that the failure of the governmental monetary system provides insurance against its reemergence might become true with a thorough reform. As Rothbard stated in one of his earlier more radical works on the subject:

> And if, as we contend, banks are inherently bankrupt and "runs" simply reveal that bankruptcy, it is beneficial for the economy for the banking system to be reformed, once and for all, by a thorough purge of the fractional-reserve banking system. Such a purge would bring home forcefully to the public the dangers of fractional-reserve banking, and, more than any academic theorizing, insure against such banking evils in the future (2000, 21).

6 Objections to the "button-pushing" plan

Let us deal with some of the objections that come to mind regarding the aforementioned plan. The first objections one would raise is the political impossibility of such a plan. This objection must of course be taken seriously.[19] The political elite, banks and

[19] Historically, there actually have been reforms entailing monetary and subsequently price deflation. That shows that the proposed reform is not in principle impossible. These reforms happened after wars, though, periods of great unrest. It happened in Great Britain after the Napoleonic Wars and WWI and in the German monetary reforms after the hyperinflation in the 1920s and after WWII in 1948. Also in the Netherland in 1946 deflation was employed in monetary reform. This induces

other individuals profiting from the current system will oppose the reform. Maybe also frightened voters unable to grasp the economic importance of and their benefits from the reform would object to the plan with politicians picking up their concerns.[20] However, it is in principle not impossible to convince the majority of voters or the population that they would benefit from a plan that is just and consistent.

More importantly, the political practicability is irrelevant when searching for an optimal reform plan. Often plans that are politically less practical present the best solutions. In turn, what is most politically popular is normally the worst solution. Adding as a fourth criteria the popularity of a reform would mean adding a criterion that does not necessarily and very probably contradicts the other three (ethical, economical, evolutionary) criteria. Also it must be understood that by offering a monetary reform, I am not opposing any other monetary reform. In fact, every reform that moves in the direction away from state intervention in the monetary system is a step in the right direction. And this step should be endorsed under the condition that it is made clear, that the step is only a step and not an ideal monetary reform.

One could further argue that another criterion for a good reform should be that it is stable. One might fear that after the reform there would occur social unrest that is likely to reverse the reform. People would say: "That did not work." While this might be considered a complementary argument, the most important criteria is that it is ethical, economically sound and leaves room for the entrepreneurial process. They are primarily important. Furthermore, the proposed reform is necessarily just and based on sound economic reasoning. In contrast, there is not necessarily social unrest. It is possible that there will be no strong social unrest for two reasons. First, in order to introduce the reform one would have to convince people of it in the first

Hamilton (1952, 330) to say about the role of monetary deflation in monetary reform: "Deflation through writing down bank deposits and destroying currency, in effect, crying down money, has been the commonest type of monetary reform in recent years [Footnote about monetary reform in Germany and the Netherland omitted] and is likely to continue in medieval fashion, alternately with inflation of paper currency and bank deposits in a distinctly modern and sometimes violent fashion."

[20] See on this problem William Hutt (1971). He points out that the competition of economists in gaining political influence and swimming with the political tide leads them to make compromises in theories. As a consequence the argumental basis and the prestige of economists as experts weakens. Paradoxically their influence might decline. He argues (1971, 22), that the economist should propose both the ideal and expedient policies and make explicit what he is dealing with. In this paper, I am proposing an ideal reform leaving it to others to come up with expedient reforms.

place. Therefore, they would know its consequences. Second, there are many winners from the reform who would embrace it. The losers are mainly the government, the banks and the welfare-warfare complex. Why should there not be social unrest when the losers of the actual system become aware that they are under an unjust system and exploited? Why should there not be social unrest if an unjust reform is carried out? In the change from the D-Mark to the Euro, Germans had to calculate in a different medium of exchange over night. With the button-pushing reform the transition would be smoother and people would gradually learn to perform economic calculations in terms of other media of exchange.

Moreover, historically button-pushing reforms have become stable and successful after initially being confronted with short lived reistance. Ludwig Erhard pushed at the button on price controls after WWII, in 1948 eliminating over night all price controlls in Western Germany and initiating the economic recovery of Germany. Erhard introduced the market economy in a day even though there was opposition by contemporaries arguing that one should make a gradual refrom. The majority of people thought that the reform could not be successful as it seemed to be too radical. Even though there was a strong opposition and a general strike, Erhardt held on to the reform (1964, 18-48).[21] A similar button-pushing reform happened in the 1990 in former communist Eastern European countries when price controls were abolished.[22] As Daniel Gros and Alfred Steinherr (2004, 107) in their analysis of the transition of former communist countries point out "...the revovery was stronger in countries that had liberalized most thoroughly..." The authors also point to the dangers of slow reforms (2004, 127):

> Our first result is that experience has shown that slow reforms meant, in many cases, just that: slow reforms and no willingness to progress faster after the ground work had been done. The tortoises did not overtake the hares.

Another set of questions is can a major "turmoil" be prevented at all, and can the existing system ever be stable. Economic theory tells us that a fractional reserve banking

[21] See Erhardt (1964, pp.18-38) for the details of the reform.

[22] There is a parallel of the former socialist countries in Eastern Europe and our case of monetary reform, because we are faced in the Western World with socialism in the monetary sphere. (See for the socialism in the monetary sphere Huerta de Soto, 2006, pp. 647-675)

system headed by a central bank leads to recurrent boom and bust cycles. That is not a stable system either. This system can easily end in hyperinflation and Rothbard predicts its crash: "...we have to realize that the banking system is headed for a mighty crash in any case" (Rothbard 1995, 11). That means that the current system causes social unrest as well, which will likely get much worse as credit expansion and economic cycles increase.

Another objection might be that the monetary system collapses. That is true. Yet, the system collapses because it is unsound and people voluntarily change towards other monies. The collapse of the German monetary system in 1923 occured, because people began to abandon the old inflated currency. Instead of letting people discover new monies that seemed to be appropriate, a process that was already under way[23], German authorities introduced another state money. Would one argue that if a fraudulent firm collapses and a sound one takes its place that this would be somehow bad and a new fraudulent firm should be installed? Of course, many individuals that were hurt by or benefitted from the fraudulent firm will experience (substantial) changes in their life. However, there is no necessary "disruption" of economic activity. As the fraudulent gas trader Enron went bankrupt, stakeholders were hurt. However, houses did not go cold due to a shut down of gas. Gas was still being produced, traded and distribuited as was in the interest of agents involved in the bankruptcy. The same will happen when the monetary fiat paper system collapses. Stakeholders in the state´s monetary system will be hurt, but their goods and services that are demanded by economic agents will still be supplied, money included.

Furthermore, to speak of "disruption" would already involve an ethical statement. There will be a redirection of economic activity. Namely, the structure of production that was distortet by continous inflation will be readapted. Further, more activity will be spent to come up with monetary innovations or barter ideas that make life simpler.

One might also argue that button-pushing reforms do not work as institutions need time to develop. However, how long will this time be? Would the development of institutions not be the fastest if there is a button-pushing reform. Moreover, this argument contrasts with the ethical criterion and leads to questionable conclusions. Against an immediate abolition of slavery one might argue that slaves do not possess

[23] See Stucken (1953, 49).

institutions to live successfully in liberty; therefore, slavery could only step by step be abolished in order to give the slave opportunities to develop institutions. Probably the slaves would not accept such a reasoning, as they wanted to develop their capacities to live free as fast as possible. The same can be said about the monetary system. Free monetary institutions can be developed faster, if monetary interventions are abolished immediately.

Another objection might be that there is a huge redistribution of wealth. Of course, every reform has its winners and losers, as has every change in the economy and continuation of government intervention for that matter. It is arbitrary to say that a certain amount of redistribution is too big. It is also hard to see, that if individuals who anticipate the abolition of government interventions and position themselves to profit from it, would earn unfair gains during the reform. The important question is if the changes that occur and turn people into winners and losers are based on decisions of voluntary interacting individuals or not. Of course, there will be a huge readjustment of the structure of production due to the redistribution of wealth. There will also be many bankruptcies. But by which standard can one say that there would be too much of a readjustment or too many bankruptcies? By which standard could one say that they are bad? One objective standard to judge this is property rights. And property rights are restored by this reform. Always when government interventions are abolished there are disruptions in the economy, small ones if agricultural subsidies are abolished, greater ones if slavery is abolished.

The last objection that is considered here is the affirmation that the proposed reform could only be undertaken on a world wide scale, because otherwise there would be huge foreign exchange fluctuations disrupting international trade. However, this is not necessarily the case. While the old currency might lose in value quickly, the new monies will not necessarily fluctuate more against foreign exchanges than the old one. They will probably increase in value, showing the competitive advantage of the new monies regarding paper money. Actually, there is a first mover advantage for those countries who apply the reform first (Hülsmann 1998, 113). This is so, because the first movers will get the new monies at lower prices, before their purchasing power increases as other countries apply a similar reform. Those countries are similar to the entrepreneurs who are more farsighted than others in choosing a medium of exchange.

7 Conclusion

Most plans for monetary reform have been interventionist and unethical and they impose results. This is partly so, because of a problematic underlying economic theory regarding deflation. Sometimes the reform plans are in apparent contradiction to other writings of the very same author. An ethical, dynamical reform based on value free economic analysis consists in the immediate abstention of state intervention into monetary affairs ("button-pushing"). This plan would very likely imply the deflation of the old money and the purge of the banking system, i.e. those consequences that other reforms tried to avoid. Even though this plan is far away from getting only near to a political approval it is important to show its advantages. It can serve as a standard for comparison.

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"The Yield from Money Held" Reconsidered[i]

Hans-Hermann Hoppe[ii]

Below we publish the Franz Cuhel Memorial Lecture of 2009 by Hans-Hermann Hoppe – a critique of the notion that money held as cash balances is barren and leads to economic predicaments. He shows that while there is a wide family of proponents of such view, few economists recognize the benefits of holding money flowing from the removal of uncertainty. He demonstrates that far from being unproductive, increasing the cash balances can be viewed as an investment into greater certainty (lower uncertainty) taking place at the cost of lower consumption of goods (present and future) perceived as certain. Hans Hoppe concludes his lecture by linking this theme with the current economic crisis and attempts at alleviating its consequence.

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[i] This paper has been delivered as Franz Cuhel Memorial Lecture during the Prague Conference on Political Economy, April 24, 2009.

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Franz Cuhel occupies an honorary place in the history of economic thought and of the "Viennese" or "Austrian" school of economics in particular. In his book *Zur Lehre von den Beduerfnissen* (1907), Cuhel presented for the first time a strictly *ordinal* interpretation of marginal utility and thus contributed to a systematic advance of pure economic theory. Since this lecture is named in Cuhel's honor, I felt it appropriate that I, too, should discuss here a purely theoretical problem of economics. My subject is not the general theory of value, however, but, more specifically, the theory of money.

I have chosen the title of my lecture after a famous article by William H. Hutt, "The Yield from Money Held."[1] Like Hutt, I want to attack the following notion: that money held in cash balances and deposit accounts is somehow "unproductive," "barren," or "sterile," offering a "yield of nil"; that only consumer goods and producer (investment) goods are productive of human welfare; that the only productive use of money lies in its "circulation," i.e., in its spending on consumer or producer goods; and that the holding, i.e., the not-spending, of money diminishes future consumption and production.

This view is extremely popular within the economics profession and outside. Hutt offers many examples of its proponents. I will offer only two here. The first is John Maynard Keynes. One famous quote from his *General Theory* will suffice for my purpose: "An act of individual saving," by which Keynes means cash holding or "hoarding" instead of consumption- or investment-spending, "means – so to speak – a decision not to have dinner to-day. But it does *not* necessitate a decision to have dinner or buy a pair of boots a week hence or a year hence or to consume any specified thing at any specified date. Thus it depresses the business of preparing to-day's dinner without stimulating the business of making ready for some future act of consumption. It is not a substitution of future consumption-demand for present consumption-demand – it is a net diminution of such demand."[2]

Here it is: The holding of money, i.e., the not-spending of it on either consumer or investment goods, is unproductive, indeed detrimental. According to Keynes, the government or its central bank must create and then spend the money that "savers,"

[1] William H. Hutt, "The Yield from Money Held," in: *Freedom and Free Enterprise: Essays in Honor of Ludwig von Mises*, ed. M. Sennholz, Chicago: Van Nostrand,1956, pp. 196-216.

[2] John Maynard Keynes, *The General Theory of Employment, Interest, and Money,* New York: Harcourt, Brace, and World, 1964, p. 210.

i.e., the holders of cash balances, are unproductively holding back, so as to stimulate both consumption and investment. (Needless to say, this is precisely what governments and central banks are presently doing to supposedly rectify the current economic crisis.)

The second example is from closer at home, i.e., from the proponents of "free banking" such as Lawrence White, George Selgin, and Roger Garrison. According to them, an (unanticipated) increase in the demand for money "pushes the economy below its potential," (Garrison) and requires a compensating money-spending injection from the banking system.

Here it is again: An "excess demand for money" (Selgin & White) has no positive yield or is even detrimental; hence, help is needed. For the free bankers help is not supposed to come from the government and its central bank, but from a system of freely competing fractional reserve banks. However, the idea involved is the same: the holding of (some, "excess") money is unproductive and requires a remedy.[3]

I do not want to engage in a textual critique of Keynes or the "free bankers" here. I only mentioned them to further elucidate the idea that I want to attack, and to indicate how widespread – and consequential – its acceptance is within the economics profession, both inside and outside Keynesian circles. Unlike Hutt, who proceeds "critically" in his article, i.e., through a textual examination of various authors, and arrives at his own contrary view of the (positive) yield from money held in a rather indirect and circumstantial way, I want to proceed "apodictically": by way of a positive demonstration of money's unique productivity.[4]

The first natural response to the thesis that money held in or added to cash balances is unproductive is to counter: Why, then, if money held in or added to cash balances is unproductive of human welfare, do people hold them or add to them?

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[3] Roger Garrison, "Central Banking, Free Banking, and Financial Crises," *Review of Austrian Economics* 9, no.2, 1996, p. 117; George Selgin & Lawrence White, "In Defense of Fiduciary Media," *Review of Austrian Economics* 9, no. 2, 1996, p. 100/01.

[4] For a detailed critique of Keynes see Hans-Hermann Hoppe, "Theory of Employment, Money, Interest, and the Capitalist Process: The Misesian Case Against Keynes"; for a detailed critique of the free banking doctrine see *idem,* "How is Fiat Money Possible?" *Review of Austrian Economics* 7, no. 2, 1994 and *idem,* "Against Fiduciary Media," *Quarterly Journal of Austrian Economics* 1, no.1, 1998.
These articles are collected in Hans-Hermann Hoppe, *The Economics and Ethics of Private Property,* 2nd Edition, Auburn, Al.: Ludwig von Mises Institute, 2006.

If cash holdings are indeed "good for nothing," no one would hold or add to them - and yet almost everyone does so all the time! And since all money is always held or hoarded by someone – when it "circulates," it only leaves one holding hand to be passed into another – money must be *continuously* "good for something" all the while it is being held (which is always).

To understand what this "good for something" of money is, it is best to ask: When and under what conditions would there be *no* demand for cash holdings? Interestingly, wide agreement exists within the economics profession on the answer. It has been most lucidly stated by Ludwig von Mises. No money and no demand for cash balances would exist in "general equilibrium," or as Mises calls it, within the imaginary construction of an "evenly rotating economy." In this construction, all uncertainty is by assumption removed from human action. Everyone knows precisely the terms, times, and locations of every future action, and accordingly all exchanges can be prearranged and take the form of direct exchanges. Writes Mises: "In a system without change in which there is no uncertainty whatsoever about the future, nobody needs to hold cash. Every individual knows precisely what amount of money he will need at any future date. He is therefore in a position to lend all the funds he receives in such a way that the loans fall due on the date he will need them."[5]

Based on this fundamental insight, we can state as a first provisional conclusion concerning the positive theory of money that money and cash balances would disappear with the disappearance of uncertainty (never) and, mutatis mutandis, that the investment in money balances must be conceived of as an investment in certainty or an investment in the reduction of subjectively felt uneasiness about uncertainty.

In reality, outside the imaginary construction of an evenly rotating economy, uncertainty exists. The terms, times and locations of all future actions and exchanges can *not* be predicted perfectly (with certitude). Action is by nature speculative and subject to error. Presently unpredictable surprises can occur. Whenever double coincidences of wants between pairs of prospective buyers and sellers are absent, for instance, i.e., when one does not want what the other has to sell or vice versa, any direct trade (exchange) becomes impossible. Faced with this challenge of unpredictable contingencies, man can come to value goods on account of their degree of marketabil-

[5] Ludwig von Mises, *Human Action,* Chicago: Regnery, 1966, p. 249.

ity (rather than their use-value for him as consumer or producer goods) and consider trading also whenever a good to be acquired is more marketable than that to be surrendered, such that its possession would facilitate the future acquisition of other directly or indirectly serviceable goods and services. That is, a demand for *media of exchange* can arise, i.e., a demand for goods valued on account of their marketability or re-salability. And since a more easily and widely resalable good is preferable to a less easily and widely resalable good as a medium of exchange, "there would be," as Mises writes, "an inevitable tendency for the less marketable of a series of goods used as media of exchange to be one by one rejected until at last only a single commodity remained, which was universally employed as a medium of exchange; in a word, money."[6]

While this brief reconstruction of the origin of money is familiar, insufficient attention has been drawn to the fact that as the most easily and widely salable good money is at the same time the most universally *present – instantly* serviceable – good (which is why the interest rate, i.e., the discount rate of future goods against present goods, is expressed in terms of *money*) and, as such, the good uniquely suited to alleviate presently felt uneasiness about uncertainty. Because money can be employed for the *instant satisfaction of the widest range of possible needs*, it provides its owner with the best humanly possible protection against uncertainty. In holding money, its owner gains in the satisfaction of being able to meet instantly, as they unpredictably arise, the widest range of future contingencies. The investment in cash balances is an investment contra the (subjectively felt) aversion to uncertainty. A larger cash balance brings more relief from uncertainty-aversion.

The term uncertainty-aversion is meant here in its technical sense, as opposed to risk-aversion. The categorical distinction between *uncertainty* on the one hand and *risk* on the other has been introduced into economics by Frank H. Knight and further elaborated on by Ludwig von Mises with his distinction between *case probability* and *class probability*.[7]

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[6] Ludwig von Mises, *Theory of Money and Credit*, Irvington, N. Y.: Foundation for Economic Education, 1971, pp.32-33.

[7] Frank H. Knight, *Risk, Uncertainty and Profit*, Chicago: University of Chicago Press, 1971; Ludwig von Mises, *Human Action*, chap. VI.

Risks (instances of class probability) are contingencies against which it is possible to take out insurance, because objective long-run probability distributions concerning all possible outcomes are known and predictable. We know nothing about an individual outcome, but we know everything about the whole class of events, and we are insofar *certain* about the future. Insofar as man faces a risky future, then, he does not need to hold cash. To satisfy his desire to be protected against risk, he can buy or produce insurance. The sum of money that he spends on insurance is an indication of the height of his aversion to risk. Insurance premiums are money *spent*, not held, and are as such invested in the physical production structure of producer and consumer goods. The payment of insurance reflects a man's subjectively felt *certainty* concerning (predictable) future contingencies (risks).

In distinct contrast, insofar as man faces un-certainty he is, quite literally, *not* certain concerning future contingencies, i.e., as to what he might want or need and when. In order to be protected against unpredictable contingencies at unpredictable moments, he cannot invest in producer goods (as in the case of risk-insurance); for such investments would reflect his *certainty* concerning particular future needs. Only *present,* instantly serviceable goods can protect against unpredictable contingencies (uncertainty). Nor does a man want to invest in consumer goods for uncertainty protection. For an investment in consumer goods, too, is an expression of certainty concerning specific momentary or immediately impending wants. Only money, on account of its instant and unspecific wide-ranging salability, can protect him against uncertainty. Thus, just as insurance premiums are the price paid for protection against risk-aversion, so cash holdings are the price paid for protection against uncertainty-aversion.

To the extent that a man feels certain regarding his future needs, he will invest in consumer or producer goods. To invest in money balances is to invest neither in consumer goods nor producer goods. Unlike consumer and producer goods, which are used up in consumption or production, money is neither used up through its use as a medium of exchange nor transformed into another commodity. To invest in cash balances means I am un-certain about my present and future needs and believe that

See also Hans-Hermann Hoppe, "The Limits of Numerical Probability," *Quarterly Journal of Austrian Economics*, 10. no. 1, 2007, and *idem*, "On Certainty and Uncertainty," *Review of Austrian Economics*, 10, n0.1, 1997.

a balance of the most easily and widely saleable good on hand will best prepare me to meet my as of yet unknown needs at as of yet unknown times.

If a person then adds to his cash balance, he does so, because he is confronted with a situation of (subjectively perceived) increased uncertainty regarding his future. The addition to his cash balance represents an investment in presently felt certainty vis-à-vis a future perceived as less certain. In order to add to his cash balance, a person must restrict his purchases or increase his sales of non-money goods (producer or consumer goods). In either case, the outcome is an immediate fall in certain non-money goods' prices. As the result of restricting his purchases of x, y, or z, the money price of x, y, or z will be lowered (as compared to what it would have been otherwise), and likewise, by increasing his sales of a, b, or c, their prices will fall. The actor thus accomplishes exactly and immediately what he wants. He commands a larger (nominal and real) cash balance and is better prepared for an increasingly uncertain future. The marginal utility of the added cash is higher than (ranks above) the marginal utility of the non-money goods sold or un-bought. He is better off with more cash on hand and less non-money goods, otherwise he would not have reallocated his assets in this way. There is more investment in the removal of perceived uncertainty, and there is less investment in needs, present or future, considered as certain.

The situation does not change if there is a *general* increase in the demand for money, i.e., if all or most people try to increase their cash holdings, in response to heightened uncertainty. With the total quantity of money given, the average size of cash holdings cannot increase, of course. Nor is the total quantity of producer and consumer goods that make up the physical production structure affected by a general increase in the demand for money. It remains unchanged. In general striving to increase the size of their cash holdings, however, the money prices of non-money goods will be bid down, and the purchasing power per unit money will correspondingly rise. Thus, the (increased) demand for and the (given) supply of money are equilibrated again, but at a higher purchasing power per unit money and lower prices of non-money goods. That is, even if nominal cash balances cannot rise as a result of a general increase in the demand for money, the *real* value of cash balances can; and it is this increase in the value of *real* cash balances that brings about precisely and immediately the effect desired of being better prepared for a future deemed as less certain.

No one cares about the nominal number of money units in his possession. Rather, people want to keep cash with a definite amount of purchasing power on hand. If the purchasing power per unit money increases as the result of an increased demand for cash holdings, each unit of money confronted with an array of generally lower non-money goods prices can do a better job in affording its owner protection against uncertainty.

This shall suffice as my attempt of providing a positive demonstration of the unique productivity of cash holdings as "yielders of certainty" in an uncertain world. Only a brief additional comment concerning the present, unprecedentedly severe economic crisis and the consequences that our theoretical considerations imply for its solution seems to be in order.

I shall say nothing here about the cause of the present crisis, except that I consider it another spectacular vindication of the so-called Austrian – or "Mises-Hayek" – business cycle theory. In any case, the crisis has led to heightened uncertainty. People want more certainty vis-à-vis a future considered far less certain than before. Accordingly, their demand for cash increases. With the quantity of money given, the higher demand for money can be satisfied only by bidding down non-money goods' prices. Consequently, as the over-all "level" of prices falls, the purchasing power per unit money correspondingly rises. Each unit of money is productive now of more certainty, and the desired level of uncertainty-protection is restored. The crisis is ended.

The solution to the crisis suggested instead by most economists and pundits and officially adopted by governments everywhere is entirely different. It is motivated by the here criticized, fundamentally flawed doctrine that money held in or added to cash balances is money unproductively withheld from production and consumption. The additions to their cash holdings that people want to bring about are thus interpreted, wrongly, as a diminution of human welfare. Accordingly, huge efforts are now undertaken to increase the amount of spending. But this stands at cross-purpose to the general public's needs and desires: In order to be better protected against heightened perceived uncertainty, prices must fall and the purchasing power of money must rise. Yet with an influx of additional, newly created money, prices will be higher and the purchasing power per unit money will be lower than otherwise. Thus, as the result of the current monetary policy the restoration of the desired level of uncertainty-protection will be *delayed* and the crisis *prolonged*.

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Islamic Economics: New Economic Paradigm, or Political Agenda?

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Abstract: The concept of Islamic economics emerged during the decolonization process in Muslim countries. Its creators sought a new economic paradigm reshaped along Islamic principles in an attempt to clearly distance the newly independent countries from their colonial legacy. The whole concept was strongly politically motivated since its very creation and this legacy has never been overcome. This paper outlines the ideological foundations of Islamic economics and its underlying theoretical principles focusing on Islamic banking, undoubtedly the most developed segment of Islamic economics. The empirical analysis of Islamic banking across Muslim countries in the last decade, however, reveals a major general discrepancy between the claims and the reality as well as some interesting regional differences. It turns out Islamic banking does not stand up to its own claims and even more so in those countries where Islamization of economy was imposed by the government. The reasons behind such discrepancy are identified, and influence of political agenda on Islamic finance is suggested as the driver behind the whole concept.

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1 Introduction

The concept of Islamic economics, i.e. economics reshaped along the principles of Islam, emerged during the decolonization process after World War II and has been gradually attracting more attention ever since. Its flagship, Islamic banking, is a very fast growing segment: while in 1970 Islamic banks in Muslim countries (countries with majority a Muslim population) occupied a mere 2% of the banking market; thirty years later it was already 15% (Aggarwal & Yousef 2000: 93). The total assets of Islamic banks today according to different sources may be anywhere between USD 200 and 500 billion,[1] roughly an equivalent of GDP of a medium-sized country like Norway or Poland. Moreover, Islamic banking is no longer confined to Muslim countries, as even the biggest Western banks now offer products compliant with the Islamic law, *Sharia*.

This boom led some authors to claim that Islamic economics constitutes a whole new economic paradigm. This is obviously suggested mainly by Islamic scholars. Choudhury (1997) for instance even claims there is Islamic Political Economy with distinct epistemology. Some Western scholars also share this view, such as Presley & Sessions (1994), Humayon and Presley (2000) or Nienhaus (2000), who writes:

> despite the fact that progress is slow and not always continuous, Islamic economics is clearly beginning to establish itself as a science, which will not allow itself to degenerate into an ideology or social revolution or a veneer for conservative dogmatism. (Nienhaus 2000: 98)

Other scholars have not been as enthusiastic. Kuran (esp. 1995, 1996) criticised the economic foundations of Islamic economics, while Aggarwal & Yousef (2000) gathered some empirical evidence to show that Islamic banking falls behind expectations. Proponents of Islamic banking acknowledged some of the critiques, but countered that these are infant diseases that will gradually diminish.

[1] Sources vary, according to Business Week ("Islamic Banks: A Novelty No Longer", August 5, 2005) it was USD 262 bn in 2005, according to Time ("Banking On Faith", December 8, 2002) almost 300 bn already back in 2002. Memri economic blog (http://memrieconomicblog.org/bin/content.cgi?news=861, January 24, 2008) even quotes the figure of 450 bn reportedly stated at the Algerian economic forum in 2008.

While the news and the Internet burst with marketing information on how Islamic banking thrives, the academic debate based on empirical research has gone somewhat silent in the last ten years. In this paper, I want to evaluate what progress there has been and whether we are finally entering the new era of two distinct competing economic systems (Islamic and Western) or whether Islamic economics is just an inflated bubble. In the first section I briefly outline the ideological foundations of Islamic economics and its underlying theoretical principles with a focus on Islamic banking, the single most developed segment in Islamic economics. In the second section, the empirical analysis of Islamic banking across Muslim countries in the last decade reveals a major discrepancy between the claims and the reality as well as some interesting regional differences. Vis-à-vis the evidence, Islamic banking does not stand up to its own claims and even more so in those countries where Islamization of economy was imposed by the government. In the third section I attempt to explain the reasons behind such discrepancy. Finally, the influence of a political agenda on Islamic banking is suggested as the driver behind the whole concept.

2 Theoretical framework of Islamic economics

2.1 Ideological background

Islamic economics emerged as a part of the Islamic resurgence—an effort to cut off from the political, social, economic and cultural heritage imposed on Muslim countries by Western colonial powers. A leading Pakistani Islamic leader, Sayyid Abu'l-A'la Mawdudi, for instance, openly stated that Islamic economics was a political tool to re-establish Islamic authority over economy (Kuran 1995: 156).

Early Islamic economists, such as Pakistani politician Mawdudi or Iraqi Shi'ite scholar Baqir al-Sadr found inspiration in socialist critique of capitalism.[2] According to them unfettered market and private ownership lead to injustice and must be contained by Islamic regulation (Watt 1988: 57, Weberová Babulíková 2001, Aziz 2003).

[2] Pro-capitalist interpretations of Islamic economics are fairly rare. One of the examples could be former Malaysian Prime Minister Mohammad Mahathir, who for instance claimed that Islam is not an egalitarian doctrine and that social stratification is given by God, who also provides tools for its reduction (2002). Mahathirm however, does not enjoy the reputation of an Islamic scholar.

As failure of socialism was gradually becoming more evident, Islamic economists moved to the "third way" argument, according to which Islam offers the moderate compromise between the two utopian extremes: capitalism and socialism (see for instance Ishaque 1983, Siddiqi 2002, Taheri 2003, Jafry n. d.)

2.2 Theoretical principles

The central principle of Islamic economics is prohibition of usury (*riba*). Usury is commonly understood as excessive profit on lending out money, and its prohibition is not unique to Islam. In ancient times it used to be a common practice with the inability to pay one's own debt resulting in slavery. That, however, gradually became socially unacceptable and regulations on interest rates were introduced in most societies.[3] Another reason probably was the effort to prevent exploitation by life-sustaining goods (animals and crops) upon which the Muslim barter-trading community was heavily dependent (Mohammed 1988:119).

In most societies harsh restrictions were later gradually lifted, but some degree of regulation remains common to date in most countries (for instance rate-caps on consumer credit is quite common). On the contrary, the proponents of Islamic banking insist that any non-zero rate of interest—even the lowest one—constitutes usury. Interest thus must be not only regulated, but banned entirely.

Apart from prohibition of usury, there are several other Quranic principles that underlie Islam. One of them is the obligation of Muslims to pay religious alms to the poor (*zakat*). While liberal Muslims understand *zakat* as their personal religious duty, many Islamic conservatives and fundamentalists maintain that *zakat* should be institutionalized, its collection centralized and enforced and its revenues redistributed by the government (Qutb 1996, Taheri 2003). Another principle affecting economy is prohibition of gambling and speculation (*gharar*) which under certain interpretations results in a ban on financial derivatives and futures, but it also renders conventional insurance unlawful as an attempt to protect oneself from the will of the God. Islamic alternative to insurance (*takaful*) is based on mutual cooperative risk-sharing.

[3] For an overview of historical development of usury and its regulation (in Czech) see Weberová Babulíková (2001)

2.3 Instruments of Islamic banking

Prohibition of interest obviously creates a need for interest-free banking methods. The two main types of transactions used in Islamic banking are profit and loss sharing (henceforth PLS) and mark-up methods.

The two pure methods to conduct business in compliance with *Sharia* are based on profit and loss sharing partnership and are called *mudaraba* and *musharaka*.[4] Under a *mudaraba* agreement the owner of capital provides it to the entrepreneur, who conducts the business. The profit is then divided between both in a proportion agreed on beforehand. In case of business failure the lender loses his investment and the entrepreneur his time and effort. *Mudaraba* is thus an equivalent to limited partnership. *Musharaka* is a partnership in which all partners contribute capital and all share the profit or loss together accordingly (general partnership).

Where partnership is not applicable, "mark-up" methods are allowed. The major two instruments are *murabaha* (deferred payment) and *ijara* (leasing). Under *murabaha* the bank buys the property for its client, increases (marks up) the price and then sells it to the client at the higher price, which is then paid by the client later, usually in instalments.[5] *Murabaha* is thus basically equivalent to mortgage or loan. Under *ijara*, the bank owns the asset and rents it to the client for a rental fee. The rental fee should be fixed at the beginning for the whole duration of the contract and entitles the client to the usufruct of the asset—it may or may not result in transfer of ownership.

As globalization proceeds and complexity of financial instruments increases, new methods are introduced, among which the "Islamic bond" (*sukuk*) became prominent. The same dispute about *Sharia* compliance applies, though. The Economist[6] points out that the prominent Islamic scholar M. T. Usmani[7] said in November that

[4] Other transliterations of *mudaraba* and *musharaka* include *modaraba*, *mudharabah*, *mozarebe*, and *musharika*, *musyarakah, musharakat* respectively. For simplicity I will use only *mudaraba* and *musharaka*, unless quoting others.

[5] Usage of terms varies slightly. For instance Malaysian banks use a separate term *Bai' Bithaman Ajil* for a mark-up transaction with one-time deferred payment, while the term *murabaha* is reserved for deferred payment in instalments. The underlying principle is the same, though, and we may safely lump them together for the purpose of this paper.

[6] The Economist, "Under the microscope", 10 March, 2008

[7] Muhammad Taqi Usmani is the deputy chairman of Islamic Fiqh Council of the Organization of Islamic Conference (OIC)

"some 85% of sukuk issues in the Gulf Co-operation Council (GCC) member states failed to comply with sharia principles."

2.4 Mark-up controversy

Muslim scholars themselves are aware that avoiding the prohibition of interest by relying heavily on mark-up instruments (such as *murabaha* or *ijara*) is a questionable practice for two principal reasons. First, it is prone to be interpreted as interest in disguise, and second, it runs against the declared superiority of economy based on profit and loss sharing. For instance A. A. Kazmi says that "if the Sharia accepts mark-up as valid, it is left with no basis to reject interest (...) Sharia jurists cannot reject interest if they accept 'mark-up'" (in Ayub 2004). Prominent Islamic economist from Pakistan Muhammad Ayub[8] adds that *murabaha* is permissible only in a very limited extent: "It goes without saying that the mark-up technique, or for that matter any Islamic modes, should not be used as a back door for allowing interest" (Ayub 2004).

Other thinkers acknowledge that genuine Islamic banking should be based on genuine PLS operations, such as *mudaraba* or *musharaka*, as illustratively summarized by M. T. Usmani (1998):

> It should never be overlooked that, originally, murabahah is not a mode of financing. It is only a device to escape from 'interest' and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where mudarabah or musharakah are not practicable.

In other words, Islamic economists agree that most of Islamic banking should be conducted on the basis of partnerships. Mark-up methods are permissible under certain circumstances where partnership is not applicable, but they should be more or less exceptional, not form the backbone of the system. For many decades the reality was the opposite, though. For instance Ariff (1988) reviewing some empirical evidence

[8] Muhammad Ayub is senior joint director in the Islamic banking department of the State Bank of Pakistan.

pointed out: "The most commonly used mode of financing seems to be the 'mark-up' device which is termed murabaha". Aggarwal & Yousef (2000:102-103) presented detailed data for several Islamic banks as well as some aggregate findings from the 1980s and early 1990s and demonstrated that the share of PLS financing consistently fell below 10 percent. They also reported that although the fully Islamised Iranian banking system relied on PLS to a greater degree, mark-up principle still outweighed it. This disparity of declarations and reality was countered by Islamic economists as a temporary infancy problem of Islamic banking and it was expected that the share of PLS products in banks' portfolios will rise in time.

One trick to disguise mark-up is so-called *diminishing musahraka*. Under it, the client and the bank buy a property together as equal partners and the client then pays rental fee, thereby gradually increasing his or her share in the partnership up to 100%, after which the agreement terminates. The defining feature of such a transaction is thus not the initial partnership, but the instalment payments based on mark-up. For instance Dubai Islamic Bank (2008) calculates the rental fee based on interbank interest rate EIBOR, meaning that interest is directly built-in!

2.5 Claimed superiority of interest-free economy

Many proponents of Islamic economics have steadily been trying to justify prohibition of interest on rational as well as moral grounds.[9]

Most claims of interest-free economy superiority are vague, ill-conceived ideologically biased declarations, whose bias is readily apparent. Some hypotheses merit closer examination, though. For instance Khan and Mirakhor (1990: 356-7) suggest that due to non-existence of interest, Islamic economy might be better suited to tackle shocks by absorbing them immediately into the nominal value of shares. This hypothesis, however, lacks any empirical evidence so far. Further hypotheses hold that interest causes unemployment and business cycles. However, Ariff notes that none of them "has really succeeded in establishing a causal link" (1988). It is also often claimed that Islamic system will enable easier financing for small enterprises.

[9] For a more detailed critical analysis of arguments underlying prohibition of *riba* and equation between *riba* and interest see the Farooq (2005). Claims made by the International Association of Islamic Banks are criticized by Aggarwal & Yousef (2000)

Siddiqi (2002) claims that Islamic finance is not only efficient but also more moral:

> (...) superiority [of Islamic finance] over conventional finance (...) lies in its promise to ensure that good returns to investments shall be accompanied by promotion of the good of the society as a whole. A combination of efficiency with morally better end results requires that institutional changes be accompanied by moral regeneration.

For Siddiqi interest is morally unjust because the lender enjoys an unfair advantage of a fixed return, while the whole risk is assumed by the entrepreneur. Secondly, interest allows for "money to be exchanged for more money, making the moneyed richer," thereby aggravating social injustice. Thirdly, prohibition of interest will result in greater emphasis on profitability, productivity of capital and hence overall efficiency.

The moral argument is bound to eventually end in a clash of value judgments. While I do appreciate such debates, I shall not enter it at this point because my goal is different. Suffice to say that there are some challenging questions that Islamic economists have not yet answered sufficiently. On a philosophical level, for instance, Kuran (1995: 157) raises serious doubts about morality of banning interest based on depriving risk-averse individuals of a safe way to invest money. El-Gamall (2000: 10) also thinks that "any financing conducted through valid trading by mutual consent is permissible [in Islam]." On a practical level, we have a recent example of Grameen Bank in Bangladesh, where interest brings demonstrable benefits especially to the poor.[10]

On the other hand, the claim about higher economic efficiency is a clear statement that can be subjected to an empirical test. I shall thus look at the real conduct of Islamic banks to assess this claim in the next section. If the argument about better efficiency of interest-free banking holds, I shall no doubt find plenty of Islamic banks offering genuine PLS-based interest-free products and services.

[10] Although operating in a Muslim country, Grameen is not an Islamic bank. It provides micro-loans based on interest. Grameen is very successful in supplying capital to the poorest people and especially women. In 2006 Grameen and its founder, M. Yunus were awarded Nobel Prize for peace for their effort.

3 Islamic banking: reality check

3.1 Hypotheses

From what proponents of Islamic banking claim and what previous scholars wrote on the topic, I am able to make following three hypotheses:

The larger part of total assets of Islamic banks are instruments of Islamic banking (both mark-up and PLS). This is the first condition if we want to speak meaningfully about Islamic banking.

The larger part of Islamic financing is based on PLS (*mudaraba* or *musharaka*). This is a logical expectation, since proponents of Islamic banking agree PLS instruments are what really distinguished Islamic banking from the conventional one.

In countries with government-imposed Islamic banking (Iran, Pakistan) we will see higher use of Islamic banking than in other Muslim countries (Middle East or Southeast Asia).

3.2 Quantitative evidence

Let us examine the first and second hypotheses in the light of empirical evidence.[11] The table below shows the proportion of Islamic financing on total assets and PLS

[11] Note on methodology: In order to avoid possible "Western bias," I gathered all data exclusively from annual reports of the Islamic banks published on their own. A second measure to avoid bias was to focus on those banks that are considered champions of Islamic banking—for this purpose I used IFN Awards, in which Islamic banks choose the best from among themselves every year (IFN Awards 2006, 2007, 2008, available at http://islamicfinancenews.com/awards.asp). Such a sample will not only be practically free of Western bias, but in fact it will probably be slightly biased in favour of Islamic banks. In total, I examined 37 Islamic banks in 15 countries. This search yielded close to a hundred annual reports from the past ten years. For the overall quantitative analysis I selected only 18 banks, for which at least three observations were available in the last five years. For each year and bank I extracted three key figures: total assets (in balance sheet), amount of PLS instruments (mudaraba, musharaka) and amounts of mark-up instruments *(mostly* m*urabaha a*nd ijara but to smaller extent also istisna, *salam an*d oth*er me*thods)—these breakdowns are *usually* a*vaila*ble in the Notes to the Financial Reports sections. From these the two key unitless ratios were calculated: the proportion of Islamic financing on total assets and the proportion of PLS instruments on total assets. Where data from two consecutive reports differed, the later report (restated) was given priority. Two Iranian banks do not break down their assets sufficiently, so we only know their PLS on total assets share, but not their Islamic financing on total assets.

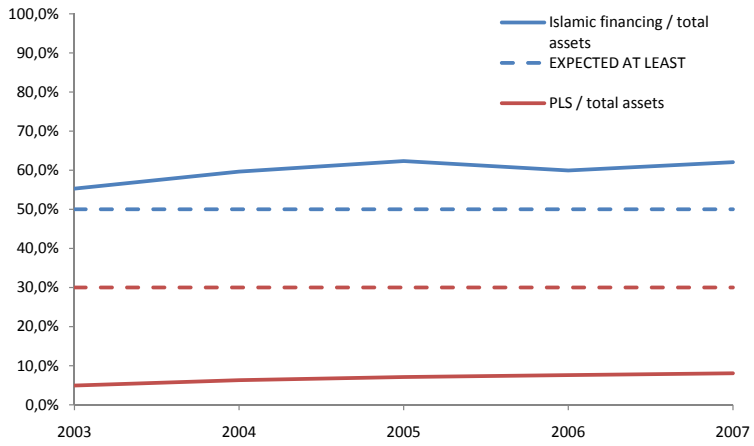
financing on total assets of 18 Islamic banks in the years 2003-2007. The chart shows the average ratio for each year.

	Islamic financing / total assets					PLS / total assets				
bank	**2003**	**2004**	**2005**	**2006**	**2007**	**2003**	**2004**	**2005**	**2006**	**2007**
Abu Dhabi Islamic Bank (UE)	59,2%	63,5%	64,2%	59,6%	58,5%	0,6%	2,7%	2,5%	4,7%	3,7%
Dubai Islamic Bank (UE)	53,7%	57,1%	65,8%	54,7%	58,4%	9,8%	9,9%	18,7%	9,1%	11,1%
Sharjah Islamic Bank (UE)	86,5%	84,1%	88,9%	82,6%	78,3%	1,5%	3,0%	8,1%	9,0%	5,7%
Al-Tawfeek (SA)	15,9%	11,3%	10,8%	19,0%		1,5%	1,5%	0,9%	0,3%	
Gulf Finance House (BH)	56,4%	62,9%	63,9%	52,4%	36,0%	0,0%	1,2%	3,2%	4,1%	3,7%
Al Baraka Group (BH)	51,5%	51,5%	54,2%	59,5%	66,1%	3,1%	4,5%	3,8%	3,1%	7,0%
Qatar Islamic Bank (QA)			72,3%	56,6%	61,4%			2,3%	2,0%	5,9%
Islamic International Arab Bank (JO)	17,3%	30,5%	44,9%	42,5%	51,4%	1,1%	2,9%	9,9%	9,2%	8,8%
Meezan Bank (PK)	66,6%	62,6%	64,4%	57,5%	51,5%	0,9%	0,5%	0,3%	0,3%	0,1%
Al Baraka Islamic Bank (PK)		58,6%	49,3%	51,4%	57,0%		0,5%	0,1%	3,0%	4,3%
Standard Chartered Modaraba (PK)	95,5%	97,1%	97,3%	96,7%	98,9%	9,8%	13,8%	7,5%	8,3%	0,5%
Refah Bank (IR)						0,4%	0,3%	0,7%	0,7%	0,6%
Sepah Bank (IR)							1,3%	2,2%	2,1%	
Parsian Bank (IR)		63,3%	67,6%	64,0%			7,4%	11,3%	15,2%	
Bank Mandiri (ID)	62,0%	75,8%	69,2%	74,9%	77,6%	9,7%	15,3%	20,2%	27,1%	32,5%
Bank Muamalat (ID)	70,4%	79,1%	80,8%	77,6%	79,7%	25,0%	37,6%	35,7%	37,9%	36,9%
Bank Muamalat (MY)	31,1%	35,8%	40,4%	39,9%	42,5%	0,0%	0,1%	0,1%	0,1%	0,1%
Bank Islam (MY)	52,4%	61,6%	63,4%	70,0%	51,7%	5,8%	4,8%	0,5%	0,5%	0,4%
Mean	**55,3%**	**59,7%**	**62,3%**	**59,9%**	**62,1%**	**4,9%**	**6,3%**	**7,1%**	**7,6%**	**8,1%**

In the first hypothesis I expected that the proportion of Islamic financing on total assets should be higher than 50%. This hypothesis is confirmed, as in every year the mean was consistently above 50%. On average through all five years it was in fact 60.0%.

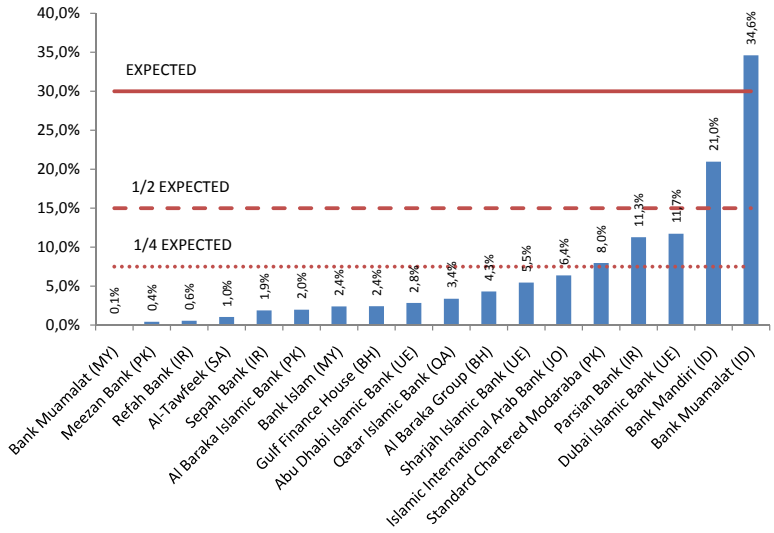
In the second hypothesis, I expected that PLS instruments will take more than half of the Islamic financing. Since the average share of Islamic financing on total assets was 60% and since I expect PLS to be more than half of that, I can reformulate

our second hypothesis: PLS will be on average at least 30% of total assets. It is readily apparent that the real PLS share is consistently and significantly lower than 30%. In all five years the ratio was in fact under 10%, although with a mildly increasing trend. The overall average through the five years was 6.84%. The second hypothesis clearly does not hold.



It is also interesting to look at average ratio of PLS on total assets of each bank over the five years, which is captured in the chart below. It is readily apparent that only a single bank (Indonesian Bank Muamalat) exceeded the expected threshold. Only two banks reached more than half of it, only five banks reached at least one quarter. Conversely, the absolute majority of the banks did not even reach one quarter of the expected PLS share.

The empirical evidence thus clearly shows that in Islamic banking continues the massive use of controversial mark-up instruments at the expense of allegedly superior PLS instruments. In other words, Islamic banking fails *on its own terms*.



3.3 Regional specifics

In order to answer the third hypothesis about the regional specifics, the overall data presented above must be complemented by other qualitative observations. I found it useful to divide Islamic banks into three groups: Middle East, Southeast Asia, and Iran and Pakistan.

3.3.1 Middle East

Most of the eight Middle Eastern Islamic banks in the table above (banks in United Arab Emirates, Saudi Arabia, Bahrain, Qatar and Jordan) kept the share of Islamic financing consistently over one half of total assets. It is noteworthy that Sharjah Islamic Bank that has one of the highest ratios was originally a conventional bank and claims to be the first bank in the world to convert successfully to Islamic banking.

At a first glance in the annual reports it would seem that many Middle Eastern banks are genuinely convinced about superiority of Islamic banking and PLS instruments. Annual reports regularly start with a prayer to Allah and the banks take great care to introduce their Shari'a Supervisory Board members. The Head of Al-Tawfeek, an Islamic investment company operating in Saudi Arabia for instance writes in their

2004 Annual Report: "Al-Tawfeek Company continue (...) its marvellous march and significant role in applying concepts of Islamic banking." (Al-Tawfeek 2004). Similarly, Faisal Islamic Bank in Egypt praises the benefits of *mudaraba* in its product portfolio:

> Mudaraba is an operation of great benefit to economic activity since there are a lot of people who have the efficiency and the ability to operate funds but do not have the money to do so, therefore, the Mudaraba contracts open the door of opportunity to many talented enterpreneurs and increases the volume of trade. (Faisal Islamic Bank 2008)

However, the reality is quite different. All eight Middle-Eastern banks rely heavily on mark-up instruments. The proportion of PLS instruments remained under 10% and it often dropped even under a scant 1%. The only exception was Dubai Islamic Bank, the "world's first fully-fledged Islamic bank," whose PLS on total assets share reached almost 19% in 2005 (still below what we expected). However, an unspecified part of PLS financing consisted of so-called *diminishing musharaka*, which, as discussed above, is in fact a mark-up product.

Al-Tawfeek's "marvellous march" is worth noting, too. Al-Tawfeek's assets in *mudaraba* in 2003 suddenly soared up more than 20 fold. Upon closer examination, however, it turned out it had been caused by an investment into an affiliated company with guarantees issued on repaying profit. That obviously violates the key risk-sharing principle of *mudaraba*. When this investment was deducted to keep the time series consistent, it turned out that the share of PLS instruments in fact never exceeded 2% of total assets. Faisal's real fondness in *mudaraba* could not be established, as Faisal consistently reports all Islamic methods in a lump sum and does not break them down into PLS and mark-up (Faisal IB 2003-2006).

Some might expect that due to conservative Islamic government, Saudi Arabia would be among the top-performers. However, Cunningham (2007) has shown that a minority of banks in SA are Shari'a compliant and that the share of PLS in those that are Islamic is minuscule. Also The Economist noticed that Saudi Arabia is a largely interest-based economy.[12]

[12] The Economist, "How to be Islamic in Business", 7 June, 2007

There are three more groups of Middle-Eastern Islamic banks that could not be included in the quantitative analysis.

The first group are banks that call themselves Islamic, but offer only mark-up instruments (different combinations of *murabaha*, *ijara*, *istisna* and *salam*) while PLS products are completely missing from the offered services. This is the case of ABC Islamic Bank (2008) and UBS Bank (2008) in Bahrain, Kuwait Finance House (2000-2006) or Emirates Islamic Bank (2005-2006).

The second group are banks that do offer PLS products, sometimes even at a very high proportion of their total assets. However, upon closer examination it is revealed that their products are altered by additional conditions that violate the very principles of PLS instruments. For example Al-Amin Bank (2003) in Bahrain reported *mudaraba* at almost two thirds of the bank's total financing. However, the bulk of *mudaraba* financing went to affiliated companies that issued guarantees on repaying the principal plus profit, again violating the fundamental principle of risk sharing. Shamil Bank (2008) in Bahrain, on the other hand, offers *mudaraba* with "profit rates" specified as fixed percentage (i.e. interest).

Third group are banks that either have been established recently and hence do not have data yet (e.g, Syrian Cham Bank established in 2006 or Emirates Global Islamic Bank established in 2007), banks that provide only old annual reports and not the recent ones (e.g. Islamic bank of Yemen for Finance and Investment has last report from 2003),[13] banks that for whatever reason do not publish Annual Reports online at all (Al Baraka Banks in Lebanon or Sudan), or banks that do publish reports, but do not break down the figures meaningfully for our purpose (Jordan Islamic Bank 2006, Faisal Islamic Bank in Egypt 2003-2006).

While banks in the third group have no bearing for my findings, the cases in the first two groups further reinforce my point that Islamic banks do not use PLS according to their own claims.

[13] Nevertheless, the share of PLS on total assets of Islamic Bank of Yemen were 5.6% and 3.7% in 2002 and 2003, respectively, which is consistent with our general finding about the very low level of PLS usage.

3.3.2 Southeast Asia

In many studies on various aspects of Islam, the Middle East seems to be somewhat more in focus at the expense of Southeast Asia (at least in Europe), despite the fact that the world's most populous Muslim country is Indonesia. Indonesia and Malaysia are often discounted as not being part of the "core" Islamic world. Southeast Asian Islamic banks are often criticized for overly liberal interpretations of *Sharia* (e.g. El-Gamall 2000: 5, Obaidullah 2005:105). An expectation might thus arise from this stereotype, that the share of PLS instruments will be trailing behind the already low percentages that we have seen in the Middle East. Certainly, our two Malaysian Islamic banks seem to support such hypothesis, as they are among the lowest-performing in terms of PLS usage in the whole sample.

Bank Islam Malaysia, specifically, is one of the older Islamic banks (established in 1983). BIM was until recently specific in that it offered interest-free Sharia-based 'benevolent loans' (*qard*) at about 2-4% of total assets, unmatched by other Islamic Banks. As of 2005, though, *qard* is no longer reported. Apart from standard mark-up instruments, BIM offers a special repurchase transaction called *Bai Al-Inah*. In it, the client sells an asset to the bank and the bank immediately sells the asset back to the client at a higher price to be paid later. Obviously, this is nothing else than a regular money loan on a fixed interest, disguised by selling an asset back and forth. The other Malaysian bank CIMB Islamic (2007) started offering a product based on the same principle in 2007. This instrument is widely criticized by Islamic scholars as *Sharia* non-compliant and BIM does not even advertise it on its website (though it does report it in Annual Reports).

If Malaysian banks play into the aforementioned stereotype of laxity in application of *Sharia*, the two Indonesian banks are truly astonishing. Both of them are clearly the top-performers in the whole sample. Bank Muamalat is the only bank in the whole sample that matches our criterion of PLS share on total assets. Our findings are furthermore corroborated by a lengthy study on Islamic banking in Indonesia by the Central Bank (Bank Indonesia 2005). The study shows that the share of Islamic financing in Indonesia grew from roughly a quarter in 2000 to three quarters of assets in 2005 and the share of PLS instruments rose from 10% to 25% in the same period.

The outstanding results of Indonesian Islamic banks are somewhat moderated by the fact that despite being the biggest Muslim country, Indonesia has only three Islamic banks altogether. It appears as though the Islamic banks focus on a specific market segment (pious Muslims), which in turn forces them to uphold high standards of Sharia compliance to preserve that distinction.

3.3.3 Iran and Pakistan

Iran and Pakistan are both special cases, because they share the experience of government-led "Islamisation" of the economy. However, they differ in the pace with which the change has taken place (Khan and Mirakhor 1990). Economic "Islamisation" in Iran was a part of the political agenda of the Islamic Revolution and had a more devastating effect. Pakistan, on the contrary, proceeded gradually in phases and the process is still underway (State Bank of Pakistan 2008).

Let us briefly examine Pakistan first. As Islamic banks are backed by favourable government regulation, we would certainly expect high ratios of PLS-based instruments. Such expectation is wrong, though, as only one bank (SC Modaraba)[14] reached 10% at least once in its history while the other two banks (Meezan and Al Baraka) trail behind with a scant one percent. Meezan furthermore increases its PLS proportion by *diminishing musharaka*, which is not a real PLS, but disguised mark-up instrument.

The situation in Iran seems similar. Despite the enforced "total Islamisation" of Iranian economy, Iranian banks (unlike their Middle Eastern counterparts) do not dedicate many pages to glorifying Islamic financing and explaining its superiority in their annual reports. In fact they barely make any reference to Islam at all. Instead, they typically focus on very secular economic or technocratic issues.

CIA World Factbook is perhaps unsurprisingly critical about the Iranian economy, but what certainly is surprising is that one of the Iranian banks cites CIA's criticism on its own website: "Iran's economy is marked by a bloated, inefficient state sector, over reliance on the oil sector, and statist policies that create major distortions throughout. Most economic activity is controlled by the state" (Saderat 2008).

[14] Standard Chartered Modaraba, despite its name, in fact does not offer *mudaraba* at all The title means that SCM and another company from a big transnational family Standard Chartered are grouped together on a partnership (*mudaraba*) basis (SC Modaraba 2008).

Analysis of PLS and mark-up instruments ratio of Iranian banks was difficult, as they do not even break down their assets according to these criteria. I used the balance sheet item "Investments and Partnerships" that most closely resembles PLS instead. Similar to Pakistan, two out of three banks (Refah, Sepah) barely reach one or two percent share. The third bank, Parsian (2006) reports much higher (but still low) 15 percent of PLS on total assets. Surprisingly though, in its annual report Parsian also openly operates with interest, both received and paid. And a closer look at the description of credit facilities offered in the form of partnerships reveals that Parsian charges interest and requires the applicant to pay for any extra costs and contingency expenses of the project (Parsian, 2008). Such agreement resembles a regular interest-based business loan rather than genuine partnership financing.

Another bank, which openly reports income from interest is Bank Refah (2004) and also London-based Persia International Bank (2007), which is a joint venture of two major Iranian banks Mellat and Tejarat.

In sum, Iranian banks in general do not seem to be very enthusiastic and genuine about the ban on interest like the Middle-Eastern banks . Quite the contrary, they seem to minimize the compliance-costs by just labelling interest as "profit rate" or "rate of return," loan as a partnership and formally adjusting accounting practices rather than transforming the substance of their products toward real PLS. Iranian banks seem to be playing parts in a gigantic theatre orchestrated by the Iranian Central Bank, which caps the annual "rates of return" of the commercial banks, but itself is excluded from the ban on interest when financing government debt (Ariff, 1988).

3.4 Summary of findings

Although in terms of PLS financing there are outliers in both positive and negative terms, we can say with certainty that Islamic banks still do rely heavily on mark-up instruments. The proportion of PLS-based instruments in most cases remains deep under hypothesised 30% of total assets and I have failed to discover a single bank that used more PLS than mark-up financing.[15] Moreover, in many cases where PLS share exceeded 10 percent it was so due to misleading usage of terms, such as *diminishing*

[15] Even the top-performing Bank Muamalat at its peak reached 41% of PLS (*mudaraba* and *musharaka*) on total assets, but the mark-up instruments (*ijara*) on total assets ratio was 42%.

musharaka. Another common trick is to label as *mudaraba* such a financial operation in which guarantees are issued, violating the very definition principle of risk sharing.

My findings thus perhaps somewhat surprisingly challenge those of Aggarwal & Yousef (2000) who found that Iran outperforms other Islamic countries in terms of PLS financing. According to my own research it appears that forced top-down Islamisation of the bank sector in Iran was in reality counterproductive: Iranian banks lag behind, and the top-performers are surprisingly Islamic banks in Indonesia, which are often considered too liberal in interpreting Islam. I shall revisit this paradox in the conclusion.

4 Why Islamic banking fails?

At the outset I noticed that Islamic economists claim that Islamic banking based on profit and loss sharing is both more efficient and more moral. I explained that the moral argument lies outside of the scope of this paper and I focused on the efficiency argument. Empirical inquiry provided sufficient grounds to reject this hypothesis—were PLS more efficient, Islamic banks would use it much more, but they do not. Having identified this failure, I would like to look at why that is the case and whether the flaws are of temporary or of structural character. Not too surprisingly, the failure of Islamic banking can be explained with common sense and basic concepts of economic theory.

A. Gafoor (2001), a defender of Islamic banking, maintains:

> Broadly speaking, a passive investor has three options: one, deposit in a bank and receive interest; two, buy securities or bonds and receive interest; three, buy shares in a company and receive a dividend. In an Islamic economy, the first two options would be regarded as riba (interest) income and therefore prohibited while the last option and the active investment are permissible. On the entrepreneur side, he may finance his project using his own capital, by selling shares in his enterprise, or by borrowing on interest. In an Islamic setting the first two methods are permissible while the last is not.

Presumably not intentionally, Gafoor accurately summarizes the crucial problem of Islamic banking and finance: it reduces individual freedom of choice by forbidding all interest-based methods without providing any functional alternative to them, effectively leaving the individual with only two options: invest on a PLS basis, or not invest at all.

4.1 Inefficiency for individuals

Khan and Mirakhor (1990: 357) suggest that eradication of interest will not necessarily reduce savings. On the contrary, if profit rates will be high enough, savings might actually increase. This argument, however, is flawed. While some market actors may be willing to allocate their capital into a riskier PLS investment, risk-averse individuals are deprived of the possibility of a safe fixed return (interest). Being stripped of incentives, they have no reason to deposit their savings at a bank. In other words, risk-averse actors are as a matter of fact forced to accumulate their wealth in cash. There is thus no reason to think that after abolishing interest, risky PLS instruments would experience a boom. Those who were willing in expectation of higher reward to invest in riskier PLS instruments have already done so. Those who deposited their savings on interest-based saving accounts were presumably risk-averse and only a fraction of them would move their funds to PLS investment. Most would choose not to invest at all. The Islamic system in fact results in precisely the opposite to what it seeks to achieve—capital circulation rather than accumulation.

A study by Presley and Sessions (1994: 587) suggests that "[*mudaraba*] under certain conditions, will act to raise the level of capital investment in the project." This can of course be true. Similarly Usmani (1998) says that particular problems, such as dishonest clients "should not be taken as a justification, or as an excuse, for rejecting the whole system of musharakah." That reality is a misunderstanding. Criticism of Islamic banking does not imply criticism of PLS methods as such. PLS instruments, such as *mudaraba* may be perfectly suitable under certain conditions (esp. high level of confidence). The real problem lies in eradicating other than PLS instruments thus leaving individuals with no choice under such conditions, where PLS is not applicable.

4.2 Inefficiency for banks

Similar problems arise for the bank as a lender. The bank, deprived of the possibility of lending out money on a fixed interest rate, incurs substantial additional costs on in-depth risk assessment that would not be necessary on an interest-based loan. While for specialized investment banks or private equity funds PLS investment (joint-venture) may indeed be the most efficient form of investment, in most other cases, prohibition of interest-based loan creates inefficiency. Moreover, these additional costs will be relatively higher for small investments, thus harming particularly small businesses. That contradicts another goal of Islamic banking: better accessibility of capital to small businesses.[16]

Finally, as Kuran (1995) and others have pointed out, banks operating under a profit and loss sharing mode face higher risk of moral hazard (deceit, information withholding and profit diversion) on the part of the entrepreneurs trying to reduce the bank's share on profit. In most countries Islamic banks compete with conventional banks. Hence, entrepreneurs will tend to choose a conventional bank when they expect high profit (instead of sharing it they will pay lower fixed interest), while to Islamic banks will go those with low expected profit (the bank will bear the loss, or a bank's proportion of the profit will be lower than would be the interest).

Some proponents of Islamic banking are aware of some of the problems following the ban on interest and suggest some counterarguments. Usmani (1998), for instance, claims that the increased risk of PLS investing can be alleviated by better risk assessment and diversification. The problems with dishonesty may be countered by a "well-designed system of auditing" and uncompromising punishments. That is, of course, true, but Usmani misses the point—these measures are exactly the additional costs that render Islamic banking less efficient.[17]

[16] Weberová-Babulíková (2001) points out that in order to asses the risk, banks will require accurate information from the investment-seeking businessman. Since common small entrepreneurs in the Muslim world are often illiterate and incapable of comprehensive book-keeping, they will less likely find funding for their projects.

[17] Usmani's argument is like arguing that the risk of driving a less safe car instead of a safer one can be mitigated by fastening the seatbelts. Seatbelts will indeed increase safety, but that applies to both cars, so it will still make more sense to choose the safer car. Islamic banking here is clearly disadvantaged. Another parallel with cars comes to mind here. As Sam Peltzman (2007) showed on Auto Safety Regulation, a newly imposed regulation tends to be partially or even completely offset by its

4.3 Internal inconsistency

Third critical point I would like to raise about Islamic banking and economics as well is its internal inconsistency. Islamic economics rests on vague grounds. For example profit of a businessman is acceptable, as long as it is "not excessive." Workers are to be paid "fair" wages, and social stratification is acceptable to a "reasonable" degree. Vague definitions may in fact be advantageous, since they allow for flexible adjustment according to the circumstances—after all Western law also operates with similar terms. The problem is that Islamic conservative religious authorities tend to monopolize the interpretation of these principles, preventing the needed flexibility.

Proponents of Islamic economics often refer to the idealized early Islamic community (*umma*).[18] Along with the Qur'an, actions of the prophet Muhammad (recorded in a collection of stories called *Hadith*), also serve as guidelines for Muslims. Liberal Muslim scholars encourage Muslims to re-interpret the meaning of the stories and apply them to contemporary issues with their own individual reasoning (called *ijtihad*). On the contrary, conservative Muslims insist that what is contained in *Qur'an* and *Hadith* is to be obeyed literally in the light of traditional interpretation. Since modernity constantly brings new challenges, their rigid interpretation is bound to produce numerous mutually inconsistent interpretations and in some cases even contradicting authoritative religious rulings (*fatwas*).

An example of such controversy is the debate on private property in Iran captured by Behdad (1995: 203). One interpretation maintains that there exists no scarcity of resources, as God provided infinite amounts of those and their scarcity in the real world is caused by "coercive social relations", private property being the major one of them. An opposing interpretation holds that the state of infinite resources in the

unintended side-effects. The impact is therefore uncertain and even a very "well-designed system of auditing" is unlikely to lead to the desired outcome.

[18] Labib (1986:80) calls this era *Pax Islamica*: "Islamic trade reached from Gibraltar to the Sea of China. The voyages of Christians, in contrast, were limited to modest coastal journeys..." However, Labib also shows that even in the idealized medieval Islamic community, interest was quite common: "Interest and usury were legally prohibited; however they were customary. Usury and excessive profit played an important role in Islamic capitalism. (...) Even Caliphs, Sultans, and Emirs received loans carrying too high an interest rate."

Qur'an refers to the era after the return of the Hidden Imam.[19] In the current real world, resources are limited and private ownership is thus legitimate. Another example are two contradictory rulings on indexation as a tool to counter inflation: one fatwa forbids it, whereas another one requires it (Kuran 1995:165, see also El-Gammal 2000:33).

Discord remains at the very heart of Islamic banking. While most Islamic thinkers seem to agree that interest equals usury (*riba*), Rector of Al-Azhar Dr. Tantawi issued a *fatwa* in 2002, which says interest is permissible on account of mutual consent and benefit of eradicating uncertainty and moral hazard. In other words not all interest is necessarily usury—only the evil abusive part of it used on others in need is banned (El Gamal 2003: 9-12). Although, as has been shown, informally practiced in reality, this view still officially remains a controversial taboo and Tantawi's fatwa was hastily rebutted by Islamic Fiqh Institute in Qatar in 2003 (El Gamal 2003: 13).

5 Conclusion

At the outset of this paper I have outlined the concept of Islamic banking based on profit and loss sharing and its claimed superiority. I have then conducted an empirical study and established that in reality Islamic banking does not deliver what it promises, being overwhelmingly dependent on interest-like mark-up instruments. I have suggested that the reason for this underperformance is that contrary to the claims of the Islamic economists, abolition of interest creates inefficiencies. Banks realize that and in practice either use various techniques to disguise interest or claim that prohibition of usury does not cover reasonable mutually agreed interest rates. In the formal public debate, though, interest remains taboo: "To be recognized as an Islamic economist, it is not sufficient to be a learned Muslim who contributes to economic debates. One must be opposed in principle to all interest" (Kuran 1995:157).

Why is that the case? Farooq (2005) suggests that it is because "Islam in general has become a victim of an overly legalistic approach, where form has overtaken the spirit and substance" and I concur. Islamic banking and Islamic economics is in-

[19] Eschatological concept of Shi'a Islam: the Hidden Twelfth Imam will return and lead the humanity to the last apocalyptic battle and salvation.

tended to present a consistent economic paradigm based on Islamic values. But since Islam is a living and internally diverse doctrine, there is no uniform set of values upon which to build. As I have shown, there is not even a clear consensus whether any interest should be prohibited or not. Islamic banking based on prohibition of interest is merely one of possible interpretations of Islam. Individuals and particularly banks do not necessarily see interest as inefficient or immoral, but they are led to believe it is un-Islamic thus propelling a "guilt-ridden Islamic subeconomy" (Kuran 1995). In reality banks offer products more or less obviously based on interest and clients use them, but formally interest is not involved by careful wording of the contracts. This, in turn, it is criticized by Islamic economists as circumventing the key principles of Islamic banking. Islamic economists fail to see or do not want to see that the very principles of the system are ill and therefore their circumvention is inevitable. Forcible imposition of Islamic banking on all Muslims is a purely political act, not very different from imposing a socialist utopia by force and regardless of the number of victims.

The "*qui bono?*" question remains to be answered: Who has the motive to perpetuate such an inefficient and economically flawed system? On one side of the equation are the banks and especially their Shari'a boards. These lucrative posts are often taken by prominent Islamic economists, who at the same time fuel the whole discourse on Islamic economics, and their "dual role" was already criticised by, for instance, El Gamal (2003: 2). The banks veil their questionable practices and resist attempts for independent external auditing (Al Nasser 2008), because that would reveal that the real level of Shari'a compliance is much lower than publicly presented.

But why do the customers participate? There are two reasons. First, because they have to—there is no alternative. The most obvious example is Iran with its top-down imposition of Islamic banking. Second, because they want to—they simply believe Islamic banking is the right way. That is probably the case of many Southeast Asian or Middle-Eastern Muslims. Their belief that God banned interest is a perfectly sufficient reason to participate on Islamic banking. Although the Islamic banks are less efficient and disadvantaged to their conventional competitors, it is a sacrifice the believers are prepared to make, because it is compensated by greater (intangible) benefits.

My research has indicated that the real level of compliance with Shari'a is highest in the most liberal Muslim country (Indonesia). The reason probably is that the clients that seek Islamic banking do so in good faith, therefore requiring genuine Shari'a-compliant products. The Middle East seems to be in the middle, with heavy reliance on mark-up and disguised interest, but with publicly displayed affection about the moral superiority of Islamic banking. This public image may be simply a marketing tool to capture a specific market segment of pious Muslims, who however do not take the pain to inspect the real level of compliance with Shari'a in depth. The lowest adherence to the principles of Islamic banking seems somewhat paradoxically be in the countries where Islamic banking is enforced by the government as a part of its political agenda (Iran). By forcing all banks to become Islamic, the Islamic specificity and genuine motivations were lost.

The differences among these three groups indicate that the more an agenda is imposed and enforced from the top, the more it becomes a caricature of what it ought to be and the less people feel attracted by it. The most conservative Muslim governments that imposed Islamic banking by force have, paradoxically, most contributed to its failure.

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