A dialogue on interest-free banking, generally known as "Islamic Banking", is going on in the world of Islam. It is a modern phenomenon and mainly a result of the crisis in the capitalist system. It has an appealing feature, particularly because of financial crisis around the world especially after the debt burden of the third world countries; as a result of which, there accrued a tendency of inflation followed by recession and then a large scale of unemployment. Ultimately there developed a growing gap between the resources necessary to finance and the revenues actually raised.

No doubt, huge oil income has played a crucial role in the development of Islamic banking. But its emergence in low income countries in South East Asia and Africa also speaks of its viability from religious point of view. Uptill now, around 47 Islamic finance institutions have been reported.

In recent times a good deal of literature have appeared on the subject written mainly by Muslim apologetics. An attempt is being made to develop a new study that could on the one hand, 'spell out an Islamic critique of modern economics and, on the other, to undertake a reformation of economic theory and policy in the light of Islamic values and principles. Professional economists are also taking interest in issues related to Islamic
banking. These writers are trying to work out the monetary and fiscal 'policies' of Islam mainly through the institution of Zakah and the prohibition of riba, i.e., interest—around which most of the contemporary literature on Islamic banking revolves.

However, in a number of Muslim countries, Islamic banking has been introduced—special banks operate on a non-interest basis. Countries like the Islamic Republic of Iran claims that the entire financial system is based on Islamic principles. It has rightly been pointed out that Muslim economists seemed to be so fascinated by all those ideas that appears to be good that they become 'Islamic' for them. For example, the objectives of monetary policy adopted by western economies do not appear un-Islamic for them. Almost every tool used in macro-economic analysis is also applied in Islamic economic system. This has brought a charge from the western press that Muslims have hastily reinterpreted their orthodox doctrine to adopt recent tendencies originating in the West.

There are many areas where disagreement persists among Muslim economists. For example, the question whether creation of credit is allowed in shari'ah, since relationship of credit with interest is vital and a bank's credit supply is greatly influenced by the interest rates. Then question arises: how does Islamic bank do this job? Muslim scholars in this matter
object that commercial bank in the process of credit creation, create money for which neither the bank nor their depositors make any sacrifice. They argue that under present system the primary beneficiaries of credit creation are commercial banks and their customers. Other main areas of disagreements are: strategy of transition to Islamic economy, short-term financing, indexation of loans during inflation, stability of the economy and so on. All these and other issues have sparked among Islamic writers and also lead them to think on these lines. One wonders, how an interest-rate which is the cost of loans will disappear from credit market. Likewise, in an Islamic economy, how the rate of interest will be replaced by the rate of profit. The rate of profit, however, depends on the business conditions. Thus, the saving, investment decision in an Islamic economy would not depend on the rate of interest but only on the expectation about business prospects. How then the monetary policy will have any impact on the real sector of economy? I have tried to examine all these issues in the light of the current discussions that have appeared in the existing Islamic economic literature.

The basis of this thesis is on the fact that the Islamic concepts of interest-free banking system totally rejects the institution of interest. As a matter of fact, question of banking on Islamic principle, if we go through the earlier literature, had its origin in earlier muslim writers of the late
19th and early 20th century. In India, for example, Sayyid Ahmad Khan and in Egypt Muhammad 'Abduh raised these issues. The later works of Anwar Iqbal Qureshi and Abul A'la Mawdudi are worth mentioning. Qureshi, in his book *Islam and the theory of interest* (1945) points out that interest prevents the flow of capital towards projects with a low yield even though they are most useful. He has argued that in the absence of interest the margin of investment could be extended till the rate of return approaches zero. In his book he analyses the question of interest in the light of economic theory. In the book, he explained the western viewpoint about interest, exposed the weaker aspects of all the theories of interest. While discussing the origins of usury and interest, he has elucidated the prohibition of banking systems from Islamic standpoint. He has also mentioned the repercussions of profit and interest on human society. Another writer, Abul A'la Mawdudi, in his book 'Sūd' (1961) (originally written in Urdu and later on translated into English and Arabic), pointed out that a basic imbalance is caused between production and consumption by the phenomenon of interest. This happens in two ways. Firstly, interest on consumption loans transfers part of the purchasing power from a group of people with high propensity to consume to a group with low propensity to consume. This latter group mostly reinvest its income from interest which means that consumption demand is
accompanied by an increase in production. Secondly, interest on productive loans raises the cost of production, hence the price of consumption goods. Once again the amount taxed away from the people, in the form of higher prices falls in the hands of a class with a lower than average propensity to consume. This imbalance is seen as the source of many evils such as stagnation and depression, monopoly and ultimately imperialism.

Another significant work on interest and banking is the Report of the Council of Islamic Ideology. It was submitted to the Government of Pakistan in June 1980. The report contains a detailed blueprint for reorganization of banking practices and procedures on the basis of the principle of profit-loss-sharing in accordance with the Islamic legal concept of Shirkah and mudarabah. The methodology suggested in the report is modelled more or less on the same line as in the case of commercial banks. The council of Islamic ideology, however, recognize the difficulties in the elimination of interest from transactions relating to international loans and aids and has therefore, accept government borrowing from abroad on the basis of interest for the time being.

Among the recent important works on the subject includes; Issues in Islamic Banking by M.N. Siddiqi. This book in the form of collected essays, introduce the idea of a banking operation based on the Islamic principles of partnership and profit-sharing free of interest. It demonstrates how the creation
of high powered money as well as of bank money in the Islamic system can be firmly linked. Comparing and contrasting the Islamic system with the interest-based banking system it shows the superiority of the former on grounds of distributive justice, allocative efficiency, stability and growth. The author shows how the ratio of profit-sharing between suppliers of capital and its users can be determined rationally by the forces of supply and demand. The book surveys recent contributions to the theory of money, banking and monetary policy in an Islamic economy.

Another work related to this topic is *Money and Banking in Islam*, edited by Ziauddin Ahmad, Nanawar Iqbal, and M. Fahim Khan. This is a useful contribution by Muslim scholars. This book is based on the proceedings of the seminar on the Monetary and Fiscal Economics of Islam held in Islamabad, 1981. The book deals with an Islamic economy which has a bearing on monetary and fiscal policies, and its objectives and instruments. It also takes a thorough examination of the experiments in Islamic banking in different parts of the world in general, and the Report of the Council of Islamic Ideology of Pakistan on the elimination of interest from the economy in particular.

Another interesting work is *Towards an interest-free Islamic economic system* by Waqar Masood Khan. This book is basically a Ph.D thesis submitted at the University of Boston; the author has demonstrated that under a set of conditions
the interest-free system is superior to the traditional system. Mr. Khan cautions the policy makers about the increased monitoring costs which Islamic financial Institutions will have to incur in order to make the new system operational.

The author arrives at the above conclusions through a rigorous analysis. In a number of ways his analysis is worth studying. He accepts the position of total prohibition of interest and adopts profit-loss sharing as the alternative for interest-based financing, but he has analysed both issues in the context of secular economy. In this way, he has departed from the usually assumed ideal Islamic society condition. Among the important works done by a non-muslim on this topic includes Ingo Karesten's paper "Islam and Financial Intermediation" in IMF's Staff papers, (March 1982). This paper describes a number of steps that have been taken towards the Islamization of financial system. It reviews some of the practical issues that have to be resolved, and analyses the implications for savings, investments, and development process. Particular attention is paid to the Pakistani Model. Some of the problems, the author points out are: how to ensure that the uncertainties implicit in this system do not undermine saving incentives. He, however, finds it difficult to make any assessment of the prospect for the financial success of Islamic banks, because information on their
performance is rather limited. A critical survey of Islamic economics, entitled, 'The Economic System in Contemporary Islamic Thought: Interpretation and Assessment', by Timur Kuran is in *International Journal of Middle Eastern Studies* (U.S.A.) Vol. 18, 1986, pp. 135-164. This is an scholarly paper, fully documented and useful contribution in Islamic economics. In the paper author raises serious questions about the claim that Islamic economic system provides a functional alternative to existing system. While focusing on the central features of proposed system where individuals are guided in their economic decisions by a set of behaviour norms, mainly derived from the Qur'an and sunnah, the author says that the implications of these norms are ambiguous in most of the context where they are expected to operate. Moreover, these norms cannot fit into the modern society of today. In the paper the author has also examined the role of state in Islamic economic system, the institution of zakah and the rationale for the prohibition of interest, and finally the contemporary experiences of Islamic banks.

As for the prohibition of interest, the author believes that it is unenforceable in a large society. Unless one can show that people's need to borrow and lend at interest would disappear with the establishment of an Islamic system, it is
reasonable to expect interest to persist, if in thinly disguised form. He has also pointed out that even with the existing Islamic banking system, no less than in medieval financial circles, various indirect forms of interest have been legitimised.

The author has, however, tried to show that a successful economic growth and development requires a measure of institutional flexibility. He says that even in Prophet Muhammad's time institutions were modified or abandoned as circumstances warranted. The major flaw in Islamic economics, as they point out, is that it shuns confrontation with historical evidence when the Islamic community began to grow, the spirit of the ban on interest was routinely violated throughout Islamic history. The author concludes that a large society of present day can be hardly suitable for Islamic economist's ideal economy.

This thesis attempts to describe certain salient features of Islamic banking system and focuses on the experiments carried out in Saudi Arabia and Egypt. This work, in one way, is a survey of important thoughts on Islamic banking both on theoretical as well as empirical level. Our objective is to look at the effort of the Muslim scholars devoted to the development of Islamic financial system. I have also tried to
find out that how Islamic banking, based on equity participation, provides the best path of development for financial crisis facing the third world and how Islamic bank will work in competition with Western banks and what are its tools and rationale behind the operation. It is this problem of feasibility, especially in respects of Egypt and Saudi Arabia, that forms the subject-matter of this thesis. In short, it is concerned with ideological as well as practical problems of Islamic banks. Much of my discussion is based on the literatures produced by Islamic writers. I have tried to raise the various important issues that are under constant discussions. My purpose is to highlight these issues so as to see in the framework of contemporary economic theories. For example, how in the absence of interest rate, the profit-sharing will substitute the mechanism of western financial institutions.

The available literature on Islamic banking consists of either writings of a theoretical nature explaining how Islamic banking would work in an interest-free atmosphere or some articles reports. However, an attempt was made to collect as many reports and documents, on Islamic banks as possible, Proceedings of various international conferences on the subject have also been used in this thesis. A recent report on the problems of Islamic banking published by International Monetary Fund (IMF) covers
gives an interesting account of the feasibility of Islamic financial system. The report of Islamic Research and Training Institute, Jeddah, also provides important data on the working of Islamic banks. It deals with business operations of Islamic banks and associated problems. The thesis is divided into seven chapters. The first chapter traces the origins of modern controversies on interest. The second chapter deals with critique of interest, and profit-sharing system. Chapter three describes the historical background of Islamic banking and focuses on its various financial instruments. It also examines the business practices of Islamic banks. Chapter four identifies certain problems that hinder the effective implementation of Islamic banking system. Chapter five is on the monetary system of Islam particularly in the context of modern literature written by Muslim writers. Chapter sixth and seventh are devoted to the critical assessment of the experiments in Islamic Banking in Egypt and Saudi Arabia. Useful appendices have been added which contain some important data regarding the performance of these Islamic banks.