6 Non-interest Finance and Macroeconomic Stability

The most frequently posited advantage of profit-and-loss sharing (PLS) is its contribution to the stability of the non-interest economy. Whereas conventional finance supposedly amplifies the business cycle, PLS finance is predicted to dampen it. The case will be examined by setting out the supportive ‘monetary’ and financial theories of the cycle and the ways in which non-interest banking would alter matters.

‘MONETARY’ THEORIES OF THE CYCLE

Although fashionable in the 1930s, ‘financial’ explanations of the business cycle have since been neglected due to their abrogation of the neo-classical ‘real-money’ dichotomy, and the absence of rigorous microfoundations (Gertler, 1988). The former aspect has never been an insuperable problem, but the latter has only recently been addressed by the introduction of asymmetric information considerations into financial modelling.

Wicksell

Wicksell (1935, 1936) developed a business cycle theory which held the prevailing interest rate structure responsible for cyclical fluctuations.¹ The ‘natural’ rate of interest \( r \) is determined by the supply and demand for ‘real’ capital and, as such, dependent upon the expected profitability of new investment and the propensity to save. \( r \) would prevail if money did not exist, equating savings and investment \textit{ex ante} and ensuring output and price stability.

That such stability is not experienced is attributable to the existence of money and the prevalence of fractional reserve banks in the monetary supply mechanism, ensuring that the money rate of interest \( i \) need not coincide with \( r \) at all. Divergences arise because banks cannot easily identify when \( r \) has changed. For instance, if \( r > i \), planned investment will exceed planned savings. The price level will rise as excess demand is financed by dishoarding or the creation of bank

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¹ P. S. Mills et al., \textit{Islamic Finance: Theory and Practice} © Paul S. Mills and John R. Presley 1999
credit, with the process sustained by extrapolative expectations of price increases. Inflation and output expansion continue whilst \( r > i \).

A turning point is reached either when the banks realise they have over-lent, reserves become scarce, the monetary authorities become fearful of inflation, or the dictates of a monetary system (e.g. the Gold Standard) enforce a tightening. Temporarily, \( i > r \) as profit expectations are reduced, money is sterilized in hoards, credit is withdrawn and the price level falls. The process stabilizes at the original price level, when \( i = r \) again.

This system displays a long-period equilibrium of full employment and price stability when \( i = r \); whilst the monetary system reflects the ‘real’ economy, there is a tendency to move smoothly towards equilibrium. It is only when the monetary system operates independently of ‘real’ forces that cycles in output and prices arise. Hence, Wicksell could maintain the orthodox dichotomy, whilst claiming that monetary forces had a significant cyclical impact by driving a wedge between the natural and market rates of interest.

**Hayek**

Wicksell’s analysis formed the foundation of many subsequent ‘monetary over-investment’ cycle theories, such as that of Hayek (1933). He believed in the efficacy of the price mechanism to regulate the supply and demand for ‘real capital’, but that:

> Only when we come to consider the second group of prices (those paid for borrowed capital or, in other words, interest) is it conceivable that disturbance might creep in since, in this case, price formation does not act directly, by equalising the marginal demand for any supply of capital goods, but indirectly, through its effect on money capital, whose supply need not correspond to that of real capital. (ibid., p. 77)

The root of the monetary contribution to instability is that the price of loans \( (i) \) does not, and cannot, reflect perfectly the fluctuating profit expectations of investors in ‘real’ capital projects.

Hayek regards an elastic money supply, resulting from fractional reserve banking, as the ‘necessary and sufficient’ condition for the exaggeration of perturbations in the productive economy into a full-blown cycle (ibid., p. 141). The artificially low \( i \), that results from easy credit expansion, leads to over-investment and an excessive expansion