

Chapter 6

Abrahamic Finance: Economic Reasons for Prohibition of Usury/Interest Rate

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ABSTRACT

This chapter explores the economic foundations of the prohibition of usury and interest in the Abrahamic faiths; Judaism, Christianity, and Islam. It revisits the historical context in which usury and interest rates were initially used interchangeably and how the emergence of goldsmith banking led to a formal separation between the two. Nonetheless, this chapter contends that their distinction based on a specified interest rate that changes over time and place is economically weak. It argues that the economically stronger way is to highlight the fact that interest rates, unlike price, fail to function as true equilibrating variables in loanable funds markets due to their conceptual complexity and practical distortions. The chapter presents four core critiques.

INTRODUCTION

The dictionary definitions of “usury,” which leave the determination of a legal rate to contemporary authorities or the state, reflect a deep-rooted misunderstanding that has been common from ancient times till today—namely that both usury and interest rates perform the same function of equilibrating variables in loanable funds markets as prices perform in commodity markets. All economics textbooks, such as Mishkin (2019) and Mankiw (2021), show interest rates as the equilibrating variable in loanable funds and money and bond markets. See also Persky (2007), Friedman (1970), Weber (1930), Tawney (1926), and Bentham (1806). Usury, in this view,

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executes the market-clearing role if loaning is mostly for pressing consumption needs, while interest rates do this job when loaning is mostly for production or investment purposes. The first type of loaning, however, provides an opportunity for lenders to take advantage of the severity of the human needs of borrowers. So, lending and borrowing becomes a zero-sum game. That is, poor borrowers accept usurious rates unwillingly under the pressure of their human needs and then have difficulty paying back their loans and the accrued interest. Glaeser and Scheinkman (1998) concluded that the higher the wealth inequality in a state, the higher the market-determined interest rates on loaning for consumption needs, and thus, the stricter the usury regulations. On the other hand, interest-based commercial loaning, in this view, is an economic necessity and a positive-sum game. Businessmen and firms need external financing, and commercial banks have funds to loan out. Households save money, which they do not loan out directly to avoid the adverse selection and moral hazard problems attributed to information asymmetry. Therefore, they deposit their savings in banks. Then banks pass on the deposited money, plus the money that they themselves create based on the fractional reserve banking system, to the business community. This misunderstanding is deepened further when one compares the higher economic growth rates of those countries that have highly developed interest-based financial systems with the lower growth rates of those countries that have less-developed financial systems (Abbas et al., 2022; Asteriou & Spanas, 2019; Guru & Yadav, 2019).

Therefore, the research gap addressed by this chapter is the centuries-old myth that interest rates serve the same purpose in a loanable funds market that price serves in a commodity market. To put it differently, the research gap is the contradiction present in the common conviction of followers of all Abrahamic religions that usury, which closely resembles interest rates, is prohibited, and their common practice of dealing with interest-based transactions and justifying interest rates as necessary for the proper functioning of a financial system. The objective of this chapter is to dispel this myth so that the contradiction in belief and practice can be resolved.

The misunderstanding about the equilibrating role of interest rates can be clarified easily, in our view, by adopting the Quranic way of first comparing the price of a commodity with the interest rate and then categorically rejecting their similarity by decreeing price as permitted and interest rates as banned.⁵ The Quran did not, however, justify the banning of interest rates precisely because, in our view, such a ban could not have been understood properly until the inception of economics and finance as separate disciplines of knowledge and until the prevalence of the interest-based financial system in its developed form. Therefore, it is now the right time to justify a Quranic prohibition of interest rates by reinforcing fundamental lessons of economics and finance and by benefitting from hindsight knowledge of the ongoing interest-based financial system. If the dissimilarity of interest rates and price can be

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