Islamic Interest-Free Banking

Reply to Doak

MOHSIN S. KHAN*

IN HIS COMMENT on my paper (*Staff Papers,* Vol. 33, March 1986, pp. 1–27) Doak contends that I used the "wrong" model to characterize the Islamic banking system, and that I should have employed criteria other than dynamic stability to contrast the Islamic and traditional banking systems.

The objective of my paper was clearly stated: to examine the dynamic response of an Islamic bank to a sudden decline in income (fall in asset values). The model specified, which is simply a dynamic version of the standard IS-LM framework, seems perfectly sensible for the purpose at hand. The assumption of only outside money is perhaps unrealistic, but relaxing this assumption to allow banks to issue deposits does not change the analysis in any way. There is only one bank in the system (with no distinction made between the central bank and commercial banks), and it issues a liability. I called that liability money but could easily have called it deposits.

I agree with Doak that my model does not explain the effects of moving to a 100 percent reserve requirement for banks. But the model was not designed to do so. There are a whole host of important issues in Islamic banking and finance other than stability, and, as shown in a recent collection of papers on the subject,[1] one needs different models to analyze them. Doak's criticism of my model—that it is not sufficiently general to be able to handle all the relevant issues, including "questions of a political nature"—is certainly correct. But how many models in economics would be immune to such criticism?

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[1] Khan, Mohsin S., and Abbas Mirakhor, eds., *Theoretical Studies in Islamic Banking and Finance* (Houston: Institute for Research and Islamic Studies, 1987).