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Sequence of Exchange in Murabahah, Flow of Goods and Benefits

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Abstract

Trading in money, which is the core of lending with interest, leads to expanding credits beyond the needs of those dealing in goods and services. As a result, a discrepancy develops between real exchanges and cash flows, which is the essence of instability. The attempt of this paper is to estimate that monetary flows use murabahah transaction in the real flows of goods and services. This paper uses two sequences of exchange. In the first exchange, the seller exchange money and goods on immediate payments. While, in the second sequence of exchange, the Islamic bank subsequently sells the goods on deferred basis to buyer. Do these sequences of

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exchange create a smooth flow of goods? If yes, does it benefit the economy? These questions become the main focus of this paper.

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1. Introduction

Islamic finance has been growing in importance in recent decades. One of its major characteristics is that no interest rates can be charged, rather, the financier charges a mark-up, or shares in the partner's profits. Several standard products have been developed to meet the financing needs of trade and projects. Some are based directly on structures described in the Quran and hadith, others are feats of financial transaction, combining various permitted financial instruments to arrive at a product that combines acceptable returns with acceptable risks.

Several authors, such as La Porta, et al. (1997, 1998), Glaeser, Johnson, and Shleifer (2001), Djankov, et al. (2003), Demirgüc-Kunt and Levine (2001) and Mario Draghi (2009), argue that financial transaction depends on the law origin. The law origin makes financial transaction smoothly. It helps the flow of transaction based on the view that the law origin leads to an efficient transaction, and hence, it leads us to a very important issue, i.e., in what ways murabahah contract (which is derived from Islamic law) help to smooth the flow of goods, and subsequently, the impact of murabahah to the welfare of both buyers and sellers.

The application of this trade-related structure with a pre-determined profit rate (or pre-agreed margin or mark-up) is possible in shariah compliant financing and deposit products as well as in liquidity management or treasury instruments and other investment products or securities. One of these products which implement the murabahah contract is the Commodity Murabahah House (CMH), that is being established will be an important platform that will further enhance global inter linkages in the international Islamic financial system. This product is designed to be a multi-currency and multi-commodity exchange-traded platform to facilitate the trading and settlement of commodity which acts as the underlying transaction for liquidity management between Islamic financial centres.

The terms and conditions under murabahah contracts are many. One of them is goods involved. Both parties in the transaction must own the goods they are exchanging.[3] The goods must be things that can be handed over at the time of the sale. The point is that the buyer must be certain that he will be able to hand over the goods when the sale is made.[4] In addition, the goods must be something clearly known to both parties in a sale agreement.[5] Therefore, the ownership, dispensability and the absence of anonymity can produce the flow of goods better. However, there are still other unresolved issues. How does the exchange benefit the parties? Do the benefits mutually independent? The answer for this unresolved issue might justify the determination of mark-up rate.

[3] Both buyer and seller own money and goods, respectively.

[4] Furthermore, It is also not permissible to sell a lost item or something that the seller is not certain if it is still in his possession or not. If the buyer is not totally capable of handing over the goods, then this is a kind of gharar that the Prophet (SAW), prohibited.

[5] Selling an unknown or unspecified item, without specifying the actual item, is a kind of gharar.

Therefore, the objective of this paper is to examine the monetary flows use murabahah transaction in the real flows of goods and services. This paper is organized as follows. Section 2 provides reviews of murabahah contract. Section 3 discusses the model on which the estimated the irreversibility of exchange and two sequence of exchanges which generate benefits to economy. Section 4 presents the implications on money growth and inflation. The last section discusses the conclusions.

2. Review of Murabahah Contract

The Qur'an generally allows the buying and selling contract. Among others, the Qur'an says:

> O ye who believe! spend of that wherewith We have provided you before a day come when there will be no trafficking, nor friendship, nor intercession. The disbelievers, they are the wrong-doers (Surah Al-Baqarah: 254).

The Tafseer of the Quran said that about spending in the way of God. The instruction given here is that those who have adopted the cause of the true faith should undertake financial sacrifices for its sake. Here the expression 'they who disbelieve' signifies either those who refused to obey God and held their property to be clearer than God's good pleasure, or those who did not believe in the Day of which they had been warned, or those who cherished the false illusion that in the Hereafter they would somehow be able to secure their salvation and that their association with men devoted to God would stand them in good stead for they would intercede with God on their behalf.

Then the Qur'an says in Surah Al-Baqarah: 275 about the exchange that involve riba:

> Those who swallow usury cannot rise up save as he arise whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitted trading and forbidden usury. He unto whom an admonition from his Lord cometh, and (he) refrain (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who return (to usury) - Such are rightful owners of the Fire. They will abide there in.

This verse use the term riba in Arabic means 'to grow, to exceed, to increase'. Technically, it denotes the amount that a lender receives from a borrower at a fixed rate of interest. At the time of the revelation of the Qur'an several forms of interest transactions were in vogue and were designated as riba by the Arabs. Of these one was that the vendor sold an article and fixed a time limit for the payment of the price, stipulating that if the buyer failed to pay within the specified period of time, he would extend the time limit but increase the price of the article.

Another was that a man loaned a sum of money to another person and stipulated that the borrower should return a specified amount in excess of the amount loaned within a given time limit. A third form of interest transaction was that the borrower and vendor agreed that the former would repay the loan within a certain limit at a fixed rate of interest, and that if he failed to do so within the limit, the lender would extend the time limit, but at the same time would increase the rate of interest. It is to transactions such as these that the injunctions mentioned here apply.

Buying and selling transaction also is clear from the following verses in surah al-Ibrahim and al-Hajj. The Qur'an says:

> Tell My bondmen who believe to establish worship and spend of that which We have given them, secretly and publicly, before a day cometh wherein there will be neither traffic nor befriending (Surah Al-Ibrahim: 31).

Then, the Qur'an says:

> Those who have been driven from their homes unjustly only because they said: Our Lord is Allah - For had it not been for Allah's repelling some men by means of others, cloisters and churches and oratories and mosques, wherein the name of Allah is oft mentioned, would assuredly have been pulled down. Verily Allah help one who help Him. Lo! Allah is Strong, Almighty (Surah Al-Hajj: 40)

The Qur'an stress that the people whom neither commerce nor striving after profit diverts them from remembering Allah when it says:

> Men whom neither merchandise nor sale beguile from remembrance of Allah and constancy in prayer and paying to the poor their due; who fear a day when hearts and eyeballs will be overturned (Surah An-Nur: 37).

However, in the Surah Al-Jumu'ah: 9, Qur'an says:

> O ye who believe! When the call is heard for the prayer of the day of congregation, haste unto remembrance of Allah and leave your trading. That is better for you if ye did but know.

This verse means, three things in this sentence are particularly noteworthy: (i) That it contains mention of the call to the Prayer; (ii) that the mention is of the call to such a Prayer as has to be performed particularly only on Fridays; and (iii) that these things have not been mentioned so as to suggest that the call is to be made for the Prayer and a particular Prayer is to be performed on Friday, but the style and context clearly show that the call to the Prayer and the particular Prayer were both already being performed and practiced on Friday. The people, however were being negligent in that on hearing the call to the Prayer they would not hasten to it but would remain occupied in their worldly activities and trade and business transactions.

From the above discussion, although buying and selling transactions are permissible, but how about the buying and selling transaction with deferred payment or known as murabahah. The legality of Murabahah can be deduced from the Sunnah of the Prophet (SAW), the consensus of the Muslim jurists and Qiyas (analogy). In the sunnah of the Prophet (SAW), There is no direct juristic authority from the Sunnah of the Prophet (SAW) on the legitimacy of Murabahah sale. It is deemed permissible based on the general permissibility of sale in Islamic law. The Prophet Muhammad (SAW) is reported to have said: "The best earning is what man earns with his own hands and from a permissible trade". (Narrated by Muslim)

In the ijma' of the muslim jurists, it is noted that people have inherited these transactions (Murabahah) for ages without any objection and that would constitute consensus (Ijma') on permissibility of Murabahah. Therefore, in analogy (Qiyas), since the Prophet (SAW) has approved the sale based on cost price, the sale on mark-up will be equally permissible on the basis of analogy on the sale based on cost price. The determination of cost and making it known to the buyer are common in both the sale based on cost price and Murabahah sale.

The foremost question about murabahah is that, when used as a mode of financing, it is always effected on the basis of deferred payment. The financier purchases the commodity on cash payment and sells it to the client on credit. While selling the commodity on credit, he takes into account the period in which the price is to be paid by the client and increase the price accordingly. The longer the maturity of the murabahah payment, the higher the price. Therefore the price in a murabahah transaction, as practiced by the Islamic banks, is always higher than the market price. If the client is able to purchase the same commodity from the market on cash payment, he will have to pay much less than he has to pay in a murabahah transaction on deferred payment basis.

The question arises as to whether the price of a commodity in a credit sale may be increased from the price of the cash sale. Some people argue that the increase of price in a credit sale, being in consideration of the time given to the purchaser, should be treated analogous to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment (see, Zarqa (1983)).

On this basis they argue that the murabahah transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by conventional banks. This argument, which seems to be logical in appearance, is based on a misunderstanding about the principles of Shariah regarding the prohibition of riba. For the concept view, the modern capitalist theory does not differentiate between money and commodity in so far as commercial transactions are concerned. In the matter of exchange, money and commodity both are treated at par. Both can be traded in. Both can be sold at whatever price the parties agree upon. The only condition is that it should be with mutual consent.

The Islamic principles, however, do not subscribe to this theory. According to Islamic principles, money and commodity have different characteristics and therefore, they are treated differently. The basic points of difference between money and commodity are the following: (i) money has no intrinsic utility. It cannot be utilized for fulfilling human needs directly. It can only be used for acquiring some goods or services. The commodities, on the other hand, have intrinsic utility. They can be utilized directly without exchanging them for some other thing; (ii) the commodities can be of different qualities, while money has no quality except that it is a measure of value or the medium of exchange. Therefore, all the units of money, of same denomination, are equal to each other; (iii) in commodities, the transaction of sale and purchase is effected on a particular individual commodity, or at least, on the commodities having particular specifications. For example, if A has purchased a particular car by pinpointing it and seller has agreed, he deserves to receive the same car. The seller cannot compel him to take the delivery of another car, though of the same type or quality. This can only be done if the purchaser agrees to it which implies that the earlier transaction is cancelled and a new transaction on the new car is effected by mutual consent.

3. The Model

In this section, we will discuss two areas: first, the irreversibility of exchange that produces a smooth exchange of goods; and second, in murabahah contract, the goods' owner only receives the payment by stages. But, the customer has already used the goods and received a stream of benefits. How does this exchange generate benefits to economy? To find out the answer, we will construct the model of exchange under murabahah contract which involves two sequences of exchange.

3.1 The Irreversibility of Exchange

If contact between sellers and Islamic bank with different conditions of controlled variables (as discussed in Section 2) is established then they trade and exchange flow arise. The flow of goods depends on the difference between the buying price and the selling price. Thus, non-zero difference between buying price and selling price is necessary to have non-zero rates of goods flows.

If contact is established between two parties with different conditions of controlled variables then exchange flows occur. One can control these flows by controlling the conditions of controlled variables. It is useful to single out the class of subsystems whose intensive variables are controllable. Islamic banks, which set prices, also belong to this class. We shall call such systems active. Passive systems differ from active ones because their controlled variables change only as a result of changes to their uncontrolled variables.

If we consider a market when one good is traded and where only one Islamic bank buys and resells the goods. This Islamic bank chooses the price P_X to minimize the price it pays (or to maximize the price is received) and to receive the stream of installments in the given period of time *T*. The condition of price can be interpreted as the condition of minimal trading costs. It holds if the trading costs are minimal subject to the given average rates of trading.

In addition, the smooth flow of goods also happen, if the ownership of goods is immediately transferred to first, the Islamic banks and subsequently, to customers. Here, the irreversibility of exchange can be realized by using, for example a short term leasing contract or utilizing the goods for a certain period. The incentive to engage in such agreement is to ensure the quality of goods is there.

3.2 Benefits to Economy

In analysing the benefits of murabahah on the economy, we will construct the model of exchange which involves two sequences of exchange.

a. Sequence I

Assume that, there are two parties involved in murabahah financing, the seller and the bank. The seller sells good X to Islamic bank. The former sells the goods at P_X to Islamic bank. We also assume that the payment is made in cash. The seller discloses the actual cost he has incurred in acquiring the good X and then adds some profit thereon. The seller receives M_X amount of money. This money would generate benefits to the seller (S_B).

If Islamic banks decide to utilize the goods then it will benefit the owner, (B_B). Since, we have two set of benefits, which is B_B is a benefit for the Islamic bank as a purchaser and S_B is a benefit for the seller. However, both B_B and S_B are said to be independent and hence:

$$B_B \cap S_B = \emptyset,$$

where $\emptyset$ is the empty set. Therefore, these two sets are independent. Therefore, the benefit to the economy is bigger in the presence of two mutually independent sets.

If there are only two sequence can be determined the benefit to economy by:-

Result: $E_B = B_B + S_B$

Follow the goods, the possible graph we can get for these two independent set in Diagram 1:-

Diagram 1: Independent set (cash payment)

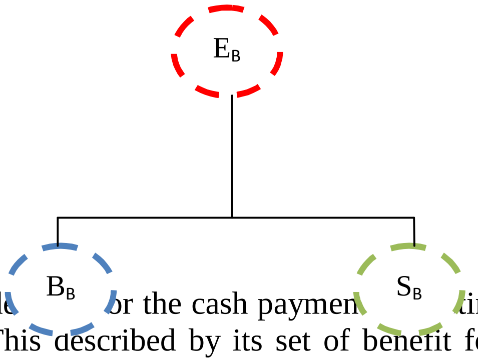


Diagram 1 shows independe... or the cash paymen... ting of two subsets, for the bank (B_B) and the seller (S_B). This described by its set of benefit for economy including a set of benefit for the bank and seller.

b. Sequence II

The Islamic bank would then make an offer to the customer to sell him the goods at the marked-up price. In its letter to the buyer, it clearly states the payment schedule. The amount of mark-up at the rate already agreed between the bank and the client would be calculated for the period from the date that the bank paid for the goods to the dates that the buyer pays.

Here, the Islamic bank sells the goods to customer at selling price (P). But, the selling price comprises two items, i.e., the buying price (P_X) and margin (M_X). But, the payments are done periodically (P_1, P_2, ..., P_T), where t=1,2, ..., T represent the payment schedule. We assume that this exchange generates several benefits to: shareholder of Islamic banks who provide capital (which is equivalent to P_X), employee, government and others. The employee claims part of this margin, while shareholder bears the other costs (O) (such as stamp duty and other operational costs) and also the dividend (D) (after the payment of salary and zakat). Specifically, the government receives zakat (Z). The employee receives salary (S)

The customer gets the benefits in utilizing the goods. For example, the benefits can be in the form of rental payment or at t=T, the value of goods is higher than P.

As a result, we also have two set of benefits, which is B_B is a benefit for the Islamic bank as a purchaser and C_B is a benefit for the customer. Again, we can get two mutually independent sets.

$$B_B = \{B_1, B_2, B_3 \dots B_T\}$$

and

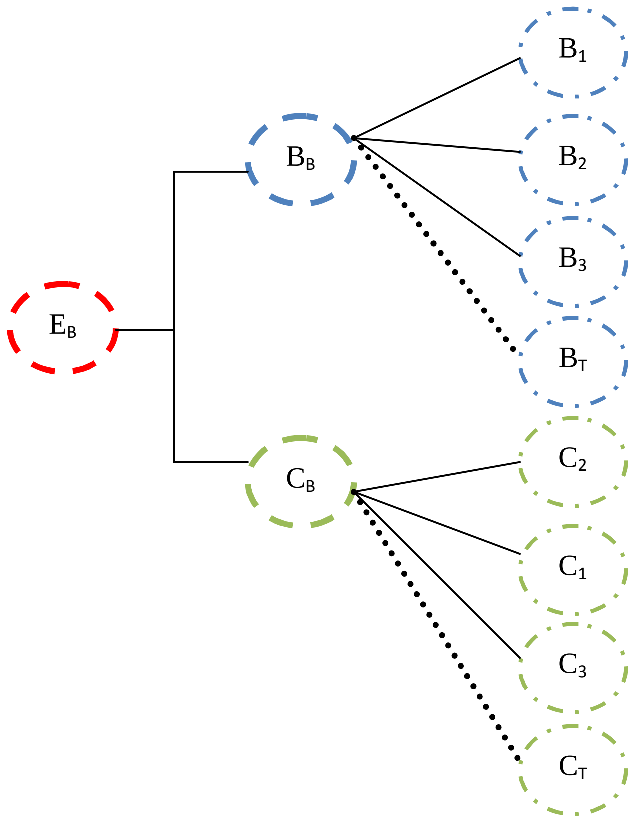
$$C_B = \{C_1, C_2, C_3 \dots C_T\}$$

Therefore, the benefit to each party at time t can be written as follows: At t=1; Islamic banks and customers receive the benefits, B_1 and C_1, respectively. The sequence can also be realized at t=T, where the benefits are B_T and C_T for each party. The total benefits to the economy at each time period ($E_{B,t}$) can be written as:

$$E_{B,t} = [B_{B,t}] + [C_{B,t}]$$

This sequence of exchange produces a set which is also mutually independent. Graphically, this set can be seen in Diagram 2. Diagram 2 reports the vertex cover which shows the point of benefits for each bank and customers. Set B_B and C_B are connected to every other vertex in the same set.

Diagram 2: Vertex Cover for independent set (periodically payment)



From the above set, a cluster in a drawing of a diagram in the plane is the set of periodically endpoints of the two edges benefit involved in a crossing. An independent set is a drawing in which the cluster are pairwise disjoint. Therefore, this diagram shows that for independent set is sufficient to guarantee a constant benefit for the each party.

4. Implications on Money Growth and Inflation

From the above discussion, the murabahah contract refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. It means that the customers need to acquire funds to pay the instalments. By paying this instalment, higher amount of deposits is reported on the liabilities side of Islamic banks and consequently, the amount of money supply also increases.

When money supply increases, it pushes down the profit shared among the rabbul mal. If the Islamic banks react by pushing a higher marked up rate, then this reduces the sale of goods because the demand declines. Bank responds by setting lower prices in order to maintain a constant profit paid to depositors. When the money supply grows at a faster rate than the underlying pool of goods on which to spend it, relatively more money competes for relatively less products. This bidding pushes down general price levels. Hence, inflation can be reduced.

Inflation can have positive and negative effects on an economy. Negative effects of inflation include uncertainty about future inflation may discourage investment and saving, and high inflation may lead to shortages of goods if consumers begin hoarding out of concern that prices will increase in the future. Positive effects include a mitigation of economic recessions, and bonus relief by increasing the level of profit. When inflation is unanticipated, as it so often is, there's a redistribution of wealth from customers to bank.

5. Conclusion

From the above discussion, we can produce several conclusions. First, we find out that the benefits to the contracting parties are mutually independent. Therefore, the basic ingredient of murabahah is that the seller discloses the actual cost that she has incurred in acquiring the goods, and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage. The payment in the case of murabahah may be at spot, and may be on a subsequent date agreed upon by the parties. But, both types of payment might still produce the irreversibility of exchange. Therefore, it could lead to a better flow of goods. Second, the sequence of exchange for deferred payment produces a set which is also mutually independent. It implies that the point of benefits for each bank and customers are connected to every other vertex in the same set. Therefore, this independent set could be sufficient to guarantee a constant benefit for the each party.

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