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# On the pareto-optimality of futures contracts over Islamic forward contracts: implications for the emerging Muslim economies

M. Shahid Ebrahim<sup>a,\*</sup>, Shafiqur Rahman<sup>b</sup>

<sup>a</sup> Nottingham University Business School (Jubilee Campus), Wollaton Road, Nottingham NG8 1BB, UK

<sup>b</sup> School of Business Administration, Portland State University, USA

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## Abstract

A general equilibrium approach is used to demonstrate that: (i) futures contracting (on Islamically permissible commodities) is *pareto-optimal* over the Islamic forward contract of *Bai' Salam*; and (ii) both forms of contracting constitute a *quasi-equity* claim instead of debt (*dayn*) as construed by the majority of Islamic jurists. These results are of import as they: (i) remove a major hurdle against futures contracting by the Islamic jurists thereby enabling the renovation of the financial intermediation system of emerging Muslim economies; and (ii) demonstrate that the arbitrage principle needs to be re-examined under non-linear asset pricing.

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## 1. Introduction

This paper examines how emerging Muslim countries can benefit from developing their financial markets by incorporating futures contracts. The rationale behind this stems from

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\* Corresponding author. Tel.: +44 115 84 67654; fax: +44 115 84 66667.

E-mail address: m.shahid.ebrahim@nottingham.ac.uk (M.S. Ebrahim).

Demetriades et al. (2000), who propagate the view that a good financial intermediation system can contribute significantly to the growth of a nation. We investigate the pareto-optimality of a “synthetic” futures contract over Islamic forward contract known as *Bai’ Salam*.<sup>1</sup> The synthetic futures contract is a package that is financially engineered by combining futures contract on Islamically permissible commodities and Islamic cost-plus sale contract (*Bai’ Murabahah*). We demonstrate that such a financially engineered package meets all the requirements of Islamic jurisprudence and dominates Islamic forward contract on efficiency and welfare issues. This result is contrary to the intuition that under competitive markets, arbitrage-free first-order conditions lead to pareto-neutrality of both contracts.

*Islam*, an Abrahamic religion, endorses free markets, discourages price controls and forbids financial contracts based on *riba*, *gharar* and *maysir* as explicated below (Islahi, 1988):

- (i) *Riba* literally means an increase, addition, expansion, or growth, or the “premium” that must be paid by the borrower to the lender with the principal as a condition for the loan or for an extension of its maturity. However, *riba* has some very broad connotations, as expounded by the well-known Islamic jurist Ibn Qayyim Al-Jawziyya (1973) to imply: (a) unfairly trading in any form, manipulating the market or engaging a market participant to trade under duress (*riba-al-fadl*); and (b) interest-based debt contracts (*riba-an-nasi’ah*) (Fazlur-Rahman, 1969; Saeed, 1996). Ibn Qayyim rationalizes the prohibition of interest transactions in an era where the bulk of society lived in bare subsistence and were prone to exploitation by lenders. Nonetheless, the majority of contemporary Islamic scholars (termed as the Neo-Revivalists by Saeed) still rationalize its prohibition in Islam based on the social impact of bankruptcies and loan defaults emanating from excessive debt obligations.<sup>2,3</sup>
- (ii) *Gharar* in a financial contract entails deception.
- (iii) *Maysir*: Promoting *gharar* pre-empts *maysir*, which is gambling (*qimar*) (Ibn Taymiya, 1951, n.d.).<sup>4</sup>

<sup>1</sup> Please refer to the Glossary in Appendix for further exposition of Arabic terms associated with Islamic finance.

<sup>2</sup> It should be noted that the scriptures of other Abrahamic religions (before *Islam*) also proscribe interest. For example, in a letter, Pope Urban III (1185–1187) cited the words of Christ, “lend freely, hoping nothing thereby” (Luke 6:35) (Hastings, 1922). In Judaism, there are three Biblical passages (Exodus 22:24; Leviticus 25:36–37; Deuteronomy 23:20–21) that forbid taking interest from “brothers,” but permit it when the borrower is a Gentile (non-Jew). In Leviticus, “increase” is the rendering of the Hebrew “marbit” or “tarbit” that denotes gain on creditor’s side. Lending on interest is considered by Ezekiel (18:13, 17) among the worst sins. Also, in Psalm 15, among the attributes of the righteous man is the fact that he does not lend on usury (Anon., 1901, p. 338). See Keen (1997) for an excellent discourse on the shift in the attitude in the West from complete prohibition of interest to its acceptance.

<sup>3</sup> The evolution of the Islamic banking industry is attributed to the literal view of the Neo-Revivalists that all forms of trading money (or monetary equivalents) for more money over time constitutes *riba-an-nasi’ah*. In contrast to the Neo-Revivalists there is a minority of scholars (termed as Modernists by Saeed), who believe that *riba-an-nasi’ah* proscribed in the Muslim holy book (*Qur’an*) is the exploitative (i.e., the usurious) one.

<sup>4</sup> Incidentally, the elements of *gharar* and *maysir* have the capacity to impair the reputation of the financial services industry. This is precisely the reason why regulations in the developed economies encourage fair credit reporting laws and full disclosure laws and restrict insider trading.

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