
Contrary to popular opinion : time value of money is the essence of Islamic Banking

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They say: Time is the essence. This is one of the pillars of finance. Time has value because “today” is more valuable than “tomorrow”

A future stream of income diminishes in value. To know how much it is worth today it has to be discounted for present value. The time value of money serves as the foundation for all other notions in finance. Today’s value of a future cash flow we all know, is worth less than the (nominal) sum of that cash flow. The difference can only be known by the use of a discount rate most famous is interest. Because Islamic banking is interest-free, this led to the assumption that, in Islam, there is no such thing as “time value of money”. Because it almost given that “time value of money results form the concept of interest”. It is obvious that the concept of time value of money is “sensecal”. Assuming that one dollar a year later is worth a new dollar today goes against “common sense”. Therefore, saying Shari’ah does not recognize time value of money means Shari’ah is “non sensecal”. Nothing can be further from the truth. Shari’ah does recognize time value of money, includes many contract the only obvious purpose of which is to facilitate a monetary compensation for time. In all the classical books of Jurisprudence,

scholars leave no doubt about their position on the issue. They express their views in terms not too different from contemporary economists who always speak of “time preference” a statement that is frequently found in their books and may be considered by some to be a maxim in that “time has its share in price”. Nothing can exhibit this idea more than the contract of Salam. Salam is a forward contract where one can buy a crop for immediate payment of cash price and future delivery. The Salam contract is a finance contract par excellence. In the past, prices used to be very stable particularly in the short run. This is due to both habit and market conditions. One of the basic elements in this Salam contract is that the price paid today is the future price discounted by a factor to reflect the time value of money. The same thing is done in installment sales where the deferred payment price is raised by a % reflecting that time value of money. In fact one major Shari’ah scholar tries to justify the great rewards a believer will receive in the here after in compensation for good deeds in his life time using the same concept. Since present is more valuable than a distant future, it is only just that for a short life of goodness a believer is rewarded an eternity of happiness in the heavens.

When then gave rise to this perception that Islam doesn’t recognize time value of money? Actually it is not without justification.

Not only for there is no interest rate in Islamic banking but also because time value of money is completely disregarded in lending. A loan is a benevolent act, reward for the giver is promised in the hereafter. Believers are requested to lend to the needy but expect no compensation against the time value of money. In fact, even here Islam promises, as the narration from the Prophet indicates, a higher reward for such lending that even exceeding charitable giving.

The question is why. Why is it that Shari'ah recognizes time value of money in sale but not in lending.

The answer can't be derived from the texts of jurisprudence but from the books of modern economics. The source of instability in contemporary economics is the dichotomy between the financial and the real sector. For an economy to be stable, it must always keep the "match" between the two sectors. Compensating lenders with money for time is fine as long as their capital is used to create value similar or more than such compensation. On a Macro level, this is impossible to insure at all times. This is because prices of goods and services from which profits are generated are decided not in money market but in the real sector. Such dichotomy will disappear if we make sure that when

money is used to settle a transaction over time, this is done for real goods and services not “money for money. This is exactly what we call Islamic economics.