The Relevance Of Risk Sharing For Modern Economies

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Abstract. The purpose of this study is to confirm and demonstrate that risk sharing policy is practical and viable alternative to the conventional system. This study is an archival research, including inspection of documents held in libraries and on-line. Within this framework, statistical data, audio and printed materials provide the source for analysis. This study found that in 1933-1935, Germany instrumentalized the principle of risk sharing to fund the Work-Creation Programs –a national agenda that successfully improved domestic labour market condition. Practical Implications from this study are twofolds: First, the finding abrogates the current misconception that Islamic finance is difficult, impractical, and not viable. Second, for policy makers, the study laid out another reason of why risk sharing principle should be adopted into economic policy. It is the first study that demonstrates, based on historical record, the Islamic financial principles of risk sharing was implemented into the macroeconomic policy of Germany 1933-1935. The aptness of risk sharing to the national economic policy in Germany 1933-1935, which has protected the country against depression and provided millions of jobs to its people, provides an academic support for the direction of current Islamic financial system towards risk sharing.

Key words: Risk sharing, Macroeconomic Policy, Economic History, Islamic Financial System, Germany 1933-1935.

1. Introduction

1.1 Background

One of the on-going misconceptions about Islamic finance is that it works only in a primitive economy. It is argued that Islamic finance principles, in particular the principle of risk sharing, has no longer compatible -thus non practical- to organize our open and modern market. The incompatibility lies on the argument that the laws and rulings that underlie Islamic financial transaction are not flexible enough to address the complex and "modern" financial products. Such opinion stems from the view that Islamic law is "obsolete" and "has lost its effectiveness" throughout time [1].

This negative argument further indicates that Islamic commercial law is not apt for the more globalized financial market. They pointed on different Islamic schools of thought that introduce different rulings (fatwas). Indeed, Timur Kuran, who is known for his critics for Islamic finance, claimed that Islamic law of commercial contracts and the redistributive instrument of waqf (trust) are two blocks that caused economic underdevelopment in the Muslim countries [2]–[4]. Considering the status quo of Islamic finance, such critics might

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look plausible so that it influences public opinion that Islamic finance is non-functional in a modern, complex economy.

However, the work of economic historians indicates that Islamic finance principles offer a key to economic progress. Centuries ago, risk sharing being the binding institution of Islamic finance has enthused economic development at macro and micro levels. Historians document a significant influence of risk sharing financial arrangement towards economic development in various parts of the world throughout time. In the Middle-Eastern region, risk sharing contracts, such as “modaraba” and “musharaka”, were dominantly utilized in the 6th century by the merchants. As the arab merchant travelled to the West for trade, it is later discovered that they also influenced the Italians of the risk sharing financial arrangement. It is now known that commenda is another name for modaraba. Later, risk sharing instruments thus become the impetus for socio-economic development of the region. In nineteenth century, risk sharing transactions also drove economic growth in major part of Europe and facilitated the built of railways and city beautifications.

Hereforth, it is argued that the risk sharing principle was the key institution of a successful economic policy in Germany 1933-1935. During this period, Germany implemented an “unconventional” economic policy that initiated the country’s comeback from a defeated to a prosperous nation in only a brief period. Such policy, known as Vorfinanzierung, was able to allow direct and active participation of households, private sectors, banking and financial institutions into national programs in proportion to their risk taking ability. Combined with monetary policy of rediscounting, such risk sharing arrangement had helped the government to provide jobs to over 4 million citizens without exacerbating the fiscal condition. As a result, Germany was able to not only increase the national output and reduce unemployment at significant rate, but also to initiate the country’s industrialisation phase.

Furthermore, the national policy of 1933-1935 was reportedly free from any racist policy, which only appeared later after August 1936. In another words during the time of study, there was no indication of expropriation of Jewish properties and that Jewish were still allowed to do all sorts of economic activities. There was, however, one year debt moratorium payment (Hoover moratorium) from 1931 to 1932 in order to alleviate fiscal constraint of Germany. Thus, it is argued that the economic policy of Germany 1933-1935 is genuine conceptualization of a risk sharing policy.

1.2 Objective

The hypothesis of the study consists of the main issue: the principle of risk sharing in macroeconomic policy rested on a structure whereby risks of development projects are distributed among society members through financial participation that allowed them equal access to the resources. Financing participation deters piling financial risk on one segment or offering a particular segment privileges and protection over the others. Such arrangement may improve internal liquidity and provide buffers under difficult circumstances, such as financial crises and economic instability.

The German economic policy in 1933-1935 is a remarkable economic recovery. How could a bankrupt nation become one of the most dynamic industrial economies in such brief period? Attempts to answer this question would be instructive for academic researchers and policymakers to gain insights on successful policy tools used to achieve economic growth. As explained in the previous subsection, a commonality existed between the instruments employed in the German economic policy and risk-sharing principle. Therefore, this research intends to:

1. Examine and document the characteristics of the risk sharing instruments
2. Review and document the mechanism of the risk sharing instruments
3. Draw a conclusion on whether the economic policy of 1932-1935 centred on the risk sharing principle.

2. Literature Review

2.1 Background Theory

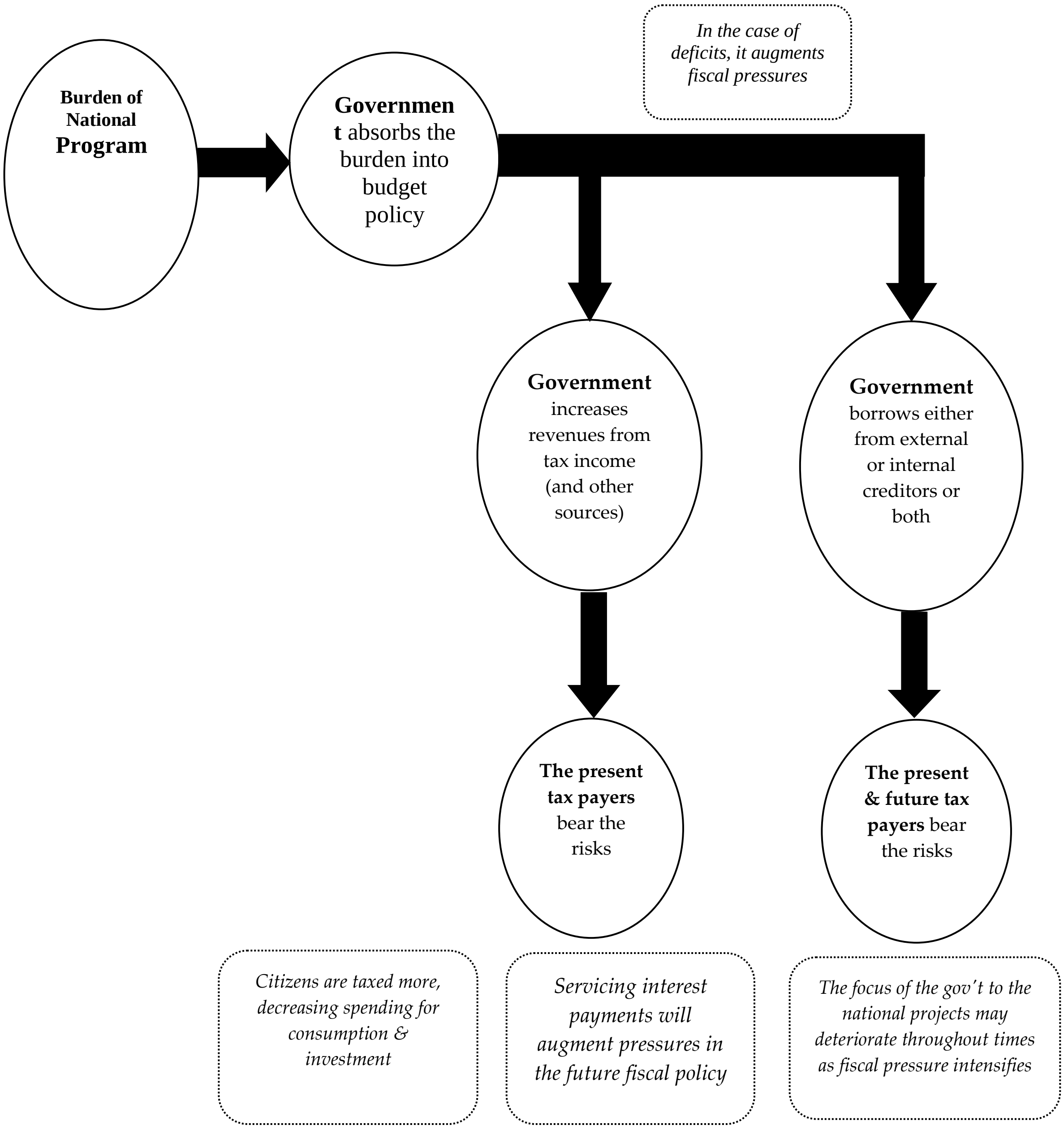
There are two conditions of Islamic financial system. First, serving as sufficient condition, is abolishing interest-based contracts. Interest-based contracts are risk transfer/shifting arrangement. In principle, risk- transfer or shifting system allows for one party to receive benefits for moving risk to the counterpart with or without his or her consent. If the counterparty agreed to accept the risk and give out the advantage to the agent, there must be a certain intention or specific condition that "forces" him to enter the transaction. If his decision is influenced by economic motive like the need for working capital, thus this call is an internal force driven by the vision of development. If the need for cash is caused by an unpredicted event and consumptive use, it is classified as external force driving him to risk transfer contract.

When internal force drives the motive, committing interest rate payment stipulates a real cash outflow despite the future cash flow is yet unreal. Even if an estimation of cash inflow or expected return on investment is measurable, it should not be the decision factor for taking loan with interest considering risks surrounding the business that firstly demand a compensation account. It only makes economically feasible if interest payment is counted at the final profit after compensating other factors of production. If payment is made first, it would jeopardize other allocation posts, such as salary, machinery, and dividends among others. Due to its financial pressures and uncertain outcome it's created, entering risk- transfer or shifting contracts creates similar result like gambling.

Interest based loan, albeit a "norm" in our financial system, is a "noise" to a smooth resource distribution process. The surplus unit imposes surcharge to the deficits for the action of financial transfer. Charging interest rate would likely to aggravate income inequality problem because the process transfers the money from the deficit to the surplus agent. The surcharge is a noise to the process of distribution because, by default, it hinders an equitable access for all members who seek for financing. It, not only imposing a rate upon a loan, but also create social class based on assets.

In terms of public project financing, interest-rate based mechanism leaves little room for innovation. It is a convention that if budget is not sufficient to finance the national agenda, government must: (1) improve collection to commensurate with expenditure, (2) seek loan, or (3) a combination of both. Improving collection is less popular for ruling government because it usually leads to increasing customs, diminishing tax shortfall, and that it takes time lag for a significant improvement in revenue. The second alternative is borrowing from domestic and/or international market via bonds issuance. This option gives faster liquidity than the first alternative, given the market acceptance to bonds. If these prescriptions are yet to suffice the deficits, the government has to risk the entire economy by pursuing the third alternative.

Figure 1. Risk Transfer and Shifting in Financing National Projects



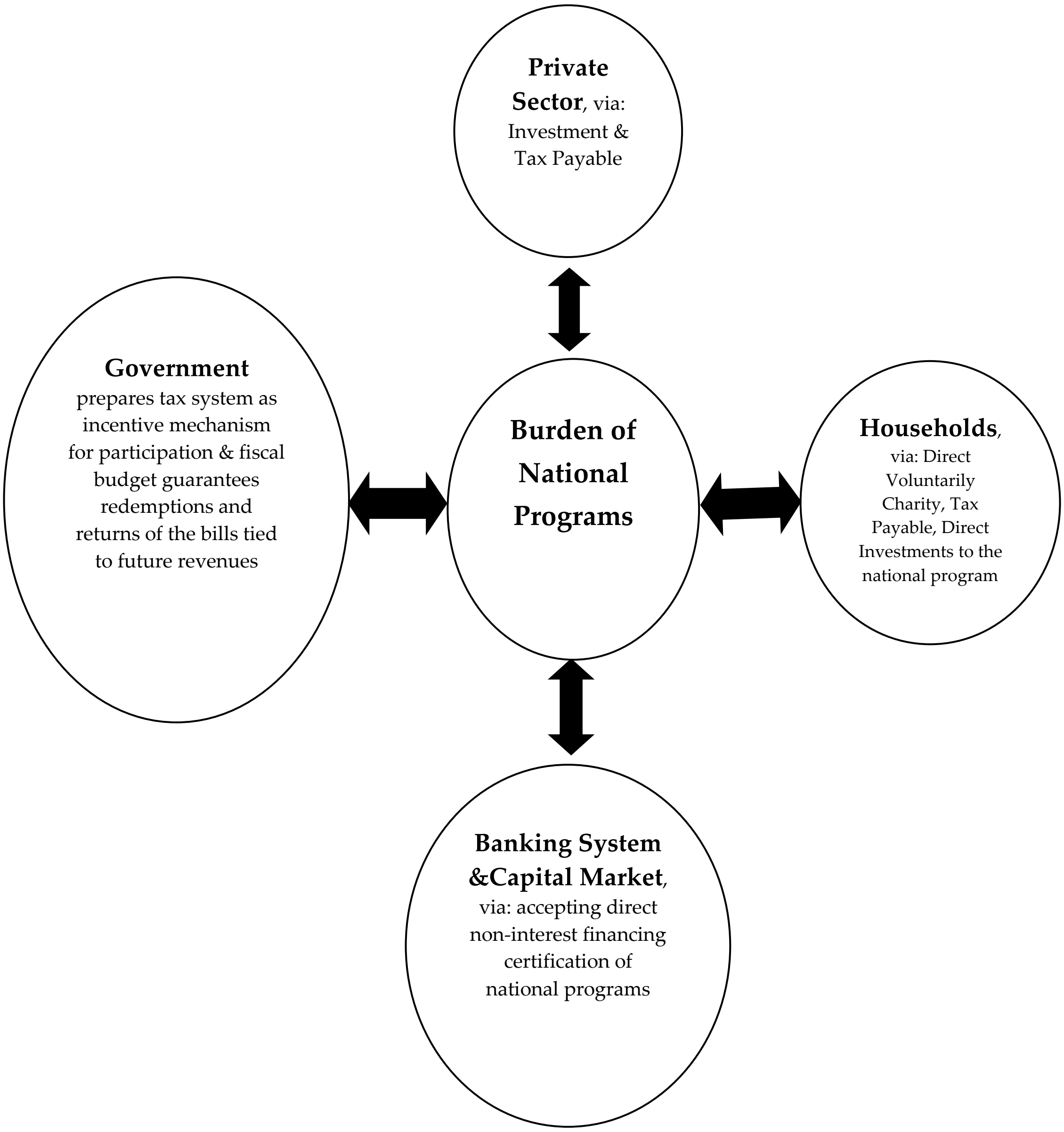
Source: Swastika (2018)

Promotion of exchange-based contracts is the necessary condition for Islamic financial system. Islamic finance views the only and ideal alternative for resource allocation is through risk-sharing deals whereby risks are shared between the two contracting parties. The mechanism for risk division may vary according to which transaction contract they followed. The form may range from sales, leasing, to partnership contracts which give basis to joint-venture capitalism. Despite its variations, the main feature of risk sharing contract is that all partners must put their "skin into the game". By putting skin into the game, all groups in the society bear the responsibility, the risk, thence the profits from the economy.

In the sphere of public risk management, risk sharing deals with government policy which aim to distribute economic risk to all members in society. The distribution rule of thumb, however, is straightforward, that it must follow the group's ability of bearing the risk. The responsibility is distributed according to the agent's ability to carry risk, so no one segment of the society carries beyond its capability. This mechanism implies that the policy should not jeopardize the interest of middle-low income class while preserving the interest of the wealth. In other words, there should be no leeway for shifting or transferring the risk of financial activity to a particular class.

It is practical financing national programs via risk sharing arrangement. Risk sharing opens equal and directly public participation to the planning, organization, financing, and oversight the projects. Government sets a robust mechanism and issues regulations that allows private sectors and public to support the agenda, without losing its authority to control, supervise, and oversight participation of private sectors and households. Government, in order to increase participation of private and households sectors, regulates using incentive mechanism, such like tax deduction and alternative non-interest rate fiscal instrument. The latter must be able to absorb liquidity not only in financial market but also at the households while protecting their rights to receive potential returns from the instrument. Thus, national programs become the common interest of tripartite (government, private, and households sectors).

Figure 2. Risk Sharing in Financing National Projects



Source: Swastika (2018)

An open and equitable access to financial resources, therefore, is a capital to achieve an optimal risk reduction of the society thus is a bridge toward a sustainable economic development. Such features of risk sharing instrument would push policy makers to produce innovative products that facilitates the need of government and the "thirst" of first grade interest-free securities. More importantly, if combined with tax incentives such as tax rebates certificates, fiscal instruments could be a new asset class for private and household sectors.

Households can trade this tax rebates in financial market for liquidity and private sectors shall benefit from this system.

2.2 Previous Studies

An example of a successful economic policy based on risk sharing is Germany 1933-1935 that led to a rapid recovery of the economy that eclipsed more advanced economies during the Depression Era. It was argued that the Central Bank, "Die Reichsbank," reconnected the financial sector of the economy to real productive sector. Under the lead of the President Hjalmar Schacht, the monetary system was organized under the principle of keeping money supply in line with production. Schacht wrote in his memoir: "… I was able to break new ground. I abandoned the central banks' so-called classic discount policy. I embarked on a program of productivity expansion not dependent on savings (that is, on a restriction of capital expenditure) but on the actual creation of wealth. I rejected the trading methods which traditional British economic theories had bequeathed to us." [5, p. 471]

According to the above statement, the fundamental reform of monetary policy was to tie money circulation to production. The German people seemed to agree that the expansion of credit would jeopardize the asset side of the balance sheet since the consumption level might drop due to financial burden from the interest rate that would lead to a lower expenditure budget. They feared that budget deficit, coupled with expansionary monetary policy, the 1923-1924 hyperinflation period could reoccur and further suppressed their economic life. Therefore, the policy was to design the commercial channels so that money circulated to support productive expansion.

The alternative macroeconomic policy in Germany in the early-1930s broke the risk-transfer and risk-shifting tradition. This policy smoothed the money circulation, liquidated hoarded money, redirected these resources to real sector activity, promoted production, and more importantly enabled all agents of the economy to engage in promoting national agenda of work creation. To spread the risk of fiscal budget, German policymakers deployed instruments, such as work-creation bills and tax-remission certificates, to induce participation of the private sector and households in financing public infrastructure projects and provide jobs. The projects included: toll roads, residential houses, agriculture, railways, automobile industries, and other infrastructure projects. Work creation bills thence became the instrument that directed savings that sit on banks for financing public projects.

The mechanism for this bills was fascinating. These commercial bills of exchange mobilized idle money resources, workforce, and inactive plants for useful projects. It was stated that some bills were issued commensurate with the progress of production so that they were "synchronized with the growth of the economy" [6, p. 115]. To make it even more attractive, the certificates were discountable at banks and re-discountable at the Reichsbank. The process resulted in pre-financing "Vorfinanzierung" the projects from the capital of businesses and saving deposits of banks.

Interestingly, the pre-financing method did not resemble debts or loans. Although the Government vowed to redeem tax certificates and work-creation bills, the redemption was optional. Consequently, these securities might or might not be returned to the Government. Moreover, the redemption mechanism was directly linked to the future budgetary receipts so that the annual conversion payments could not exceed government income of that period. Such characteristic distinguished the yield of the papers from the interest rate. Interest from loans separated its payment from the future outcome (cash flows) of the business since it demands fixed predetermined returns that had to be paid by the borrower regardless of the outcome of the venture. It was hypothetically apparent to state that the policy of pre-financing had been classified as risk-sharing policy, considering the participation of the households in pre-financing of private sector productive activities and tying returns to this financing to that of the productive sector.

During 1933-1935, the inflation rate was stable so that it enhanced the living standard of the middle-class to a comfortable level after years of poverty and low consumption [7, pp. 42–43]. Market conditions for production and business expansion improved. People regained their confidence to run their factories and investments without fear of Government acquisition [8]. As a result, trade revived [9], and "national production rose 102% from 1932-1937, and the national income doubled" [10, p. 229]. This substantial improvement was reflected in the labour market where new jobs were created. Unemployment reduced from 6 million in 1933 to 2.7 million in 1934, and 2.5 million in 1935 (Statistische Beilage zum Reichsarbeitsblatt, 1928-1939).

Germany challenged the prevailing ideology that wealth was created through "transfer of income," and changed course to "creating income." The government changed the nature of national policy to securing the interest of people by providing every citizen with a job [6]. Schacht subscribed to the risk-and-reward theory that emphasized the need for real effort and risk taking to underpin raising income. He stated, "How to make money – this question and its attendant problems engage more of man's thoughts and efforts than almost anything else. The correct answer to the question is “through work and saving… (but) Making money is always bound up with risks. He who seeks profits must be able to bear losses" [6].

The implication of such a fundamental shift in policy, in John Maynard Keynes' view, deserved praise. He asserted that the German way of managing the economy was "a contemporary approach to our current problems." (The preface of The General Theory of Money, Interest, and Unemployment, German edition, Keynes, 1936). Kenyon E. Poole, a Harvard economist, argued in his book "German Financial Policies 1932-1939" [9], that "The achievement of Germany in transforming herself from a financially and physically prostrate nation into a first-class world power in the brief space of five years has been looked upon by many observers as a "miracle"… However, there is no mystery in the accomplishment… considering the all-encompassing revolution in tax, spending, and price policies under the Hitler regime. Even if they do not succeed in "priming the pump" (i.e. increasing the volume of private investment), they form a necessary interlude until entrepreneurial initiative does revive." A more recent analysis by Turgeon [12, pp. 1–2] implied that Germany had implemented "the neutralization of monetary policy," which technically meant pacifying interest rates in the economic system.

In his report to National Resources Planning Board, Lewis L. Lorwin, a prominent American economist, wrote: "A complete analysis and appraisal of German planning in all its phases are not intended here. The scope of this Report is determined by the fact that there is a widespread feeling that, whatever our attitude toward Nazi philosophy, its economic procedures may carry a lesson for democratic countries." [13, p. 3]

2.3 Conceptual Framework

The Quran (S2:275) promotes exchange-based contracts and prohibits interest-based contracts. These two principles of Islamic finance represent the required and the sufficient conditions of an Islamic contract. The sufficient condition abolishes risk-transfer contracts, such as interest-based debt contracts. However, the system is not comprehensive without meeting the prerequisite—implementation of risk- and reward-sharing in exchange-based contracts. Muslim scholars identified other principles from the Quran: prohibition of speculative behaviour; the ban on transactions involving asymmetric information; promotion of asset-based transactions, the sanctity of contracts, and preservation of property rights [14]. Çizakça added wealth distribution and redistribution mechanism, free trade, and honesty as tenets of the Islamic finance observed in the old application [15].

Al-Riba is commonly defined as "the practice of charging financial interest or premium more than the principal amount of a loan" [16]. Emerging from this interpretation, Islamic scholars delineate two types of riba: (i) riba an-nasiyah and (ii) riba al-fadl. The first refers to charging a fixed rate on loans as a reward for waiting [17]. The common example is the interest rate on loans. The second is riba al-fadl, "all excess over what is justified by the counter-value" (Ibn al-Arabi, 1957, p.242, as quoted in Chapra, 2006). An example of riba al-fadl would be a barter of the same food type, but different quality and quantity, which is prohibited for fear of leading to injustice in the exchange. In a broader context, riba is a contract whereby people expect a fixed positive return from their financial transactions. Some commentators, such as [18], imply that applying such a broad definition of riba as a parameter to measure Sharia compliance of Islamic financial practices would allow only a few banks to be labeled Islamic financial institutions.

If taking of interest payment from a loan is viewed as an immoral action, justice prevails when the surplus agent became investors to the entrepreneurs. At this stage, both investors and entrepreneur enter a sharing deal, whereby the business risks (or the predictable estimated loss) are borne by the two sides respectively. In another words, the financier and the working agent must share responsibility and risk thence profits. This reason applies into the context of risk sharing economy because economic risk can be optimally reduced if all agents put their "skin into the game". Otherwise, some groups in the society might be left out from the progress because they must bear all costs from risk shifting/transfer economic policy. Therefore, it is now apparent that the verse 275 of the chapter 2 talks not only the financial definition of Al-Bay' and Al-Riba, but it is extended to the economic concept of risk sharing vis-a-vis risk transfer/shifting system.

The commandment to apply risk sharing has been well documented in the classic and contemporary books of Islamic jurisprudence. An exhaustive compendium of ‘fiqh-ul muamalat’ (Islamic commercial law) helps to scrutinize contract forms from the perspective of sharing the risk among transacting parties. The role of these parties determines their individual ability in bearing risks. The Islamic commercial law does not let one party bear all the risks while another party enjoys the rewards. Indeed, analogous to risk sharing, a rule of jurisprudence (Al-qawaid Al-fiqhiyyah) is ‘Al-ghunm bi Al-ghurm’ (profit comes with liability), one of the acclaimed maxims in Islamic finance. Historical studies of economics and financial transactions of Muslim governments provide evidence of utilization of risk-sharing contracts. Researchers [15], [19]–[23] provided examples of the use of risk-sharing from the earliest days of history in Medina during the time of the Prophet ﷺ to the time of the Ottoman Empire.

3. Methodology

Due to its nature, this study falls into the category of historiography. It employs archival strategies in order to reconstruct and explain the mechanism of risk sharing institution that were instrumentalized into the national policy. Sources of data were mined dominantly from public archival records in Germany. Sources of primary data include confidential reports, government documents, newspaper articles, and photos which are related to Germany national economic policy of 1933-1935. Private archival records, such as autobiographies (memoirs) and letters of key figures, such as those who were in the circle of policy making, are also used in identifying the philosophy behind their decisions reflected in the policy outcome. Meanwhile, secondary sources which involve the written documents created by others not immediately at the time of a given event that relate to the research questions, such as textbooks and journal articles. Following is the list of archive centers visited during the study:

Table 1. List of Archive Centers

Name of Institutions	**Location**
Berlin Document Centre	Berlin Lichterfeld
Deutsche Nationalbibliothek	Leipzig
Internet-Archive Centres	**Website**
The British Newspaper Archive	http://www.britishnewspaperarchive.co.uk/
The New York Times	http://www.query.nytimes.com/
Staatsbibliothek zu Berlin	http://www.zefys.staatsbibliothek-berlin.de/
Federal Reserve Archive	http://www.fraser.stlouisfed.org
Deutsche Bank	http://www.bankgeschichte.de/en/
Institut für Zeitgeschichte	http://www.ifz-muenchen.de/

According to [24], there are three characteristics through which researchers approach the history of economics. First, studying the evolving ideas of the subject throughout periods. Economic history deals with observing the economic ideas that were changing over the time and the influence of institutional factors on economic thoughts. Second, institutional elements, such as (a) the culture, (b) sociological factors, (c) government policy and politics, (d) developments in other disciplines, and (e) biographical information on the thought leaders. The third characteristic, the "robustness" of the written history. Three parameters assist in assessing history: (i) logical consistency, (ii) compatibility with evidence, and (iii) future developments of the subject. To sum up, the defining characteristics of the historical view of economic thoughts and application are "path-dependence" that undergird institutions and government policy.

A deductive historical approach is adopted in this research to understand the nature of the subject under study. The three parameters above: the changing ideas, the institutional factors, and the appraisal methods are points to consider in the study. Within this framework, statistical data, speeches, printed and audio recordings provide pivotal sources for analysis.

4. Results And Analysis

4.1 Results

Within short period, the government was able to turnaround the depression to functioning economy. Government had opened 3.5 million jobs for people and undertook necessary infrastructure projects to alleviate the standard living. And all these "economic wonders" were achieved through non-conventional prescriptions, that is risk sharing mechanism.

Risk sharing engage three primary economic players (tripartite); government, private sectors, and households, in to the projects. Private sector and households acted as the owner, or the main investors, of the projects, of which thence empowering the parties to involve in all process of designing, financing, and supervisioning the projects. Government and monetary authority ensured the incentives resulting from participation of the projects. The instruments smoothened money circulation and financial resource were redirected to real sector activities. These instruments, such as job-creation bills (arbeitsbeschaffungswechseln), tax voucher (steuerngutscheine), and rediscounting policy, followed a basic economic principle, that is sharing responsibility.

4.1.1. Job-Creation Bills

The work-creation bills were crucial instrument for the success of the policy. They enabled the funding of the massive public projects without the Reich's direct financing. This condition evoked many claims, particularly from contemporary historians who stated that the work-creation bills were a trick to expand the state-controlled economy. Wolfe, one of the historians, wrote, "The monetary device used by the Nazis to deal with the unemployment crisis, the famous "work-creation Bill," was a sort of practical financial joke played on the German credit system." [25, p. 393]

It is further argued that bills shifted the burden of financing of work-creation projects to the Reichsbank. They often referred to the statistics that showed that, by end-1934, more than half of the circulated bills were held at the Reichsbank. The Reichsbank held about 60% of the bills through the second semester of 1934. Although convincing, the Table also demonstrated the decreasing number of work-creation bills held at the Reichsbank over 1935 and forward, thereby making the conclusion seem erroneous. Under the 1924 Bank Act, the Reichsbank could perform rediscounting of the commercial bills without restrictions.

Table 1. Work Creation Bills in Circulation (1934-1936, in Mil. RM)

End of month	Bills in Circulation	Percentage held at Reichsbank
March 1934	854	46
June 1934	1048	50
September 1934	1183	58
December 1934	1276	52
March 1935	1307	41
June 1935	1206	34
September 1935	1041	30
December 1935	1022	16
March 1936	1046	10
April 1936	1008	7
June 1936	929	12
August 1936	825	13

Source: [7]

Therefore, the circulation of the bills for drawing, accepting, and discounting was lawful and conceptually permissible from an economic perspective.

On circulation, the demand for work-creation certificates was immense. Liquidity of the certificates remedied the absence of foreign loans in the capital market. The "rediscountable" feature of the certificate satisfied the need for banks and financial institutions that sought "first-class" asset. During the 1920s, banks and financial institutions reaped a substantial gain from liquid assets of foreign capital that dominated the German capital market. However, the crisis and a massive capital flight wiped out all profit and collapsed the banking sector. Consequently, the Government imposed strict control on foreign exchange capital to keep certain reserves amount to stabilize the economy. The Government also blocked transfers of the German currency to maintain internal liquidity. Moreover, the market "benefited" from the Hoover moratorium which increased the liquidity of the capital market. Considering the available liquidity and the need of investors, the capital market absorbed the work-creation bills.

In such a decentralized financing structure, the work-creation bills succeeded in linking financial resources to real enterprises. They were neither government subsidy nor debt because they were an off-balance sheet of the national budget until presented for redemption [26, p. 349]. Redemption required two conditions: one, economic recovery had provided increased revenue to accommodate payments; two, the financed projects by the bills had been completed [7]. When these economic conditions were met, the government redeemed the bills from holders who requested the payment. Statistics figures in Table 2 do not reflect the actual money paid for redemption, but reflect the Treasury allocation for the work-creation bills of each fiscal year from 1934 to 1938, if the conditions were satisfied. Related cost was any amount linked to redemption, including reimbursement to participating credit institutions for costs connected with financing the work creation program.

Table 2. Projected Burden of Work Creation Programs on Reich Treasury (mil. RM)

Program	1934	1935	1936	1937	1938
Papen Program					
Bill Redemption (incl. related costs)	190	55			
Gereke *Sofortprogramm*					
Bill Redemption	53	137	137	137	137
Related costs	28	25	17	8	1
First Reinhardt Program					
Bill Redemption	28	243	243	243	243
Related costs	35	40	25	15	50
Second Reinhardt Program					
Subsidies	475	-	-	-	-

Tax Reimbursement	58	58	58	58	58
Total (Papen, Reinhardt 1 and 2)	867	558	480	461	444
Tax vouchers	312	324	336	348	360
Grand Total (Papen and Reinhardt Programs, tax vouchers)	1.179	882	816	809	804

Source: In-house report, May 23, 1934 "Finanziellen überblick über den Reichshaushalt 1934" Silverman (1998, p.256, Table 5)

The bills distribution plan also demonstrated a clear private initiative. Local enterprises and corporations undertook projects of mutual interest with those associated with a job-creation program, such as local governments and communities. After getting the approval from the job orderer, these companies issued the bills to the financial market, that is through the banks and financial institutions and capital market, while the latter institution accepted the bills at discounts. The role of the financial sector became significant since the certificate had to be acknowledged by an appointed public bank with a special mandate to finance public works of different domains. “Die Deutsche Gesellschaft für Öffentliche Arbeiten A.G.” (the Oeffa) specialized in financing public utilities; the “Die Deutsche Bau- und Bodenbank A.G.” (the Baubo) financed projects for building construction; and “Die Deutsche Rentenbank-Kreditanstalt” (the RKA) financed projects for agricultural improvement.

It was mandatory for the bills to carry two signatures: that of the principals (Die Träger der Arbeit), and the other of the pre-financing bearer (Die Träger der Vorfinanzierung). This acknowledgment was essentially a long-term loan contract, usually from 10 to 25 years’ tenor (depending on the probable length of life of the investment), between the principal and the bearer, and served as the source for drawing the commercial certificates that were discountable at German private banks. The principals were entitled to discount the bills at private banks anytime, so long the certificates had yet to mature. The bills theoretically matured after three months, but in practice were prolonged indefinitely.

Another feature for the success of the bills was the absence of inflation risks. During the experiment, the common fear among economists was that such massive distribution of credits would lead to currency inflation. This was expected considering the experience with an expansionary monetary policy that led to hyperinflation problem. However, there was no danger of inflation. Richard Ferdinand Kahn, a German-born British economist, remarked that during the time of crisis, a monetary expansion for public works would not pose a threat to inflation provided it was accompanied by an increase in the supply of an output from idle resources and unused productive capacity. Furthermore, the work-creation bills linked the economic system with future budget receipts and expenditure. As such, additions to money supply was created commensurate with an increase in production. Baerwald stated that "The liabilities are so distributed that the annual payments resulting from the guarantee of the Reich do not exceed the possibility of being covered by regular budget receipts." [27]

In principle, using the work-creation bills as the means of financing public projects would not lead to inflation if the pace of the monetary expansion followed the supply of output. The bills were an instrument for the government to correct the problem of deficits when the nominal quantity of money is supposedly sufficient to cover the projects financing. This condition is starkly similar to the Friedman rule, which proposes default-free bonds and riskless physical capital, and rate of deflation (or discounting) that eventually will make the nominal interest rate equal to zero [28]. Such policy would be commendable, justifiable, and necessary as it has once proved able reducing the number of unemployed.

4.1.2. Tax Voucher

Tax remission certificates were an important instrument of German fiscal policy. Introduced by Chancellor von Papen, it aimed to stimulate private initiative to invest by remitting the payable tax. Under Hitler, the Government maintained the instrument as a legal, fiscal tool for abolishing unemployment. The government "rewarded" entrepreneurs and businesses who undertook new capital investments and whose average period of utilization did not exceed five years, and those hiring more workers in their plant. Such mechanism aimed to induce public participation in the government program of jobs-creation while presenting an indirect means of financing to the governments. Unlike the work-creation bills, "tax remission" did not reflect the critical purpose of the paper, or the “raison d'être” of the instrument. It only indicated the function of the paper – or what it offered – as the holders could remit their tax dues at a future time, using their certificate. One distinct feature of the certificates was, it could be pledged for credit or discountable for cash at a small rebate. Entrepreneurs could use this venue to obtain immediate liquidity and used the proceeds for their production expansion. Banks acceptance further enhanced the certificates’ attractiveness in the secondary market where holders freely traded it. No tax was imposed on trading this certificate for it enhanced market traceability.

However, two conditions were attached to using the tax remission: First, the authorities distributed the paper between October 1, 1932, and September 30, 1933, only to entrepreneurs or businesses that hired more workers than in the previous quarter of June to August 1932. For each additional worker, the government granted a tax remission certificate worth 100 marks. Corporations that were quick in servicing turnover, ground, and trade taxes were also eligible to attain the certificate because these taxes were related to sales and trading and were remitting the payable tax which would have lowered prices, increased turnover, and recycled for an increase in production. The second condition was associated with time restriction. Treasury only accepted the certificates for the stipulated fiscal year, from April 1, 1934, until March 31, 1939. Katona documented that vouchers distributed from October 1, 1932, to October 1, 1933, were fall due at any period between 1934 and 1938 at the Treasury [29]. Table 3 shows statistics of tax remission certificates between 1932 to early-1936.

The characteristics of the tax remission certificates could be summed as follows: For holders, the certificate was a good asset with its value based on the government's liability for a reduction in future tax payment. Because of this quality, the holders could use the paper to obtain direct liquidity, either from banks discounting or traded at the stock exchange for cash.

Table 3. Statistics of Tax Remission Certificates (Mil. RM)

Period	Issued*	Redeemed**	in Circulation	Period	Issued	Redeemed	in Circulation
1932/10	3	--	3	1934/07	1448.8	8.7	1184.5
1932/11	42.8	--	42.8	1934/08	1455.2	8.4	1182.3
1932/12	263.2	--	263.2	1934/09	1460.2	4.5	1182.6
1933/01	325.7	--	325.7	1934/10	1464.4	3	1183.6
1933/02	391.1	--	391.1	1934/11	1467.9	4.2	1182.7

1933/03	471.9	--	471.9	1934/12	1471.1	2.1	1183.2
1933/04	549.7	--	549.7	1935/01	1472.4	1.5	1182.7
1933/05	644.8	--	644.8	1935/02	1473.4	3.6	1180.1
1933/06	726.6	--	726.6	1935/03	1474.7	1.4	1179.9
1933/07	817.8	--	817.8	1935/04	1475.3	139.4	1041
1933/08	911.6	--	911.6	1935/05	1475.8	83.7	957.9
1933/09	987.8	--	987.8	1935/06	1476	45	913.1
1933/10	1072.7	--	1072.7	1935/07	1476.4	8.4	905
1933/11	1142.1	--	1142.1	1935/08	--	7.4	897.8
1933/12	1215.2	--	1215.2	1935/09	1476.5	1.9	895.9
1934/01	1276.5	--	1276.5	1935/10	1476.6	1.9	894.1
1934/02	1326.3	--	1326.3	1935/11	1476.9	3.7	890.7
1934/03	1362.5	--	1362.5	1935/12	1477.2	0.9	890
1934/04	1395.1	127.9	1263.3	1936/01	1477.3	0.7	889.4
1934/05	1417.8	70.3	1215	1936/02	1477.5	1	888.6

Source: [30]

* Papers in Issuance (Issued): there is no information for August 1935
** Papers on redemption (Redeemed): there is no information until March 1934

Though the certificates were classified as Government liabilities, they did not, correspond to debt nor were they like Government bonds. Also, the holders of certificates were not entitled to cash benefit, as the benefit was subject to its submission as a tax rebate. The paper was also not a legal tender, although Treasury accepted the certificate as legal means for tax payment. The high or low of the voucher circulation depended highly on public participation in the work-creation program affecting the Government's tax revenue. During the time of growth, this tax voucher contributed to a reduction in the actual tax receipt but not from the accounting standpoint, simply because its redemption also represented a decline in liability, composed of income from tax. It was reasonable to posit also that the instrument differed from the subsidy. The tax-remission certificates further emphasized the risk-sharing principle in the economic system where Government and financial and private institutions assumed their responsibilities in the financing of the work-creation programs.

4.1.3. Rediscounting Policy

Before 1933, at the heart of the German monetary policy was credit expansion. During 1933 to 1935, however, credit assumed a much weaker role as individuals and private sector participated in various public projects because the Reichsbank policy to rediscount commercial papers related to work-creation programs. The chief characteristic of the rediscounting policy was not the act of rediscounting per se, but the principle it followed. Rediscounting could be effective only if the additional money supply reached the real sector. The effect of this policy was significant because it ensured stable payment system, especially for suppliers and contractors of the work-creation programs. It also made it possible for the German banks to channel additional money supply directly to the principals that undertook to do the projects. In other words, this policy recouped the financial sector and the real sector of the economy.

Such monetary policy was in sharp contrast to the conventional monetary policy. At the time, the latter policy focused on maintaining a stable reserves system and inflation rate by increasing or decreasing the supply of money. It was also the conventional prescription that a central bank should undertake a more defensive role in reducing unemployment. These were common principles followed by mainstream monetary authority. The Reichsbank embraced an unorthodox expansionary policy when it considered the depleted reserve and its position in the global economy. The policy displayed a strong commitment to reconnecting the financial and the real sector, a principle they called "Mengenkonjunktur statt Preiskonjunktur" (production boom instead of price boom).

Despite its aggressive policy to support the work-creation programs, the Reichsbank chose to remain autonomous as an independent organization of the State. The Reichsbank kept its control over the monetary policy and enforced a strong discipline in the financial market. All banks and financial institutions had to adhere and support the Reichsbank’s efforts in setting up a payment system based on the speed of real sectors activity.

Legal system too supported this policy, which became the foundation of creating an effective financial system, lowering political costs and uncertainty, and ensuring that the parties involved in the work-creation programs complied with the rules of the game. By discounting the commercial bills of work-creation, all additional credits were disbursed for payment of the real sector. This principle was important because it meant it could successfully restore private sector's confidence in banks and financial institutions. This way, financial institutions also shared the burden with the real sector. Moreover, as immediate impact, discounting liquefied the existing frozen capital to working capital for public investments.

The different policy limited the room for the interest rate to influence production and distribution of financial resources. The guarantee of rediscounting had lowered the cost of the transaction to the minimum, as the Reichsbank guaranteed the necessary liquidity to back the commercial bills. This system also suppressed the power of rentiers in determining capital allocation. In other words, entrepreneurs and households felt the psychological impact of the rediscounting policy as it offered a conducive environment for their participation in providing resources directly to production. The business also perceived more certainty as payment for undertaking the projects was assured by this mechanism.

Table 4 shows the slowdown in the Reichsbank rate of discount and a continuous decrease in all market money rates since the end of 1932. This downward evolution reflected a deliberate measure to limit the influence of interest rate in the real economic activity. Interest rate channel thus became impotent in setting the cost of capital and the price of money.

Table 4. Interest Rates from 1932 to June 1936

Period		**Central Bank Discount Rate**	**Private Discount Rate**	**Money for One Month**	**Day-to-Day Money**
1932	January	7	6.94	7.58	7.86
	June	5	4.75	5.76	5.7

	December	4	3.88	5.08	4.91
1933	January	4	3.88	5.03	4.98
	June	4	3.88	5.5hyuhhn	4.93
	December	4	3.88	5.5	4.97
1934	January	4	3.88	4.78	4.74
	June	4	3.76	4.67	4.57
	December	4	3.5	3.56	4.28
1935	January	4	3.51	3.93	3.82
	June	4	3	2.93	3.16
	December	4	3	3.23	2.15
1936	January	4	3	3.09	2.81
	June	4	2.88	2.74	2.67

Source: [31, p. 656]

Guillebaud pointed out the effect of Dividend Law that regulated for distribution of corporate dividend not to exceed 6% [32]. He suggested that such legal restraint reduced transactions in the Stock Exchange "except as a market for dealing in old shares" [32]. The projects of work-creation programs were devolved to the local communities, excluding the Autobahn project, which further discouraged big private lenders from their usual activity.

The monetary policy of Reichsbank for the period of 1933 to 1936 encompassed the policy of discounting and deserves a wider discussion. However, the importance of focusing on only discounting and not on other components of monetary policy of the Reichsbank was to demonstrate the risk-sharing principle behind German economic miracles. The return of the Central Bank to its social function enabled the institution to restore confidence in the financial market as well as the trust of private sectors and households to support the Government work-creation policy. As a result, people who were involved in the programs also participated in planning and financing of the projects according to their financial ability. The currency and trade controls of the Reichsbank through ASKI (Ausländer Sonderkonten für Inlandszahlung) instrument was not covered in this study considering the limitation of the scope of the thesis.

5. Conclusion And Recommendation

5.1. Conclusion

The crux in this thesis is to demonstrate that financing government agendas without borrowing was applied and successful to turn over the impacts of crisis in a modern economy.

Under the pre-financing system, liquidity was supplied from private sector and banking system via instruments of commercial bills and discounting. This scheme allowed for more fiscal room, because it was off the government's balance sheet. The government promised to settle the credits only after calculating the surpluses from the budget and that the projects are finished. Under this arrangement, the principals and the private banks financed the programs at a rate commensurate with the rate of progress of the public projects while repayment and surpluses were ex-post transactions.

Such monetary mechanism relaxed government's fiscal position. As the result, the tax remission certificate, fiscal instrument that improved participation of individuals and households to the national agenda, was intended to reward individuals and private sector who joined the work-creation programs by increasing their consumption of stipulated items or expanding their production capacity by adding manpower. The Treasury accepted the voucher at par for fiscal year tax liability as per value is shown on the bill. Thus, the Government set a certain share in the future fiscal budget. It was common, owing to this feature, to exchange or discount tax vouchers for liquidity in the secondary market or banks. The paper shared no attribute of Government bonds or other debt-based Government security and did not constitute Government subsidy.

The study found that the system possessed a risk-sharing feature, the necessary condition for Islamic finance. As detailed in earlier discussions, its method improved liquidity through a fair risk allocation to households, private sectors, banks and financial institutions as per their economic resources and social mandate. It is worth mentioning that the work-creation exchange bills and tax-remission vouchers improved credit expansion, consequently, a smoother capital distribution that diminished the power of big lenders. This development led to economic recovery, funded by its resources. The interest rate mechanism had little bearing on setting or deciding the borrowing cost or the lending price since cost of accessing financing was significantly reduced when private sectors engaged into the work-creation projects. These policy features of directing savings directly to fund infrastructure projects without incurring intergenerational risk and sovereign risk is the foundation of organizing risk sharing.

Risk sharing in Islamic finance requires policy mindset that restores the original function of economy as a shared responsibility. It emplaces money as means of exchange and payment at the first place. This basic principle helped to redirect individual or organizational orientation in pursuing economic objectives, from accumulating money to expanding production and output. Consequently, the government as the risk managers of its people could focus on pooling and sharing the risk of financial transactions and potential loss of the large population and not a shift/transfer of risk to only a certain segment of the population. Programs of public interest are sustained by sharing contribution amongst private-, financial-sectors, and households regardless the upheavals in economics, politics, or natural calamity. The financial system was reoriented toward its core function of mobilizing financial surpluses and intermediate them to entrepreneurship. In Germany, government budget extended aid and financial support to poor households to help them attain an adequate living standard. The Central Bank responsibility was to safeguard a competent risk distribution and provide a transmission channel and to assist the financial sector in expanding in tandem with the real sector. At an individual level, government policy persuaded people to accept the shared risk in return for more stable growth and prosperity.

Some of these policies are appropriate also for implementing risk sharing Islamic finance. In an Islamic finance system, monetary policy resorts to adopting the rate of return to the real sector of the economy to achieve adjustments in the portfolio of the private sector, in the absence of interest rate mechanism. Similarly, fiscal policy will have to rely on non-debt creating flows to supplement its tax revenue, to undertake public investment. The most important lesson from the German experience (1932-1935) with risk sharing is that to institutionalize this concept in the society, governments must incentivize its adoption by economic agents through appropriate monetary and fiscal policies and actions.

5.2. Recommendation

Historical research in this study mainly consisted of economic policies and factors for certain of states of affairs that occasionally led to multiple interpretation and inferences based on the difficulty effort of constructing, at times reconstructing, history and extracting relevant messages to address present queries. This study could not be underrated because history was often repeated and economic policy was based on some interrelated factors, including experience in encountering similar problems at present. Consequently, study findings were a relative contribution to policy formulation.

Nonetheless, the findings of this study suggest that risk sharing based national policy is practicable in a modern and open economy. It directly negates commentator's claim that Islamic finance principles were difficult to fulfill. Prohibiting risk-shifting and transfer and the commandment to implement risk-sharing were viewed as incompatible with today's open and globalized market. They argued Islamic finance could be applied to a close and small society since its practice was associated with trading instruments in the Middle East during the era of the Prophet ﷺ. This argument, however, sounded contradicting to the recent knowledge in finance. However, there was a prohibitive cost for such oxymoron that had to be borne: reputational risk.

Islamic financial institutions face difficulties in propelling innovations because there is an uneven playing field toward the conventional counterpart. The macroeconomic policy of the Third Reich became an example for its applicability in managing the modern and more complex economy. The results of policies adopted and implemented during 1933-1935 can potentially be adjusted and applied to our time to mitigate financially and the sovereign debt crises that have become a fact of life as a consequence of operations of existing risk transfer system.

Authorities should restore the original role of the financial system as an intermediary between this sector and the real sector of the economy. Under risk sharing paradigm, monetary policy decides how wealth is ought to be created, and handle conflicts of interest between financial sectors and real market. Accordingly, the policy should influence portfolio decision of private sectors to take part in organizing public projects. Meanwhile, fiscal instrument can be utilized to induce a wider public participation in financing infrastructure and other developmental projects or to persuade private sectors and households to certain attitude or rule compliance that supports the government's objective of managing financial risks of the budget. As demonstrated in Germany fiscal policy 1933-1935 is that, government should leave complicated tax structure and attempt to redesign its fiscal posture in order to achieve the objective of balanced budget.

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