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Islamic Finance and Beyond

Premises and Promises of Islamic Economics

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Abstract

Some distinctive features of Islamic banking are reaffirmed. A close linkage between the real economy and finance obviously holds in sharing-based financing modes but also in fixed-return modes such as *murābaha̱*. Islamic finance can meet all the transaction needs of the market and do so more efficiently than conventional finance because it focuses on productivity rather than creditworthiness. By aligning entrepreneurs' payment obligations with revenue accrual, Islamic finance reduces instability in financial markets. The paper notes that exchange-rate fluctuations hurt developing countries, hence the need for regulation framed and enforced by an international agency. Although the prohibition of interest can help cure the ills of contemporary finance, much more must be done to create a safer, saner financial world. Islamic economics incorporates altruism along with self-interest: the institution of *waqf* is a witness to the reality of individual behavior with a social purpose. The scope of morally inspired economic behavior, common today as well as in the past, needs to be broadened.

I. Introduction

This paper seeks to concentrate on two issues before concluding with some observations relating to Islamic economics: Firstly, a reaffirmation of some distinctive features of Islamic banking and finance that can contribute to human felicity. And secondly, there are some worrisome aspects of modern finance, especially globalized finance, which call for attention.

II. Distinctive Features of Islamic Finance

Islamic finance ensures a closer linkage between real economy and finance, the former dictating and the latter following. The linkage is obvious in sharing-based modes of investment and financial services. When two parties, the financier and the entrepreneur, agree that an opportunity for creating additional value exists, they come together to realize the gain and share it. Since economic activities are, by definition, value-creating activities, sharing as a basis of finance is inconceivable without economic activity. In the uncertain world in which these activities have to be conducted, they do sometimes fail to create additional value. There is nothing to share. Sometimes part of the existing wealth may be destroyed—the losses borne by capital, the entrepreneurial efforts gone unrewarded.

This linkage between real economic activity directed toward creation of additional wealth and financial transactions continues in case of non-sharing Islamic modes of finance such as *murābaha̱* (cost-plus), *salam* and *istiṉā*[c] (prepaid orders) and *ijāra* (leasing). These deals, which are being used by contemporary Islamic banks to secure predetermined returns on their investments, are possible only when some real economic activity is involved. There have to be some goods and services to be objects of *murābaha̱*, *salam*, *istiṉā*[c], and *ijāra*. The demand and supply of these goods and services whose exchange is "financed" through the above mentioned contracts ensures that financial activity is the servant not the master of real economic activity.

Prohibition of "interest" has closed the door on exchange of more money for less money, even when a period of time intervenes. Stratagems (*Hiyal*) securing the same goal by bringing in a commodity in a nominal way e.g. *ina*, *tawarruq* or *bay*[c] *al-wafa* are rejected as impermissible.

There remains the gray area of exchange between different monies, i.e. selling one currency for another. Islamic economic research in this area has yet to catch up with the times. I do not have any opinions to pronounce save noting that it is a necessary economic activity facilitating exchange of goods and services across borders. Fear of making financial transactions "profitable" without there being any link whatsoever with exchange of real goods

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and services makes many Muslim scholars opt for the strictest interpretation of the relevant rules. But that carries the danger of restricting what may be really necessary. The challenge of finding the golden mean remains.

III. The Viability of Islamic Finance

It has been demonstrated that all market activities can be financed by using the various Islamic modes, such as *mushāraka*, *muḏāraba*, *murābaẖa*, *salam*, *istis̱nāᶜ*, and *ijāra*. No stratagems are needed. Financing consumption needs that fall outside the market (there being no prospective income to pay from out of) requires humanitarian solutions in the voluntary-cooperative sector or under a state sponsored safety net. Financing government deficits has also been shown to be quite feasible.[i] How far it is desirable to run deficits, how long and what for, are however issues far beyond the scope of "finance."

We have been arguing that interest-free Islamic modes of finance can replace the conventional interest based finance with certain added advantages. By synchronizing entrepreneurial payment obligations and accrual of revenues, sharing-based modes of finance remove a major source of instability from freely functioning markets.[ii] Also by linking financial intermediaries' returns to the actual revenue of the fund users, allocation of funds to invest is redirected to projects expected to produce more value than their alternatives.

Even though the predominance of non-sharing modes of finance in the current practice of Islamic banking dilutes these advantages, the Islamic system would score far better than any system that permits exchange of more money for less money. Part of the reason is the vast opportunities of exchange that this permission opens bypassing the real economy which is focussed on exchange of goods and services with one another, money serving as a means of such exchange. Exchange of money for money degenerates into a game of chance in which people indulge to try their luck, little benefit flowing to the production of goods and services which exchange is supposed to promote. Prohibition of interest is directed at restoring money to its essential functions, which certainly do not include a means for gambling.

IV. Beyond an Interest-free Economy

We now turn to the worrisome aspects of contemporary financial markets. As already noted, prohibition of interest would go a long way in improving the situation. You exchange money either for goods and services, or for money or for debt. In the Islamic framework we have no problems with the first, the second, exchange of money for money is severely constrained, and the third is almost eliminated. Islamic law allows cash for debt only at par,[iii] which leaves no room for a "market" in which debt could be sold for cash. It also allows exchange of debt for debt at par and with further restrictions. Again the possibility of a "market" for debt is slender. There would, of course, be a market for common stock, *ijāra* (lease) certificate,[iv] and financial papers based on *salam* or *istis̱nāᶜ*.[v] But, despite their presence, the scope for speculation in an Islamic framework would be far less than witnessed at the present.

The disturbing features of contemporary finance, which would remain unaffected by the prohibition of interest, restrains on the money market and the demise of the market for debt, are the following.

1. The possibility of massive capital movements into and out of a country, which has destabilizing, effects, especially for small economies.
2. Wide exchange rate fluctuation, to the great disadvantage of small developing countries dependent on foreign trade.
3. Social, cultural and political aspects of financial globalization and multinational corporations (MNCs) dominating the market. This is especially worrisome to developing countries in Africa and Asia that do not share the sociocultural background of the regions where the MNCs are based. These countries also lack sophisticated bureaucracies, mature politicians and efficient media, which could be a guard against the possible undesirable role of MNCs.

We now take up these issues one by one. In an Islamic framework the influx of foreign capital in a country would hardly be in the form of loans, as they would earn no returns. Foreign capital would come either in partnership with local capital and/or enterprise, in which case it would commit itself for medium or long run, or as price paid for common stock, in which case it would be short term. It could also come through a *murābaẖa* contract in which case the date for its possible exit with returns is determined from now. Capital invested in financial papers based on *ijāra*, *salam*, or *istis̱nāᶜ* can, however, make an exit at will. In sum, we have two kinds of foreign capital, the long-term partnership and *murābaẖa* based capital which is subject to a predetermined schedule so far as its

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withdrawal is concerned, and the short-term capital invested in the market for common stock and other financial papers. It is the second kind which calls for attention as it can leave the country at will. The usual solution is to impose some kind of discipline so that the destabilizing effects of withdrawals of foreign capital are minimized.

Some kind of regulation is necessary. Several ideas, including those of James Tobin are relevant.[vi] The crucial thing, however, is to shift the focus from ad hoc individual initiatives and policies to some kind of international understanding. There is a need for an international agency, maybe part of the UN system, to be set up to engineer the needed regulation and protect the small and the weak from actions emanating from profit-driven investment decisions (and speculation) oblivious of the social political and ethical dimensions of such decisions. The conscience of the world community must take charge where the market fails to give due weight to mankind's larger interests (i.e. interest other than enrichment of capital owners).

The post World War II fixed exchange rate regime collapsed in 1971 because of the inability of the United States of America to continue honoring its commitment to a certain gold value of the dollar. A return to gold standard now seems neither feasible nor desirable. But the type of exchange rate fluctuations experienced by Southeast Asian economies in 1997-98 is simply a killer. It demonstrated for all not only the dangers of freely floating exchange rates but also much more that needs correction, so succinctly indicated in the following quote from the Human Development Report 1999.

> "When the market goes too far in dominating social and political outcomes, the opportunities and rewards of globalization spread unequally and inequitably—concentrating power and wealth in a select group of people, nations and corporations, marginalizing the others. When the market gets out of hand, the instabilities show up in boom and bust economies as in the financial crisis in East Asia and its worldwide repercussions, cutting global output by an estimated $2 trillion in 1998-2000. When the profit motives of market players get out of hand, they challenge people's ethics—and sacrifice respect for justice and human rights."[vii]

Some degree of exchange rate stability must be ensured if the small and the weak have to coexist on planet earth with the big and the strong—as they must. It is generally recognized that this necessitates some regulation of capital flows, but the timing and modalities of such regulation are not clear. In the absence of an agency especially designed for this purpose, most favor the IMF and the World Bank to take up this role.

If taken up in earnest there is a need to set limits within which only supply and demand are allowed to determine exchange rates. That in its turn calls for manipulating supply or demand, as the case may be, when needed. Only an agency with almost unlimited resources (in respective currencies) can play this role (of the "lender" of last resort). Does this mean the power to create money? Maybe yes.

It can now be seen how difficult it would be for the IMF and the World Bank, under their current constitutions, to take up this task. A new international understanding is necessary.

The clock of globalized finance cannot be turned back. It need not be. It is good even for small developing countries that international financial giants—banks, mutual funds, investment companies—can find it profitable to pour in resources to exploit the vast opportunities for wealth creation these countries in Africa and Asia offer. But there are some problems—psychological, cultural, and political.

Smart briefcase holding (mostly Western) representatives of the MNCs, stepping out of five star hotels remind onlookers of the colonial days. How to change that perception? Employing local boys helps. Broadening the vision of MNCs to include the social dimension in their profit making activities will help more.[viii]

This goes hand in hand with encouraging tourism and helping local entrepreneurs to invest in developing resorts, which could attract foreign tourists and earn hard currencies. Add dish antennae, casinos, and nightclubs, and you have a scenario ripe for breeding misgivings leading to anger among the "natives." They visualize a cultural onslaught and feel being targeted with hegemonic designs of the western culture and fear losing their age-old traditions.

Sovereign states are supposed to take care of themselves. Those who feel the need enter into alliances for defending their boundaries, even enlist foreign cooperation in maintaining internal security. Vulnerability to the manipulations of MNCs and financial giants is however a new kind of danger, which the traditional modes of "defense" fail to handle. Primitive administrative structures, inexperienced political elite, largely illiterate electorate—that is not a position very helpful in dealing with the new danger. Protection is needed which can come only in the form of counseling and, if needed, intervention, by some international agency, preferably working under the UN system.

These observations are offered here with two ends in view.

First, it is to reassure all concerned that the Islamic economists share the anxiety justifiably caused by the current happenings in the financial markets in particular and in the economic aspect of living in general. They too share the search of a better way for managing our affairs.

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Second, it is to shake out of their naivete those sympathizers of Islamic economics who might presume that abolition of interest takes care of all the current problems in finance and economics. There is a need to go beyond that necessary but not sufficient step in an Islamic reconstruction of man's economy.

V. PREMISES AND PROMISES OF ISLAMIC ECONOMICS

More than any thing else, Islamic banking and finance, a sub-culture of Islamic economics, has been a quest for justice and morality into "the ordinary business of life." Justice and morality cannot, however, be all encapsulated into laws and regulations, especially when it comes to protecting the small and weak from the big and strong. Some behavioral changes are called for. Justice and morality have to penetrate the behavior of all economic agents, including the decision-makers at the national and international level, so that all can live together in peace and harmony. Has Islamic economics something to offer in making this possible?

At the heart of the Islamic economic culture lies care for others as a force tempering man's innate selfishness. In sharp contrast to neoclassical economics, which dominated the scene during the twentieth century, Islamic economics brings the social dimension of living into focus, thus downsizing individualism. It also recognizes morality as a potential motor of action and overseer of self-interest. The former, the social dimension, is compulsory; economic analysis can ignore it only to its peril. The latter, ethical action, is a potentiality in the realization of which civilizations have had different records. But no human society has been devoid of the moral dimension. Thus, ignoring it can never be justified.

As regards, Islamic economics the moral dimension is its raison d'être. As the literature shows, the last fifty years have shown several attempts to analyze morally informed human behavior in production, consumption, and exchange.[ix]

Nothing captures the distinguishing features of Islamic economics noted above i.e. a care for others, as does the institution of *waqf* (charitable endowments). Unlike the *Zakat* levy and the prohibition of interest, there is no legal force behind *waqf*. No Muslim is under compulsion to create a *waqf* under any circumstances whatsoever. And yet this institution emerged right during the days of the Prophet (peace be upon him), and continued to grow through out Islamic history. This giving away of private property for social purposes must have had ripple effects on the economies in which it took place, but the phenomenon has yet to attract the attention of analysts other than historians.

The other pillar of capitalism, along with private property, is free enterprise. Here social and moral dimension shows up into priorities in production and consumption and self imposed limits on profit making. The literature of *h̲isba*[x] (accountability) partly captures this, as do the economic writing of Ibn Taymiyyah, al Ghazzali, Muhammad Ibn al Hasan al Shayhani and Abu Yusuf—in the reverse chronological order.[xi] Recent attempts to study Muslim economic agents under influence of Islamic norms and values have been very few,[xii] reflecting the continued domination of neoclassical economics. But we do have enough evidence on the reality of ethical economic behavior[xiii] in the contemporary societies in East and West to justify attempts to broaden its scope and capture new areas. That is the need of the hour.

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[iv] Ahmed, Ausaf and Tariqullah Khan (eds.). Islamic Financial Instruments for Public Sector Resource Mobilization. Islamic Research and Training Institute, Seminar Papers No. 39. Jeddah: Islamic Development Bank, 1997. See chapters 5 to 10.

[v] Ibid., Chapters 6 and 7.

[vi] Tobin, James. "Financial Globalization: Can National Currencies Survive?" in Annual World Bank Conference on Development Economics, 1998. Washington: The World Bank, 1999. pp. 63-75.

[vii] The United Nations Development Program. Human Development Report 1999. New Delhi: Oxford University Press, 1999. p. 2.

[viii] "Multinational corporations influence the lives and welfare of billions of people, yet their accountability is limited to their shareholders, with their influence on national and international policy kept behind the scenes. If they were brought into the structure of global governance their position would become more transparent and their social responsibility subject to greater public accountability." Human Development Report 1999. New Delhi: Oxford University Press, 1999. p. 12.

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