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Knowledge, Economy & Islamic Finance: New Institutional Economics Perspective

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Summary by Enock Woga based on a public lecture by Professor Habib Ahmed

Knowledge based economies are the current topic of the day. This is against the idea that for economies to grow and develop they must generate knowledge and use it at each and every level of the economy. Knowledge is very essential and important for economies. For example the World Bank has come up with the knowledge index and the knowledge economy index recognizing importance of knowledge.

So this paper will discuss the role of knowledge in the economy and provide a theoretical basis of how to include knowledge in the economy using the New Institutional Economics (NIE) perspective. To do that the NIE will be discussed along the status of knowledge in the Muslim world. It is difficult to get information and data on the Muslim world so instead data on the Arab world will be used as it generally represent the Muslim world. After discussing the status of knowledge in the Muslim world the paper will go on to talk about implications for Islamic finance looking at the NIE framework.

In economics knowledge is viewed in different perspectives. There is the traditional neo-classical approach which views knowledge as being incorporated into the economy. For example a neo classical growth theory will look at capital and say that knowledge is embedded in capital. They did not explicitly talk about knowledge although in the 1980's the new growth theory included explicitly in the growth model but talks about it in a very aggregate way with three main factors labor, capital and knowledge. Compared to these theories is the New Institutional Economics (NIE) theory that gives a very comprehensive perspective of how knowledge is an integral part of the economies and how they grow and develop. The NIE looks at structures and evolutions of economies in a multi-disciplinary way and looks at societies at four different levels which are culture, institutions, organizations and Market and transactions.

There are many different definitions of culture. The most comprehensive definition adopted for this discussion is taken from the Arab Human Development Report (AHDR) of 2003 which defines culture as, “All human contributions to ideas, perceptions, customs, socio-political systems and economic constructs.” This definition matches well with the NIE perspective. Culture can be viewed at three different levels that is, the CORE, MIDDLE LAYER and EXPLICIT. The core basically relates to the ontology of philosophy and the middle layer is culture in relation to the norms and values with the explicit level referring to the outward appearances of culture which most people refer to when they talk about culture.

The next level of analysis is a discussion about institutions. NIE defines institutions in a much broader perspective as the political system, the state, the constitution and the justice system. So institutions will include public institutions like the executive, the judiciary and courts, the human and political rights and the rule of law in any society. As for the economy institutions define property rights and rules for their exchange.

The third level is the organizations which are defined as group of people who come together with common purpose of achieving certain goals. Organizations can be for profit like banks, firms and businesses and can also be not for profit like schools and unions. In organizations what is mostly studied is their structure and their governance and when they are discussed in economics it is mostly in relation to efficiency and incentive structure.

The last level is markets and transactions. It is the markets where the allocation and exchange of resources, goods and services takes place. From an economic perspective markets and transactions can be looked at as supply and demand and how they interact, and from a legal perspective as a nexus of contracts. Technology, prices, costs and risks determine what type of products to produce and what type of contracts to use. NIE criticizes neo-classical economics because they just look at one level of analysis, like they will look at supply and demand and stop there. From the NIE perspective this is only one level of analysis and there are other levels/factors which actually affect these transactions and markets. There are two ways in which

economies and structure evolve. One is intrinsic evolution. The key assumption is that the culture basically entails knowledge. So from culture we have the knowledge and this knowledge determines the type of institutions the economy will have. Then the institutions determine the types of organizations to exist in the economy. For example if there is a law for waqf, a waqf organization can be legally created but if there is no law for waqf, waqf organization cannot exist legally.

The key factor here in terms of how economies evolve is the role of knowledge. Production of knowledge determines the institutions and organization a country will have. So culture should represent the norms and values and institutions should reflect this. The speed and direction of change of economies will depend on the rate and kind of knowledge produced. Of course there are other ways change can take place but usually these changes are usually minor or marginal. For example, if there is a demand for some products organizations react by producing these products but this does not change the institutions, the legal system or regulatory system.

In NIE perspective knowledge is embedded in cultures, institutions, organizations and products. New knowledge is reflected in institutions and organizations and this kind of economy will be producing knowledge based products and services. If we have an economy where cultures are slow to produce and use knowledge then basically these are stagnant economies which are mainly commodity based and passive consumers of knowledge products. To see whether economies are dynamic and producing knowledge, look at some of the legal laws of the country and see whether they reflect contemporary times or not.

It can be said that knowledge is an essential part of the NIE theory so a few points about knowledge are worth mentioning. Knowledge is created through a process and there are many ways literature classifies the process. Mostly the process is classified into five, noise, data, information, knowledge then wisdom. From noise data is created and with human effort information can be extracted from the data. But this is not knowledge yet. Information becomes

knowledge when it can be used productively or usefully. Then to use the knowledge in a right way will be called wisdom.

Given this basic structure, the discussion will move on to talk about the status of knowledge in the Muslim world. It is known that Islamic knowledge reached its zenith in the 10th century and remained at high level until the 17th century. A quote from Rosenthal¹ confirms this by saying, “There is no other concept that has been operative as a determinant of Muslim civilization in all its aspects to the same extent as I’lmi’lm is Islam.” This is a reflection of what civilization was and the status of knowledge back then. The fast forward to the present, “The Muslim mind lost its ability to give birth to new ideas, to update its institutions and to produce the planning means and policies to further progress at the civilization level.”(Dr. AbdulHamid)². Literacy rates data bases has confirmed this statement about the present Muslim world. According to a 2013 data base, the literacy rate and female literacy rate of the Muslim world is not only lower than the world average but also lower than the developing countries. It is a depressing picture but that is the reality about the status of knowledge in the Muslim world.

The discussion is now moving on to talk about Islamic finance in relation to all that has been discussed so far. Islamic finance is supposed to be a sector in an Islamic economic system but this has not been the case in reality. Islamic economics was officially launched in 1976 with the main objective of providing a just and humane alternative system to the ideologies of capitalism and socialism. The main conflicts between capitalism and socialism where related to growth and equity. So Islamic economists suggested that, in an Islamic economy there will be balance between growth and equity. Unfortunately there is no country that applies the Islamic economic system but there only exists Islamic banking or financial sub economies existing within economies. These systems exist but there are always questions questioning if the organizations are fulfilling the objectives of Islamic economics. Some customer surveys are even showing the

¹ Franz Rosenthal, who used to teach at the Yale University and passed away recently, This quote is from his book called [*Knowledge Triumphant: The Concept of Knowledge in Medieval Islam, 2007*] which talks about status of Knowledge in Medieval Islam.

² Dr AbdulHamid Abu Sulayman, was the Director of Islamic University in Malaysia and was also with the IIIT in Washington.

importance of balance between growth and equity. So the question of the sector failing to balance between growth and equity or failing to fulfill some the objectives can be answered using the NIE perspective.

What was needed from the NIE perspective was for the economy to create knowledge which could have supported the institutions, organizations and products which did not happen. Innovation in the industry takes place in two ways. It is either by reverse engineering or innovative engineering. Unfortunately the bulk of innovations in Islamic finance have been through reverse engineering. This is done by just getting the conventional products and making them Sharia compliant. In a survey carried out on 20 Islamic banks only 8 had a structured idea generation process without attempts to invest in research and development.

What has happened as a result is that Islamic banks models have evolved. There is the two tier mudaraba which is a theoretically ideal concept but when banks started to operate they found it difficult to use equity based contracts on the asset side. So they moved to the second best model the one tier model. Then they later moved on the third model. In the third model there is a fixed return on both the liability and asset sides. The third model basically replicates the conventional banking model. Given these happenings there have been a lot of discussions at least at the academic circles about this issue. A few lines can be quoted from the academic circles. Saleem³ wrote a book entitled, “Islamic banking –A \$300 billion deception” and Hamoudi⁴ called what Islamic banks are doing as ‘jurisprudential schizophrenia. Muhammad ElGamal⁵ talked about Islamic banking as ‘rent seeking Sharia arbitrageurs using ruses (Hila) to circumvent prohibitions. Some scholars supporting it saying that it is what is in accordance with the market.

³ was an investment banker, actually from US who came to work in the Middle East, worked in an IB and he got frustrated, went back and wrote two short books. One book was called ‘Islamic Banking - A \$300 Billion Deception’. And then wrote another one titled ‘Islamic Banking: Charade’.

⁴ professor in Law in America

⁵ professor at Rice University

A UK based survey which asked respondents if they had doubts about banking products in Islamic finance institutions shows that most Muslims believe that Islamic banking is just change of names. Maybe this is one of the reasons that Islamic banking in UK has been operating for about 9 years making losses. They might have overestimated their client base. In almost a similar survey with business officials as respondents in Pakistan the results were almost the same. The survey carried the question about Islamic banking vs. conventional banking. 44% said they are different, 23% said they are similar and 33% said they do not know. This is Pakistan, a Muslim country and a significant number of people do not know what Islamic banking is. So there must be a reputation and credibility issue.

So the major question is how do we move forward? Looking at the NIE perspective what has happened to the Islamic finance industry is that it has taken a marginal adaptation approach. The first Islamic bank was formed in Dubai with sincere intentions. The problem was that during the time it was formed there were no changes in laws and there was no organizational structure model to use, so they ended up borrowing the conventional model which does not work with social banking because it is debt based. So this example reflects that knowledge was not produced to support the institutions and organizations in terms of laws to support the industry. The industry can have a healthy growth if it adopts a holistic approach in terms of changing institutions and organizations to support the industry.

A successful example in this regard is the case of Malaysia. Mahathir came up with the vision 2020 for Malaysia in 1991 with the main objective for Malaysia to be a developed nation by 2030. They identified 9 possible challenges they had to solve to meet this objective. The strategy reflects on ethical, moral and social issues not just growth. It discussed growth in a balanced way. One of the challenges they identified was establishing a scientific and progressive society. A society which is a contributor to innovative technology not just a consumer of technology and they took proactive steps for that. Another challenge was for Malaysia to become an exporter of education and they are being successful in that. So there have been deliberate efforts to include

knowledge as a basis for development and growth in the economy of Malaysia. The other thing is that Malaysia is institutionally well developed with probably one of the most developed legal and regulatory system for Islamic finance.

To conclude the discussion, NIE shows that there is a strong interplay of knowledge and economic growth. Due to lack of knowledge creation, the Muslim world has been a marginal adapter. The first level of NIE is culture, so is there something wrong in the culture of the Muslims which is the Muslim world to produce knowledge.