

Establishing Economies According to Islamic Worldview: Problems and Way Forward

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Presentation Plan

- Islamic Economics: Ideals and Reality
- New Institutional Economics (NIE)
- NIE and Islamic Economics
 - Culture and Economies
 - Islamic Banking
- The Way Forward

Islamic Economics Initiation

- Islamic economics launched in the 1976
- The value system of Islam would provide a better concept of economic development and a pragmatic approach to achieve it
- Islamic economic system would fulfill the *maqasid al Shari'ah*
- Provide a 'just and humane' alternative to the ideologies of capitalism and socialism

Islamic Economics Ideals

- Micro level—*Homo economicus* vs *Homo islamicus*
 - Balance Between:
 - This World and the Hereafter
 - Material and spiritual
- Macro level—a humane economy promoting growth and justice
 - Balance between:
 - Economic and Social
 - Growth and Equity

Applications of Islamic Economics

- Islamization of economies have not materialized
- Islamic sub-economies in the financial sector
- Though Islamic finance has grown, some have criticized the path it has taken
 - IFIs 'rent-seeking *Shari'a* arbitrageurs' using ruses to circumvent prohibitions (ElGamal)
 - Islamic finance is 'deception' and 'charade' (Saleem)

Critics of Islamic Economics

- Islamic economics does not have a comprehensive framework for modern economy (Kuran 1995)
- There is a ‘disconnection’ between theory and practice in Islamic economics (Khan 1999)
- Islamic economics is “classical or Keynesian economics dressed and made up in Islamic terminology” (Al-Attas 1995)

Evaluation of Islamic Economics

- Too much focus and reliance on jurisprudence and little weight given to the scientific aspects of the discipline (Siddiqi 2004)
- Mainly occupied with comparing the Islamic economic system with the capitalist and socialist systems (Zarqa 2005)
- Contributions focus on *fiqh*, historical economic practices and economic principles of Islam, not on Islamic economics (Kahf 2005)

Institutions to Achieve the Goals

- *Homo islamicus* or Islamic economy cannot exist in vacuum
- Islam introduced many *institutions* to achieve the *maqasid*
- Legal/regulatory institutions
(Examples: rule of law, justice, *hisba*, etc.)
- Social Institutions
(Examples: *zakah*, *waqf*, *masjid*, etc.)

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New Institutional Economics

- **New Institutional Economics (NIE)—takes a broad/comprehensive view of economies**
- **Studies the structure and evolution of economies**
- **Uses four levels of analysis**
 - **Culture**
 - **Institutions**
 - **Organizations**
 - **Markets/transactions**

Culture

- ‘Patterns of thinking, feeling and acting—software of the mind’ (Hofstede & Hofstede)
- ‘...beliefs, preferences, and behavior of members of a community along with the mechanisms that link these traits to one another’ (Kuran)
- ‘...the means by which people communicate, perpetuate, and develop knowledge about attitude towards life’ (Geertz)
- ‘All human contributions to ideas, perceptions, customs, socio-political systems, and economic constructs’ (Arab HDR 2003)

Institutions

- The nature of polity, state, constitution, laws, justice system, etc.
- Would include public institutions like the executive, judiciary, legislation, courts, and bureaucracy
- Defines the property, human, and political rights

Organizations

- Groups of individuals with common purpose of achieving certain goals (firms, nonprofits, unions, schools, etc.)
- Structure and governance issues
- Efficiency and incentive structures
 - Minimization of transactions costs

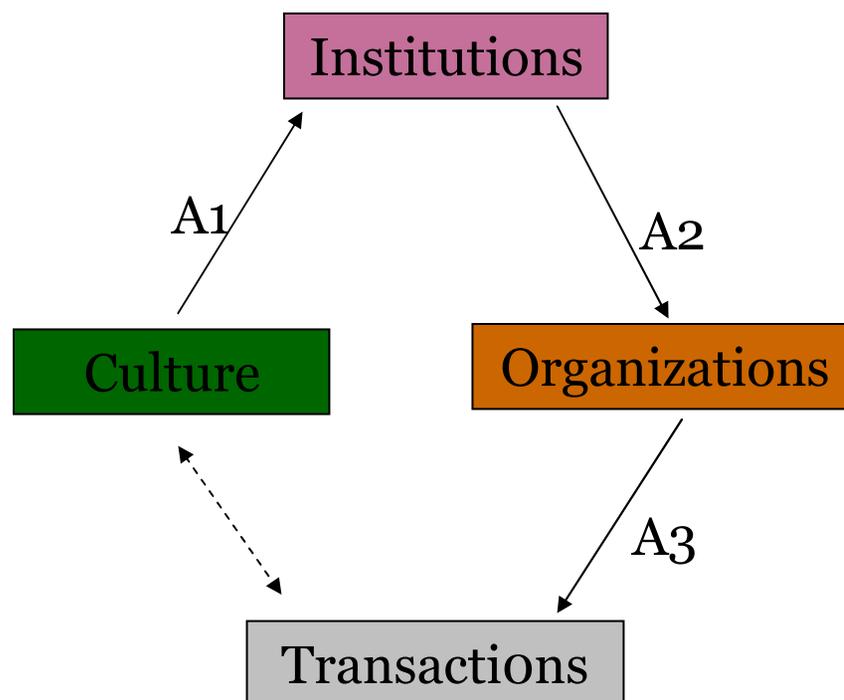
Markets/Transactions

- Allocation and exchange of resources, goods and services takes place
- ‘Nexus of contracts’
- Technology, costs and risks determine the type of markets and contracts used

NIE—Dynamics of Economic Structures

■ Intrinsic Evolution

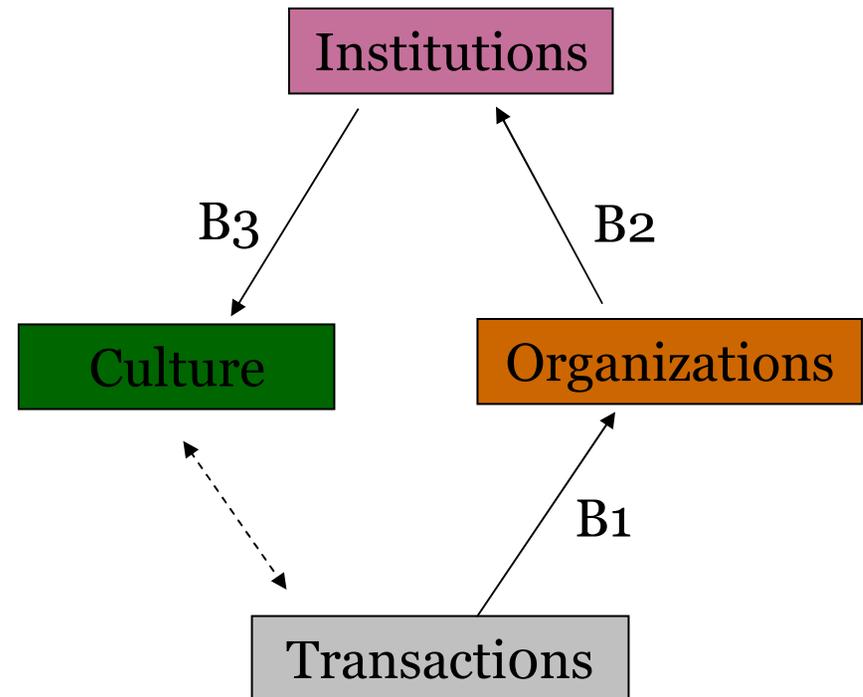
- Starts at culture (A1, A2, A3)
- Stock and production of knowledge determines institutions/organizations
- Speed and direction of change depends on rate and kind of learning, respectively



NIE—Dynamics of Economic Structures

■ Marginal Adaptation

- Starts at the transactions level (B1, B2, B3)
- Change in preferences/technology—niche market
- Organizations/institutions change to meet demand



Islamic Economics and NIE

- Most of the discussions in Islamic Economics has been on the market/transactions
- Not much has been discussed on the other aspects of NIE
 - Culture
 - Institutions
 - Organizations

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Culture and Economies

- **Intrinsic evolution**
 - Culture of learning/innovation
 - New knowledge reflected in institutions and organizations
- **Marginal adaptation**
 - Cultures slow to produce/absorb knowledge
 - Stagnant institutions and organizations

Knowledge in Muslim World- Past

Islamic knowledge creation reached zenith in the 10th century and remained at a high level until the 17th century

‘There is no other concept that has been operative as a determinant of Muslim civilization in all its aspects to the same extent as *‘ilm...’Ilm is Islam,...*’
(Rosenthal 2007)

Knowledge in Muslim World-Present

Starting 17th century—knowledge creation in the Muslim world stagnated

The Muslim mind lost its ‘ability to give birth to new ideas, to update its institutions, and to produce the planning, means, and policies essential to further progress at the civilizational level’ (AbuSulayman 1993)

Stagnant Knowledge & Islamic Economics

- As a result of stagnant knowledge the institutions and organizations based on Islamic values and principles could not develop
- In the absence of appropriate institutions and organizations, *homo islamicus* and Islamic economy cannot exist
- What are the cultural constraints inhibiting the production/utilisation of knowledge?

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Ideal Islamic Banking Model

- Two-tier *mudarabah* model

Profit-loss sharing modes of financing on both the asset and liability side

Assets	Liabilities and Equity
<ul style="list-style-type: none">■ <i>Mudarabah/musharakah</i> financing	<ul style="list-style-type: none">■ Profit-sharing investment accounts (PSIA-<i>Mudarabah</i> based)■ Demand Deposits (<i>qard hasan</i>)■ Capital

Features of Ideal IB Model

- PLS (risk-sharing) assets would imply robust investments leading to economic growth
 - Choosing projects that make good economic sense
 - Monitoring of the investments closely
 - Equity financing usually long-term—lead to growth
- Sharing risks of assets by the liability side makes the bank more stable
 - Losses covered by PSIA and capital

Islamic Banking in Practice

- Some Islamic banks started with PLS financing modes
- Risks of equity-financing different from that of debt-financing
- Banks lost money
- Resorted to modes that had lower risks
- Started using fixed-income debt instruments
 - *Murabahah*
 - *Ijarah*

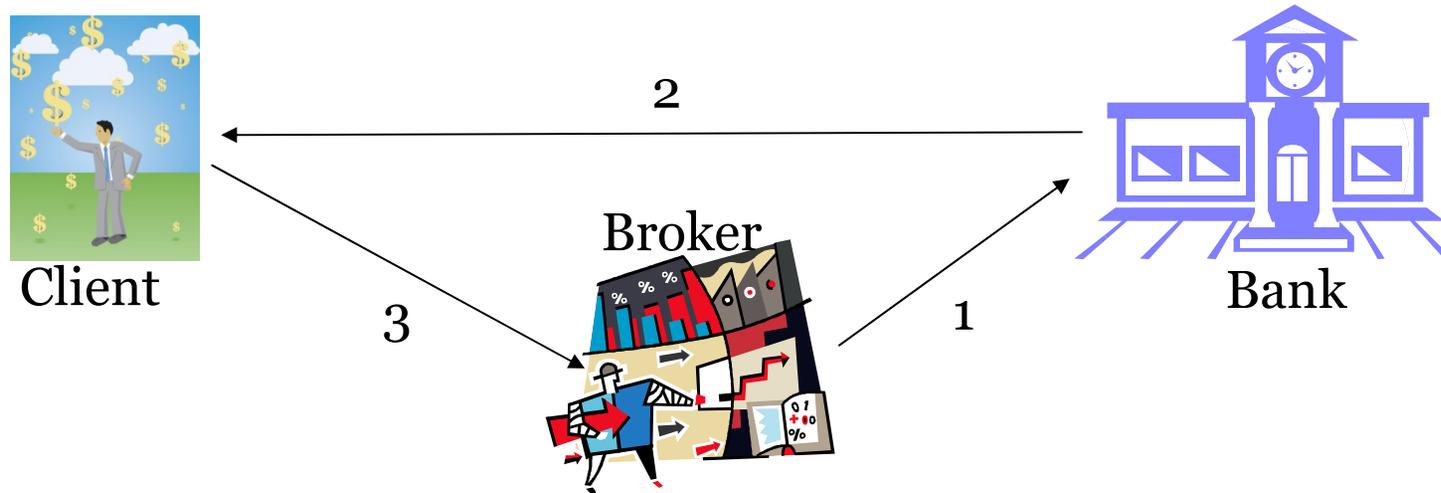
Islamic Banking Practice: 2nd Best Model

One-tier *Mudarabah* with Multiple Investment Tools

- Liability Side—PSIA (*Mudarabah* based)
- Asset Side—multiple investment tools, dominated by fixed-income contracts (*murabahah, ijarah, istisna, etc.*)

Assets	Liabilities and Equity
<ul style="list-style-type: none"> ■ <i>Murabahah</i> ■ <i>Ijarah</i> ■ <i>Istisna</i> ■ <i>Mudarabah/Musharakah, etc.</i> 	<ul style="list-style-type: none"> ■ <i>PSIA-Mudarabah</i> based ■ Demand Deposits (<i>Qard hasan</i>) ■ Capital ■ Reserves

Organized *Tawarruq*



The client wants a personal loan and approaches the bank

1. Bank buys commodity from a broker paying spot (for £100)
2. Bank sells the commodity to client payable at a future date (for £110)
3. The client sells commodity to broker spot (for £100)

[The client appoints the bank as agent to sell the commodity. The bank sells the commodity spot to the broker for £100 on behalf of the client and deposits the money in his account.]

At the end of the transaction, the client walks away with £100 and owes the bank £110 payable in the future

[*Bai al'Inah*: No third party involved—bank and client do the selling and buy-back]

Implications of *Tawarruq*

- *Tawarruq* and Gresham's Law (bad money drives away good money)
- *Tawarruq* is driving all other modes away
- *Tawarruq* replicates a loan transaction
- The result—third best model of Islamic banking

Islamic Banking Practice: 3rd Best Model

Fixed Liability with Multiple Investment Tools

- Liability Side—Fixed-income investment accounts (using *tawarruq*)
- Asset Side has multiple investment tools, dominated by fixed-income contracts (*tawarruq*, *murabahah*, *ijarah*, *istisna*, etc.)

Assets	Liabilities and Equity
<ul style="list-style-type: none"> ■ <i>Tawarruq</i> ■ <i>Murabahah</i> ■ <i>Ijarah</i> ■ <i>Istisna</i> ■ <i>Mudarabah/Musharakah, etc.</i> 	<ul style="list-style-type: none"> ■ Fixed income investment accounts (<i>tawarruq</i>) ■ Demand Deposits (<i>Qard hasan</i>) ■ Capital ■ Reserves

Other Features of 3rd Best Model

- Assets side
 - Initially different modes used for different purposes
 - Durables—*murabahah, ijarah*
 - Agriculture—*salam*
 - Real estate construction—*istisna*
 - *Tawarruq* can replace all of the above (similar to a loan)
- Liability side
 - Fixed-income investment accounts replaced PSIA
- No link between return on assets and liabilities
 - Stability argument weakened

Islamic Modes of Financing

Modes	UAE	Malaysia	Jordan	Saudi Arabia
<i>Murabahah</i>	49.29	41.04	15.41	15.81
<i>Musharakah</i>	2.59	0.24	2.99	0.65
<i>Mudarabah</i>	4.36	0.27	11.36	0.05
<i>Ijarah</i>	18.90	9.40	13.80	0.04
<i>Istisna</i>	3.22	1.72	1.20	3.74
<i>Salam</i>	-	-	-	-
Others (RE, bai-muajjal, Invest., etc.)	21.65	47.33	55.25	79.71

Source: 2007 Islamic Finance Directory, Gen. Council for Islamic Banks & Fin. Institutions

NIE and Islamic Banking

- Development of Islamic banking took the marginal adaptation approach
- Islamic banking had to adjust to the existing institutional framework and organizational formats
- For ideal Islamic banking to exist, need to create institutions and organizations that reflect Islamic values and principles

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Stagnant Knowledge & Islamic Economics

- The NIE perspective
 - Culture determines the stock and growth of knowledge
 - Production of knowledge needed to build institutions and organizations that reflect cultural values
- In the absence of appropriate formal and informal rules and organizations, *homo islamicus* and Islamic economy cannot exist

Islamization of Economies

- The focus of Islamic economics has been narrow—markets and transactions only
- To build an Islamic economic system—need to produce Islamic knowledge on which institutions and organizations can be built
- The current culture adopted by Muslims appears not to be generating the Islamic knowledge needed

Islamic Economics: The Way Forward

- Short-run—create knowledge in all areas of social sciences, not only economics
(e.g., theory of state, social theory, political theory, theories of organizations, etc.)
- Long-run—change culture that seeks and creates knowledge based on Islamic values and principles
 - Culture takes a very long time to change!

THANK YOU!