1
Introduction

1.1 ECONOMIC SCENARIO IN THE NEOCLASSICAL FRAMEWORK

Since the failure of the centralized economic system of the East in the 1980s, the efforts of economists, experts, policymakers and governments around the world have been focused on strengthening market forces to achieve optimal economic growth and sustainable development at national and global levels. However, despite some trivial development, market forces have failed to achieve balanced and equitable growth, not only at individual countries' level but also regionally among both developed and developing countries.

While the capitalist system, canonized at Bretton Woods in 1944, allowed a free hand to the capitalist countries and within them the firms and individuals to maximize their profits with minimal consideration of the human aspects, norms and ethics, the post-Bretton Woods system, based on excessive creation of monies, particularly the US Dollar, resulted in "oceans" of poverty around the world.[1]

Communism was the opposite of capitalism as far as the capitalization of resources was concerned, while ownership was hypothetical and control was centralized. Due to this extremist unbalanced behaviour, it had to go after completing its short cycle of less than a century.

Capitalism does not monopolize all resources directly but through several diversified media with different levels and distribution controls, like a master–slave set-up. Due to strong political and institutional support at international level, effectively giving veto to big powers over the activities of the IMF and the World Bank, neocapitalism has taken a longer time cycle, but as all limits have been crossed, it could at any time lead to collapse, inflicting heavy losses on the global economy.

"Greed" – the unbridled pursuit of wealth – has become the most popular slogan of individuals and particularly of the corporate world, leaving the masses to misfortune. Money created out of nothing has strengthened the exploitation mechanism and widened the gap between the haves and the have-nots. The resultant economic scenario has led to the following concerns for mankind:

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[1] The gold standard remained in practice in some shape up to 1944, when the Bretton Woods agreement was signed by the then 35 sovereigns, linking all currencies with the US Dollar in a fixed ratio and declaring them redeemable at one ounce of fine gold for 35 dollars. But in 1971 even the gold–currency link was abolished. Gold, instead of being a unit of account for determining the prices of all other currencies, became a normal commodity whose worth was expressed in terms of units of account or paper currency. All currencies depreciated, followed by the Dollar's depreciation. But the Dollar, being a reserve currency, was used as a blatant tool for exploitation of the whole world with the support of the main international financial institutions. See Perkins, 2004, pp. 212–213.

- human behaviour guided only by self-interest – no concern for behavioural aspects;
- no discipline in the creation of high-powered money, leading to unjust and exploitative payment systems and illegitimate control over the resources of weaker individuals and nations;
- contradictory policies – leaving the crucial functions of providing health, education and the basic needs of the masses to a market characterized by forces like "self interest", liberalization and deregulation, under the banner of alleviating poverty and increasing literacy levels, etc. is clearly contradictory;
- no or dubious concern for human dignity and rights;
- no care for the weak and the oppressed classes;
- no concern for justice, fair play and equity;
- the influential and the elite exploiting the weak – leading to a phenomenal concentration of wealth together with large-scale hunger and poverty;
- unhindered unethical practices like deceitful advertisements to allure consumers, leading to hefty salary packages for the marketing "experts" and leaving the real contributors to national and global production and the consumers at the mercy of market forces.

The following remarks of Keynes about harmony between private and social interests aptly sum up the actual situation in the world and lend support to the above view:

> "The world is not so governed from above that private and social interests always coincide. It is not so managed here below that in practice they coincide. It is not a correct deduction from the principles of economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally is enlightened; more often individuals acting separately to promote their own ends are too ignorant or too weak to attain even these." [2]

1.2 CONVENTIONAL DEBT: A RECIPE FOR EXPLOITATION

The grim situation briefly portrayed above is not limited to the poor or the least developed countries in Africa, Asia and other areas of the planet. Inequity has become the hallmark and the most serious problem facing mankind in all societies. Masses of people in almost all emerging/developing, Islamic and non-Islamic, and even developed and industrialized economies are facing the same fate. The interest-based financial system is a major hurdle in achieving distributive justice. It is creating unrepayable debt – making a class of people richer and leaving others poorer and oppressed.

Excessive debt and its servicing are the striking features of the interest-based mechanism: yesterday's debt can be repaid by taking out more debt today. It is not only stifling economic growth but also crippling the efforts made by the World Bank, IMF and other donors to reduce poverty in poor countries. It also distorts the payments systems, on account of which the concern for just and fair incomes and earnings is being accorded the least consideration. No one cares who is going to pay the debt: which future generations and from where? This kind of behaviour – avoiding the payment of currently owed debt – is not acceptable under any divine religion. In Islamic Sharī´ah, debt liability is subject to strict accountability on the Day of Judgement.

The economic problems of underdeveloped countries (UDCs) have emanated largely from their excessive debt accumulation. The cost incurred in the form of interest has to be paid by

[2] Keynes, 1926. Also see Chapra, 1992, pp. 53–54.

successive governments through increasing rates, taxes and charges on consumption goods and utilities. For servicing the debts, governments raise taxes without providing any socio-economic amenities or quid pro quo. Their foreign exchange earnings, including export proceeds and remittances of expatriates, are also consumed by debt servicing.

This has led to an ever-increasing share of risk-free capital, vis-à-vis risk-based capital and business, resulting in business failures, unemployment and, ultimately, gross inequalities of income and wealth. It has exerted disastrous effects by reinforcing the tendency towards wealth accumulation in fewer hands together with large-scale hunger and poverty. The unproductive and wasteful spending both by individuals and governments, which the interest-based mechanism and easily available credit have the tendency to promote, has led to a decline in savings, real investments and employment opportunities. The system, combined with inflation, becomes a recipe for economic instability and chaos. This affects the poor and the middle class, who together comprise the major part of the population, and thereby the level of national savings, leading the economies into a vicious circle of poverty and gross injustice.

So-called debt relief packages have failed to resolve the real issue of poverty alleviation. In the recent past, debt relief has been provided to 27 countries, most of which are from Sub-Saharan Africa. According to a World Bank report, the debt stock of these countries has been reduced by two-thirds.[3] Due to such efforts, the external debt burden of developing countries as a group has decreased to some extent (from 45 % of GNI in 1999 to about 40 % in 2003) but that has not been universal and there are many countries that have not been provided any relief. In addition, the aggregate declines in external indebtedness of developing countries have been offset by rises in domestic debts, exposing them to enhanced risks with regard to the scale of the overall debt burden arising from higher interest rates on domestic borrowing in almost all developing countries. Further, trade barriers imposed by developed countries on the products of poor and developing countries have not been lifted, which smacks of an exploitative approach on the part of the rich nations.

Leaving aside the poor and developing countries, even the developed countries have become accustomed to the bane of debt. On account of the continued and repeated current account deficits of the United States, it has been transformed from a significant international investor in the 1970s to the world's largest debtor country. As of today, only US nationals are apparently immune from the devastation of debt and that is by dint of the US Dollar being the major reserve currency, despite the fact that it has become a zero-saving nation with unparalleled individual, institutional and national debt. In 2004, while the US deficit was $668 billion, or 5.7 % of GDP, its net external liabilities were estimated at over $2.7 trillion (23 % of US GDP, or 7.5 % of world GDP). In 2005 it jumped to $805 billion and is likely to hit 12 % of GDP by the end of the decade.[4] American national debt has passed $9 trillion. The late eminent columnist Art Buchwald termed it "The $9-trillion heist". [5]

The real story of modern empire, writes John Perkins, is that it "exploits desperate people and is executing history's most brutal, selfish and ultimately self-destructive resource-grab."

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[3] World Bank, 2005, p. 25.

[4] *The Economist*, 18th March, 2006.

[5] *Daily Dawn*, Karachi, 20th April, 2006. In a survey of the world economy, *The Economist* (London) asks, "Why did American investments abroad perform so much better than foreign investments in America? The main reason is the Dollar. It is the world's reserve currency, and America – unlike many other debtors – can issue bonds in its own currency. Virtually all America's foreign liabilities are denominated in dollars, whereas around 70 % of its foreign assets are in foreign currencies." (24–30th September, 2005).

The empire that spends trillions of dollars created out of thin air on wars and for bribing the corrupt has not been able to spend the mere 40 billion dollars that, as per United Nations estimates, would be sufficient to provide clean water, adequate diets, sanitation services and basic education to every person on the planet.[6] "Part of America's current prosperity is based not on genuine gains in income, nor on high productivity growth, but on the borrowing from the future", states *The Economist* under the caption of "Danger time for America" in its issue of 14th February, 2006.

The system has generated inequality at alarming levels, even in developed countries like the US and Britain. As a national objective, therefore, GDP growth no longer makes such obvious sense.[7] In the US, inequality has increased since 1973, as demonstrated by the Gini coefficient – a measure of inequality of income distribution in an economy. It increased from 0.394 in 1970 to 0.408 in 1990 and to 0.462 in 2000. The current value of the Gini coefficient in the US resembles its value in developing countries. The same is the case in Britain. Emerging economies like China are also facing the same problem of inequity and a widening gap between the haves and the have-nots, despite the highly impressive performance of macroeconomic indicators.

Financing of the huge deficit with the fragile global politics could seriously destabilize the international markets and economies. Up until now the system has worked because the US has the right to print dollars. As long as the world accepts the Dollar as the standard currency, excessive debt does not pose a serious problem. However, if another currency comes along or any of the US creditors like Japan or China decide to call in their debts, the situation may become out of control.[8]

Since the collapse of the Bretton Woods system in 1971, the central focus of the IMF policies has been to safeguard the US interests, whatever her policies,[9] which has created so much vulnerability that now its critics are not only the protesters against globalization in various parts of the world, but also senior officials of the IMF in Washington. In the wake of US financial imbalances that placed the global economy at risk, the IMF criticized US economic policies during their spring meetings in 2006, but the US response was to tell the Fund to mind its own business.[10]

1.3 GROWTH *PER SE* MAY NOT LEAD TO SOCIO-ECONOMIC JUSTICE

For about half a century, the major objective of economic policy has been to promote growth in the overall pursuit of development and happiness of the population. However, it has been observed that because of rising inequality, growth alone is not a reliable indicator of socio-economic development. Despite growth in many parts of the world, a large number

[6] Perkins, 2004 pp. xii, 216.

[7] Ahmad, 2005. Also see *Daily Dawn*, 14th April, 2006; *The Economist*, Special report on inequality in America, 17–23rd June, 2006, pp. 25–27 and on Japan, pp. 31, 32.

[8] Perkins, 2004, pp. 212, 213.

[9] A hazardous policy decided jointly by the US Treasury, IMF and the World Bank in the early 1990s and implemented by the latter two for the benefit of the former, commonly known as the "Washington Consensus", aimed at trade and capital market liberalization. The countries that followed had to suffer. China and India did not follow and devised their own policies; both of them are now the fastest growing economies in the world. Malaysia was also able to control the crisis of the late 1990s as it adopted its own policies without taking advice from the IMF and the World Bank.

[10] See *The Economist*, 22–28th April, 2006, pp. 12, 14, 69, 70.

of people are unemployed, half-fed and ill-treated as a result of unhindered market forces. Steady-state growth models and "trickle-down" theory have demonstrated conclusively that they enhance inequalities of asset distribution by enabling the powerful and better-endowed groups to grow at an even faster rate than which they were growing before, leaving the masses in deeper misery.[11]

John Perkins, in the preface to his book, *Confessions of an Economic Hitman*, while analysing the dangerous world situation, writes: "The idea that all economic growth benefits humankind and that the greater the growth, the more widespread the benefits, . . . is of course erroneous . . . It benefits only a small portion of the population . . . may result in increasingly desperate circumstances for the majority . . . When men and women are rewarded for greed, greed becomes a corrupting motivator." He also points to the problems arising from fallacious concepts about economic development.[12]

A number of emerging economies are showing impressive growth rates. But economic growth under neoliberalism is not serving the welfare function; rather it is enhancing poverty because the benefits do not trickle down by themselves, due to distortions created by vested interests in a free market functioning without proper surveillance, disclosure and transparency that, in truth, reinforces skewed income distribution patterns. China, one of the fastest growing economies with a growth rate in double digits, is facing the same problem. The lot of the country's poor, particularly in rural areas, has got worse, as the previous communist system guaranteed certain basic needs including food, health care and primary education. The support systems have collapsed due to the shift to a market-based economic system.[13]

In cases where the wealth and assets are concentrated in big business and industrial segments in urban areas and the countryside is feudalistic, even the impressively high growth rate of the economy and sectors like industry and agriculture will not lead to better income distribution and poverty alleviation. As such, experience has proved that poverty does not reduce even by governments spending on health, education or infrastructure, because the basic tools of exploitation continue to work and such spending is not directed to the fulfilment of the basic needs of the masses. The resultant large-scale poverty is a hurdle to industrial investment and growth, as it lessens the consumers' demand for manufactured goods due to high inequitous income distribution. There must, therefore, be a revolutionary redistribution of assets and income prior to stabilization if the growth is desired to reduce asset distributional inequalities.

The deepening imbalances in external payments in developing and emerging economies and financing needs associated with those imbalances have created serious concerns in global policy circles and the capital markets. This may affect the external finance and commodities in which emerging market economies operate.[14] Any abrupt and disorderly adjustment of the exchange rate of major currencies or rises in interest rates may disturb all major economic indicators in these economies. This would have serious consequences for developing countries.

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[11] For details on poverty in the world's richest countries see Chapra, 1992, pp. 127–129.

[12] Perkins, 2004 pp. xii, 216, 222.

[13] *The Economist*, 11th March, 2006.

[14] Among the emerging market economies are: China, Hong Kong, India, Pakistan, Malaysia, Indonesia, South Korea, the Philippines, Thailand (in Asia), Egypt, Saudi Arabia, Israel (in the Middle East), Argentina, Brazil, Chile, Mexico, Peru, Venezuela (Latin America), South Africa and Bulgaria, Czech Republic, Estonia, Hungary, Poland, Russian Federation and Slovakia (Eastern Europe).

While it is a fact that there is no short cut method of relieving poor individuals and nations of past debt, policymakers will have to make concrete efforts to change the basis and the procedure of fund mobilization, both from internal and external sources. The solution lies in replacing risk-free with risk-related capital and making efforts to ensure inflow of foreign resources in the form of direct and portfolio investments. Borrowed funds are mainly squandered and it is imperative to replace them with asset and risk-based investments through fully thought-out and long-term proactive policies.

1.4 SOCIAL WELFARE ACTIVITIES OF THE STATES

Almost all present governments spend huge amounts of money on social security nets, but that expense does not tend to mitigate the ill effects of the injustice inflicted by the tools of conventional economics and finance and the resultant inequitous distribution of income and resources by unhindered market forces. Imbalances created by the system as a whole cannot be corrected only by a government's selective spending; it rather leads to moral hazard in a number of socio-economic directions. Compared with the problems created by the system, such social welfare activities cannot cater to the needs of the millions of poor or the vulnerable groups in any society.[15] In addition to strengthening, restructuring and expanding the social safety nets to provide support to the deserving segments of society, there must be a big change in the system at a broader level so that weaker groups can get their due share at the stage of production and distribution of wealth and assets among various factors of production.

That is why, despite heavy spending by governments and high levels of technological and industrial development, even the countries with massive resources have been unable to realize their normative goals, due mainly to the fact that there is a conflict between the operative tools of conventional economics and their normative goals. The interest-based system of creation and allocation of funds and market-based monetary policy have been viciously anti-poor and an important cause of unemployment and asset and income distributional injustice at national and global levels. Governments and central banks are becoming more and more passive to the fate of the masses in all economies, facilitating profit maximization by the corporate sector and those who are already rich.

1.5 THE MAIN CULPRIT

Obviously, there has been a long list of factors responsible for the failure of the global economic system in amicably solving the economic problems of mankind and ensuring justice, equity and fair play. However, the main two factors are the inefficient modus operandi of economic management with practically no concern over poverty or exploitation of the weak, and the functioning of money, finance and the financial markets that play the most strategic role in creating, distributing and transferring resources and wealth at national and global levels. Governments, in a bid to allow free interaction of market forces, have not been properly fulfilling their overseeing function with the objective of protecting the main

[15] Charity, on whatever scale, cannot solve the problem. This is why "Billanthropy" by the biggest charitable foundations (see report by *The Economist*, 1st July, 2006, pp. 69–71) has not been able to make a dent on poverty.

stakeholders and vulnerable segments of society. As a result, vested interests have been creating distortions in the markets to artificially control and determine the supply of goods and transfer of resources to the privileged classes.

As the major tool in the hands of governments is money, one factor that has to be taken care of to realize the overall objective of equitable and sustainable economic growth for welfare of mankind is the area of money and finance. The institution of interest, on the basis of which governments and the public and private sector corporations borrow funds, creates parasites in society and thereby the gap between the rich and the poor keeps on widening. According to the late Yusuf Ali (the eminent translator of the Holy Qur'ān into English): "Whereas legitimate trade or industry increases the prosperity and stability of men and nations, dependence over usury would merely encourage a race of idlers, cruel bloodsuckers and worthless fellows who do not know their own good and therefore are akin to madmen" (translation of verse 2: 275). It is a ground reality that the interest-based system, irrespective of the rate, is creating "idlers" and "cruel bloodsuckers".

The prohibition of interest in all revealed religions that we shall discuss in the following chapters essentially implies that there can be no gain without risk-sharing, which implies that if someone wishes to get a return, he must also be liable for the loss, if any. "No risk, no gain" is actually the basic juristic principle of Sharīʹah and a normative rule of justice. The liability to bear a possible loss can motivate investors to be more careful in making their investments. This can help remove the moral hazard that is associated with risk-free gains on financial investments and, thereby, inject greater discipline into the financial system.

1.6 THE NEED OF THE HOUR

There are many opinions about the ultimate cause of the crisis. However, sensible people have long been calling for comprehensive reform of the financial system to help prevent chaos and spread of financial crisis, or at least minimize their frequency and severity. A vast majority of Muslim jurists and scholars believe that the ultimate cause lies in disregarding the prohibition of interest, which is an important teaching of all major religions.

The state of affairs in the global economy and glaring inequalities both at inter and intra national levels necessitate the evolution of a system that could lead to a balanced, sustainable and equitable economic order in the world at large. This requires economists and policymakers to develop an economic system based on the ideals of socio-economic justice and fair play. By fulfilling this mission they would be giving to humanity the message of peace, happiness, welfare and prosperity.

In particular, the economists who have been working on Islamic economics for the last few decades and trying to conceive a model that could lead to balanced and equitable growth that benefits individuals as well as societies must undertake the job with dedication and fervour. While doing this, one thing that they should take seriously is that justice/fair play is the *raison d'etre* of any economic system that is to be sustainable in the long run, and in the Islamic worldview, it cannot be given up for any other consideration whatsoever.

The major element creating injustice is "interest". Replacing this with a risk-related capital and investment mechanism could help solve many socio-economic ills. There are a number of other benefits that can be derived from the prohibition of interest. Among these are the injection of a moral dimension into the financial system along with greater equity and market discipline to make the financial system more equitable, healthier and stable.[16]

1.7 ECONOMICS AND RELIGION

Economists have been debating the impact of religion on economic performance for many years. This aspect will be discussed in detail in the next chapter. Here, a brief introduction will suffice.

Whether economics should be mixed with religion is a significant question these days. More specifically, can Islam be helpful in economic development or it is a drag on economic growth? Any detail on this aspect is not within the remit of this book, which has to focus on finance, the most strategic part of any economic system. A large number of scholars have blamed the relative poverty of Muslims today on their religious beliefs. But Marcus Noland, an eminent economist, maintains that this long-standing view is wrong: "There is nothing inherent about these [Islamic] societies that they have to perform poorly," says the economist with the Institute for International Economics in Washington, "If anything, Islam promotes growth . . . ".[17]

While discussing the role of religion in economics one must distinguish economics as a science from an economic system. An economic system has to be discussed as a thought based upon any ideology, while economic science should be considered as a science which deals with the creation of wealth. An economic system relates to management of wealth distribution in a society that tends to solve economic problems of various groups by enabling or restricting them from utilizing the means of production and satisfaction. Thus, the system comprises the following three main elements:

1. Ownership of property, commodities and wealth.
2. Disposal of ownership.
3. Distribution of wealth among the people.

Commodities are possessed for their benefits, which represent the suitability of a commodity to satisfy any human need. Goods/assets are possessed as a result of work, inheritance, purchasing/obtaining property for sustenance, governments granting possession of something to the citizens and transfer payments or goods granted as gifts (without giving anything in exchange). From this perspective, the Islamic economic system is different from the other systems only to the extent of ownership and distribution of resources among the factors of production and various groups of society, with a defined role of the State to ensure that injustice is not done to any of the individuals, parties or groups.[18]

Islamic economics, in fact, can promote a balance between the social and economic aspects of human society, the self and social interests and between the individual, family, society and the State. It can effectively address issues like income distribution and poverty

[16] For a discussion of the socio-economic benefits of an interest-free system of financial intermediation, see Chapra, 2000a. See also Siddiqi, 1983; Mills and Presley, 1999, pp. 58–72 and 114–120.

[17] http://www.csmonitor.com/cgi-bin/encryptmail.pl?

[18] The term "commodity" includes everything possessed for utilization through buying, leasing or borrowing, whether by consumption, such as an apple, or by usage, such as a car; or through utilizing it like borrowing machinery or leasing a house. Property (Māl) is anything that can be possessed and includes money, such as gold and silver, commodities, such as clothes and foodstuffs, immovable properties, such as houses and factories, and all other things which are possessed. Human effort is a means to obtain the property or its benefit. Therefore, wealth is the property (Māl) and the effort together (Nabhani, 1997, p. 47).

alleviation, which capitalism has not been able to address. At the global level, it may be helpful in eliminating the sources of instability, thus making the world a happier place with harmony among followers of various religions.

In the contemporary world, we have macro-level evidence of distributive justice and development. The trickle-down theory (TDT) adopted in Malaysia during 1957–1970 failed miserably and resulted in the tragedy of 13th May (1969) race riots in the country. Then the Malaysian government adopted a policy which applied the core value of Islam, i.e. justice with fairness, that has contributed significantly to the country's miraculous achievement in the last three decades. Although the government could not fully apply the Sharī´ah principles, it adopted a pragmatic policy (New Economic Policy) that had the twin objectives of eradicating poverty and restructuring society to ensure justice with fairness. This policy of higher growth with distributive justice emerged as a direct response to the failure of the growth alone development policy (TDT) pursued during the 1960s. Success at the macro-level did act as a contributory factor to compensate the failure of some institutions and values at the micro-level.

Based on the principles laid down in the Holy Qur'ān and the Sunnah of the Prophet, Muhammad (pbuh), the Islamic system played a strategic role in the development of human society from the second half of the seventh to the tenth century AD. The early Muslims excelled in all the fields of knowledge of their times, besides understanding and practising the tenets of Islam.

The period from the Pious Caliphate after the demise of the holy Prophet (pbuh) up to the 11th century AD represented the zenith of Muslim glory. Muslims were able to develop and extract wealth from their lands and through their world trade, strengthen their defence, protect their people and guide them in the Islamic way of life.

As the expanding frontiers of the Islamic State gave birth to monetary issues, mercantilism, urbanization and socio-economic problems, they developed the system and theories to resolve the emerging issues. A large number of individual scholars and thinkers of the Middle Ages developed a number of branches of knowledge, including economic principles, that could be considered as the basis of the modern political economy and economic thought. As such, the Medieval Age was considered the golden period of Muslim history.[19]

With intellectual regressiveness, the Muslim civilization began to wither, becoming more and more preoccupied with minor issues. The Industrial Revolution was totally missed. This regressiveness continued until the British and French instigated rebellion against Turkish rule and brought about the downfall of the Ottoman Empire, the last Muslim world power, replacing it with European colonies. It was only after World War II that these colonies became independent.

1.8 ISLAMIC PRINCIPLES CAN MAKE THE DIFFERENCE

The above discussion implies that problems have emanated from

1. The unchecked creation of money.
2. A reliance on market forces without any ethical limits.

[19] For details on the contribution by Islamic jurists to economics, see Chapra, 2000a, pp. 145–172. The assumption made by Joseph Schumpeter in his book *History of Economic Analysis* (1954) and reference to it by the Nobel Laureate, Douglas North (in his December 1993 Nobel lecture) that the period between the Greeks and the Scholastics was sterile and unproductive and the theory of the "Great Gap" based on this assumption is false and lacks credibility.

3. An emphasis on growth and profit *per se* without regard to the distribution aspect.
4. The negative role of the State and the regulators in allowing the pursuit of greed and unchecked profit.

Islamic principles of economics and finance provide checks for all these factors. They focus on clarity and lack of ambiguity, just and fair treatment for all and care for the rights of others. But these principles are necessarily ethical and, as a ray of hope, some senior policymakers have been witnessed talking about ethics. These principles need to be adopted for the relief of mankind.

Market mechanisms, private property and enterprise, self-interest and competition are integral parts of Islamic economics, just as in the case of a free-market system. After the goods are produced, these are consumed or used in the process of further production through the two main contracts, namely sale/purchase (trading) and leasing, that can be entered into by individuals, partnership firms and corporations. For undertaking these transactions properly, Islamic jurisprudence provides other contracts/subcontracts along with detailed rules.

The fundamental feature of Islamic economics and finance is socio-economic and distributive justice. It also has a comprehensive system of ethics and moral values. It does not allow the destruction of output by, say, dumping into the oceans or burning, to force up or to maintain prices fictitiously at a higher level. Under the effective supervision of the government, markets can function freely under a competitive price mechanism, transparency and disclosures, subject to the condition that they are not distorted by the influential and stronger segments of a society. Within this overall framework, individuals have the right of ownership and freedom of enterprise, and can get return or profit by creating additional value and sharing gains and losses. The State has to undertake an overseeing role so that a closer linkage between real economy and finance can contribute to growth and evenly shared income.

The Islamic economic system prohibits commercial interest, excessive uncertainty, gambling and all other games of chance and emphasizes a social welfare system based on mutual help, character building, behavioural changes, the system of Zakat (the religious obligation of every Muslim who has wealth in excess of his consumption needs at the nonprogressive rate – generally 2.5 % of net wealth or 5 or 10 % in the case of agricultural produce above a minimum limit – Zakat money has to be distributed among the have-nots and the needy as per the tenet of the Holy Qur'ān given in verse 9: 60) and care and dignity for the poor. It accepts the right of capital to enjoy a just return with the condition that it also bears the liability or risk of any loss. Any entitlement to profit or return comes from value addition and bearing the business risk, the nature of which will be different in different business contracts or transactions based on partnership, trading or leasing.

The main principle governing permission to trade/exchange, subject to fulfilment of certain rules, and prohibition of Riba (interest), games of chance or gambling and other illegal contracts is that all gains and receipts in exchange transactions must be accompanied by any consideration stipulated with free will and mutual consent of the parties. Contracts covering various transactions have been classified as commutative and noncommutative (Uqood-e-Mu'awadha and Uqood Ghair Mu'awadha – discussed in Chapter 5). While profit or return is valid in the case of the former, like the contracts of sale and leasing, no return can be taken in respect of the latter, as in the case of gifts, guarantees[20] and loans, as loaning, guaranteeing or gifting are considered by Islamic Sharī´ah as gratuitous and benevolent acts. Loans are granted for timely help of the needy and the debtor cannot be charged any amount over the amount of loan or debt. However, a loan has to be repaid one way or the other until the creditor gives relaxation or the debtor is declared insolvent. Accountability of loans or debts in the Hereafter remains intact, even in the case of insolvency, until the creditor waives the amount of debt.

1.9 REGULATING TRADE AND BUSINESS

Islam recognizes the role of markets and freedom of individuals in business and trade. Trade and business practices have contributed a lot to the development of the economies of Europe, the East and Far East. As expressed by Gordon Brown, the then Chancellor of the UK's Exchequer: "It was mainly through peaceful trade that the faith of Islam arrived in different countries".[21] Islamic finance, by offering trade-based models of financial intermediation, can provide an opportunity for closer interaction between Muslim and non-Muslim communities and enhance social cohesion among various societies. It may bring nations and countries closer through trade based on ethical values and some standards of justice and fair play. However Islam also recognizes the possible adverse impact of totally unregulated businesses on the various sections of society, particularly the poor and the disadvantaged.

All of this implies that economists and policymakers should concentrate mainly on two areas to streamline the global economic system and place it on a sound footing. First, the role of government, which has been a highly contested issue between the neoclassical/liberals and the conservatives over the last few decades. In view of the bitter experience of capitalism, with a passive government role resulting in growth for only a few individuals and groups and leaving the majority of human beings in utter poverty, economists should consent as a group that governments must perform an active role, not for conducting various businesses, but for ensuring the proper and smooth functioning of market forces with accountability and transparency, so that vested interests cannot manipulate through their malpractices. Concepts that have emerged in conventional economics and finance in recent years, like ethical finance, green funds and socially responsible investments, tend to imply a closer link between the desirable objectives of any economic system caring for human beings and the world as a whole.

The second area is that of money, banking and finance – financial instruments, institutions and the markets. Islamic finance requires that all financial transactions and the instruments must be represented by genuine assets and business transactions as per their respective rules and norms relating to fair play, transparency and justice. It is true that the gold standard cannot be adopted again, but there must be some foolproof criteria for the creation of money. The principles of Islamic finance – that all financial assets must be based on real assets (not necessarily gold or silver) on the one hand, and that the time factor in business transactions has value only through the pricing of goods and their usufructs on the other – provide the best

[20] Guaranteeing a financial obligation for a price involves Riba, which is prohibited. The guarantor is, however, allowed to recover out-of-pocket expenses incurred for providing the guarantee (not including the opportunity cost of the funds for securing the contingent obligation) (council of the Islamic Fiqh Academy, 2000, Resolution No 12(12/2), p. 18.

[21] Brown, 2006, p. 10.

such criteria. This could provide a paradigm shift for financial services by seeking a moral compass for the system based on market forces by linking them with the real economy. The only requirement is that the economists and the people at the helm of affairs start thinking seriously without any preconceived biases and prejudices.

Creating financial assets out of nothing and putting others at undefined risk is tantamount to cheating and fraud, which should no longer be allowed if peace, tranquility and human dignity are the objectives, as the so-called super powers, human rights organizations and other democratic groups often proclaim. There has to be some sound basis for the creation of money, because the absence of such a basis has resulted in injustice and imbalances in the global system and economies. The piling up of fictitious assets without any real economic activity and the unjust transference of risk to others should not be acceptable to minds concerned with human rights and dignity. As such, all financial assets must be based on real assets and business activities.

If the financial system at national and global levels, along with its tools and instruments, was based on a just and equitable foundation, governments could easily formulate and implement policies for the proper functioning of market forces, leading to fair distribution of income and allocation of resources. This would be accomplished indirectly through fiscal, taxation and monetary policies and directly through control over rogue forces to facilitate smooth market functioning. Therefore, economists should proceed to suggesting a proactive facilitative role for regulators and governments. This is particularly required for the functioning of the financial system, as it is like a heart in the human body and the major tool for efficient and balanced flow of resources among various groups in society. It is pleasant to read the then Chancellor of the UK's Exchequer Gordon Brown quoting a Hadith of the holy Prophet (pbuh) relevant to this discussion: "The Ummah, the Muslim global community, is like the human body, when one part feels pain, the other parts must reflect the pain – a truth of relevance in and beyond the Muslim world that emphasizes our duty to strangers, our concern for outsiders, the hand of friendship across continents".[22]

When economists, even many of those sitting in Washington and London, deem the imbalances a huge threat to world development, peace and prosperity, they may call for the application of a system according to which all financial assets have to be based on some real assets and economic activities conducted on the basis of such assets. Applying these principles to the supply and demand of money and management of savings, investments and financial assets could lead to sustainable and equitable growth and development, leading to the happiness of mankind as a whole.

The allocation of funds on the basis of interest needs to be replaced by risk-related placement under the principle of partnership and other contracts based on genuine and valid trading and leasing activities, implying that the fund owners should share both the risk and the return with the users of the funds. All parties to a contract have to undertake respective liabilities for entitlement to profit and the deciding factor is the nature of the transaction. The parties owning risk and reward at various stages in the process of undertaking transactions will charge differently in business activities based on trading, leasing or the Shirkah (partnership) principles. But the risk will have to be borne one way or the other, which can be mitigated but not totally eliminated if profit generated from such a transaction has to be legitimized.

[22] Brown, 2006, p. 12.

1.10 ISLAMIC FINANCE PASSING SIGNIFICANT MILESTONES

Islamic principles of economics and finance, briefly laid down above, have already proved their ability to attract policymakers and practitioners from all over the world to develop the edifice of an efficient financial system on this basis. From the dawn of the 21st century, Islamic finance has been developing so vigorously that it has evolved from a nascent industry to a global market, where Muslim and non-Muslim are working together and learning from each other for the development of relevant products and services. It has passed the significant milestones of existence, recognition by the global financial authorities and most recently in delivery of sophisticated and lucrative financial services with competitive pricing and sufficient care for Sharī´ah compliance.

All of this was achieved within just 25 years. Until the early 1970s, Islamic banking was an academic dream, of which few people were aware, even educated Muslims; now it has become a widely known practical reality. It made headway in the 1980s as a new system of financial intermediation, in spite of an unfavourable environment and without the help of the auxiliary or shared institutions needed for its successful operation.

Its recognition around the world relates to its workability and viability. It has also attracted the attention of mega international financial institutions, regulators like the Federal Reserve Board, FSA of England, international financial institutions like the IMF and the World Bank and prestigious centres of learning like Harvard and Rice Universities in the United States and the London School of Economics, Loughborough and Durham Universities in Britain, International Islamic Universities in Malaysia and Pakistan and a number of other institutions in Saudi Arabia and Egypt.

Islamic banking and finance is being practised in over 75 countries around the world, with about 550 Islamic financial institutions in the field. A number of international institutions and regional financial centres are playing a crucial role in the standardization of Islamic finance products and thus enhancing its credibility. Almost all multinational conventional finance groups are offering Islamic financial products through specially created subsidiaries or windows. It is a healthy sign of good and ethical business in future that will increase the prosperity and peace of mind of millions of people who were previously either keeping away from the conventional banking system or feeling guilty due to the involvement of interest in their transactions, otherwise prohibited in all revealed religions.

The development of standard-setting bodies and global facilitators like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM) and the Liquidity Management Centre (LMC) is providing recognition for Islamic finance and enhancing its credibility to both customers and regulators. Bahrain, Malaysia, Saudi Arabia and Dubai have been serving as its hub for about the last two decades. Now, London and Singapore are also striving to become centres for Islamic finance. Britain's then Chancellor of the Exchequer Gordon Brown told the Islamic Finance and Trade Conference held in London in June 2006 that he wants to make London a global centre for Islamic finance by offering regulatory and tax regime measures to support the creation of Islamic finance products.[23]

Demand for Islamic finance is on the rise, both in Muslim majority and Muslim minority countries. In the UK, for example, the Islamic Bank of Britain (IBB) is working as a

[23] Brown, 2006, pp. 11, 15.

full-fledged Islamic bank with seven branches (planned to increase to 12 branches by the end of 2007). The first customer to open an account in the Leicester branch of IBB was a non-Muslim who travelled over 100 miles because of the ethics and transparency offered by an Islamic bank.[24] Besides this, the European Islamic Investment Bank (EIIB), HSBC Amanah, Alburaq (a subsidiary of Arab Banking Corporation), Lloyds TSB, ABC International Bank Bristol & West Building Society, KPMG, Clifford Chance, Norton Rose, Dawnay Day and 1st Ethical are among those offering services also to non-Muslim customers. In Malaysia, about 40 % of Islamic banks' clients are non-Muslims. In the US and North America, a large number of institutions are providing Islamic financial services, mainly to the Muslim community.

Prospects for the future are expected to be better, particularly if the instability that now prevails in the international financial system continues to accentuate and leads to a realization that it cannot be removed by making cosmetic changes in the system but rather by injecting into the system greater market discipline. This discipline is ingrained in Islamic finance principles.

1.11 COULD IT WORK TO ACHIEVE THE OBJECTIVES?

The question is: will Islamic economics and finance theories sooner or later reach a point where they provide a better alternative to the world at large? The question is quite a complex one; it has many dimensions to think over and requires courage to fix the targets. Economics is the most strategic part of everyday life – given much emphasis in Islam due to its social implications – but unfortunately it is not being developed and implemented anywhere at State level. Unless the policymakers, regulators and central monetary bodies take solid steps for Research & Development, followed by practical application, any selective and half-hearted application by individual IFIs might not be able to provide a better alternative for governing global finance and economies.

Now the foundations have been laid, if the majority of the world's 1.2 billion Muslim population chose to abide strictly by the tenet of the Sharī´ah, i.e. charging or paying interest is forbidden, many of the Islamic governments, investment institutions and ultimately the bulk of global commerce would transform to the natural instruments of business based on fair play and justice. If the human rights groups and those believing in ethics also joined hands and worked together for the cause they proclaim, many serious issues including hunger, poverty and social conflict could be resolved and the countries and the people could come closer, making the planet a more peaceful place to live.

But the point worth consideration by the experts in Islamic finance is that the system has to be developed to make it not only legally or formally Sharī´ah compliant, but also to change its basis and the mindset of the stakeholders and the market players in such a manner that it could be helpful in realizing the objective proclaimed by the pioneers of Islamic finance theory. The message this author wants to convey is that Islamic financial institutions which look at the products offered by the conventional system and mould them to see how they can formally or legally fit in the Islamic perspective without regard to their impact on various segments in society can only undermine the integrity of the Islamic theory

[24] Piranie, 2006, p. 24 (paper presented at the IFTC, 2006).

of finance. Compliance to principles should be Sharī´ah inspired and must, therefore, be the foremost consideration before the product developers, implementers and regulators.

Good ethics, which play an important role in the functioning of Islamic finance theory, are missing in present human society, including Islamic countries. In this area, governments, academicians and other opinion makers will have to do a lot of work to persuade the policymakers and educate the masses not to compromise on the rules of fair dealing and justice, both at national and international levels. It may take a long time, but we have to move in the right direction if the objective is to be realized sooner or later.

Keeping in mind the low ethical standards in almost all present societies, it will be a challenging task, but if conducted with dedication and effective coordination on a large scale, it is not impossible. Islamic countries have to set the precedent by applying the system in line with its principles vehemently and vigorously so that others have no choice but to follow it. In addition to raising risk-based capital at national levels, inflow of borrowed capital needs to be replaced with direct and portfolio investment. Governments will have to do a lot in this regard, especially by playing a facilitation role while ensuring that vested interests do not exploit the masses in general and the weak and the poor in particular. There has never been a "perfect" society in all respects, and there will not be in future. Always there have been elements creating distortions. It is the State that has to save the masses and society from such rogue elements or vested interests.

1.12 ABOUT THIS BOOK

This book relates to one part of the agenda prescribed above and that is deliberating upon the principles and the practices of Islamic finance. A financial system provides operating tools and instruments to an economic system, on the basis of which it tends to achieve its objectives. Likewise, Islamic finance is only one, but the most effective, part of the overall Islamic economic system and not the all-conclusive part. Its importance as the most effective part, however, has to be recognized because the flow of money, and thus transfer of resources, to various segments in a society is controlled by the banking and financial system, which, at its current stage of development, works like the blood circulating in the human body.

As regards the interpretation of the tenets of the Sharī´ah, the book represents the mainstream view of Islamic finance for the reason of its recognition at a wider scale and also because it is the basis for Islamic banking practices in the Middle East and other parts of the world. The Sharī´ah principles, accounting, risk management and other performance standards as being developed by the standard-setting institutions like the AAOIFI and the IFSB, are also based on the mainstream view. This should not be taken as a big problem for readers or the system, as practices based on the minority view in respect of a few concepts are in the process of transformation to make them compatible with the mainstream view and philosophy.

The challenges facing Islamic finance include educating and creating awareness among the stakeholders on a large scale and convincing people that the theory of Islamic finance is workable on a sustainable basis. A number of myths occupy peoples' minds about the Islamic financial system. Removing those myths and promoting Research & Development is crucial in promoting the system. Policymakers, bankers, the business community, industrialists, Sharī´ah scholars, students of business schools and the people at large need to know what

Islamic finance is, what its features and philosophy are and how it works. In particular, the product developers, those responsible for implementation and also the financial experts need to be familiar with the essential requirements of different Islamic modes of business, enabling them to provide financial services relating to retail, corporate and government sectors ensuring Sharī´ah compliance and the best operating procedures. This book is an effort in this regard to make available a textbook-type resource to students, bankers, the business community and the general public. Hopefully it will be useful in providing a sound understanding about the principles of Islamic finance and how they work to form a viable system.

The nature, scope, objectives and main features of the Islamic economic system are discussed briefly, just to lay a foundation for discussion while studying and understanding the Islamic financial system. The main body of the book is devoted to explaining the philosophy and concepts of Islamic finance, how it has to be applied at the micro-level and what its prospects and challenges are. The book comprises three parts, each part spanning a number of chapters.

Part I discusses the need for, basis and overall structure of Islamic economics, presenting a framework under which the Islamic financial system is supposed to work. It explains the philosophy and the main features of Islamic finance that form the basis of operations for Islamic financial institutions (IFIs). The major prohibitions that IFIs are required to observe are also discussed in this part. As the prohibition of Riba is the least controversial issue, more emphasis in discussion has been given to the connotation of the term Riba and how it encompasses various forms of present-day business and finance.

Part II provides an overview of the Islamic law of contracts and elaborates upon basic requirements of various transactions to be undertaken by IFIs, enabling readers to understand what the nature of various contracts is. While conventional banks' main function is loaning, Islamic banks' activities pertain to trading, leasing and other real sector business through a number of business structures. Rules of trading and loans and debts are, therefore, crucial for Islamic banking practitioners. Spanning three chapters, this part explains the components of major contracts like those of sale, loans and debts and some related subcontracts like Hawalah (assignment of debt) Kafalah (guarantee/surety) and Rahn (pledge).

Part III, the most strategic part, gives an overview of financial products in conventional and Islamic perspectives and discusses the main Islamic modes of business and investment and how they have to be used by IFIs as modes of financing. Explanations of the concepts of credit and forward sales (Murabaha–Mu'ajjal, Salam and Istisna'a), leasing of assets and services (Ijarah), partnership-based modes like Musharakah, Mudarabah and Diminishing Musharakah are followed by the procedures that IFIs could adopt for respective modes to facilitate a variety of clients, ensuring Sharī´ah compliance.

Chapter 13 discusses some accessory contracts that could be used by IFIs (along with other main contracts) like Wakalah (agency), Tawarruq (acquiring cash through trade activities), Ju'alah (stipend or reward for doing any defined job) and Istijrar (repeat sale/purchase or supply contract).

Chapter 14 contains some guiding principles on the application of the system on both the deposit and the asset sides, the issues involved in product development, deposit management and financing of specific areas.

Chapter 15 discusses the most vital and recently emerging topics in Islamic finance – Sukuk and securitization, elaborating upon the concepts and discussing the procedures. It explains how the concept of Sukuk can be used to realize the huge potential of Islamic finance.

Chapter 16 is devoted to the concept, practice and potential of Takaful – the Islamic alternative to insurance – the development of which is necessary to complete the cycle of Islamic banking and finance.

Islamic banking theory, as well as practice, is subject to a large number of objections and criticism, not only by those who have doubts about the prohibition of modern commercial interest, but also by those who visualize an ideal and absolutely "pure" system having socio-economic benefits within a given timeframe. Chapter 17 is devoted to the appraisal of such criticism.

Chapter 18 – The Way Forward – concludes the book by discussing the prospects, issues and challenges facing the Islamic finance movement and how and to what extent it can play its role for the socio-economic development of societies.