

# A Brief History of Globalization and Islamic Finance

**G**lobalization is a process that enhances the flow of goods, services, capital, people, technology, and ideas across national borders. It is a phenomenon whereby numerous countries combine and increasingly appear as one country; complete globalization is akin to the unification of states that today make up the United States of America. The process of globalization proceeds more rapidly when barriers between countries that affect the movement of goods, services, capital, technology, and labor are reduced, and is enhanced by reduced information and transportation costs. It is a multifaceted and multidimensional process of growing interconnectedness among the nations and peoples of the world. Its main dimensions are: (i) economic and financial, (ii) cultural, and (iii) socio-political. Its economic and financial dimensions include growing trade flows across countries, flows of capital and investment, flows of technology, and labor flows (both skilled and unskilled), accompanied by standardization of processes, regulations, and institutions, all facilitated by the free flow of information and ideas. Its cultural implications are the amalgamation of cultures, adverse impact on languages (diminution of their use) that are used by a few and are not important to business and commerce, and diminution of distinct cultural identity. Its socio-political tendencies are convergence of ideas, political and economic institutions, and norms. It is a process that affects every dimension of life and existence. The reverse of globalization may be termed de-globalization. Globalization and de-globalization are ongoing processes, and at any point in time one dominates the other; as such, the process is continuous, whether the world is becoming more, or less, global.

While the impact of globalization on conventional finance has been studied and recognized, its impact on Islamic finance, a relative newcomer, has not been addressed. Islamic finance is a system of finance that prohibits debt-based financing; thus, it prohibits interest, and the financing of activities that are not permitted in Islam, such as gambling and the manufacturing

and distribution of spirits and wines. Islamic finance is based on risk sharing, trust, transparency, and the upholding of Islamic values. It has developed and grown side by side with conventional finance over the last 40 or so years.

How will globalization affect both conventional and Islamic finance? Will they continue to flourish as two distinct financial systems, or converge over time, or will one absorb the other? How will conventional and Islamic finance affect globalization? What does their history and the history of globalization reveal about their future?

## **1.1 A Brief History of Globalization**

---

Globalization is not a recent phenomenon but has a long history, as indicated by its definition as a continuous process. When the process began, nobody knows. As Findlay and Lundahl (2002, pp. 1–2) note:

*Even the most cursory inspection of the rapidly accumulating literature on the subject indicates that there appears to be about as many answers to the question as there are authors who have posed it.*

Findlay and Lundahl (2002, p. 2), however, do assert that:

*It is more than sufficient to note that if we go back eight centuries what was up to that point the strongest wave of or effort at globalization hitherto in history emanated from the Mongols. They were the main agents of the process, that is, they “pushed” globalization as it were.*

The Mongolian event of the 13th century was in some sense the earliest truly global event and, as Findlay and Lundahl note, the Mongolian Empire still has the distinction of being the largest continuous empire in recorded history. As a result of the Mongolian push, trade routes were opened from England to China. Muslims, in turn, created sea trade along the ports of the Indian Ocean and the Persian Gulf. Trade, perforce, resulted in the movement of people, and even of diseases (such as the Black Death). The rapid expansion of the Chinese economy and the power of the Mongols in China were the forces that integrated the world economy.

Beginning in the 18th century, trade started to be dominated by British, French, and Dutch overseas companies, all chartered by the state. These conditions continued until structural changes occurred in the world economy in the late 18th and early 19th centuries—railroads and steamships, and the advent of the Industrial Revolution. At the same time, the American

Revolution and independence movements elsewhere meant that nation states wrested control of their resources from foreign domination, while simultaneously European countries used their military power to expand the commercial interests of their nationally chartered companies. The British, the French, and the Dutch extended their economic imperialism into Asia and Africa, while the United States started to reach into Latin America, with military might and economic expansion going hand-in-hand. At times, global integration has been fueled by economic forces, sometimes by military conquest, and sometimes by both economic and military forces. Yet, the process of globalization has not always been unidirectional; that is, toward ever-higher levels of global integration. It has proceeded in fits and starts, with globalization and de-globalization going hand-in-hand.

The most recent periods of this continuing process of globalization, whether boom or bust, are:

1. The globalization boom of 1820–1914
2. The globalization bust, or de-globalization, of 1914–45
3. The globalization boom of 1945–?

Again, as may be inferred from the titles of the above three periods, globalization is not unidirectional as witnessed over the last two centuries. Before the onset of the hostilities that led to World War I, trade, capital, and labor flows across national borders had been increasing steadily. World War I, nationalism, and the Great Depression (accompanied by protectionism as countries attempted to protect their domestic markets) reversed the process. It was not until after World War II that there was the will to reverse the process and reduce barriers. Even then, only trade barriers were reduced, followed much later by a reduction in barriers limiting financial flows, with labor flows across most borders still highly restricted even today.

The first of these globalization phases, as in earlier periods, was imposed by military power, underpinned and supported by industrial might. England forced its way into China and conquered all of India. France colonized North Africa. A number of European powers carved up Africa. The United States enhanced its domination over South America. During the first globalization boom, the lowering of barriers and the dramatic reduction in transportation costs (steamship, rail, canals) enhanced trade and mass migration of labor, with significant convergence in commodity prices and real incomes (Lindert and Williamson, 2001). This process was widespread—across Asia, Europe, and the Americas.

In the case of labor flows, labor migration was prevalent in the 19th century, as the motivation (real wage differential and social networks) was significant with little government impediment. For example, the labor force

in Argentina and in the United States increased by 86 percent and 24 percent, respectively; while Ireland's labor force was diminished by 45 percent, and, as to be expected, with varied impacts on wage rates and economic growth (Lindert and Williamson, 2001, p. 14). International monetary reform, as embodied in the convertible currencies of the gold standard (and the silver standard), was adopted by the vast majority of countries in 1870. At the same time, given the high rates of return on foreign investment, cross-border capital flows increased significantly to levels not seen again until the last decade of the 20th century (Lindert and Williamson, 2001, p. 13). The lowering of barriers and the convertible currencies helped increase international trade/gross domestic product (GDP) from 10 percent to over 20 percent between 1870 and 1914, and cross-border capital flows/GDP from 7 percent to nearly 20 percent (Mishkin, 2005, p. 1). But capital did not flow from capital-abundant to capital-scarce countries, as would be predicted by theory (Lindert and Williamson, 2001, p. 17). Instead, capital inflows and GDP per capita were positively correlated. Thus, capital flows were not a force for convergence, indicating that the so-called Lucas paradox was a fact of life even in the 19th century. (Economic theory predicts that capital should flow from where it is plentiful to where it is scarce—that is, from developed to developing countries—but in fact the most significant flows are between developed countries; thus the paradox.) Lindert and Williamson (2001, pp. 17–18) have summarized the effect on income inequality during this period:

*Within rich, land-abundant New World countries, more trade and more immigration augmented inequality. Within poor, primary-product-exporting Third World countries, they did the same. Within poor, land-scarce, participating Old World countries, more trade and more emigration reduced inequality. As for income gaps between countries, migration had an equalizing effect, one that was only partly offset by the fact that capital flowed to rich New World countries . . . Overall, prewar [World War I] globalization looked like a force equalizing average incomes between participating countries, but with mixed effects on inequality within participating countries.*

The second era, the period of de-globalization of the inter-war years, was marked by political upheavals (such as the Bolshevik Revolution in Russia and the rise of fascism in Western Europe), rising nationalism, and policies erecting barriers and disincentives to the flow of goods, labor, and capital across countries. In North America in the face of growing domestic income inequality prior to World War I, and later during the Great Depression (high unemployment and negative economic growth), the government

adopted policies to reduce imports and to stop the inflow of emigrants. These policies were counterproductive and, in turn, affirmatively anti-global, as they slowed the flow of goods, labor, and capital across national borders. Other countries followed suit to protect their own markets in a futile bid to preserve employment and economic prosperity. Trade, labor migration, and capital flows across countries slowed dramatically. This slowdown was accompanied by acceleration in the rising inequality between countries (Lindert and Williamson, 2001, p. 19). By the end of World War II, the world economy was at a standstill, with almost no trade or capital flows across borders and little emigration. The paramount lesson from this de-globalization period is clear: if globalization marginalizes a big segment of the population of a country, especially one that is organized and influential, then the globalization process will be threatened. This simple lesson is even more valid today, when instantaneous communications around the globe are possible. The forces of anti-globalization and nationalism rise when interests are threatened. While, on the one hand, labor, and trade and capital flows affect wage rates and rates of return to capital, on the other hand, those that are affected do not directly see the impact of trade and capital flows on real wages. While the effect of trade and capital flows on wage rates is somewhat invisible, affected workers can see plainly the emigrants who have taken their jobs or reduced their real wages. As a result, in times of falling wages or rising unemployment, labor flows may be more sensitive to populist attacks than trade.

The ongoing third period, the post-World War II globalization boom, was motivated and has been driven by the shortsighted policies and the economic trauma that marked the inter-war years. The world attempted to undo the damage of those years by adopting institutions and policies that would promote cross-border flows. At the international level, the United Nations (UN), the International Monetary Fund (IMF), the World Bank, the General Agreement on Tariffs and Trade (the GATT), and more were established to promote economic reform and lower barriers to trade and capital flows. The Bretton Woods Agreement was adopted to avoid disruptive exchange rate changes and to provide short-term financing for countries facing balance of payments difficulties in order to avoid the damaging global economic contractions that had occurred in the 1930s, especially in the aftermath of Austria's inability to secure short-term financing. However, this post-World War II reversal in policies was adopted only slowly. Countries were still reluctant to dismantle trade barriers quickly, as attested to by the fact that they could not agree on setting up a World Trade Organization (WTO). A number of countries, most prominently the United States, were reluctant to compromise on important issues, especially when they felt that their national sovereignty was threatened. The best they could do was to set

up a system with little enforcement, or teeth, that was subject to periodic painful negotiations to reduce tariffs on goods alone—the GATT. Numerous trade rounds under the GATT reduced barriers to the movement of goods across national borders. The process, though not always smooth, is continuing under the more recently established WTO, with coverage extending to services and including capital flows, and with enforcement powers.

This latest period of globalization differs in many important ways from the earlier one that ended prior to World War I (Lindert and Williamson, 2001, p. 20). Labor migration has been less significant than in the earlier period. The impressive gain in the cross-border movement of goods, services, and capital has not been matched by cross-border labor flows. Even capital exports have been less significant than in the earlier period of globalization; for example, the capital exports to GDP ratio in the United States during 1989–96 was 1.2, while it was 4.6 in Britain during 1890–1913 (Lindert and Williamson, 2001, p. 20). While various measures of capital flows, especially foreign direct investment (FDI), may still be below their pre-World War I levels, the trade to GDP ratio is higher today, supported by lower trade barriers and lower transportation and communication costs. The reason for these differences between the two periods has been largely attributed to changes in US policy (Lindert and Williamson, 2001, p. 20):

*These differences are tied to policy changes in one dominant country, the United States, which has switched from [being] a protectionist welcoming immigrants to a free trader restricting immigration. Another difference . . . the postwar world started out much more unequal than the world of 1820 or 1870, and international income gaps, not income gaps within countries, now dominate the global inequality of living standards.*

During this recent phase, the process of globalization has been especially rapid since 1973: the ratio of world trade to GDP increased from 22 percent to 42 percent in 2000 (Estevadeordal and Taylor, 2002) and the share of capital inflows to GDP increased from about 3 percent in 1990 to about 14 percent in 2005 (IMF, 2007a).

But, as in an earlier period, globalization is being blamed for a number of emerging economic, social, and environmental ills: disparity in income across countries, income inequality within countries, labor standards (with countries maintaining low standards to attract foreign investors), labor conditions (with multinational firms attracted to low labor cost countries no matter what the conditions), poverty, climate degradation, and the global financial meltdown of 2007–09. While the effects of globalization on income inequality across countries and within countries are being hotly debated (see Chapter 2), the rising inequality within the United States and the United Kingdom

in the last two decades is readily confirmed by adverse changes in Gini coefficients and shares of income accruing to differing percentiles. The result is more nuanced for other OECD countries (Lindert and Williamson, 2001, p. 31). But to what degree are these effects due to globalization? While labor and environmental conditions may have suffered, to what extent are these a failure of government policy or directly attributable to globalization? It is evident that globalization, as with most other things in life, may have both positive and negative effects. The issue may be whether governments can ameliorate the negative effects through policies to enhance the benefits and become net beneficiaries of the process of globalization. In assessing the impact of globalization and devising policies to maximize its net benefits, it must be remembered that globalization is not the most direct instrument for affecting incomes, growth, income distribution, poverty, or more. Governments have an arsenal of policy instruments at their disposal for addressing such issues much more directly.

## **1.2 How Complete Is Globalization?**

---

Today, the broad global economic picture is one of diversity, or more accurately, one of gross inequality (see Table 1.1). While the US per capita income was around US\$38,000 in 2007, the world average was in the neighborhood of US\$6,000 and that of low-income countries was a mere US\$334. For the countries that comprise the Islamic Conference (OIC), representing nearly 25 percent of the global population, per capita income was only US\$1,501, a figure that was a fraction of the Organization for Economic Co-operation and Development (OECD) average, only a quarter of the global average, and would fit neatly in the “lower middle income” category as defined by the World Bank.

Globalization is today far from “complete.” For instance, consider a country whose share of global GDP is 25 percent and whose trade/GDP is 15 percent. Is globalization “complete” for such a country? The answer is an emphatic “no.” If a country’s share of global GDP is 25 percent (roughly similar to the United States today), for “complete” trade globalization, its trade/GDP should be 75 percent, not 15 percent (again, the rough US share today). By this measure, globalization in the area of trade has a long way to go (compare Tables 1.1 and 1.2). The United States represented 29.3 percent of global GDP but had an export/GDP of only 10.5 percent (which should be in the order of 70 percent for complete globalization) and the OIC represented 5.5 percent of global GDP but had an export/GDP of 30.6 percent (which should have been in the order of 95 percent for complete globalization).

In the case of financial globalization, such a ready measure is not available, as a country’s share of global finance is difficult to define. One could

**TABLE 1.1** Economic Indicators

	GDP (US\$ billion)		Per Capita (US\$)		Population (million)	
	2000	2007	2000	2007	2000	2007
OIC <sup>1</sup>	1,567	2,194	1,228	1,501	1,276	1,461
United States	9,765	11,564	34,600	38,338	282	302
Euro area	6,245	7,069	20,400	22,182	306	319
High income	25,934	30,398	25,793	28,777	1,005	1,056
High income: OECD	24,730	28,781	26,767	29,805	924	966
High income: non-OECD	1,207	1,656	14,793	18,257	82	91
Middle income	5,647	8,506	1,425	1,997	3,962	4,260
Upper middle income	2,903	3,833	3,715	4,659	781	823
Lower middle income	2,745	4,671	863	1,359	3,181	3,437
Middle East & North Africa	431	585	1,561	1,868	276	313
Low income	370	538	334	415	1,108	1,296
World	31,949	39,436	5,258	5,964	6,076	6,612

Source: World Development Indicators, The World Bank.

<sup>1</sup>Limited or no data for some countries, including Afghanistan, Iraq, Qatar, and Somalia.

**TABLE 1.2** Trade and Capital Flows

	Exports (% of GDP)		Imports (% of GDP)		FDI Inflows (%)		FDI Outflows (%)	
	2000	2007	2000	2007	2000	2007	2000	2007
OIC <sup>1</sup>	38.53	30.63	31.44	36.74	0.56	2.94	0.18	0.60
United States	11.2	10.5	15.1	16.3	3.3	1.4	1.6	1.8
Euro area	36.6	39.8	35.9	38.5	10.2	3.8	3.5	5.5
High income	23.9	25.7	24.4	26.4	5.3	2.7	3.5	3.5
High income: OECD	22.1	22.5	22.8	23.9	5.2	2.6	3.4	3.4
High income: non-OECD	69.8	112.4	62.2	99.5	0.0	8.7	0.0	0.0
Middle income	27.4	31.0	25.9	31.2	2.8	3.1	0.4	1.2
Upper middle income	27.8	30.5	26.2	29.5	3.4	3.3	0.6	1.7
Lower middle income	27.1	36.8	25.6	33.9	2.1	2.9	0.1	0.7
Middle East & North Africa	26.8	33.9	25.6	39.1	1.3	4.2	0.1	0.0
Low income	28.0	30.5	30.0	36.1	1.7	3.1	0.0	0.0
World	24.6	27.0	24.7	27.2	4.9	2.8	3.0	3.0

Source: World Development Indicators, The World Bank.

<sup>1</sup>Limited or no data for some countries, including Afghanistan, Iraq, Qatar, and Somalia.

venture a proposition that, with globalization, the domestic investment to GDP ratio should be comparable to foreign investment to GDP ratios. Taking FDI as a surrogate for foreign investment, the reported FDI ratios are not comparable to what we assume to be domestic investment to GDP ratios. At the same time, the FDI ratios are diverse across country groups and are quite low for most country groups. Globalization is clearly limited in the area of finance; flows between the rich countries dominate these flows (the Lucas paradox), indicating that flows to developing countries have a very long way to go. Moreover, if Shiller (2003) is even partially correct in foreseeing the future of financial markets and the new financial order, then the management of risk, especially cross-border diversification of risk, has barely begun.

While trade and capital flows may have a considerable way to go before being truly globalized, the “tap” on labor flows has not even been opened in the current globalization phase. The severe restriction on labor flows is dramatized by the number of would-be illegal immigrants who die on the high seas or in railroad cars, and stand in long lines at the embassies of advanced countries and wait, sometimes for years, to secure legal immigrant status. Today, the legal flow of labor is largely limited to those with higher levels of education. The cross-border flow of educated labor increased in the latter half of last century, and especially following the change in immigration laws in the United States in 1990. But quotas and other restrictions still severely limit the flow of even educated and skilled labor. The flow of labor has a long way to go before “complete” labor globalization can be claimed, with similar wage rates paid for comparable labor skills all over the world.

The unimpeded flow of technology across borders also has far to go. Many countries, but especially the United States, have imposed ongoing sanctions on dozens of countries, especially in the area of advanced technology. Companies are afraid to license their most sensitive technologies until they are afforded better protection against piracy.

No country in the world comes close to meeting these targets indicated for complete globalization in terms of the flow of goods, capital, labor, and technology. If countries today feel the pressures of globalization, they have seen nothing yet compared to what lies in store should the globalization process ever be permitted to continue unabated.

Globalization has both its fans and detractors. Some argue that globalization increases economic growth and prosperity, no matter what; others believe that faster growth can come about only *if* countries are properly positioned to take advantage of it, requiring sound institutions and policies; and yet others argue that globalization is bad for everyone, no matter what policies and institutions are embraced. Some assert that globalization increases income inequality between countries, others that it has an adverse effect on income equality *within* countries. Still others argue that globalization increases global poverty. Because globalization can be so all-encompassing,

there have been some attempts to examine the effects of individual components of globalization (largely, trade and financial flows) on these variables. The danger for the future of globalization is that if enough countries—or large constituencies within countries—either do not gain from globalization or feel threatened by it, then the forces of protectionism will increase, as was experienced early last century and which reached a pinnacle during the Great Depression, a case of near autarchy where every country was a loser. Similarly, during periods of severe economic contraction, as is occurring currently with the onset of the sub-prime mortgage crisis in the United States, protectionism raises its ugly head and globalization is threatened at its very foundation. As of late summer of 2009, unemployment in the United States was 9.4 percent and was expected to peak at about 11 percent by the end of the year. Moreover, economic recovery was likely to be slow during 2010.

After this brief summary of globalization, a few observations should be evident. Globalization is an ongoing process; it has a long way to go to be “complete,” but it is not monotonic and could be reversed. The impact of globalization is multidimensional. Some segments of society will gain while others will lose, or at least the gain or the loss will not be equally shared. This is the nature of the beast. If and when a large segment of society in a country loses out and becomes disadvantaged, then the voices of protectionism become loud, as was the case from around 1910 until the end of World War II. In fact, even today, by some measures (such as flow of FDI and labor mobility across national borders), globalization may be less advanced than at the beginning of last century.

The overall extent of potential benefits depends on how a country is organized, its competitiveness in global goods and services markets, the flexibility of its markets, and its policy and regulatory infrastructure. All countries have to develop the necessary economic and social policies, the appropriate regulatory and supervisory environment, flexible markets, financial stability, and the needed institutions to benefit from globalization, while guarding the economic welfare of *all* segments of society and preventing social and economic upheavals by means of increased access to education, healthcare, labor training, and the like. It is all too easy to blame all of a country's ills on globalization. Even if there were no such process as globalization, countries would still need to address the economic welfare of *all* segments of society and promote social and economic harmony and justice, with increased access to education, healthcare, labor training, and the like. The development of policies and institutions is the key, with or without the process of globalization. We believe that globalization may have an additional, all too hidden and never mentioned, benefit: the need and the push for governments to adopt better policies, institutions, and governance structure.

### 1.3 A Brief Introduction to Islamic Finance<sup>1</sup>

---

Islam defines guiding principles and a set of rules for all aspects of human life, including economic aspects. These laws, most commonly known as *Shari'ah*, consist of constitutive and regulative rules according to which individual Muslims, and their collectivity, must conduct their affairs. The basic source of the law, in Islam, is the *Qur'an*, whose central reality in the life of Islam and its influence upon the life of Muslims cannot be overemphasized. It includes all the necessary constitutive rules of the law as "guidance for mankind." The principles enunciated in the *Qur'an* were explained, amplified, practiced, and exemplified by the Prophet (*pbuh*) whose personality, actions, and sayings, known as *Sunnah*, leave an indelible mark on the consciousness of the individual Muslim. Hence, after the *Qur'an*, the Prophet's sayings, and his actions, are the most important sources of the law and a fountainhead of Islamic life and thought.

Although the *Qur'an* and the *Sunnah* are the primary sources of *Shari'ah*, *ijtihad* (from the same root as *jihad*) plays a critical role. *Ijtihad*, through which efforts are expended by individual jurists to extract solutions to problems based on the primary sources, is the vehicle by which rules of behavior not explicitly addressed to problems that arise as human societies evolve are determined. *Ijtihad* is exercised through the earlier consensus of jurists (*ijma*), analogy (*qiyas*), judicial preference (*istihsan*), public interest (*maslaha*), and customs (*urf*). Secondary sources of *Shari'ah* have to satisfy the condition that they do not introduce any rules that are in conflict with the main tenets of Islam. Compliance with the rules of the *Shari'ah* is essential to the preservation of the community and is assured by the fact that the individual's behavior is constrained by adherence to the binding norms of the socio-economic order and through coercion by the collectivity.

Throughout their history, Muslims have endeavored to develop their societies by following the principles of *Shari'ah*, and there were no exceptions for economic activities. An economic system according to Islam is based on preservation of property rights, emphasizing sanctity of contracts, ensuring justice in exchange and markets, expecting high ethical standards, sharing risks, and promoting social justice. The financial system is pivoted on the prohibition of *riba*, which includes payment and receipt of interest in all forms as understood in today's business world. The term "Islamic finance," which is a relatively new term and has emerged in only the last two to three decades, is often reduced to a system where "interest" is prohibited. However, this simple description is not only inaccurate, but is also a source of further confusion. The most significant implication of this prohibition is

the removal of pure “debt-based” contracts from financial transactions. There is no doubt that the most critical and distinguishing feature of such a system is the prohibition of *riba*. The Islamic financial system also encourages risk sharing, innovation, and entrepreneurship, and emphasizes “materiality,” by which we mean that it endorses a strong linkage between the real and the financial sector and promotes asset-based financing as opposed to pure lending-based financing. Islamic scholars have argued that when the notions of economic justice and risk sharing are combined with other fundamental principles of Islam, it can lead to a financial system that is inclusive, efficient, and stable, and which promotes economic development. The box below summarizes the basic principles of an Islamic financial system.

### **BASIC PRINCIPLES OF AN ISLAMIC FINANCIAL SYSTEM**

***Prohibition of interest.*** Prohibition of *riba*, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales,” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal (that is, guaranteed regardless of the performance of the investment) is considered *riba* and is prohibited. The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of “interest” as widely practiced. A direct implication of prohibition of interest is prohibition of pure debt security with a predetermined interest rate.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and creation of additional wealth, whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion, and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.

***Risk sharing.*** Because interest is prohibited, pure debt security is eliminated from the system and therefore suppliers of funds become investors instead of creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits and losses.

**Asset-based.** The prohibition of debt and encouragement of risk sharing suggests a financial system where there is a direct link between the real and the financial sector. As a result, the system promotes a “materiality” aspect requiring linking of financing directly with the underlying asset so that the financing activity is clearly and closely identified with the real sector activity. There are strong linkages between the performance of the asset and the return on capital used to finance it.

**Money as “potential” capital.** Money is treated as “potential” capital—that is, it becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital and not “potential” capital.

**Prohibition of speculative behavior.** An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.

**Sanctity of contracts and preservation of property rights.** Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. Islam places great importance on preservation of property rights; defines a balance between the rights of individuals, society, and the state; and strongly prohibits encroachment of anyone’s property rights.

*Sources:* Mirakhor (2003a); Iqbal and Mirakhor (2007).

In modern history, interest in conducting *Shari’ah*-compliant business rose with the first sign of expansion of conventional “interest-based” commercial banking in the Arab and Muslim world. In the late 19th century, a formal critique and opposition to the element of “interest” started in Egypt when Barclays Bank was established in Cairo to raise funds for the construction of the Suez Canal. Further, a formal opposition to the institution of “interest” could be found as early as 1903, when the payment of interest on post office saving funds was declared contrary to Islamic values and therefore illegal by *Shari’ah* scholars in Egypt.

During the first half of the 20th century, there were several attempts to highlight the differences between the emerging conventional financial system and the areas where it conflicted with Islamic values. By the 1950s and 1960s, several Muslim countries had begun to regain their freedom after

years of colonial rule and, along with this new-found freedom, there were attempts to rediscover their Islamic values and heritage. By 1953, Islamic economists had offered the first description of an interest-free bank. By the start of the 1960s, there was a growing demand for *Shari'ah*-compliant banking, resulting in the establishment of the Mit Ghamr Local Savings Bank in Egypt in 1963 by the noted social activist Ahmad-al-Najjar. It is worth noting that Dr. Najjar chose not to label this institution as an “Islamic bank” but promoted it as a social welfare institution (Martin, 2007). Unfortunately, this experiment lasted for only four years. Around the same time, there were parallel efforts in Malaysia to develop a saving scheme for Muslims wishing to undertake the pilgrimage to Mecca.

The establishment of the Dubai Islamic Bank in the United Arab Emirates (UAE) by some traders in 1974 is considered to be one of the earliest private initiatives. The 1970s witnessed a rise in the price of oil, leading to rising oil revenues and financial assets in several oil-rich Islamic countries, especially in the Middle East. Oil revenues of the 1970s, sometimes referred to as “petrodollars,” offered strong incentives for creating suitable investment outlets for Muslims wanting to comply with the *Shari'ah*. Interest-free or Islamic banking, which was only a concept in the early 1970s, was subsequently given a strong business foundation. This business opportunity was exploited by both domestic and international bankers, including some of the leading conventional banks.

In 1975, the Islamic Development Bank (IsDB) was established along the lines of regional development institutions with the objective of promoting economic development in Muslim countries, as well as offering development finance according to the rules of the *Shari'ah*. Since its inception, IsDB has played a key role in expanding Islamic modes of financing and in undertaking valuable research in the area of Islamic economics, finance, and banking. The 1980s proved to be the beginning of a trend of rapid growth and expansion of an emerging Islamic financial services industry. The major developments of the 1980s included continuation of serious research work at the conceptual and theoretical level, constitutional protection in three Muslim countries, and the involvement of conventional bankers in offering *Shari'ah*-compliant services. The Islamic republics of Iran, Pakistan, and Sudan announced that they would transform their overall financial systems to make them compliant with the *Shari'ah*. Other countries such as Malaysia and Bahrain started Islamic banking within the framework of their existing system. The IMF initiated research into understanding the macroeconomic implications of an economic system that operates without debt financing and interest as the rationing price of money. Similar research was conducted to understand the issues of profit- and loss-sharing contracts and the financial stability of a system based on the sharing of profit and loss.

During the early stages of growth of the Islamic financial market in the 1980s, Islamic banks faced a dearth of quality investment opportunities. This created business opportunities for conventional Western banks to act as intermediaries to deploy Islamic banks' funds according to the guidelines given by the Islamic banks. Western banks realized the importance of the emerging Islamic financial markets and started to offer Islamic products through "Islamic windows" in an attempt to attract clients directly, without having an Islamic bank as intermediary. The number of conventional banks offering "Islamic windows" grew and several leading conventional banks, such as the Hongkong and Shanghai Banking Corporation (HSBC) and Citicorp, began to pursue this market aggressively.

By the early 1990s, the market had gained enough momentum to attract the attention of public policy makers and of institutions interested in introducing innovative products. In 1996, Citibank was one of the earliest Western banks to establish a separate Islamic bank—Citi Islamic Investment Bank (Bahrain). HSBC today has a well-established network of banks in the Islamic world. With the objective of promoting Islamic asset securitization and private equity and banking in OECD countries, HSBC Global Islamic Finance (GIF) was launched in 1998. With the growth of Islamic products and services, the need for regulation and standards increased, resulting in the establishment of a self-regulatory agency—the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain, which has played an important role in furthering growth.

By the late 1990s and early 2000s, Islamic finance began to attract international attention as more and more countries began to embrace the concept that a system without interest (debt) is workable. This recognition can be attributed to two major factors. First, during its history of more than 30 years, no major Islamic bank has failed; indeed, such banks have proved to be as efficient and profitable as their conventional counterparts. Although there were cases of bank failures, these failures were caused by and were attributed to bad governance and lack of risk management. In none of the failed banks was the issue of any Islamic product or the design of financial intermediation questioned. This success of over 30 years has engendered confidence and trust in customers and skeptics alike. Second, the advancement of financial theory in both conventional and Islamic literature, in the area of portfolio theory and understanding of financial intermediation, has been supportive. Such an advancement in theory has shown that a system without interest can be designed and that, under certain conditions, such a system may prove to be more stable than the conventional one (Khan, 1987).

More recently, during the period 2005–08, there had been another wave of interest in Islamic finance. Similar to the situation in the 1970s, the recent

surge is stimulated by increased oil revenues in the Middle East. Whereas during the 1970s interest in Islamic finance was limited to the high net worth class, current growth is the result of demand by a much wider group, including small investors and retail consumers. Several countries where Islamic finance was dormant are experiencing a sudden surge in demand for *Shari'ah*-compliant products. One example is Saudi Arabia, where a long-entrenched skepticism about Islamic finance and lack of encouragement for its growth has suddenly given way to an increasing public pressure to embrace *Shari'ah*-compliant finance. For example, Saudi Arabia's largest bank, National Commercial Bank, has converted its entire branch network to *Shari'ah* principles (RedMoney, 2007). Both Bahrain and Malaysia have taken an active role in the development of Islamic finance and have made serious efforts to establish world-class financial centers to promote it.

There is no formal or systematic source of statistics on Islamic finance, but several estimates are often quoted by different commercial and non-commercial sources.<sup>2</sup> According to the 10-Year Master Plan for the Islamic Financial Industry prepared by IsDB and the Islamic Financial Services Board (IFSB), by the end of 2005, more than 300 institutions in over 65 jurisdictions were engaged in Islamic finance. In a broad sense, the Islamic financial industry consists of a number of components such as Islamic banks, Islamic windows, capital markets, Islamic insurance (*takaful*), and other non-bank financial institutions. "Islamic banking" usually refers to offshore and onshore deposit taking, and commercial and investment banking, and is the most dominant sector of the market. Islamic windows are specialized windows available through conventional banks catering to the demands of Islamic products. Historically, Islamic banking and windows have been the most active sector, but in the last decade, other forms of financial products and services have been gaining momentum. Activities in the capital markets in the form of Islamic funds or Islamic bonds (*sukuk*) are increasing and there are institutions specializing in asset management, mutual funds, and brokerage houses. Islamic non-bank financial institutions include specialized institutions offering financial services through leasing (*ijarah*) or partnership (*mudarabah*) similar to conventional fund management companies. There is also a limited but growing number of institutions engaged in micro-finance, venture capital, and private equity financing.

Table 1.3 shows the total size of different segments of the market, compiled from various sources. Due to a lack of transparency of financial disclosure by financial institutions in developing countries, these estimates are if anything on the conservative side, and the actual size of assets under management is considered to be significantly higher.

Financial intermediation performed by Islamic banks is based on the principle of profit and loss sharing. The depositors agree to share profits

**TABLE 1.3** Total Assets under Management, 2007

Sector	Amount (US\$ billion)
Islamic banks	300
Islamic windows	200
<i>Sukuk</i>	70
Islamic funds	20
<i>Takaful</i>	4
Total	594

Source: Askari, Iqbal, and Mirakhor (2008).

**TABLE 1.4** Theoretical Balance Sheet of an Islamic Bank

Assets	Liabilities
Cash balances	Demand deposits ( <i>amanah</i> )
Financing assets ( <i>murabahah</i> , <i>salaam</i> , <i>ijarah</i> , <i>istisnah</i> )	Investment accounts ( <i>mudarabah</i> )
Investment assets ( <i>mudarabah</i> , <i>musharakah</i> )	Special investment accounts ( <i>mudarabah</i> , <i>musharakah</i> )
Fee-based services ( <i>joalah</i> , <i>kifalah</i> , and so forth)	Reserves
Non-banking assets (property)	Equity capital

Source: Van Greuning and Iqbal (2007).

and losses with a bank that uses its skills and market knowledge to invest depositors' funds in *Shari'ah*-compliant assets. Table 1.4 shows a stylized balance sheet of a typical Islamic bank. Depositors' funds are invested in either financing instruments used to finance trade activities or leasing or manufacturing/construction activities, or in investment instruments through partnership and equity-partnership arrangements.

Distinct intermediation raises two concerns. First, Islamic banks' assets are dominated by short-term trade and leasing-based financial instruments. These instruments tend to be of short-term maturity and are not highly liquid assets. This poses a serious problem for Islamic banks that are unable to transfer illiquid assets in the secondary markets, and because of this illiquidity, Islamic banks tend to shy away from medium- to long-term financial instruments. Second, Islamic banks are often characterized by their small size, in terms of assets and capitalization. Several studies have suggested that the industry should seriously consider consolidating smaller banks to reap the benefits of economies of scale and scope. However, the larger the institution, the greater the risk of financial contagion in the case of institutional failure.

As the science of financial engineering developed in conventional finance, its application in Islamic finance also led to innovation. The first wave of innovation came in the form of Islamic funds where portfolios of commodities, equities, Islamic leases, and other Islamic products were established. In the case of equities, special screening and filters were developed to comply with *Shari'ah* and to filter out stocks of companies whose businesses or practices involved dealing in debt, or in prohibited activities such as gambling, alcohol production, and socially irresponsible practices. Research has shown that the application of such screens or filters does not impact the benefit of diversification. Today, the FTSE, Dow Jones, and S&P maintain benchmark indices consisting of *Shari'ah*-compliant stocks, which are used as performance benchmarks by portfolio managers.

The other significant breakthrough came in the form of *sukuk* (Islamic bonds), where a pool of *Shari'ah*-compliant financial instruments is securitized in the form of a fixed-income security. The issuers of *sukuk* include both sovereign and corporate entities, and the success of *sukuk* is evident by the high growth this market has enjoyed. *Sukuk* have also proved to be a bridge between Islamic and conventional markets and have led to the gradual development of capital markets, as discussed in the following section. The *sukuk* market grew from approximately US\$1 billion in 2002 to US\$47 billion in 2007. For example, 207 *sukuk* were issued globally in 2007, compared to 199 in 2006 and 89 in 2005 (IFIS). Slow growth in the number of issues was attributed to the sub-prime crisis in the global financial markets but this did not have an adverse effect on the size of issuance, which doubled between 2006 and 2007. Dow Jones and Citicorp have introduced an index of *sukuk* to serve as a benchmark for portfolio managers.

With the growth of institutions providing Islamic financial services, considerable research and practical advancement has taken place in the area of regulatory framework, supervision, risk management, and corporate governance. In this arena, a close collaboration among the industry, public sector, multilaterals, and other stakeholders is evident. The results of these efforts are beginning to show, as many countries that were averse to the idea of non-conventional financial institutions are now more open to the idea; and the fear of the unknown has been reduced because of the dissemination of practical experience and knowledge. From a research standpoint, this area has attracted the most research, making a number of valuable contributions.

As the number of financial institutions and their geographical reach spread and expanded, there was a need to formalize the self-regulatory aspect of the Accounting and Auditing Organization for Islamic Financial Institutions and to establish the Islamic Financial Services Board with a wider scope. The IFSB was established in 2000 with the efforts of the IMF

and more than 10 central banks of Muslim countries with a strong commitment to this industry. On the occasion of its 14th meeting—held in Riyadh, Saudi Arabia in 2009—the Council of the IFSB admitted two new regulatory and supervisory authorities as full members, and eight new financial institutions as observer members, which brought the IFSB membership to 185 members operating in 35 jurisdictions.

Since its inception, the IFSB has made significant contributions by issuing standards on capital adequacy, risk management, and corporate governance.<sup>3</sup> These standards are issued in consultation with all stakeholders and follow a thorough process of peer review. A working group of technical experts in the relevant area was formed to review and draft documents before they are approved by member countries. The IFSB's standard on capital adequacy was issued in December 2005, offering a comprehensive framework for the identification of risk weights for *Shari'ah*-compliant products and the methodology for computation and determination of capital requirements for Islamic financial institutions.

The IFSB issued guiding principles of risk management for institutions offering Islamic financial services in December 2005. These principles deal with risk profiles of different products and make suggestions on how to deal with credit, market, and operational risk of Islamic products. The principles also identify risks specific to Islamic instruments and the ways and means to control such risks. The IFSB strongly urges Islamic financial institutions to have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report, and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. In December 2006, the IFSB issued guiding principles on corporate governance for institutions offering Islamic financial services. The IFSB defines seven guiding principles classified into four broad categories: general governance approach; rights of investment account holders (IAH); compliance with Islamic *Shari'ah* rules and principles; and transparency of financial reporting in respect of investment accounts. These principles—which exclude Islamic insurance (*takaful*) institutions and Islamic mutual funds—are considered merely for the purpose of guidance, as the IFSB recognizes that there is no “single model” of corporate governance that can work well in every country or every organization.

In December 2007, the IFSB issued guidance on key elements in the supervisory review process of institutions offering Islamic financial services. The objective was to offer guidance on the practices that supervisory authorities are expected to apply concerning capital adequacy, risk management, internal controls, and corporate governance. The guidelines take a risk-based approach to the process of supervisory review. The IFSB

recommends that the supervisory authority should fulfill the adequacy of various compliance aspects, including the *Shari'ah* rules and principles, with reference to the IFSB's standards, including those on capital requirements, risk management, governance structure and processes, transparency, and market discipline. The latest achievement of the IFSB is the establishment of the Prudential Islamic Finance Database (PIFD), with the purpose of facilitating macro-prudential analysis and helping to assess the structure and state of development of the Islamic financial services industry. Some key standards and drafts are shown in Table 1.5.

*Shari'ah* scholars play an important role in the governance of Islamic financial institutions. *Shari'ah* scholars provide guidance to the institution on product development and work closely with the management to ensure that the institution is conforming to the principles of *Shari'ah*. Once a product or financial instrument is cleared or certified by the *Shari'ah* scholars, it gives comfort to other stakeholders that the financial institution is not engaged in any activity that is against the essence of their religious beliefs. During the early stages of Islamic finance, there were limited numbers of *Shari'ah* experts and most of them were not well versed in the English

**TABLE 1.5** Key IFSB Standards and Exposure Drafts

IFSB Issued Standards	
2009	Capital Adequacy Requirements for <i>Sukuk</i> , Securitizations, and Real Estate Investment
2009	Guiding Principles on Governance for Islamic Collective Investment Schemes
2007	Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance ( <i>Takaful</i> ) Institutions and Islamic Mutual Funds)
2006	Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (excluding Islamic Insurance ( <i>Takaful</i> ) Institutions and Islamic Mutual Funds)
2005	Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)
2005	Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)
<b>Exposure Drafts (work-in-progress)</b>	
	Guiding Principles on Governance for Islamic Insurance ( <i>Takaful</i> ) Operations
	Conduct of Business for Institutions offering Islamic Financial Services (IIFS)
	Guiding Principles on <i>Shari'ah</i> Governance System

language and/or the principles of economics, finance, and banking. Each institution formed its own *Shari'ah* board and made every effort to attract prominent names to establish credibility for the institution. With the entry of Western institutions, demand for *Shari'ah* scholars who were reasonably conversant in the English language also increased, and with the increased demand, remunerations also increased.

With the continuing growth of Islamic finance and the scarcity of properly trained *Shari'ah* scholars, competition among *Shari'ah* scholars increased and many started to represent multiple *Shari'ah* boards. This sharing of resources raised concerns about the transparency and confidentiality of decision making by scholars representing multiple institutions. Siddiqi (2006) makes very pertinent observations that, in the beginning, during the 1970s, issuing a *fatwa* (religious proclamation) was considered a sacred duty and an action of public good, as compared to legal experts in conventional banking charging significant fees. However, this changed over time when competition and compensation created a lucrative market for experts who could bless a transaction and make it *Shari'ah*-compliant. With this commercialization, innovation went from the public domain to behind the closed doors of financial institutions that guarded the deals to maintain their competitive advantage.

Today, it is standard practice for financial institutions to maintain a *Shari'ah* Supervisory Board (SSB) that provides an oversight of the institution's dealings in *Shari'ah* matters. Each SSB is subject to an institution's internal procedures and processes to ensure compliance. From the governance point of view, the functioning of SSBs raises five main issues for corporate governance: independence in decision making; confidentiality of decision making; competence of members; consistency of decision making; and disclosure requirements (Graiss and Pellegrini, 2006). In addition to internal corporate governance arrangements, national regulators and international standard setters in several countries have implemented guidelines for SSBs. These often refer to the general duty of SSBs to ensure *Shari'ah* compliance of transactions and, less frequently, indicate areas of competence, composition, and decision making. For example, regulators in Bahrain, Malaysia, Pakistan, Kuwait, Jordan, Lebanon, and Indonesia have defined terms of reference for SSBs, and Bahrain, Pakistan, Jordan, Lebanon, and Indonesia have developed guidelines for the appointment and dismissal of members of SSBs (Graiss and Pellegrini, 2006).

There is more awareness today of the importance and the role of *Shari'ah* boards, and a realization that the industry should move toward defining *Shari'ah* standards. The need for standards stems from the existence of different schools of Islamic jurisprudence and different practices in different jurisdictions. The AAOIFI took early initiatives in defining *Shari'ah*

standards, and as of 2008, it had drafted 23 accounting standards, five auditing standards, six governance standards, two codes of ethics, and 30 *Shari'ah* standards (see [www.aaof.com](http://www.aaof.com)). Similarly, the idea of a centralized *Shari'ah* Supervisory Board (also referred to as a High *Shari'ah* Authority, or Fatwa Board) has been implemented in some countries. For example, Malaysia, Sudan, Kuwait, Pakistan, United Arab Emirates, and Indonesia have established centralized boards to provide guidelines and to perform an oversight function over individual *Shari'ah* boards (Grais and Pellegrini, 2006).

Islamic finance has begun to go global; that is, it is gradually being introduced in countries other than Muslim countries. Although Western financial centers and financial intermediaries have always played an important part in executing and innovating Islamic transactions, such activities have been mostly carried out in the private sector and in a discrete fashion. By early 2000, this trend began to change and several non-Muslim countries began to take an interest in this emerging financial market. This interest can be attributed to several factors, such as booming oil revenues leading to the accumulation of investible funds looking for attractive investment opportunities, increased awareness of regulatory issues relating to Islamic financial intermediaries, and the desire by sovereign and corporate entities to tap into alternative funding resources.

Given the historical significance of London as a financial center, its reputation, sound regulatory framework, reputable financial houses, financial depth, and attractive time zone with respect to the Middle East have made it a popular choice for Islamic financial transactions. It is claimed that more money flows through the London financial center in terms of the most-widely used Islamic financial instrument, commodity *murabahah*, than through any other center (Oakley, 2007). With a Muslim population of almost two million, there was sufficient demand in the United Kingdom to establish the Islamic Bank of Britain in September 2004, which by the end of 2006 had attracted deposits worth £83 million from 30,000 customers and whose assets stood at £120 million (Martin, 2007). Similarly, the European Islamic Investment Bank (EIIB) began its operations in April 2006 with the objective of promoting *Shari'ah*-compliant investment banking. In 2008, European Finance House (EFH), a unit of Qatar Islamic Bank, was awarded a banking license in the United Kingdom to provide *Shari'ah*-compliant banking. EFH plans to target the European Union's 14 million Muslims who will have access to Islamic financial products (Spikes, 2008). Table 1.6 lists the top UK Islamic financial institutions and their ranking among top Islamic banks.

The UK has also attracted researchers on Islamic finance. A number of universities, including CASS Business School, Reading University, Durham

**TABLE 1.6** Top UK Islamic Financial Institutions

Rank	Institution	As of Date	Asset Size (US\$ million)	Top 500 Ranking
1	HSBC Amanah	June 2008	15,194	10
2	Bank of London and the Middle East (BLME)	June 2008	1,196	85
3	European Islamic Investment Bank (EIIB)	Dec. 2007	648	112
4	Islamic Bank of Britain (IBB)	Dec. 2007	337	146

Source: RedMoney (2009).

University, Loughborough University, and Surrey University, are engaged in research and offer courses in Islamic finance. The Chartered Institution of Management Accountants (CIMA) now also offers a certificate in Islamic finance, the first global qualification to be offered by a professional chartered accountancy body (RedMoney, 2009).

Realizing the significance and potential for Islamic finance domestically and internationally, the UK government has taken steps to make its markets “Islamic finance friendly.” To tap into the increased liquidity looking for *Shari’ah*-compliant venues for investments, the UK government in 2007 started evaluating the possibility of launching a sovereign *sukuk* with the objective of encouraging the domestic Islamic financial market and developing a global benchmark. It was also declared in the 2007 budget that *sukuk* were to be accorded the same tax status as conventional debt instruments, and that the income to *sukuk* investors was to be treated as interest income. These measures were introduced to send positive signals to potential *sukuk* investors and to ensure a level playing field with conventional securities.

As more steps are taken to develop London as a hub for Islamic finance, the city poses serious threats for regional financial centers such as Bahrain and Malaysia that are trying to develop dedicated Islamic financial centers. Some argue that this may lead to capital flight, which can hamper the development of regional financial centers. However, others argue that London can play a complementary and enhancing role through financial innovations, cost-effective execution, and access to other markets.

Islamic finance has a long history of a silent presence in Europe. The major early development was the establishment in Geneva in 1981 of the Dar al Maal al Islami Trust, an investment company that holds stakes in several Islamic banks (Wilson, 2007). Many high net worth clients demanding *Shari’ah*-compliant investments deal directly with European banks—not-

bly with UBS of Switzerland, the leading provider of *Shari'ah*-compliant wealth management services. The pioneering *sukuk* in Europe, was set up by the German Federal State of Saxony-Anhalt, which raised US\$100 million through an issuance of five-year *sukuk* in July 2004 (Wilson, 2007). Although London has been active in the market, in the rest of Europe the idea of Islamic finance has yet to attract attention on a large scale. For example, in France, where the Muslim population of six million is three times that of the UK, the authorities and regulators have been slow to realize the potential of this market (Oakley, 2007).

In the rest of the world, Japan and Hong Kong are also engaging in Islamic finance. The Hong Kong Monetary Authority (HKMA) has given permission for the operation of the first Islamic banking window by Hong Leong Bank of Hong Kong (HLBHK), with limited operations to take Islamic deposits to be invested in commodity *murabahah* (RedMoney, 2009). Tokyo has taken concrete steps to capture a slice of the Islamic finance market. For example, Japan's trade promotion body, the Japan Bank for International Cooperation (JBIC), has announced plans to issue a *sukuk* to attract Middle East petro-dollars (Martin, 2007). Several Japanese banks and their securities divisions are keen to establish themselves as a gateway to Malaysia for Japanese investors to tap into this market. Japan based Toyota Motor Corporation issued two *sukuk* in Malaysian ringgit in 2008 and 2009 worth US \$31M and US \$11.4M respectively. (IFIS).

The presence of Islamic finance is beginning to be felt all over the world, and multilateral institutions are also engaging with the market. While the World Bank and the IMF have made contributions to this field through research, other institutions are also now getting involved. The International Finance Corporation (IFC)—the private sector arm of the World Bank—has executed several *Shari'ah*-compliant transactions. In 2007, Multilateral Investment Guarantee Agency (MIGA)—one of the agencies of the World Bank Group—provided its first-ever guarantee for *Shari'ah*-compliant project financing, worth US\$427 million.<sup>4</sup>

Islamic financial institutions (IFIs) have also been impacted by the financial crisis, but for different reasons. Due to the prohibition of interest, IFIs do not have access to debt and therefore were unable, in the lead-up to the crisis, to create leverage as was done excessively by conventional banks. In addition, IFIs did not have any exposure to toxic assets, which are not considered as *Shari'ah* compliant. As a result, IFIs were not impacted during the early stages of the financial crisis. However, as the crisis developed into an economic slowdown and recession, IFIs started to feel the pinch. Exposure to IFIs appears in the form of a drop in real estate prices in the Gulf Cooperation Council (GCC) countries, a sharp correction in regional stock

markets, and deteriorating asset prices in US and European financial and real estate markets (RatingsDirect, 2009). The real test of IFIs will be how to manage the expectations of the investors (depositors) who are expected to share the profits and losses of assets of the bank. Some financial institutions maintain reserves known as profit equalization reserves (PER), which they can tap into to give better returns to their investors during slow times. It is widely anticipated that IFIs will be making use of such reserves in the near future.

The financial crisis has highlighted a vulnerable area for Islamic financial institutions: liquidity management. IFIs do not have access to the liquidity management tools available to conventional banks, but in addition depressed asset prices made managing liquidity more difficult. Access to liquidity through *sukuk* issuance was also limited. Total *sukuk* issuance worldwide declined to US\$14.9 billion in 2008, compared to more than US\$34.3 billion a year earlier.<sup>5</sup> The liquidity issue can become a serious one if the economic recovery is delayed. Stakeholders have started to address this issue and efforts have begun to find solutions to the problem. The IFSB has formed a working group to understand the issues and to suggest solutions to the problem.

While the financial crisis poses challenges to Islamic financial institutions, it also offers opportunities to exploit. Depressed asset prices in the developed economies are attracting investors and Islamic financial institutions to make long-term investments. Such opportunities can become another venue for the introduction of Islamic finance in economies less familiar with this form of finance. Both developed and developing economies can tap into this market by understanding the requirements of Islamic finance and providing a level playing field at the legal and regulatory level.

The future of Islamic finance in Muslim countries will depend in large part on the pace of economic growth in OIC countries, the success of privatization programs, the extent and quality of economic and financial reforms, oil price developments and the size of available investment funds in oil-exporting countries, the quality of governance and supervision in Islamic countries, and the evolution of the global financial crisis that started in 2007 and continues unabated in 2009. As economic performance improves in OIC countries, as financial liberalization continues, as financial regulatory and supervisory administration of Islamic financial practices matures, as Muslims are afforded diverse and better opportunities to save and invest in accordance with their religion, and as the inherent stability of an Islamic financial system becomes acknowledged and accepted, the growth of Islamic finance should be more rapid than anything we have seen in the past.

## **1.4 Islamic Finance and Globalization: Convergence or Divergence?**

---

After examining the various facets and manifestations of globalization and Islamic finance in Chapters 2–6, we will attempt in Chapter 7 to answer this central question: Is it likely that, with continuing globalization, conventional finance and Islamic finance will converge over time?

Our answer to this question will turn on the core elements of Islamic finance, conventional finance, and globalization. Islamic finance is based on risk sharing, trust and transparency. Islamic values, which are the foundation of an Islamic economic and financial system, preach the importance of economic and social justice, universal access to education, a level playing field, hard work, the rule of law, economic and material growth and progress, and state intervention to correct deviations from the accepted norm. These are the values that Muslim countries have to embrace and adopt in their quest to be more Islamic.

Recent progress in conventional finance has centered on unbundling risk and developing instruments to appropriate risk. While the net effect of financial globalization may be debated, the fact that it has a significant effect on risk sharing, financial stability, economic growth, incomes, cross-country income differentials, within-country income inequality, poverty alleviation, and more, cannot be denied. Whether Islam embraces financial globalization or not will depend on the extent that globalization supports Islamic values and goals and, even more importantly, on the ability of Islamic governments to develop policies and institutions to benefit from globalization, while minimizing the effects that are not compatible with Islam. At the same time, the global financial crisis of 2007–09 will undoubtedly affect the evolution of both conventional and Islamic finance. The role of debt financing and leveraging will have to be addressed. The impact of debt financing on financial stability will be important to both conventional as well as Islamic finance. The extent and role of cross-border transmission of financial shocks will have to be studied. The evolution of financial regulation and supervision will be key factors in the financial system that will evolve from what is likely to be the biggest financial meltdown since the Great Depression. The financial stability characteristics of conventional and Islamic finance will be important determinants of how Islamic finance may affect globalization and globalization affect Islamic finance. Will the world at large reduce its reliance on debt financing and leveraging and move more toward equity-based financing?

Ideally, Muslim countries should preserve, and hopefully even enhance, their Islamic character while reaping the benefits of globalization. If the

required policies and institutions to benefit from globalization are universal access to high-quality education, a level playing field, the rule of law, efficient institutions, and state intervention to correct deviations from the accepted norms, it might appear that globalization may even afford Muslim countries additional policy support in their quest to be “more” Islamic.

**Endnotes**

- 1 For an introductory text on Islamic economics and finance, see Iqbal and Mirakhor (2007).
- 2 General Council of Islamic Banks and Financial Institutions (CIBAFI) is making efforts to maintain statistics on Islamic financial institutions.
- 3 For further details, see [www.ifsb.org](http://www.ifsb.org).
- 4 [www.miga.org/news/index\\_sv.cfm?aid=1696](http://www.miga.org/news/index_sv.cfm?aid=1696).
- 5 Standard & Poor's, February 20, 2009.

