

## Frontier of Islamic Economics and Finance: New Challenges

### Critical Overview of the History of Islamic Economics: Formation, Transformation, and New Horizons

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#### Abstract

The history of Islamic economics, which originated in the middle of the twentieth century, is strongly tied to the practice of Islamic finance. The emergence of the commercial practice of Islamic finance in the Gulf countries and the challenge of the introduction of comprehensive Islamic economic systems in Pakistan, Iran and Sudan gave strength to the arguments about Islamic economics. The tension between theory and practice resulted in a division of the discipline into two groups: 1) the aspiration-oriented school which aspires to the ideal of Islamic economics and adheres to the *mudaraba* consensus obtained at the early stage, 2) the reality-oriented school which gives importance to the economic feasibility of Islamic finance and accepts the current practice of commercial Islamic finance. Islamic economics has been developed with arguments between both schools regarding aspiration and reality in the theory and practice of Islamic finance. This paper demonstrates that both groups share common ground for their arguments regarding the definition of *riba*; this implies that those who do not agree to its definition do not participate in the argument of Islamic economics. This fundamental framework of Islamic economics is robust and shapes every argument among Islamic economists although a few efforts to evade the framework can be recently found.

#### Introduction

Islamic economics has been developed in the dynamics between aspiration and reality in the theory and practice of Islamic finance. In particular, these dynamics can be observed after the rise of the commercial practice of Islamic finance in the 1970s. While Islamic economics is the theoretical background of the practice of Islamic finance, which is currently achieving rapid growth, its practice shapes the history of Islamic economics by raising arguments on the theoretical feasibility of Islamic economics. In such interactions, some Islamic economists give priority to the aspiration of Islamic economics while others give importance to the economic feasibility of Islamic finance and accept the current situation of commercial Islamic finance.

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There are several existing studies, both literature reviews [Siddiqi 1981; Khan, M. A. 1983, 1991, 1998; Islahi 2008] and descriptions of the history of Islamic economics [Wilson 2004; El-Ashker and Wilson 2006]. However, these works focus mainly on the stream of theoretical outcomes, and do not mention how such outcomes have been applied to the practice of Islamic economics or developed through reflection on this practice. Therefore, this paper focuses on the dynamics between Islamic economics and the practice of Islamic finance, and describes how Islamic economics was formed, has been transformed, and has evolved; and then, the paper tries to clarify the fundamental framework of the discipline.

## 1. Formation of Islamic Economics

This section traces back to the early history of Islamic economics. Before the formation of Islamic economics, Muslim intellectuals argued the Islamic legitimacy of interest rate which Western banks charged. The section firstly reviews their arguments and describes that some of them were engaged in the establishment of the new economic system without charging any rates of interest, which is the origin of Islamic economics. At the initial stage, Islamic economics was not considered as an academic discipline as is now recognized; the section tries to clarify a momentum for the formation of Islamic economics as an independent academic discipline.

### 1.1 *Riba Controversy in the First Half of the Twentieth Century as a Prehistory of Islamic Economics*

The formation of Islamic economics was a reaction to Western penetration of the Islamic world in the modern era. Beginning in the middle of the nineteenth century, several Western countries established their own banks in order to support their commercial activities. For example, the British Empire established the Imperial Ottoman Bank (1856) in the territory of the Ottoman dynasty and the Imperial Bank of Persia (1889) in the territory of the Qajar dynasty.

The establishment of such Western banks, which charged interest, was a grave problem for Muslim intellectuals. Since the rise of Islam in the seventh century, the doctrine of Islam has prohibited any transactions including *riba*. In the context of Islamic jurisprudence, the concept of *riba* is generally considered to imply some sort of inequality,<sup>1)</sup> and defined as some sort of banking interest in the modern context. Muslim intellectuals focused on the relationship between this implication of *riba* and the function of interest in the Western banking operations, and questioned whether transactions with interest were forbidden due to the *riba* factor.

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1) For more discussion of the pre-modern Islamic jurisprudence literature, see [Saleh 1992].

This problem was discussed not only in the context of interest-based wholesale finance for industrial modernization, but also interest-bearing retail finance such as fixed deposits. For example, during the early stages of the Anglo-Egyptian Condominium (1899-1955) the Post Office Savings Bank in Sudan provided a special service that allowed depositors to reject the interest on their accounts [Stiansen 2004: 155]. As another example, Rashid Rida, the editor-in-chief of *Al-Manar* magazine, reported that when the Egyptian government introduced interest-bearing postal savings, called *Sandūq al-Tawfir*, in the first decade of the twentieth century, more than three thousand depositors rejected the interest [Mallat 1988: 71].

The main controversy is to what extent interest is regarded as *riba*. There are two resolutions to this question among Muslim intellectuals. Some define *riba* only as a usurious rate of interest, and allow any normal rate of interest. In this paper, we call such a view the “usury-*riba* school.” These intellectuals believe that normal rates of interest can serve as a lubricant of economic activities, which implies that interest has a function in improving the efficiency of economic transactions; therefore, only interest rates that would harm economic efficiency and equity should be prohibited. The precursor to this view was put forward by Muhammad Abduh, a mentor of Rashid Rida; his interpretation of this problem was based on the concept of *riba al-jahiliya*, which was defined as defaulted and usurious interest in the Hijaz region during the Prophet’s era [Khalil and Thomas 2006: 70-71]. Abduh considered this kind of interest, which was harmful to the efficiency and equity of society during the Prophet’s era, to embody the concept of *riba*. Most supporters of this view follow Abduh’s interpretation. Syed Ahmad Khan broadcast this view in South Asia in the 1920s [Siddiqi 2004: 56; Aziz *et al.* 2008: 38], and Fazrul Rahman of Pakistan wrote an influential paper entitled “*Riba* and Interest” to support this view in the 1960s [Rahman 1964].

Another group of scholars defines any rate of interest as *riba*; therefore, they consider any transactions involving interest to be impermissible in the light of Islam. In this paper, we call such a view the “interest-*riba* school.” The earliest proponent of this view was considered to be Abul A’ala Mawdudi, a pioneer of the Islamic revival movement in South Asia. He first mentioned the relationship between *riba* and interest in 1941, saying, “It is strictly prohibited in Islamic law to lend these accumulated savings on interest. If you lend your money to anyone, it does not matter whether he borrows for his private needs or for business purposes, you can claim only the principal money and not a single pie more” [Mawdudi 1975 (1947): 37]. Following his argument, Anwar Iqbal Qureshi published a theoretical book in Lahore, which was titled *Islam and the Theory of Interest* in 1945 [Qureshi 1945]. After the 1950s, a number of books and articles on this subject

were also published in the Arab world.<sup>2)</sup>

The opponents of this school of thought usually criticize the fact that it underestimates the positive function of interest as a lubricant. The school counters this criticism by saying that the evil of interest exceeds its use; therefore, any rates of interest should be prohibited. For example, even Muhammad Umer Chapra, one of the pioneering Islamic economists with experience at the Saudi Arabian Monetary Agency (SAMA), who is versed in the importance of monetary policy using interest rates, always begins his writings by mentioning the negative effect of an interest-based financial system in order to criticize capitalism [Chapra 1985: 107-145, 2006: 99-102, 2009: 2].

### 1.2 *Origin of Islamic Economics*

While the view of the usury-*riba* school was consistent with the existing capitalistic system, that of the interest-*riba* school was against the dominant economic regime; it challenged the existence of interest rates. In the middle of the twentieth century, the supporters of the latter view started pursuing an alternative economic system, that is, the Islamic economic system.

This challenge was seen within the context of Islamic revival, which has been a sweeping trend since the beginning of the twentieth century. Islamic revival is an intellectual and pragmatic movement that aims to construct a modernized Islamic civilization based on the ideas of Islam established in the Prophet's era; modernized Islamic civilization implies neither the recycled design of Western modernization nor the revival of pre-modern Islamic "traditional" civilization [Kosugi 2006: 5].

While members of the early generation of the Islamic revival, like Jamal al-Din al-Afghani, Muhammad Abduh, and Rashid Rida, mainly contributed their energy to political and social matters, rarely mentioning economic matters, Mawdudi gave a concrete picture of the modernized Islamic economic system in South Asia in the middle of the twentieth century [Nasr 1996: 103]; therefore, he is well known as a founder of Islamic economics [Kuran 2004: 39; Wilson 2004: 196].

Mawdudi critically analyzed modern economic institutions and explored Islamic ways of renovating them. For example, Mawdudi admitted the government's role in redistributing wealth, but criticized the failure of the fiscal policy in the capitalistic framework to correct the gap between the rich and the poor. He alternatively proposed the institutional reform of the income redistribution function utilizing *zakat*, one of the five pillars of Muslim obligation [Mawdudi 1975 (1947): 16-17, 36-39].<sup>3)</sup> His approach of combining "modern" (not Western) concepts with the

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2) For representative examples, see [Abu Saud 1957; Abū Zahra 1970; Abduh 1977].

3) *Zakat* is the Muslim obligation for every Muslim to pay a certain portion (2.5% in case of cash) of his/her wealth annually. The amount collected is distributed in the way the Qur'an indicates: to the poor, *zakat* collectors, new Muslims, and so on.

ideals of Islam established in the Prophet's era reflected the ideological framework of the Islamic revival mentioned above, and is succeeded by into the methodology of Islamic economics.

Mawdudi crafted his proposal for Islamic economic reform in the political framework; therefore, it did not present a comprehensive picture of an Islamic economics system. However, many others of his day came under his influence, and tried to create a concrete and comprehensive picture of the modern Islamic economics system. The following discussion focuses in particular on some benchmark studies on the preferable financial system based on the ideals of Islam.

In the 1940s, two pioneer works by Islamic economists addressed the Islamic financial system. Anwar Iqbal Qureshi stated in his above-mentioned book that "Islam prohibits interest but allows profits and partnership. If the banks, instead of allowing loans to the industry, become its partners, share the loss and profit with it, there is no objection against such banks in the Islamic system" [Qureshi 1945: 158-159]. His statement implies that the implementation of partnership-based financial instruments, which we currently call *mudaraba* and *musharaka*,<sup>4</sup> is most suitable for the Islamic financial system. Around the same time, Mahmud Ahmad stated in his book, also published in Lahore, his preference for partnership-based systems, saying, "The Shirakat banks would lend money to industry and commerce on the basis of Shirakat, that is, they would share the profit with their debtors rather than burden industry and commerce with a fixed rate of interest" [Ahmad, M. 1947: 170].

Although both works left much to be determined for banking practices, according to Nejatullah Siddiqi's review, they were pioneering in the literature of Islamic economics [Siddiqi 1981: 30]. This is because most Islamic economists of the next generation followed their lead; they also encouraged *mudaraba* and *musharaka* as preferable instruments for Islamic finance. Therefore, this paper calls this trend the "*mudaraba* consensus."

Among this next generation of scholars, Muhammad Uzair and Muhammad Nejatullah Siddiqi played important roles in developing the theory to make it feasible in practice. In 1951, Uzair wrote a paper entitled "Interestless Banking: Will It be Success?" and disclosed the practical idea of *mudaraba*, which became known as "two-tier *mudaraba*" in later times [Uzair 1978]. The originality of his idea is to use two *mudaraba* transactions in one scheme. Depositors (*rabb al-*

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4) *Mudaraba* is a form of business contract in which one party offers capital and another party undertakes some business with this capital; the former is termed *rabb al-mal* and the latter *mudarib*. Any resulting profit is distributed between both parties based on a previously agreed ratio, while the entire loss would be borne by *rabb al-mal* unless *mudarib* is proved to be negligent. *Musharaka* is a form of business partnership in which multiple parties invest. Any profit is distributed between both parties in a previously agreed ratio or shared depending on the amount invested. Any loss is borne by both parties depending on the amount invested.

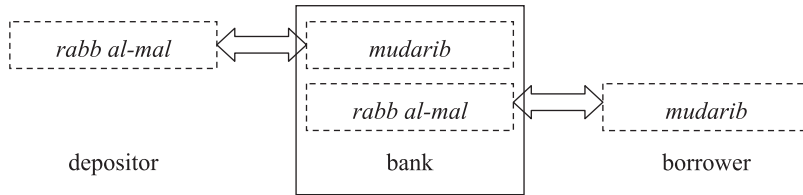


Fig. 1. Mechanism of Two-tier Mudaraba

Source: Author's Own.

*mal*) and a bank (*mudarib*) conduct the first *mudaraba*, while a bank (*rabb al-mal*) and a borrower (*mudarib*) conduct the second *mudaraba* (see Figure 1). Parties of the first *mudaraba* share the bank's profit while those of the second *mudaraba* share the borrower's profit. This mechanism enables a bank to finance in a more efficient way by pooling money from multiple depositors.

In 1969, Siddiqi published a book in Urdu that was later published in English as *Banking without Interest* [Siddiqi 1983 (1973)]. He not only elaborated the theory of two-tier *mudaraba*, but also expanded its applicability to the relationship between commercial banks and a central bank; therefore, his contribution was to show a comprehensive picture of a *mudaraba*-based Islamic financial system.

### 1.3 Islamic Economics as an Independent Academic Discipline

Before the 1970s, a number of works on the Islamic economic system were written by economists and Muslim jurists. As Muhammad Akram Khan points out, these works were scattered in different kinds of journals and magazines; there was no common ground or society through which such issues were discussed [Khan, M. A. 1983: 11]. Therefore, it can be said that Islamic economists did not share the perception that they were driving the engine of constructing the Islamic economic system together.

From February 21 to 26, 1976, a large conference called the "International Conference on Islamic Economics" (Makka Conference) was held in Makka (Mecca), Saudi Arabia. The conference gathered 180 participants with different backgrounds, including economists, Muslim jurists, bankers, and journalists from all over the world. Table 1 shows a summary of sessions organized at the conference. It can be seen that a variety of topics, including Islamic finance, were discussed during the conference [Ahmad, K. 1980: 369-374].

Khurshid Ahmad, a member of the steering committee of the conference, states in the introduction of the book based on the conference presentation:

**Table 1. Summary of Sessions Organized at the Makka Conference in 1976**

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Day 1: February 21, 1976
Inaugural Speeches
Day 2: February 22, 1976
Concept and Methodology
A Survey of Contemporary Literature on Islamic Economics
Day 3: February 23, 1976
Concept and Methodology
Production and Consumption
The Role of the Islamic State in a Modern Economy
Teaching Islamic Economics
Insurance within the Framework of Islamic Shari'ah (Jurisprudence)
Day 4: February 24, 1976
Production and Consumption
Interest-Free Banking
Economic Development in an Islamic Framework
Insurance within the Framework of Islamic Shari'ah (Jurisprudence)
Day 5: February 25, 1976
Interest-Free Banking
Zakat and Fiscal Policy
Economic Co-operation among Islamic States
Day 6: February 26, 1976
Concluding Session

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Source: [Ahmad, K. 1980: 369-374]

The Conference provided the Muslim economists with a rare opportunity, the first in recent history, to address themselves to the problems of Islamising economics including an effort to elucidate the basic concepts of Islamic economics and deliberating upon ways and means of implementing them in the contemporary world. It was highly rewarding for the Muslim economists to meet each other and develop personal and professional contracts directed towards promoting research in the nascent social discipline of Islamic economics. It was also a unique experience for the professional economists to co-operate at such close quarters with the “Ulema” and mutually avail themselves of each other’s expertise in the promotion of a common cause [Ahmad, K. 1980: xviii]

From Ahmad’s statement, it can be said that this conference was a milestone in the history of Islamic economics in the sense that Islamic economics became an independent academic discipline.

This view is shared by many researchers [Khan, M. A. 1983: 7; Khan, T. 1984: vii; Haneef 1995: 1; Wilson 2004: 200-201; El-Ashker and Wilson 2006: 349].

After the conference, Islamic economists became very active, forming professional institutions of Islamic economics. The following year, King Abdulaziz University in Jeddah, Saudi Arabia, set up the Islamic Economics Research Centre (IERC).<sup>5)</sup> The establishment of the IERC was the third recommendation of the Conference Communiqué [Ahmad, K. 1980: 353]. In addition to the IERC, the Islamic Development Bank headquartered in Jeddah, Saudi Arabia, established an affiliated organization for Islamic economics named the Islamic Research and Training Institute (IRTI) in 1981. As for the academic society, the International Association for Islamic Economics (IAIE) was formed in 1984 and continues to organize the same kind of conferences to the present.<sup>6)</sup>

## 2. Transformation of Islamic Economics

At the same time as the inaugural conference on Islamic economics, two kinds of Islamic economic practices were emerged; one was the commercial practice of Islamic finance; another was the introduction of comprehensive Islamic economic systems. This section tries to clarify how both movements have an impact on the dynamics of Islamic economics.

### 2.1 Emergence of the Commercial Practice of Islamic Finance

The commercial practice of Islamic finance was launched in the Gulf countries in the 1970s. The Dubai Islamic Bank, the first commercial Islamic bank in the world, started operations in 1975. Subsequently, a number of Islamic banks were established, not only in the Gulf, but also in other Arab countries (see Table 2).

The rise of the practice of Islamic finance provided an exciting opportunity for Islamic economists who shared the *mudaraba* consensus to examine the feasibility of their theory. However, from the 1970s onward, the practice did not necessarily reflect the theoretical suggestions made by Islamic economists prior to that period. While most Islamic banks adopted *mudaraba* for the scheme of deposits (especially for term deposit accounts), they did not adapt it as the main financing scheme, but adopted *murabaha* as an alternative instrument.<sup>7)</sup> Since the 1970s, *murabaha* has been the most popular financial product in the asset side of Islamic banks. With regard to its share, a

5) In 2011, the IERC evolved into the Islamic Economics Institute (IEI). The IEI aims to provide educational graduate programs and training courses for the private sector.

6) The latest conference (the eighth conference) was held in Doha, Qatar, in 2011.

7) *Murabaha* is a form of contract wherein a seller sells a product to a buyer at a price comprising its wholesale cost and the seller's margin, as agreed by both parties. The settlement is generally paid in installments. In Islamic finance, a bank buys a product specified by the customer on his behalf from the market and sells it to him at a price that adds the bank's profit.



Table 2. List of Islamic Banks Established in the 1970s

Name	Country	Date of establishment	Date operations began
Dubai Islamic Bank	UAE	March 10, 1975	September 15, 1975
Kuwait Finance House	Kuwait	March 22, 1977	August 31, 1978
Faisal Islamic Bank of Sudan	Sudan	April 4, 1977	May 10, 1978
Faisal Islamic Bank of Egypt	Egypt	August 27, 1977	July 5, 1979
Jordan Islamic Bank for Finance and Investment	Jordan	November 28, 1978	September 22, 1979
Bahrain Islamic Bank	Bahrain	March 7, 1979	November 22, 1979

Source: Prepared by the author based on data collected through field research.

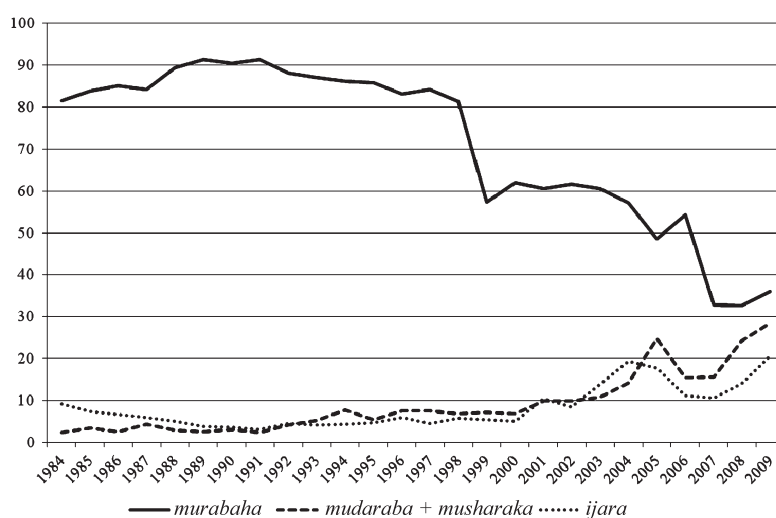


Fig. 2. Dubai Islamic Bank: Mode of Financing (% of Total Financing)\*

\* *Ijara* is a leasing contract in Islamic finance.

Source: Calculated from the annual reports of the Dubai Islamic Bank, 1984-2009.

majority of Islamic banks in both the Middle East and Malaysia exhibit a widespread preference for *murabaha*. For example, *murabaha* has occupied a higher share of the assets of the Dubai Islamic Bank, even if the annual share in the 2000s is smaller than those in the 1980s and 1990s (see Figure 2). At Bank Islam Malaysia, established in 1983 as the first commercial Islamic bank in Southeast Asia, *murabaha* (including *bay bi-thaman ajil*, that is similar to *murabaha*) has also occupied the highest share of total financing on its asset side every year (see Figure 3). Al-Harran estimates that 80-90% of financial instruments on the asset side of Islamic banks were *murabaha* from the 1970s through the first half of the 1990s [al-Harran 1995: xi].

## 2.2 Islamization of the Economy in Pakistan, Iran, and Sudan

In the 1980s, three countries, Pakistan, Iran, and Sudan introduced comprehensive reforms to

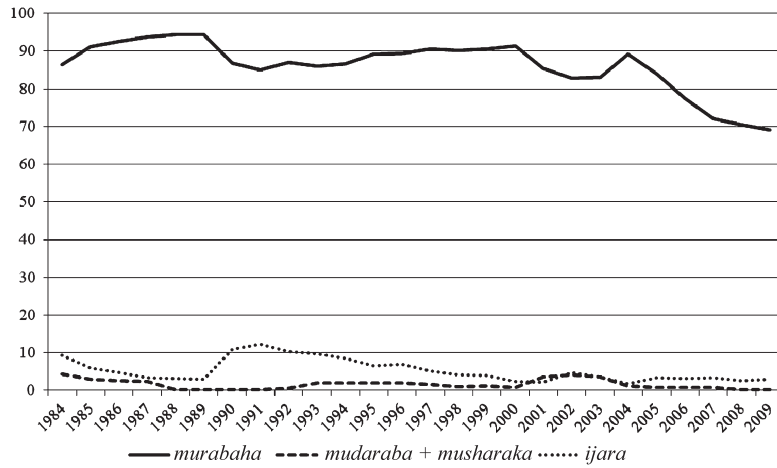


Fig. 3. Bank Islam Malaysia: Mode of Financing (% of Total Financing)

Source: Calculated from the annual reports of Bank Islam Malaysia, 1984-2009 (Data from 1984 to 1987 are cited from [Sum 1995: 95]).

Islamize their economic systems. In the banking sector, these countries tried to totally abolish interest-based operations. For example, Pakistan embarked on the Islamization of banks after Zia-ul Haq’s takeover in 1979, starting with state-owned banks in the same year, and commercial banks in 1981 and completing the project in 1985 [Khan and Mirakhor 1990; Anwar 1992]. Iran started implementing the Islamic economic system after the Iranian revolution in 1979 [Amin 1986; Anwar 1992]. Sudan undertook the Islamizing project of Jaafar Numeiri’s regime in the 1970s [Shaaeldin and Brown 1988].

Counter to the commercial practice of Islamic finance that originated in the Gulf countries, these countries introduced the system in accordance with the theoretical suggestions made by the Islamic economists mentioned above. As many studies have already mentioned, however, the challenge of Islamizing the economies in these countries was not necessarily successful for several reasons [al-Omar and Abdel-Haq 1996; Khan and Bhatti 2008]. In the case of Pakistan, the policy of Islamizing the economy was phased out after the accidental death of Zia-ul Haq in 1988. In 1991, the Federal Sharia Court rendered a judgment that dealing with interest rates in banking operations was incompatible with the teaching of Islam because of the concept of *riba*. The judgment ironically shows that interest-based banking operations still existed in the early 1990s, which means that the Islamization of the economy, including eliminating interest-based finance, had already lost substance by that time.<sup>8)</sup>

Al-Omar and Abdel-Haq explain that one of the difficulties in Islamizing the economy was the

inability to apply Islamic financial instruments to some important areas of finance, like public and external debt and monetary policy [al-Omar and Abdel-Haq 1996: 101-102].<sup>9)</sup> Khan and Bhatti point out a number of deficiencies and concerns about the practice of Islamic finance in Pakistan: (1) deviations from the initial design of Islamization, (2) lack of proper Islamic training for bankers, (3) public concerns and doubts about Islamization, and (4) insufficient measures by the government [Khan and Bhatti 2008: 121-125].

### **2.3 Islamic Economics: Aspiration and Reality**

Both outcomes of the commercial practice of Islamic finance and the comprehensive Islamization of the economy raised questions about the feasibility of the theoretical suggestions by Islamic economists based on the *mudaraba* consensus, although several external factors (political, economic, and social) should be considered. Islamic economists discussed different aspects of this problem and eventually formed two groups.

Firstly, those who still aspire to the ideal of Islamic economics and adhere to the *mudaraba* consensus seek feasibility in a partnership-based financial system with indefatigable energy. In this paper, we call this group the “aspiration-oriented school<sup>10)</sup>.” This school is rigidly committed to creating an entirely new financial system to replace the current world economic regime, which is the original motivation of Islamic economics. Some of them try to show the theoretical advantage of *mudaraba* using an economic model. For example, Mohsin Khan [1987] focuses on the recovery process of banks’ balance sheets in case of recession, and compares the recovery speed between Islamic and conventional banks. According to his result, Islamic banks using a two-tier *mudaraba* scheme can recover their balance sheets immediately due to the combination of assets and liabilities, while conventional banks need more time to recover their balance sheets due to the separation of assets and liabilities. Therefore, he concludes that Islamic banks are relatively more stable than conventional banks.<sup>11)</sup> In the field of economics, new economic models like information economics and game theory are positively adopted to prove the theoretical advantage of the partnership-based financial system [Khan, W. M. 1985; Khan and Mirakhor 1987; Mills and Presley 1999; Iqbal and

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8) Since 2000, a number of Islamic banks have been established in Pakistan. This trend is not in line with the Islamization of the economy but the commercial practice of Islamic finance, as in other countries. Meanwhile, Iran and Sudan are still pursuing the comprehensive Islamization of the economy.

9) Iqbal and Molyneux also point out the difficulty for central banks in conducting monetary policy using the financial instruments introduced in the Islamization phase [Iqbal and Molyneux 2005: 41-42].

10) Zubair Hasan calls this group the “Jeddah school” [Hasan 2005: 11] because a number of Islamic economists in Jeddah support the *mudaraba* consensus, where the IERC and IRTI are located.

11) Khan uses “stability of the financial system,” but it seems better to use “soundness of banks,” because he only focuses on the soundness of the balance sheets of banks and does not examine the stability of the banking system itself.

Llewellyn 2002]. Furthermore, others pursue the potential of partnership-based instruments to reduce poverty and increase rural development in the context of the social role of Islamic finance [Osman 1999; Sadr 1999; Abdalla 1999].

Secondly, those who face reality and give importance to the economic feasibility of Islamic finance accept the current situation of commercial Islamic finance, which mainly adopts *murabaha* as a tool. They are very sensitive to the market demand of the Islamic financial industry and help produce a number of new financial products. For example, they produced several prototype schemes in the 1990s that contributed to the rapid growth of Islamic finance in the 2000s: Islamic securities currently known as *sukuk*, a liquidity management tool currently known as commodity *murabaha*, and Islamic credit cards. In this paper, we call this group the “reality-oriented school.” Their vision of Islamic finance is that it should be competitive with conventional finance and provide an alternative choice in the current world economic regime. Nizam Yaquby, who leads the Sharia Supervisory Board of several leading Islamic banks, states, “The claim that traditional financial institutions desire to unfairly compete with Islamic financial institutions can be refuted by saying that competition is always in favor of the most suitable, efficient, and fittest. This kind of competition may prompt Islamic financial institutions to exercise more diligence and care to introduce better quality products and conduct their activities more efficiently” [Yaquby 2005: 47]. This group includes not only academic researchers and Muslim jurists, but also bankers and lawyers. Most of them join in the industry and play an active role in mainstream Islamic finance.

Although supporters of the reality-oriented school accept the current situation of *murabaha* as a major tool in commercial Islamic finance, they consider *murabaha* second best, which implies that *mudaraba* is the first-best solution in their view. On the other hand, a few Islamic economists think that *murabaha* best reflects the ideals of Islam. For example, Monzer Kahf approves of *murabaha* because it provides liquidity by means of a series of buying and selling transactions; he insists this feature is a core idea of the Islamic economic teaching [Kahf 1999: 449-451].<sup>12)</sup> His view is not necessarily shared by the majority, but it seems to have the potential to resolve the dichotomy between the aspiration and reality of Islamic economics and finance.<sup>13)</sup>

### 3. Emergence of New Horizons in Islamic Economics

The rapid growth of Islamic finance after 2000 raises a new question on the practice of Islamic finance. The criticisms have been raised against the compatibility of current Islamic financial

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12) Abdul Halim Ismail also shares Kahf's view [Ismail 2002: 2].

13) Nagaoka [2007, 2010] tries to clarify the core features of Islamic economic teaching from the same perspective.

products as a whole and their purpose. This section overviews the arguments on the issue and clarifies how Islamic economics tries to overcome this challenge.

### **3.1 *Rapid Growth of Islamic Finance and the Critique of Its Practice***

The commercial practice of Islamic finance rapidly grew after 2000 in terms of both numbers and spread. The average annual growth rate after 2000 was over 20%, and the total assets of the Islamic financial industry reached one trillion USD at the end of 2009 [TheCityUK 2011]. Although the market share of Islamic finance in the world is under 1%, its share in developing and emerging countries is 15%.<sup>14)</sup> Therefore, the practice of Islamic finance is expected to expand worldwide in the near future if we consider its potential economic growth.

One of the key factors in the rapid growth of Islamic finance is the development of new financial products, some of which have been mentioned above: *sukuk*, commodity *murabaha*, and Islamic derivatives. These products were developed to match the development of conventional finance and maintain competitiveness. Since their development, Islamic finance has succeeded in taking a certain portion of market share.

As unanimously agreed by the bankers and researchers in this field, all the services of Islamic finance must be compliant with the teachings of Islam; the existing Islamic financial institutions certainly attach high importance to this condition. In order to be commercially successful in a situation where the practice of Islamic finance coexists with conventional finance, Islamic finance needs to provide competitive financial products that are acceptable to all customers (both Muslims and non-Muslims). Thus, the practice of Islamic finance must maintain a balance between the above two conditions—complying with the teachings of Islam and providing competitive financial products—in order to survive as a financial practice.

However, most practices of Islamic finance do not necessarily satisfy both the conditions. Many controversies regarding this matter—for example, determining which condition must or should be considered more important by Islamic finance—have been observed throughout the history of this field, as shown in the case of *murabaha* and *mudaraba*. The situation of Islamic finance in the 2000s stimulated this controversy because the new products mentioned above were developed giving high priority to marketability.

Generally speaking, each Islamic bank has its own Sharia Supervisory Board consisting of prominent Muslim jurists that judges the compatibility of the products with the teachings of Islam. Of course, these controversial products are also approved by the board. However, criticisms have

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14) Except China and India. Calculated by the author based on [Mckinsey Global Institute 2009; TheCityUK 2011].

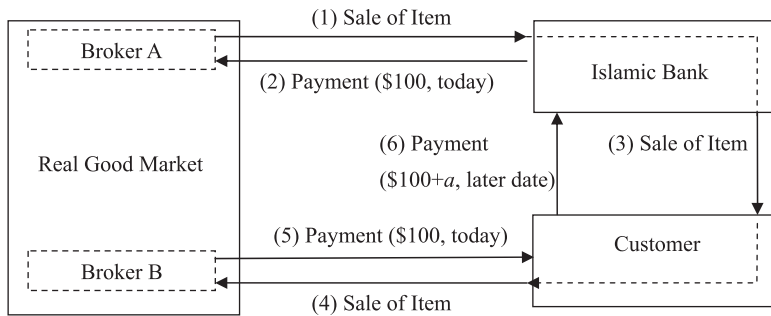


Fig. 4. Scheme of *Tawarruq* in Islamic Finance

Source: Author’s Own.

been raised against the focus of Muslim jurists on the Sharia compliance of each transaction, on an individual basis, and not considering the compatibility of Islamic financial products as a whole and their purpose. Mahmoud El-Gamal calls such a process of approving products “Sharia Arbitrage” [El-Gamal 2006: 174], and the critics generally use the term “Sharia-compliant finance” to criticize the current situation of commercial Islamic finance.

### 3.2 Controversy over Sharia-Compliant Finance: A Case of *Tawarruq*

The most controversial case of Sharia-compliant finance is *tawarruq*. *Tawarruq* is a form of contract for monetary liquidization. According to al-Zuḥaylī, the name was mentioned in classical Islamic jurisprudence [al-Zuḥaylī 1997]. In the practice of Islamic finance, an Islamic bank primarily buys a real good from the commodity market at the current market price on behalf of its customer who needs instant liquidity.<sup>15)</sup> Then, the Islamic bank sells it to the customer using a *murabaha* scheme. Subsequently, the customer sells it back to the commodity market at the current market price to gain monetary liquidity. Finally, the customer pays the amount specified by the *murabaha* agreement on the date of maturity.

According to a concise review [al-Shalhoob 2007] and the author’s independent field survey regarding the current practice of *tawarruq* in Islamic finance, the National Commercial Bank (NCB) in Saudi Arabia is a pioneer in using *tawarruq* as a financial product under the brand of “*taysir*” in 2000. After this launch, several Islamic banks in the Gulf countries began to adopt *tawarruq*, and presently it is a very popular financial product for consumer loans.<sup>16)</sup>

15) The scheme of *tawarruq* generally involves metals (zinc, bronze, nickel, tin, and copper) in its transactions while dealing with large international commodity markets such as the London Metal Exchange (LME).

16) A wide variety of product brands is based on the scheme of *tawarruq*: “*mal*” at the Saudi British Bank, “*Dinar*” at Bank al-Jazira, “*Tawarruq Khayr*” at SAMBA, “*Khayr*” at the Abu Dhabi Islamic Bank, and “*Tasbir*” at the Bahrain Islamic Bank.

The controversy is raised over the legitimacy of *tawarruq* bundling and stipulating the “resale and liquidization process” (Nos. 4 and 5 in Figure 4) with the original sale. In most cases, Islamic banks arrange and manage the whole process of *tawarruq*, and only receive the difference between the price for the *murabaha* scheme and the market price. Critics of *tawarruq* mention that this stipulation makes *tawarruq* merely a fictitious instrument to avoid interest-based loans because in such a practical application of *tawarruq*, the actual transactions of the real good tend to become just nominal on paper. They consider that such application ignores the real purpose of *tawarruq*. For example, Siddiqi emphasizes that *tawarruq* is identical to interest-based loans not only at the functional level, but also from the macroeconomic perspective [Siddiqi 2006: 16]. Furthermore, Kahf insists that the use of *tawarruq* must be limited because it may be economically worse than the practice of interest-based loans [Kahf 2004: 6].

The revision of the legal resolution issued by the Fiqh Academy at the Muslim World League (MWL, *Rabita al-Alam al-Islami*) reflects this tendency of critique of recent practical applications of *tawarruq* in Islamic finance. Until recently, the Fiqh Academy at MWL issued two legal resolutions on *tawarruq*. In the first resolution issued at the fifteenth meeting held on October 31, 1998, the Fiqh Academy approved *tawarruq* with no reservations (No. 5 resolution of the meeting) [MWL 1999: 161-162]. However, along with the prominence of *tawarruq* in Islamic banks, particularly in the Gulf countries, the Fiqh Academy revised the former resolution and divided *tawarruq* into two types: *tawarruq haqiqi* (intrinsic *tawarruq*) and *tawarruq munazzam* (organized *tawarruq*). In a resolution issued at the seventeenth meeting held December 13-17, 2003, the Fiqh Academy approved *tawarruq haqiqi*, while it disapproved *tawarruq* practiced in Islamic finance—the so-called *tawarruq munazzam* (No. 3 resolution of its meeting) [MWL 2004: 287-288]. According to this resolution, the Fiqh Academy defines *tawarruq munazzam* as including the following three impermissible factors:

- (1) An Islamic bank is involved in a resale and liquidization process (Nos. 4 and 5 in Figure 4) as an agent of its customer.
- (2) The involvement of Islamic bank in the entire process of *tawarruq* makes the transfer of the title of the relevant good unclear.
- (3) Providing *tawarruq* becomes merely a stable way for the bank to earn profits.

Most recently, the Fiqh academy at the Organization of Islamic Cooperation (OIC) issued a new resolution on *tawarruq* at the nineteenth meeting, held on April 26-30, 2009, under the auspices

of the MWL. Although this resolution fundamentally confirms the second resolution by the Fiqh Academy at the MWL, it adds one more condition for defining impermissible *tawarruq munazzam*. In the second resolution by the MWL, the involvement of an Islamic bank in any part of the process of *tawarruq* is not allowed, as this is the impermissible *tawarruq munazzam*. The latest resolution by the OIC reinforces this rule by defining *tawarruq munazzam* more clearly:

The contemporary definition on organized *tawarruq* is: when a person (*mustawriq*) buys merchandise from a local or international market on a deferred-price basis. The financier arranges the sale agreement either himself or through his agent (*tawkil*). [OIC 2009: 12-13]

The important point in this statement is that even the involvement of the agent of an Islamic bank is impermissible. This resolution causes many arguments among bankers in the Gulf countries because many Islamic banks in the Gulf countries use the scheme of *tawarruq* with their agents. Most Islamic bankers and Muslim jurists at the Sharia Supervisory Board do not feel pessimistic about the latest resolution. For example, Nizam Yaquby comments that because all these Islamic finance tools are organized (*munazzam* in the Arabic, noted by the author) to a certain extent, it is very difficult to do something that is not organized. He concludes that if proper procedures are implemented, then *tawarruq munazzam* is a useful tool and can be used.<sup>17)</sup> It seems that although the scope of *tawarruq* that satisfies such conditions as mentioned in the above resolutions continues to narrow, bankers and Muslim jurists will search for a prudent way to utilize *tawarruq* in the practice of Islamic finance; therefore, the controversy over Sharia-compliant finance will continue.

### 3.3 Beyond Sharia-compliant Finance

After the middle of the 2000s, a new trend from the aspiration-oriented school emerged in Islamic economics in order to overcome the current situation of Sharia-compliant finance. The incubators of this trend tried to exploit the new areas of the practice of Islamic finance, where conventional finance could not ensure enough service or could cause negative effects [Asutay 2007: 16]. They focused on microfinance lending and socially responsible investment (SRI) as concrete areas for applying Islamic finance.

The idea of microfinance does not originate in Islamic finance, but shares commonality with *mudaraba* and *musharaka* in terms of the mechanism that makes a lender responsible for the

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17) Yaquby talked about *tawarruq munazzam* in an interview with *Reuters*. His comment referenced in this paper is cited from the website of the *Gulf Times* (July 26, 2009, <<http://www.gulf-times.com/>>).



business of a borrower. The pioneering Islamic banker Ahmad al-Najjār, who established Mit Savings Ghamr Bank in Egypt in 1963 had proposed an idea similar to microfinance [al-Najjār 1972]. Although there are many microfinance institutions in the informal sector, the aspiration-oriented school of Islamic economists proposed implementing the practice on a commercial basis. There are currently few practices on this form of Islamic microfinance [Askari *et al.* 2009; Seibel 2008], but it has started to catch the attention of both academic researchers and practitioners [Abdul Rahman 2007; IRTI 2008; Obaidullah 2008].

The proposal for Islamic SRI is synchronized with the world trend of SRI, that is, corporate stakeholders put high priority on companies that do social good. Unlike conventional SRI, Islamic SRI includes religious aspects of corporate activities and social action programs like educational, welfare, and medical services through the *zakat* payment. In addition, the exclusion of incompatible business in the light of Islamic teachings is also a distinctive feature; for example, gambling (casinos, horse racing), unethical businesses (military, pornography industry), and un-Islamic transactions (deals involving alcohol and pork, issuing interest-bearing corporate bonds) are forbidden. Recently, Islamic indices (Sharia indices) for the stock market have been developed in order to clarify which companies keep their business compliant with Islamic teaching.<sup>18)</sup> These indices select companies compliant with Islam based on their own criteria.<sup>19)</sup>

In addition to Islamic microfinance and Islamic SRI, the aspiration-oriented school has recently focused on the traditional Islamic economic institutions like *waqf* and *zakat*.<sup>20)</sup> The practices of these institutions are still alive in the contemporary Islamic world, although they are getting scarce in many regions. The aspiration-oriented school is trying to activate these institutions using the scheme of Islamic finance, tapping a new market for Islamic finance. For example, it can be observed in Singapore that the multiple channels of Islamic finance are used to activate *waqf* properties: fund-raising using *sukuk* and renovating properties using *musharaka* [Abdul Karim 2010]. As another example, some Gulf countries have plans to turn over their sovereign *zakat* funds using Islamic financial instruments.<sup>21)</sup> These practices have just been launched, but have great potential to allow organic integration of the Islamic economic system in the modern world, which many Islamic economists of the early generation emphasized as necessary.

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18) FTSE began releasing the FTSE Global Islamic Index in 1998; Dow Jones and the Kuala Lumpur Stock Exchange (Now Bursa Malaysia) began releasing their own Islamic indices in 1999. Currently, these institutions provide more detailed indices specialized for each region. In Japan, the S&P/TOPIX 150 Sharia Index and the FTSE Japan Sharia Index are aimed at domestic companies.

19) For more details on the criteria for each index, see [SC 2009].

20) *Waqf* is a property donated by the owner for Muslim religious or charitable purposes.

21) Information based on the author's field research in the United Arab Emirates in 2011.

As briefly reviewed in the previous section, the aspiration-oriented school concentrated its efforts in the 1990s on the development of theory based on the *mudaraba* consensus. In contrast, the efforts in the 2000s also consider the practical feasibility with their beliefs. Although the main part of the current practice of Islamic finance depends on the reality-oriented school, the new horizons driven by the aspiration-oriented school will be a certain portion of Islamic finance in the near future.

### Concluding Discussion

This paper described the history of Islamic economics in terms of the dynamics between the aspiration and reality. It can be summarized that the history of Islamic economics, which originated in the middle of the twentieth century, is strongly tied to the practice of Islamic finance. In particular, the emergence of the commercial practice of Islamic finance in the 1970s gave strength to the arguments about Islamic economics, and resulted in a division of the discipline into two groups: the aspiration-oriented school and the reality-oriented school. All the issues involving Islamic economics have been argued using this fundamental framework. Remarkably, it can be found that both groups share common ground for their arguments; that is, they both define *riba* on exactly the same basis, that of the interest-*riba* school. This implies that the usury-*riba* school mentioned in this paper is completely marginalized from the arguments in Islamic economics. Furthermore, there are no interactions between the interest-*riba* school and the usury-*riba* school. Figure 5 describes this situation regarding the relationship between Islamic economics and the position towards *riba*.

As a matter of fact, all Islamic finance products are structured without interest, which is based on the interest-*riba* school's definition of *riba*. This rule is, of course, applied to recently developed financial products, which has led to criticisms against Sharia-compliant finance. Regarding this issue, voices outside Islamic economics say that the problem of these products stems from the perfunctory application of the definition of *riba* without substantial consideration. In contrast, we cannot find such criticism among the supporters of the aspiration-oriented school. This shows the robustness of the fundamental framework of Islamic economics based on the position towards *riba*.

Remarkably, a few polemic Islamic economics researchers promote implementing the Islamic economic system in the modern world. Mahmoud El-Gamal pursues the ideal practice of Islamic finance, by criticizing Sharia-compliant finance and stating that if a certain financial product causes harmful results, in terms of both economic efficiency and religious compatibility, such a product should not be approved as an Islamic financial product even if it does not include interest. From this statement, we can understand that he belongs to the aspiration-oriented school. Unlike the other

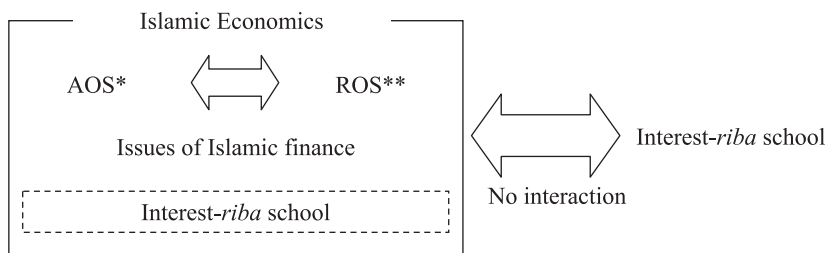


Fig. 5. Fundamental Framework of Islamic Economics

\* AOS: aspiration-oriented school

\*\*ROS: reality-oriented school

Source: Author's Own.

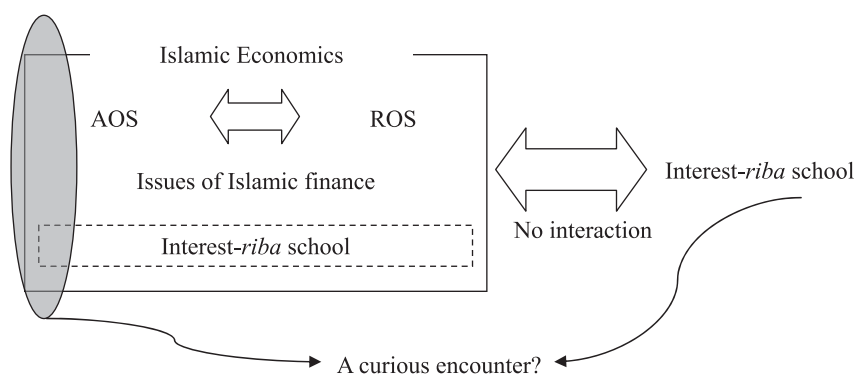


Fig. 6. A New Innovative Fusion of Islamic Economics?

Source: Author's Own.

Islamic economists of the school, however, he addresses the perfunctory application of the definition of *riba* to Islamic finance [El-Gamal 2006: 175-189]. He radically states that if a certain financial product enhances economic efficiency, such a product should be approved as an Islamic financial product even if it includes interest. In this sense, he obviously depends on the usury-*riba* school's definition of *riba*. This is a curious encounter of the aspiration-oriented school and the usury-*riba* school, which can be called a new innovative fusion of Islamic economics (see Figure 6).

El-Gamal's position is too innovative to be accepted by either Islamic or non-Islamic economists (supporters of the usury-*riba* school). This is because his idea sounds inconsistent in the sense that he pursues the ideal Islamic economic system with referring the usury-*riba* school definition of *riba*. However, seeing his idea, we can freshly recognize the fundamental framework shown in this paper, and also realize the innovativeness of his argument as a new horizon in the context of the modern movement of Islamic economics.

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