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Southeast Asia Strategy

**A fundamental principle
of Islam is the equitable
distribution of wealth.**

This is not happening.

**Is this a failure of
economics?**

**Or does the problem lie
elsewhere?**

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Unequal wealth

States influenced by Islamic law have enormous economic potential that has so far gone largely untapped. Is this because Islam and the neoclassical economic model are incompatible? By examining the successful neoclassical model in an Islamic context, we find the problem rests with government and outmoded interpretations of the Scriptures. Our analysis shows the workings of an Islamic economic model, and suggests ways to work with restive Muslim communities.

Islam can accommodate neoclassical economics

Malaysia, Turkey and Indonesia are examples of how secular government can create the conditions of the neoclassical economy within a predominantly Muslim state. Islamic banking in those countries is growing in the right direction as it finds innovative ways to offer products that comply with the Scriptures while fulfilling the objectives of equitable wealth distribution.

Isolationism is no panacea

The global economy is an interdependent one. Ownership of resources, trade and services within Islamic economies is complex, but the neoclassical economic world has supplanted the pre-modern, requiring a re-examination of how best to recognize and reward inputs and outputs.







A prevalence of ignorance exists

Global economics requires a compatible set of economic tools, but there is an interpretative gap between the Scriptures and their modern application, which is being exploited by vested interests. Education is being directed towards reinforcement of fundamentalism over adaptation towards realism, and the absence of government in guiding constructive education is often the cause of, not the solution to, economic problems.

Lessons for southern Thailand

Islamic fundamentalism, financed and spread from the Middle East and feeding on poverty and lack of development, threatens to bring instability to Southeast Asia's moderate Muslim communities – not least in largely Buddhist Thailand's increasingly unstable Islamic southern provinces. In this report, we suggest a six-point plan for the Thai government to resolve, in an acceptable manner, its southern problems to the mutual benefit of both Buddhist and Muslim communities. Basic to any resolution must be effective economic stimulus that reinforces a sense of nationalism and hope. This approach has application across Southeast Asia, which has long been a seat of a moderate Islam until now divorced from the problems of its Middle Eastern cousins.

Six-point plan for Thailand

-  **Take control under acceptable standards**
-  **Break the vicious educational cycle**
-  **Provide economic stimulus to the region**
-  **Localise institutions and power**
-  **Reinforce nationalism and create hope**
-  **Accurately price the future social value of the region**

Contents

Executive summary..... 3

Introduction 4

Islam’s basic objectives 6

Islamic economic model 7

Obstacles to Islamic market economy.....18

Islamic political economy20

Evolution of an Islamic economy.....26

Islamic banking30

Implications for Thailand (with a six-point plan)36

Conclusions40

Appendices

Appendix 1: Glossary of economic terms 41

Appendix 2: Select bibliography 42

CLSA Islamic banking
ASIA-PACIFIC MARKETS Sector outlook

Creative opportunity
Starting as a collection of nationally distinct experiments in the 1970s, Islamic banking is now one of the biggest growth areas in international finance. A key attraction is its ability to mobilise latent potential in, and capital of, the 1.3bn-strong Ummah, or Muslim nation. This segment is poorly served by conventional banks which do not meet Shariah law. As product and regulation become increasingly uniform, integration of this significant market into global financial infrastructure is a matter of time.

Overview of Islamic banking

- Key principles underlying Islamic banking relationships are prohibition against charging interest (riba) and the profit-loss sharing relationship with customers.
- Notwithstanding additional supervisory elements such as religious committees, Islamic banking instruments now rival those of the conventional sector.

Islamic banking in Malaysia – Framework

- Malaysia’s Islamic banking system is the most proactive in the world, receiving strong support from the government and central bank.
- A pioneer in ground-breaking products such as sukuk (Islamic bonds) and takaful (Islamic insurance), almost 50% of banking assets are Islamic.
- With a complete Islamic finance infrastructure in place, Malaysia aims to become an Islamic banking hub with the issue of three new banking licences.

Islamic banking in Malaysia – Growth

- Growth took off in 1993 when conventional banks were allowed to operate Islamic banking windows – those entities now account for over 70% of the system assets.
- Key traits are a strong retail focus at 73% of financing and undistributed reserve base with a financing/deposit ratio below 70%.

Bank Islam – Renaissance?

- Bank Islam was established in 1982 as the first Islamic bank in Malaysia.
- Lack of investor familiarity with operations and its erratic financial performance make it the cheapest bank in Malaysia, with market valuation a bargain 0.6x P/BV.
- Already in a phased restructuring, a potential merger with Bank Muamalat and infusion of new management would significantly improve its operating outlook.

Islamic banking assets as % of Malaysian banking system

Year	Percentage (%)
1997	2
1998	3
1999	4
2000	5
2001	6
2002	7
Mar-03	8
Jun-03	9
2010	18

Source: Bank Negara Malaysia

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CLSA regularly monitors Southeast Asia’s innovative approach to blending Islamic thinking with modern economics.

Unequal wealth

Fundamental principles

One of Islam’s fundamental principles is the equitable distribution of income. Empirically, this is not happening in Islamic society. Is there a basic economic reason for this failure, or is it an organizational one?

Key questions

This paper will consider the answers to a number of key questions. Is there such a thing as an Islamic economic model? Will the elaboration of such a model yield useful insights into the current functioning and future possibilities for Islamic states? Will this delineation of the political-economy of Islamic states provide guidelines for Thailand’s three most-southern provinces?

Moral obligation

The answer in all cases is “yes”. The moral obligation to achieve equitable income distribution lies in the hands of those vested with the responsibility to govern, and is not impeded by any fundamental economic constraints.

Interpretative gap

The basis for the prevailing Islamic economic model follows from the Prophet Muhammad’s five pillars – of faith, daily prayer, fasting, contributing to the poor and pilgrimage. It is these basic principles that form the basis of Islamic law as interpreted by Islamic leaders today. However, there is an interpretative gap between the Scriptures and their modern application. This gap makes any clear statement of an Islamic economic model difficult, though not impossible. This paper highlights the original premise for the economic system and how some interpretations differ from the original.

Neoclassical economic

We will first look at the basic components of the neoclassical economic framework, and consider them in the Islamic context. This includes an external sector, international linkages, the government sector, financial markets and the money supply, and their implications for interest rates and the household sector. Critical to understanding the Islamic economic model are the government sector and financial markets.

Original intent

A cornerstone to the Prophet Muhammad’s original intent was that individuals were to achieve a satisfactory standard of living and there should be an equitable distribution of wealth across individuals. The governmental sector under Islam, *to the extent it must participate*, must act upon its responsibility to tax and redistribute wealth to achieve an equitable distribution of wealth.

Zero interest rate

Financial markets are given much attention by Islamic scholars on the basis of interpretation that interest rates must be zero. This paper sets out the case that Islam does not preclude a positive interest rate and discusses the consequences of a forced zero interest rate, particularly in an open economy.

Vested interests

This paper discusses the ramifications of such a model for the political-economies of Islamic states. Islamic political economics will be shown to be undeveloped due to particular interpretations of the Scriptures, historical vested interests preserving the status-quo, and a non-cooperative international setting.

Outside forces

A specific examination is made of Southeast Asia, and the current state of unrest in the southern Thai provinces is considered in light of the basic framework of Islamic principles and the Islamic economic model outlined. This report finds opposing economic forces and desires exacerbated by outside forces. The Royal Thai Government must be proactive in instituting a fair and equitable Islamic political-economy better integrated into the economic mainstream.

Those who govern have a moral obligation

An ideal Islamic society

Islamic economy has not evolved beyond the simplistic

After dominated the early spice trade . . .

Introduction

When the Prophet Muhammad and his followers moved from Mecca to take Medina in the early seventh century, the pre-modern economy in which the Prophet was a participant was expanding rapidly, had partially monetised and was relatively closed (by today's standards and realities).

In receiving the words of Allah, the Prophet Muhammad expounded certain guiding principles in the *Quran* (the Koran) that needed to be satisfied, and upon which the ideal Islamic society should be built. In the interests of relevance, the Scriptures he revealed must accordingly be read and interpreted in such light if we are to realistically attempt to define an Islamic economic model in the early 21st century. Failure to do so is to ignore technological or social development since that time, and that man's use of resources entrusted to him has been at best under-optimised, and at worst wasted.

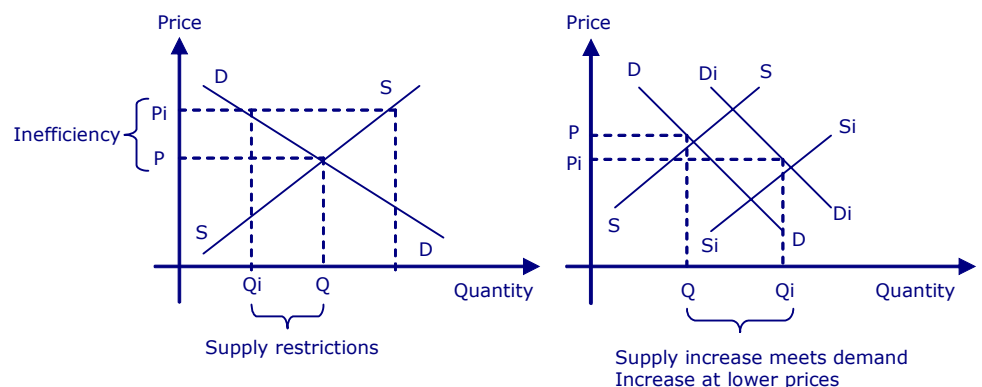
There have been many revisions and interpretations of the Prophet Muhammad since his death in 632CE (Common Era).

Development of Islam, in its many forms, is well documented. On that developmental path there have been many fractures, healings and re-fractures, with the result a stable Islamic economy has not had the opportunity to evolve beyond the most simplistic one encountered by the Prophet Muhammad. However, there have been periods of relative stability that shed light on the possible form of such a model. Even a cursory examination reveals consistent characteristics and preconditions.

One of these conditions has been the existence of relatively efficient markets. Take the example of the spice trade. The most simplistic supply and demand curves were in existence and operated according to basic neoclassical economic principles. A shortage of supply was capitalized upon by Islamic traders through the pricing mechanism, which prevailed until technological developments enabled the purchasers to determine alternative supply sources/routes. Initially more expensive, these alternative supply channels (by sea, avoiding the monopolistic land-based routes) succeeded in expanding supply, lowering costs, and breaking the monopolistic traders' hold over product pricing. The response of the disenfranchised should have been to retaliate, but history shows failure to react through the pricing mechanism (and technological development) led to permanent disenfranchisement.

Figure 1

Supply and demand analysis



Source: Authors

. . . traders lost control of this lucrative market by failing to compete

If we consider why reaction did not occur and traders consequently lost control of this lucrative trade, we are drawn to a number of possible conclusions. Was it failure to socially develop (as the usurpers of the spices trade had) into a nation-state, failure to develop capital markets to combine the power of collective savings into the required investment that enabled technological change, or failure to develop legal instruments that enabled the sharers of risk to restructure? We will examine these possibilities in further depth later in this paper, but what is not in question is that market mechanisms worked, becoming more efficient through technological and social development.

Joseph Schumpeter in *Ten Great Economists*, writing on the founder of the Austrian school of economics, Carl Menger, says:

. . . all specific economic events can be comprehended within the framework of price formation. From a purely economic standpoint, the economic system is merely a system of dependent prices. His essential aim is to discover the law of price formation.

Islam's basic principles are not an impediment

Can an Islamic economic model exist?

Prima face there is nothing to suggest Islam's basic principles are an impediment to the operation of a robust economy. However, there is strong evidence to suggest historical and current interpretations of fundamental Islamic principles are an impediment to the formation and operation of such a model, and there are strong vested interests in propagating continued impediments to the development of vibrant Islamic economics.

Islam has a hierarchy of basic needs . . .

Islam's basic objectives

Islam, as revealed to the Prophet and by the Scriptures, has both basic needs and a hierarchy of basic needs man is expected to follow and act accordingly. They are drawn from the five pillars of faith, daily prayer, fasting, contributing to the poor, and pilgrimage. They can be basically defined as:

- 1) Cater to man's basic needs.
- 2) Enable man to achieve Moral Ascendancy, Spiritual Ascendancy and Economic Welfare.
- 3) Provide a satisfactory standard of living.
- 4) Achieve equitable distribution of wealth between individuals and the state.
- 5) Be bound by hierarchies of individual virtue (satisfaction of basic needs) and social justice (consideration of the needy) through work and need.

. . . around which is built a guiding code of behaviour

From these basic principles, drawn from Islamic Scriptures, guiding codes of behaviour have been structured. In today's world we find Islam's guiding laws have the following features:

- They are based on interpretative Principles.
- Interpretation of these Principles is selective.
- Understanding of these Laws is consequently bound in confusion.
- Achievement of Islam's basic objectives is inhibited.

Confusion is exploited by selective interest groups

It is not surprising there are interpretive issues. Collection of the *Quran's* revelations was not completed until after the Prophet's death, with an authorised version only established during the third caliphate of 'Uthmān (644-56CE). It is an old book from a world considerably less technologically sophisticated. It is no wonder there is confusion, and no wonder that confusion is exploited by selective interest groups.

Fragmentation in Islam

The fragmentation in Islam over time is also an obviously contributing factor, as it has been in other mainstream religions, such as Christianity and Judaism, and resultant confusion should not surprise.

Progress mired in interpretation

It appears there may be vested interests acting against Islamic society achieving an operating model in accordance with the revelations of the Prophet. Those interests have successfully created a "Catch 22" that works to effectively derail such achievements, by miring progress towards fulfilment in interpretation. We will discuss this very important issue later.

'Secular rationality . . . does little to satisfy the human heart'

There is an inherent challenge in encouraging economists to objectively enunciate an economic model under a theocracy. As recently stated by Professor Morton E. Marty of the University of Chicago, 'secular rationality works for much of the "operational" side of life but does little to satisfy the human heart . . . I am a Christian, but I think in Secular ways.'

It is important, given the strong theocratic foundations of Islam, to keep this in mind during our search. However, before we can attempt to construct a case for or against the existence of an Islamic economic model, we must first look at the neoclassical economic model.

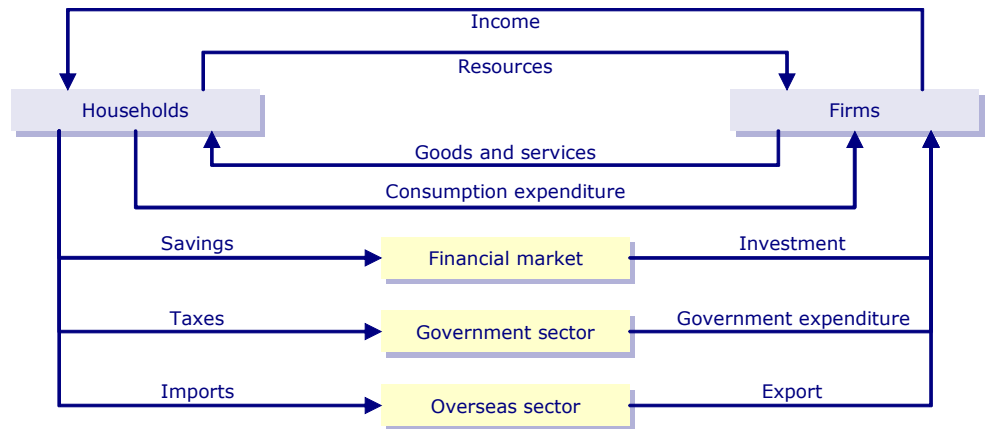
Can Islam accommodate the neoclassical model?

Islamic economic model

In order to consider the Islamic economic model question, it helps to start with the simplest form of the widely accepted neoclassical economic model. The intent is to determine whether the Islamic doctrine or code of behaviour makes it impossible to accommodate such a model, or whether in fact barriers have been created that make it seem Islam cannot adopt such a model.

Figure 2

Circular flow of income model



Source: Authors

This simplified model captures the internal and external elements that interact in today's economy. Beginning with the provision and exploitation of resources by households and firms, to the production of goods and services that meet the needs of households (and in turn provide the flow of funds that enables the cycle to continue and grow) we have introduced the role of government, the external (foreign) sector, and well-functioning and fungible financial markets.

Islam has no objection to markets

Efficient operation of the model is contingent on the existence of markets. Islam has no objection to markets, and accepts them as essential to the efficient clearing of goods and services. It does, however, object to inefficient market behaviour (or operation) that interferes with Islamic objectives of satisfying basic needs and the consideration of the needy.

In the above model, there are a number of markets. We will deal with each of the main markets and illustrate how their efficient operation is not predacious to Islam's basic tenants.

Exchange of goods and services

External market

With the external sector, which we simplify to be the exchange of goods and services facilitated by an accepted medium of exchange, there are two principle elements: the market, for the exchange of goods and services into and out of the economy, and the surplus or deficit resulting from the aggregation of those exchanges.

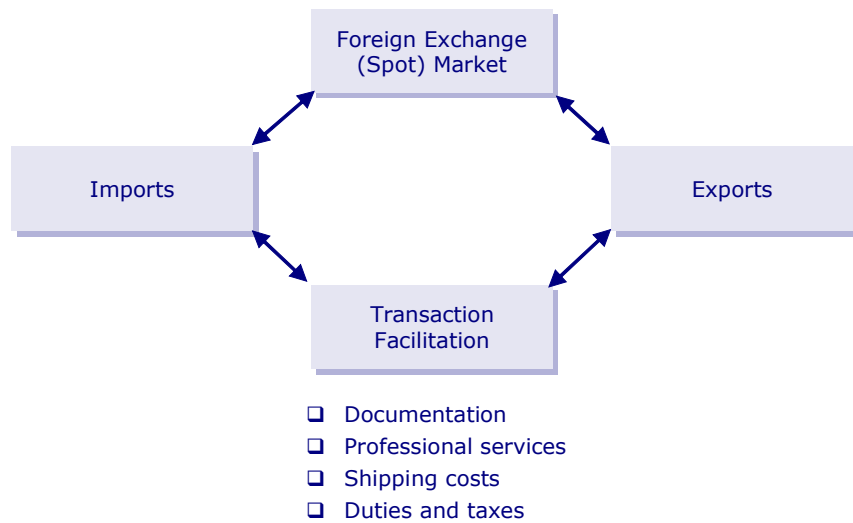
The inward and outward flows can be a physical exchange, or an exchange facilitated by money. Both require documentation – to validate what is being exchanged or traded – for which a service fee is payable by both parties. The fee is agreed on a case-by-case basis, and will reflect resources required to

effect the transaction, based on the time and expertise involved and the complexity of the transaction. Where more than one currency is involved, the service fee will also reflect the effort involved in ensuring one or the other party is not disadvantaged by a movement in the underlying value of currencies, which may be beyond the control of either party.

When a surplus or deficit arises, this will flow into, or be matched by other resources within, the economy.

Figure 3

International linkages



Source: Authors

In the case of the external sector, an efficient market can operate relying upon documentation and an exchange of currencies to support the exchange of goods and services, with fees payable to parties in exchange for their expertise and efforts expended in facilitating the underlying exchange. In attempts to facilitate such exchanges, and lower transaction costs, certain conventions, such as standardisation of documentation, have evolved. In addition, to facilitate and lower costs, sub-markets have evolved in currency transactions, where the expected costs associated with hedging the future value of different currencies (essential for the equitable treatment of parties relying on a cross-currency settlement at a future date for the exchange of their respective goods and services) are reflected in the forward price of those currencies. The apparent variable of more than one currency is accordingly removed at the time the terms and conditions of the transaction are agreed, without detracting from the unknowns associated with the future value of the transaction itself.

Trade is an essential element in ensuring that not only are basic needs, and the needs of the community at large, satisfied to the greatest extent possible, but also that trade is being used to ensure the best access to, and utilisation of, resources is achieved, in accordance with Islamic Scripture.

Government market

It is in the government sector that one encounters very clear indications of intent from the Scriptures, in contrast with their very mixed implementation by those governing some Islamic economies (or states) today. The role of government is to ensure that appropriate levies or taxes are drawn from the

Trade essential to ensure best use of resources

Clear indications of intent

Revision to reflect today's values and activities

members of the community earning income and/or possessing wealth, and ensuring these taxes are redistributed across the community in accordance with need. The first part of the equation – drawing voluntary payment of taxes – is performed in accordance with the Scriptures' quite objective instructions concerning *zakaat/khums* – annual wealth/income taxes – to be distributed to the needy. There are wide interpretive applications of these taxes, but for the purposes of this section we will assume tax collection occurs, and that the process is open to administrative and equitable reform.

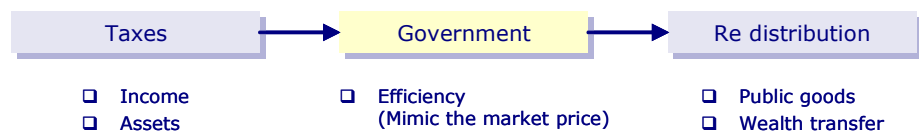
The taxable items identified by Tibur Kuran in *Islam and Mammon, The Economic Predicaments of Islamism*, as being 'agricultural output, livestock, minerals and precious metals (the major sources of income and wealth in seventh-century Arabia') were not specified by the Prophet Muhammad, but clearly relate to items prevalent in his day. The list requires revision to reflect today's values and activities.

It is in the process of the second part – redistribution, and its management – that observed practices vary widely, and can hardly be said to be either equitable or efficient. Given efficiency in managing and influencing the redistribution process, there is no impediment to this marketplace working as one element of the Islamic economic model.

The following diagram simplifies the equation to include the government's role as a collector and distributor of taxes, and of voluntary *zakaat*.

Figure 4

Distributive role of government



Source: Authors

Zakaat ineffective in parts of Islamic world

Why do our observations indicate this element of the model is not, in practice, working in many parts of the Islamic world? We believe:

- 1) Inputs, that is, tax rates and collection, do not seem to be functioning reasonably, and
- 2) We question whether ruling elites are contributing their fair share of wealth and income. Taxable *zakaat* items need to reflect the reality of today, corruption must not be permitted in the collection process, and if the original intentions of *zakaat* are to be fulfilled, equity in all elements of the equation is required. In general, government plays too large a role in Islamic economic societies – well beyond its *zakaat* responsibilities.

Next we focus on outputs – the redistribution – where operations seem less than optimal. There are three broad elements of outputs:

- Who gets how much and in what form. Is it equitable?
- The actual distribution. Do recipients get what was intended?
- Management of the process. Is the function performed expeditiously and efficiently? Is it conducted in a transparent manner, so all constituents can be objectively satisfied that Islam's intent is being observed?

Serious overhaul required to meet the Prophet's intent

Belief only government can manage resources

Scriptures oppose wasteful expenditure

Maturity varies . . .

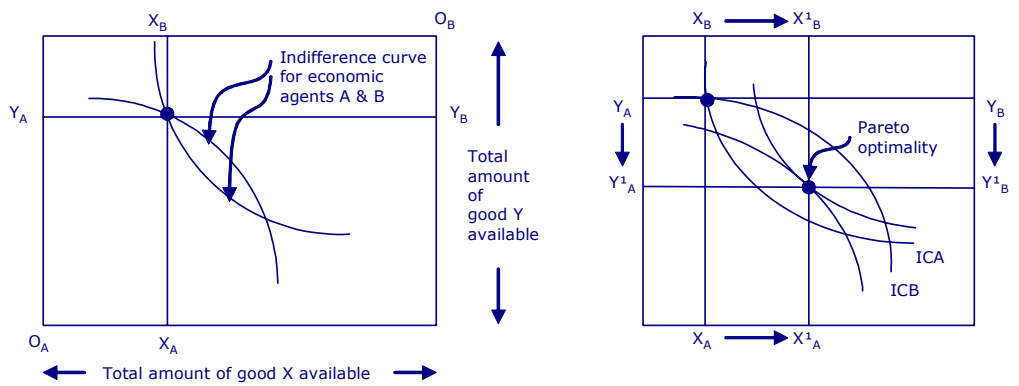
. . . from secular democracies to feudalistic states

We do not believe any of the above three elements are being optimized. A serious overhaul will be required if there is to be sincerity by all constituents in seeing the Prophet's intent achieved.

One position is often postulated by those who believe the Islamic economic model is very different to economics today, and that is the need for government to manage resources, as individuals (and firms) do not have the capability to distribute equitably. We hold that this is a fallacious position, for two reasons. History has shown that political leaders may start with the right intentions, but are rarely able to perform more equitably than the market place. Secondly, it is reasonable for one party to choose to increase its share of a particular good, with another deciding to take a lesser share – the two parties may be indifferent to an increased share of that good, and content to trade away a possible increase, as the following diagram indicates.

Figure 5

The Edgeworth box and competitive equilibrium



Source: Authors

In the government sector, we contend that if the three components are executed as intended by the Scriptures, if government's role in the economy is kept to an absolute minimum, and the process is transparent – in effect, subject to audit that is itself an essential element in the satisfaction of basic needs – the government sector can operate efficiently in the Islamic economy. And where this sector is not operating efficiently, it is incumbent upon all constituents to review the appropriateness and competence of those entrusted in managing the process, and improve where necessary managerial performance. The Scriptures are quite specific on the importance of avoiding *israf*, or wasteful expenditure. However, interpretation often degenerates into discussions about the degree to which consumerism is allowed, thus distracting from the real debate about making the utilization of resources as efficient and equitable as possible. It is by enhancing the efficiency of the collection and redistribution role of government and keeping its participation in the economy to a minimum we believe most attention is needed today.

This issue is compounded by the various stages of maturity of Islamic states.

At one end of the spectrum are such secular Islamic democracies as Malaysia, Turkey and Indonesia, with many of the essentially feudalistic states of the Middle East (including Saudi Arabia and Iran) at the other. Further examination of the merits of the secular versus theocratic in the interdependent global economy is required if we are to convince constituents of the merits of the democratic secular state as a means of ensuring

Some in the Islamic world equate interest with usury

transparency and efficiency in the role of government, and the fair and equitable redistribution of taxes across society. As explained above, we see no impediment to this market working efficiently as an element of an Islamic economic model other than behavioural – the way things are executed rather than the intention and capability of execution.

Governments, in the tax and redistribution equation have timing differences and can run deficits. These deficits require financing, and governments turn to the capital markets to secure that financing. This is a timing issue, and such access bears a cost. In the neoclassical economic model, the cost is reflected in interest rates and transaction costs. Some in the Islamic world equate interest with usury.

Interest rates reflect a number of factors and ultimately are set at the point where a government's demand for capital is at an equilibrium point with the provider's willingness to supply.

The same applies in Islamic economies. The service fee (interest) payable by government borrowers should not be construed as usurious. The capital provided by savers could be deployed elsewhere, but savers have determined to supply it to government borrowers, as they believe the expected return is just, if uncertain. Bond values, notwithstanding a predetermined yield (or time value of money estimation made at the time the bond is issued) change over time, providing the purchaser with an element of uncertainty as to the future value of his investment.

Efficient markets are necessary for any economic model

For optimal operation of any economic model, efficient markets are necessary. We note some scholars have seen a link between efficient markets and the promotion of human liberty and freedom (such as Friedrich Hayek in *The Road to Serfdom*) when others (such as Milton Friedman in *Free to Choose*) have focused on prosperity and utility.

Impediment increase inefficiency, and cost

Every impediment to the efficient operation of markets creates inefficiencies, each of which has a cost. Cumulatively, these costs act as impediments to Islam achieving its basic objectives. Accordingly, it is incumbent upon those vested with the responsibility of contributing to the achievement of Islam's basic objectives to remove impediments to efficient markets.

Opportunities for graft and corruption

Opportunities for graft and corruption, intended or otherwise, prevail when behaviour is not subject to the disciplines of the marketplace. The examples of wastefulness that have accompanied collection and redistribution of wealth in democratic and non-democratic societies are legion, and avoidable. History shows that an over-reliance on centralised decision-making and distribution inevitably adds layers of bureaucracy to the allocation process, is subject to human frailty, and is regularly wrought with inefficiency.

Hijacking of *zakaat* by non-state interests

In addition, the channelling of *zakaat* to the *madrassah*, in the belief that spiritual education – notwithstanding that curriculum, teacher qualifications and performance are neither supervised nor administered – outweighs the needs of the impoverished equates to hijacking of *zakaat* by non-state interests that are not interested in the economic well-being of the people.

Contravenes Scriptures

Does not this contravene the Scriptures, which prescribe open access to resources and place an obligation on the individual to deliver the best value from those resources to all needy constituents? It does, and those who obstruct the development of efficient marketplaces are failing in their duties.

Capitalist economies do ignore 'equity'

There are shortcomings in many "developed" economies and a strong argument can be made for enhancements to overcome market imperfections by which, for example, the disadvantaged are regularly ignored. This is really caused by many capitalist economies ignoring "equity" which is a question of faith and spirituality and the failure of the state to instil and reinforce appropriate values, rather than the model itself. So-called capitalistic economies are based on the "positive" side and do not address the "normative" side. However, aberrations do not necessarily repudiate a model's potential, and we are looking in our discussion for the Islamic economic model, not critiquing evolution of the neoclassical model in some societies.

For a final word on the government sector, Alan Ebenstein in his 2001 *Friedrich Hayek: A Biography* eloquently described Hayek's view of the role of government:

There was in his mind a difference between the framework laws that define a society and more day-to-day measures to handle public welfare functions. His essential concern regarding the latter was that government should be small rather than large, implemented at a local or state (rather than national) level, that government services should be administered competitively, and that as many public welfare services as possible should be provided privately.

Managing uncertain future cash flows

Financial market

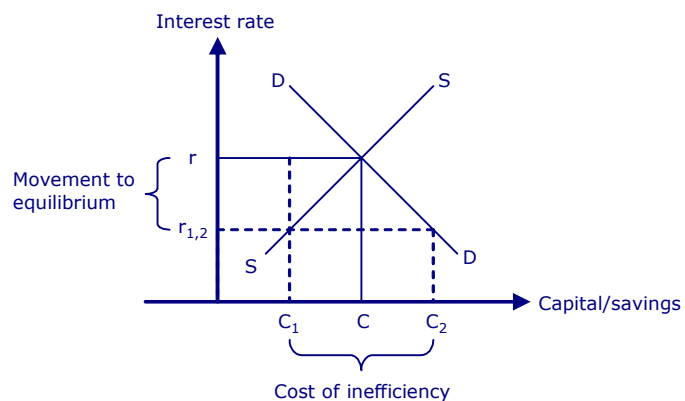
Financial markets function to intermediate savings and investment flows, and to help individuals, companies and governments to manage uncertain future cash flows. They gather savings, which would otherwise be very fragmented, and inefficient, and unable to achieve the Prophet Muhammad's intentions. They match a society's surpluses, or savings, with the myriad of demands for capital, or investment, across complex societies. They add efficiency to the process through development of financial intermediaries, most notably banks.

Banks reward savers

Banks have developed expertise and thus lower the cost of gathering savings across an economy, and now globally. Banks reward savers by providing them access to the profits generated by the productive investment of those savings, less the cost of managing the process.

Figure 6

Efficient capital market – effect of a zero interest rate



Source: Authors

Limited liability

As there is sophistication in this process, society has also developed the concept of limited liability to protect unsophisticated savers from the otherwise unlimited liability of individual or partnership transactions. This, in turn, more closely aligns profit- and loss-sharing opportunities for low-risk providers of capital with users of capital.

Lender of last resort

The role of the state in its capacity of protector of the needy – and the less experienced/sophisticated – and as economic stabiliser has also evolved in some societies into that of lender of last resort.

Savers have a choice . . .

Banks, and financial markets, give savers a choice of profit- and loss-sharing opportunities through a range of risk-bearing returns and tenors, manifest in different products. Potential profit is calculated in an algorithm that integrates the cost of managing the intermediation process with the expected gains (or losses) from the basket of investments (lending) to which savings are applied, by using historical experience and expected future events, to estimate future investment and return flows, and any costs incurred in seeking expertise in the process. Not surprisingly, where competition is encouraged amongst financial intermediaries, expected profit and cost are able to be calculated with some accuracy, and savers are treated fairly in the process. All constituents in the process are subject to future profit and loss uncertainties, but savers are provided with choice.

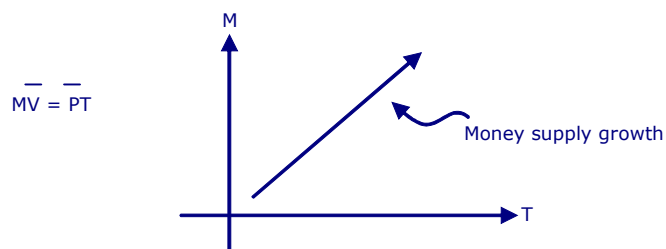
. . . as do borrowers

As far as borrowers of capital are concerned, similar conditions have evolved. Different products have been developed, reflecting the different degrees of risk – and risk- or profit-sharing – contained in the borrower’s plans for the capital to be utilized in specific projects. These products are sufficiently sophisticated to be able to forecast future capital utilization potential, and to apply costs associated with gathering required capital, expressed as a fee to the user of capital.

Some commentators have called for a fixed money supply, such as a return to the gold standard, which is neither appropriate nor feasible in the Islamic economic model without an unacceptable movement in prices or the velocity of circulation. A fixed money supply inhibits growth and resource allocation.

Figure 7

Transactions and money supply grow with productivity and population growth



Source: Authors

From the above chart, we assume:

- Velocity is constant.
- Prices are constant.
- Transactions rise with productivity and population growth.
- Money supply must accordingly grow.

Open to interpretation

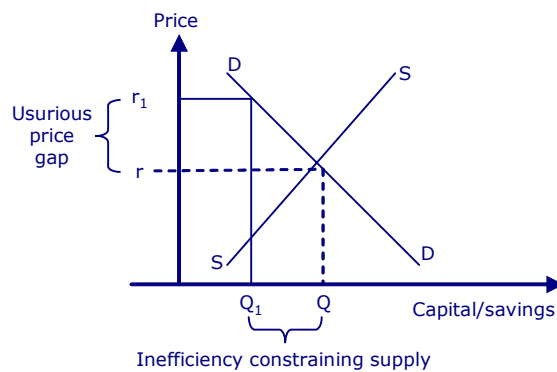
From this brief analysis, it is fair to say the ingredients for a financial market-economy exist in the Islamic world, and an Islamic economy in the neoclassical sense is quite feasible.

Interest

Of considerable sensitivity is the discussion of *riba*, or usury. The *Quran* is quite clear – usury is not permitted. However, interpretations of the intent of this prohibition often conclude that the charging of any interest is usurious. Here, we beg to disagree. Certainly, at the time the Scriptures were laid down, money lenders were largely unregulated and known to double the borrower’s principal and interest obligations in the event of default. Enslavement was the final solution to settling the debt obligation. In the seventh century, there were no bankruptcy or Chapter 11 laws. Such interpretations of the Scriptures indicate a lack of understanding of what interest rates are and how interest rates are determined. At the time, though, usury – *riba* – led to enslavement, and was accordingly prohibited.

Figure 8

Preconditions for usury



Source: Authors

From the above chart, we conclude:

- ❑ Efficient market place is restricted (supply), by
- ❑ Monopoly (opportunistic and regulatory), and
- ❑ Prejudice (social barrier), and
- ❑ Convention (too expensive to service the poor), and
- ❑ Immature legal infrastructure.

Capital can make a 'just' return

The *riba* issue seems to be mired in the misunderstanding that capital is not allowed to make a fair return, which is not the case. The Scriptures are clear that capital is allowed to make a “just” return. A further misunderstanding is that interest rate levels are somehow drawn from the ether, and neither reflects the risks associated with the deployment of capital, nor the supply-demand equation for savings-investment. Borrowers and lenders must be perfectly matched in a series of exactly equal partnerships for there to be a true sharing of risk and reward. It should be noted that the Scriptures do not specify that borrowers and lenders are to share risk equally, only that both share some risk – some uncertainty – in the outcome of the particular transaction. All of this ignores the aggregation of demand for capital with the gathering (supply) of savings across today’s more complex societies, and the role of interest rates in both reflecting and balancing that supply-demand equation, and the myriad of risks therein.

In open and competitive banking, rates are fair

Modern society has developed a number of mechanisms to delineate interest from usury. First, there is the open and competitive banking system, where competition and transparency ensure interest rates are fair, and truly represent the costs of intermediation, the equating of supply with demand, and an accounting of the risks likely to be incurred in investing savings. Second, there are requirements on disclosure of information on risks and rates so savers can make informed decisions on where to place their savings, depending upon their risk appetite. Third, regulations require minimum standards of operation to ensure intermediaries are adequately skilled, capitalized and report frequently and fairly, and that both savers and borrowers are protected by equitable laws. Fourth, ombudsmen provide an appeals process against unfair treatment. This overview of available mechanisms is by no means exhaustive.

Narrow definition of Islamic banking

However, even these steps and protections are deemed inadequate by some to comply with an extremely narrow definition of Islamic banking.

To meet the demand for intermediation services, and remain “compliant” with Islamic principles, we have seen creative structuring developed, which escapes reference to interest or repossession where capital is not serviced or repaid. In some instances, the return a lender should expect from entrusting an intermediary with his (or her) savings is synthesized into a discount, which bears striking resemblance to prevailing interest rates, on initially depositing the money. Fund structures, which more closely relate investments with capital utilization performance, but lack liquidity for the saver, are becoming more common, albeit impractical for small savers and borrowers across a complex economy. And for borrowers who do not wish to place themselves in an environment where the lender can seek recourse to the courts to repossess chattels on which the capital deployed has not been serviced, simple “lease” arrangements are entered into, where the intermediary retains title to the good or service for which capital has been deployed – title only passing at the end of the “lease” term. By such simple techniques does the marketplace circumvent strict adherence to the narrowest interpretations of the Scriptures.

No prohibition on investment

To reiterate, the Scriptures do not prohibit capital earning a just return. Nor do they prohibit savers providing capital for business ventures, and sharing (not necessarily equally) in any profit (or loss) generated from that deployment. However, in complex societies, the process of intermediating savings and investment has itself become complex, and a simple matching of savers with borrowers and a specific business venture is largely impractical. It has been superseded by pooling both sides of the equation, utilizing intermediaries to add efficiency and expertise. Expected (*ex ante*) returns from the ventures are synthesized into an equation expressed in the form of interest rates. Varying levels of risk, as would be the case in an individual making an investment decision on a specific business request, are reflected in different products, with commensurate expected levels of return. A series of material defaults will trigger failure of the intermediary, and losses to the provider of capital, who has consequently shared the risk of lending with the borrower.

Interest rates are not usury unless the rate applied is away from the equilibrium point for the suppliers of savings with the users of savings. In such cases, rates may be deemed usurious, or at such a low level as to

Money lenders thrive because of bank barriers to borrowers

Zero interest rates only work in deflation

Common sense approach

supply savings at an artificial rate that does not reflect real risks associated with a particular venture – and is, accordingly, not optimizing humankind’s fair exploitation of Allah’s resources.

In many societies, informal money lenders do thrive, charging usurious rates of interest – the environment that permits their survival is typified by barriers of entry for their client base to the formal banking community, and it is imperative governments remove those barriers.

There is a situation in which zero interest rates can exist in the neoclassical intermediated economic model, and still ensure providers of capital receive an adequate return, and that is a deflationary one. With deflation, the provider of capital, at zero nominal interest rates, receives the principal at the end of the investment term, but that principal has a greater value as asset prices have declined over the term of the investment – the purchasing power has increased. The provider has similarly shared in the risk, that is, the future outcome of the venture, as the future value of the principal is unknown at the time of the investment. We further note that whilst the nominal rate of interest was zero, the real interest rate would have been positive.

Apart from the desirability or otherwise of deflation, this takes us into the realm of nominal versus real interest rates. In effect there has been a positive real interest rate even though nominal rates have been set at zero. So whilst the precondition of a zero nominal interest rate satisfies the Scriptures’ requirements, users of capital have incurred real interest rate costs, manifest in the reduced purchasing power of their future assets.

And so again, given the application of common sense to the concept of the time value of money and the legitimacy of capturing transaction costs, we see no impediment to today’s financial markets, as operated in Islamic societies, being a functional element in an Islamic economic model. Professor Abdullah Saeed of the University of Melbourne says:

To determine whether interest is prohibited in a financial transaction, one must look at the structure of the transaction and link it to the moral and ethical dimensions of *riba*.

Further, Sheikh Saber Talaab, head of the research committee secretariat of Egypt’s Al-Azhar Institute, which is the philosophical centre of Sunni Muslims, says:

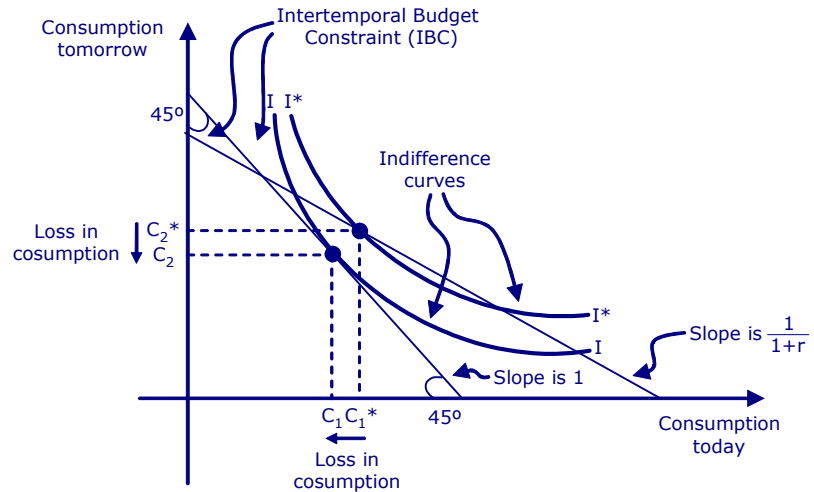
Religious jurisprudence means change, and it is illogical to remain frozen (in time) while the world changes around us.

Household market

The final market is the household sector. It is here the exchange of goods and services and resource utilization between households and firms primarily occurs. Labour is compensated for its efforts in a market environment, rates set by demand and supply, and money facilitates the exchanges. Society has developed many ways to ensure markets are fair and equitable, not the least of which is the role of collective bargaining, and whilst there is a market dynamic that sees swings and balances in matching the demands of all constituents, this marketplace functions relatively efficiently.

Figure 9

Intertemporal consumption model



* = Non-zero interest rate. Source: Authors

Growing danger from disgruntled youth . . .

However, there are examples of inefficiencies, particularly where sudden changes, such as a rapid growth in population with commensurate demographic anomalies in age distributions, occur and those vested with the responsibility to manage these shocks fail to efficiently do so. It appears there is one such shock currently occurring in the Middle East, with a very large youth sector for which employment creation and the equitable distribution of wealth and opportunity do not appear to be reacting quickly enough. Ruling management has an urgent task at hand, as one of the consequences of inefficiency has been the flood of money and the disgruntled willing to acts of terrorism.

. . . requires forward-thinking leadership . . .

An example of a relatively enlightened ruler was the late Sheikh Zayed bin Sultan al-Nahayan, ruler of Abu Dhabi and founding president of the United Arab Emirates. His diplomacy, generosity, frugality and forward thinking are a good example of what can be achieved. He was inspirational in directing productive investment in irrigation, reforestation, regional aid and the development of the UAE, along with the need to foster immigrants who comprise 75% of Abu Dhabi's 4 million population – the challenge is for his successors to display similarly laudable traits.

. . . but not 'cradle-to-grave' autocracy

There are real limitations to a "cradle-to-grave" model, particularly when educational reform and economic restructuring fail to keep pace with constituents' changing profiles and needs. The disciplines of the marketplace enable change, lower dependency on the state, and question the sustainability of dynastic autocracies.

Let us return to our prime objective – to define the Islamic economic model. Are there real obstacles to the development of the Islamic economic model, or are there artificially created obstacles that stand in the way of such development? And why has the model evaded definition?

Best exploitation of resources needs efficient open markets

Obstacles to Islamic market economy

Drawing from the Scriptures, and basic Islamic principles, it is necessary to check whether we have allowed a fundamental flaw of logic to enter our reasoning, and thus distort our findings.

- Ownership of resources by Allah is not in question.
- Right of access to resources by all is agreed.
- Obligation to exploit resources is not in question.
- Management of resources is a right.
- A "just" reward for resource managers is accepted.
- A "just" return on capital is accepted.
- Calculation methodology of the "service fee" for resource managers and capital providers is not sufficiently clear.
- The debate on the permissibility of interest has become buried in interpretive confusion.
- There has accordingly been limited Islamic commercial banking development.
- There is little central bank functionality.
- The probability of the existence of inefficient financial markets is high.

When markets, which act as an efficient clearing house for the transfer of goods and services, fail to operate efficiently, the transfer of those goods and services becomes less efficient. This leads to sub-optimal production of those goods and services, and accordingly sub-optimal exploitation of resources from which those goods and services are produced.

So we can accept that for optimal exploitation of resources, and production of goods and services in the quest for satisfaction of basic needs, we require efficient markets. To achieve that efficiency, we have to agree on a definition of the "service fee" that is paid to those who manage resources, the production process, and most importantly those who provide and use capital, for any possibility of harmony in a definition of the Islamic economic model.

'Closed' Islamic economy ignores realities

It is not an acceptable argument to say conditions that applied in seventh-century Medina are similarly appropriate today. Accordingly, to assume a closed Islamic society is to ignore one of the fundamental platforms of the Scriptures – that it is incumbent on man to exploit the resources of Allah for the betterment of man and mankind. Insisting on a closed Islamic society or economy is not the way to achieve that guidance.

- The global economy is interdependent.
- Ownership of resources, trade and services is complex.
- A fixed money supply is not an historic fact.
- Trust, not verifiable assets, is the basis for money supply growth.
- The neo-classical economic world has superceded the pre-modern.

Rules of 7th century Medina inappropriate

Interdependent global economy

So what stands in the way of an equitable method of determining the appropriate "service fee" for the exchange of goods and services in today's open economic environment?

There is no question the global economy is interdependent, and many benefit from this interdependence. There are imperfections, but to turn back the clock on integration is a zero-sum game for all parties. Similarly, whilst Allah is the ultimate owner of resources, custodianship has been passed to many for optimal management, and that custodianship and its related trade and services has evolved into a complex, interdependent network.

Credit traditionally based on trust

It is interesting to argue that money supply has been constant, and such a state is desirable, but such argument is false. Credit has traditionally been granted on the basis of trust. Security or collateral came later. As societies expanded, relationships become more complex and trust became less reliable – and there was a commensurate development of tools upon which one could rely in the event trust broke down, called the law. Management of credit has become very sophisticated. Some confuse adherence to the gold standard with fixed money supply, and believe reinstating the gold standard will fix the money supply, but again, that is incorrect. The gold standard is no more applicable, nor efficient, today than trying to perfectly match individual savers with individual investors – efficient intermediation fulfils that role. Pragmatism and recognition of the benefits to all constituents of sensible growth has enabled the evolution of the market economy base of the neoclassical era, on which today's economies and societies are built and thrive.

Risk remains for all parties

Risk remains for all parties to any transaction. The service provider may not get paid for his services, the obligor may not repay the monies borrowed, and the lender may receive less than is due, as a result of one part of the chain breaking down. It may appear a pre-determined interest rate has been set at the start the transaction, future uncertainties over its life may affect the actual rate of return, notwithstanding an apparent agreement up front.

Imperfections exist

Imperfections exist, which distort the efficient and equitable distribution of resources. Our collective attention is required to remove those imperfections, not tearing down the basis of much of the economic world.

The service fee is an absolutely acceptable element of any transaction, particularly when transactions have been financially intermediated and that intermediation has been expedited – that is, value has been added to the transaction, by those with the requisite expertise. As discussed above, a service fee is appropriate when a service has been received in the process of exchanging and/or intermediating goods and services. The fee represents the value contributed to the process, as a result of which the process has been expedited and made more efficient – in keeping with Allah's requirements that all resources should be exploited to the maximum extent possible, such that man and society benefit from that exploitation. In some cases the fee is "synthesized", where the costs of specific calculation of the many elements of the fee outweigh the benefits the service provider has delivered, represented by the fee. The fee is then shared by all parties to the specific, or aggregated, transaction, relative to the contribution to that transaction.

So what are the remaining impediments to evolution of the Islamic economic model? In our search we will turn next to a brief look at the development of the Islamic political economy.

Islamic societies take many forms

Islamic political economy

Today's Islamic societies take many forms. They range from the world's largest, Indonesia, which has assumed a democratic form and recently undergone independent and violence-free Presidential elections, to Iran, which has persisted with theocracy, and parts of the Middle East locked in a feudalistic time warp of theocratic kingdoms. There is no single form, even with wide variations such as are found in neoclassical democratic societies, and it will help our understanding to review why some remain as they have.

- ❑ Islam splintered following the death of the Prophet Muhammad, and continues to have interpretive conflicts today.
- ❑ Interpretation of the *Quran* has mixed lifestyle definitions with the realities of politics.
- ❑ A legacy of feudal political structures persists, and often inhibits political and social development.
- ❑ Legal codes are borrowed from the colonial past with little regard for tradition and natural evolution.
- ❑ Colonialism has left a deep scar, causing the colonised to dwell on past historical Islamic triumphs.
- ❑ Supranationals (such as the Asian Development Bank, the World Bank and the International Monetary Fund) have unilaterally imposed standards in support of objectives not necessarily aligned with Islamic objectives.
- ❑ Persistence with fiefdoms, supported by OECD powers, continues to distort income and wealth distribution in many Islamic societies.
- ❑ There is a pervading sense of Arabic humiliation, notwithstanding past achievements in medicine, warfare, societal coexistence and trade.

Middle East Islamic political landscape is dominated by oil

The Middle East Islamic political landscape is dominated by oil – either as a result of oil reserves, or demand for oil. Oil has sculpted much of Islamic society in the Middle East, and there is no doubt the colonial heritage of the oil-rich Middle East has distorted its political development. Initially this was in reaction to the geopolitics of oil-hungry nation states and corporations, and with the power, limited in some instances, that has flowed to “families” vested with the responsibility to govern those Middle East states. The legacies range from a mix of legal codes, societal structures aligned to the legitimacy of ruling elites, and to relatively recent boundaries created almost arbitrarily by past colonial and imperial occupiers.

Most characterised by inequitable wealth distribution

Most are characterised by inequitable wealth distribution, gender inequality and limited suffrage, all of which are damaging to the respective economies, and all of which provide fertile breeding grounds for disaffection and dissent.

Evolution in secular democracies of Turkey, Malaysia and Indonesia

There are other states such as Turkey (since the 1920s), Malaysia and Indonesia, which have developed into democratic, secular states, where the role of the legislature is independent of their Islamic societies. These states represent a significantly larger Islamic population than does the Middle East. And it is in these states one can see the evolution of all sectors of the neoclassical financial model, and a path to a mature Islamic economic model.

Fundamentalists target secular states

One of the perplexing questions is why fundamentalist Islamic thinkers persist in attempting to drag the concerns of the Middle East into these secular states, when the Middle East struggle is not at all relevant to the issues those

Jihad, in which all non-Muslims are the enemy

emerging nation states are facing. They paint distorted pictures of irrelevant interpretations of the Scriptures, creating a sense of inferiority amongst their audience, and fail to reinforce the myriad of achievements Islamic societies have accomplished, of which there is much to be proud, and on which the real issues they face could well be built. Eighth century Baghdad was the cradle of half a millennium of social and scientific leadership culminating in an 80,000 volume library early in the 13th century. Public hospitals, an observatory that worked out the earth is round, mathematics and the arts all preceded similar advances in Europe by centuries. In substance, they are creating as great an impediment to growth and development as the supranationals, as we discussed earlier, and can hardly be said to be acting in the interests of Allah, efficiently working for the betterment of man and mankind.

However, glorification of the Golden Age (622-621CE) of Islam and of 13th century Arabic Baghdad (sacked by the Mongols in 1258, ending five centuries of rule by the Sunni 'Abbasids), combined with the sponsorship by the House of Saud of the *Wahhabis* doctrine of a return to the 'pure authentic Islam of the Prophet' has provided many clerics with the ammunition to teach the impressionable that extremism is valid – for Arabic and non-Arabic Muslims – as part of a holy *jihad* in which all non-Muslims are the enemy.

Turning back the clock in Southeast Asia

In effect this influence is trying to turn back the clock on the progress Islam has made in Southeast Asia, which a better understanding of the entry of Islam into the region helps explain. As described by Azyumardi Azra:

Links between Muslims in the Malay-Indonesian world and the Middle East have existed since the earliest times of Islam in the archipelago, around the eleventh and twelfth centuries. Muslim merchants from Arabia, Persia and the Indian subcontinent frequented the harbour cities of the archipelago, where they engaged not only in trade but also in the transformation of Islam to the native population.

By 1800, the Malay-Indonesian world . . . no longer drew authority, sovereignty or legitimacy primarily from Islam . . . Islam itself began to be redefined in European (Dutch and English) terms. The colonial period saw the introduction of a new sort of authority, which essentially reduced Islam to a private and personal religion and justified itself in secular terms (treaties, the colonial state).

Positive evolution of Islam under threat

The positive evolution of Islam in the region is under threat. Southeast Asia is not confronted with the tidal wave of wealth with which oil revenues have flooded the Middle East, and neither should it be burdened with the commensurate issues facing the Middle East.

Mid-East links to turmoil in southern Thailand

One example where the link to the Middle East is finance and training is the turmoil in southern Thailand, near the Malaysian border. Here, poor government failed to recognize inherent inequities – the needs of marginalised Muslim communities were not being met – and the result has manifested itself in avoidable unrest.

Tools of an insidious force

Another is Iraq and its spate of kidnappings by *jihadi* groups – comprising Iraqi and non-Iraqi fighters – prepared to sacrifice their lives in the name of God in return for access to heaven's paradise. They are simply tools of a more insidious force with access to considerable funds for the training of "martyrs" and provision for the welfare of their families once they have died. This breeding ground does not seem to be about issues between conflicting faiths

**Globalisation a challenge,
not a threat**

– Sunni versus Shiite – but more about the failure of governments in Islamic countries to deliver equity to their constituents in the form of hospitals, schools and jobs. A recent *Economist* review of a paper by University of California at San Diego economist Eli Berman (*Hamas, Taliban and the Jewish Underground: An Economists View of Radical Religious Militias*, National Bureau of Economic Research, Working Paper 10004) drew attention to the ability of religious sects to encourage their followers to extreme acts through the provision of “public goods” to members’ families (such as mutual insurance, education, law and order), essentially replacing the role of ineffective government.

Globalisation and the role of multinational corporations are often cited as reasons why Islamic society is frustrated in its political development. They are two separate issues – globalisation relating to the imposition of standards and practices by others on Islamic society, and against which Islamic societies have little or no say as they are dominated by economically and militarily more powerful states. There is some truth in this phenomenon, and it applies to all societies, not just Islamic ones. Any “junior partner” in a relationship runs the very real risk of domination by the more powerful. Some resist, some successfully determine a role for themselves in the partnership, and some are simply marginalised – these are facts of all relationships, for individuals, corporates and nation states. What is not in question is the fact that globalisation is here to stay – the world is integrated as resources are exploited for the benefit of all. The challenge for “junior partners” is to parley the best possible outcome for them in the equation.

**But a strong case for
improved accountability**

As regards multinationals and their influence on Islamic (and non-Islamic) societies, there is a strong case for improved accountability and transparency in their increasingly borderless activities. That will not happen overnight, but the pressure must continue to be applied by all if we are to see responsible behaviour surpass exploitive behaviour. There are many examples of success in this process, across most OECD economies – from the domestic, such as Japan and Minamata, a fishing community ravaged by mercury poisoning because of irresponsible toxic waste disposal, to cross-border US companies such as Union Carbide and the Bhopal disaster in India, and exposure of the exploitive practices of Nike in emerging Asia. Not enough has been done in this area, any more than is being done to restrict the punitive transfer of wealth from less developed to more developed economies akin to looting.

**Terrorism and anarchy
achieve nothing**

The place to tackle these social inequities is at the negotiating table, armed with the very tool that has accompanied the development of the neoclassical model – the law. Terrorism and anarchy achieve nothing and, by their destructive intent, have no place on the path to achieving Allah’s wishes.

There is no doubt these are issues of substance that are inhibiting the evolution of the Islamic political economy, in much the same way as the inequitable distribution of wealth by some Islamic governments inhibits development, but there are other issues as well.

**Islam has a history of
societal coexistence**

Islamic history has a good track record of societal coexistence with Judaism and Christianity, yet this seems to be lost in the current debate, as does an examination of the drivers that allowed those of the Islamic faith to live and prosper inside predominantly non-Islamic societies. Through payment of tributes (*jizya* – a poll tax/protection money), non-Muslims were able to live as a separate class (*dhimmis* - protected) within Islamic society, and

These issues require further examination

Fundamentalists Christians also an emerging threat

Mid-East, Africa seeing dramatic decline in the welfare of constituents

Education putting fundamentalism ahead of realism

frequently rose to positions of prominence, especially in finance and commerce (it is estimated Istanbul's non-Muslim population was as high as 40% of its 800,000 total inhabitants by the late 16th century). However, failure to convert to Islam or pay *jizya* resulted in death, for much of history.

These issues require further examination, as monotheistic societies are not typically tolerant of "non-believers". Likewise the concept of *jihad*, regularly interpreted in the context of revenge, but in fact a recruitment concept (both passive and aggressive) aimed at converting non-believers to embrace the faith (there is an obvious link to earlier efforts to unify hitherto warring Arabic tribes in Islam's earliest days). In the interim, we will look at the performance of some Islamic states today.

Before doing so, it is important not to quarantine western society from the debate. Whilst progress has been made there remain concerns that Christian and Jewish "hard right" fundamentalist factions are equally against progress as Islamic fundamentalists. A recent interview by Nathan Gardels of the *Bangkok Post* reported:

These zealots of the American right who rail against secular liberalism are more like Muslim *jihadists* They, too, are waging a holy war – the American jihad.

Whenever the present is based on interpretations of Scriptures written in antiquity, regardless of faith, there are inevitably wide variances in the interpretation of those ancient documents which, at the end of the day, were written for a different time in a different set of circumstances for a very different audience.

The Islamic state – No heaven on earth

Whilst some Islamic states can point to stability and measurable improvements in the health and welfare of their constituents, many cannot. In particular, some Middle East and African states have seen a dramatic decline in the welfare of their constituents, from falling per capita incomes to unemployment and inferior health and education standards. This is often against a backdrop of growth in oil revenues, which have not been translated into the improvements one would expect. The reasons are many, and complex, but may be summarized as:

- ❑ Little commonality in interpretation of Scriptures.
- ❑ Secular-Theocratic tensions.
- ❑ Feudalistic and divided *Caliphate*.
- ❑ Vicious educational cycle.
- ❑ Corrupt leadership, corrupt societies.

In particular the role of education has been confused by the emphasis in the *madrassah* on fundamentalism over realism, with an overemphasis on the past and narrow interpretations of the Scriptures rather than the future. To add to this slanted view of life, the state neither questions the curriculum – most likely to appease the clerics from interfering in affairs of the ruling elite – nor ensures religious teachers are qualified, supervised and evaluated, with the result that pupils are denied the tools to question and grow. This vicious educational cycle is discussed in more detail below.

Ignorance will take a generation to overcome

A prevalence of ignorance

This ignorance has serious consequences for many Islamic societies, and will take a generation to successfully address even if immediately dealt with. It is manifest in a number of ways, some of which are:

- ❑ Gender inequality, leading to under-employment.
- ❑ A “closed” educational system fostering an environment of complacency.
- ❑ The prohibition of “interest” and consequent financial market inefficiencies.
- ❑ Poorly structured tax systems, and resultant subjective resource collection and reallocation.
- ❑ Constraints on freedom of speech stifling innovation and creativity.
- ❑ No suffrage leading to unrepresentative and inefficient government.
- ❑ Constraints on an independent legislature and a loss of objectivity and trust in the law.
- ❑ Conformance to backward-looking Islamic morality causing sub-optimisation of current opportunities.
- ❑ Perpetuation of inefficiency and poverty.

Breakdown in development

The net result of these many issues is a breakdown in the smooth development of some Islamic societies. Even criticism frequently manifests in violence, or violent threats, which further stifles open and productive debate.

Gender inequality

Gender inequality is a direct contributor to under-employment of women, reducing the pool of labour available to support economic development and growth, and a reduction in innovative potential.

Preoccupation with ‘purity’

The intellectual element of the management of life in Islam is generally hamstrung by a preoccupation with “purity”, and this splitting process inhibits economic development and the creation of wealth. It is by the accumulation of wealth, enabled by transparency and good governance, that most progress on the path to understanding and achieving “purity” in Islam is likely to be made. There is an inherent dilemma in a society that purports to be “pure”, yet requires a secret police to enforce “purity”.

There are some signs of change emerging. Since June 2004 in Saudi Arabia, women have been granted permission to work in most sectors. However, they are not permitted to vote, nor drive. A 1990 *fatwa* issued by the Council of Senior *Ulama* (religious scholars), stated:

Women driving leads to many evils . . . included among these is her mixing with men without her being on her guard.

Women constitute more than 50% of graduates, yet only 5.5% of the 4.7 million working-age women are employed. In contrast, in neighbouring Qatar, the past decade has seen women university student numbers surpass those of men, occupy commercial and government jobs (40% of the workforce) and run for municipal office.

'Vicious cycle' of ignorance

Similarly are education systems that are not based on meritocracy, that persist with teaching interpretive concepts stuck in the past, and encourage backward-looking, unacceptable mores and codes of behaviour, and overtly discourage enquiry and innovation. This failure to allow education to be a path to the future simply guarantees a 'vicious cycle' of ignorance.

Dilemma of individualism

There is a great urgency for an appropriate valuation of the intellectual part of life over a preoccupation with the concept of "purity" in Islam today. This is especially the case in Southeast Asia, where the preconditions for successful wealth accumulation generally exist, but are hamstrung by 'splitting' debates that continue to draw society into a defensive inward looking mode rather than one focussed on wealth creation and its commensurate benefits to man. As an example, Malaysia is wrestling with the dilemma of valuing individualism and individual freedoms in its society against the legacy of the role and powers of its religious police.

We have talked about capital and its entitlement to a just return, and smokescreens erected around the concept of interest add to inefficiencies and resultant poverty.

Freedom of speech

One would have hoped that freedom of speech would be accepted as the right of all – it certainly was a platform upon which the Prophet Muhammad based his teachings, but this has all too frequently been removed under the veil of threats and recriminations, in the opaque theocratic environment that characterises many Islamic societies today.

Independent legislatures

Some Islamic societies have recognized and supported the development of an independent legislature – Qatar elects two-thirds of its 45 member Municipal Council (albeit, with limited powers); Brunei recently declared, after an hiatus of 20 years, the promulgation of a 21-member Legislative Council as one step in its process of political reform that is expected to lead to an elected body, whilst other societies remain locked in a time warp of feudalism.

Independent judiciary

An independent legal system is an integral part of any state's maturity, and an essential component of a transparent society. Islamic states are not the only ones lagging in this development, and the progress they make in encouraging and developing an independent legislature and judiciary will support the removal of ignorance and provide support for a meritocracy, and the equitable distribution of resources.

Need for relevance to 21st century realities

Much of this prevalence of ignorance can be traced to narrow literal interpretation of the Scriptures. The Prophet Muhammad and his followers were seriously preoccupied in governing within the contradiction of many diverse tribes. This coexistence must have been very difficult, and it is not surprising that one of the solutions was an overly-prescriptive set of guidelines. The aware will appreciate the need for relevance to 21st century realities in any sensible interpretation.

So what steps are required for the genuine development of an Islamic economic model?

Evolution of an Islamic economy

Social

The first step is to better understand periods of social harmony and development in Islamic history. It is all too easy to focus on a very short period of history – that which confronts us today and is associated with terrorism – and to forget about the important and valuable lessons of the past. Three broad areas are worth our attention, and answers to these should provide valuable clues to our quest for the Islamic economic model:

- ❑ Understanding of the historic Arabic process of coexistence with Jews and Christians.
- ❑ Understand how an Islamic individual can live in a non-Islamic society.
- ❑ Restore and respect the dignity and pride of the *Caliphate*.

In its early centuries of growth, the choice for non-Muslims was simple – convert, become a protected class within Islamic society (*dhimmi*) and pay *jizya*, or be slaughtered. By the 16th century, Middle Eastern Ottoman societies had significant *dhimmi* populations integrated across society and across professional and trade guilds.

However, society began to collapse. The *Caliphs* were wealthy, albeit bureaucratic, and their failure to efficiently manage, along with their failure to equitably distribute wealth to their constituents, sowed the seeds of downfall.

As the centrally-managed Islamic empire disintegrated, so did the position of non-Muslims. The further one drifted from the seat of authority, the more uncertain was one's likelihood of survival as a non-Muslim, notwithstanding a willingness to pay *jizya*. It seems that concern for security and dominance in what was essentially tribal warfare, overcame tolerance.

Whilst formal *jizya* has disappeared, immigrants the world over have informal *jizya*, which often takes generations to overcome. As one example, today in Iraq we see Christian families which have peacefully coexisted alongside the majority Muslim population being targeted as insecurity grows.

In non-Islamic societies there has been a mixed experience. France today has a major issue associated with inequitable income and wealth distribution to its five million Muslims. Many are immigrants, many live in state-provided high-rise housing that is a breeding ground for violence and crime, and many feel ostracized by mainstream French society.

The socio-economic divide does not seem as wide in Britain and the US, though it is there and real, and we have seen the development of many Islam-compliant goods and services, which cater for the needs of the Muslim minority and successfully coexist with mainstream society.

Economic

It is one thing to define an economic model, another to understand how that model will work in a non-stable state. Throughout history there have been shocks, which have had significant effects on the economic well-being of societies – some internal, some external. Today those shocks occur more frequently, and with more significant effects, given the integrated global

Lessons of the past

Insecurity grows

Breeding ground for violence

Islam-compliant goods and services

Buffering impact of economic shock

Respect and define the lender-investor and depositor-shareholder

economy in which all societies co-exist. Any search for an Islamic economic model has to understand the consequence of such shocks on that model, and more importantly, how to predict and prepare for such shocks:

- ❑ Understand the consequences of the cycle of economic collapse, and how serious it could be.
- ❑ Predict the possibility of human failure and its warning signs.
- ❑ Delineate the ownership of assets from the management of assets.

As a first step, Islamic society has to more clearly respect and define the two classes of lender-investor and depositor-shareholder. When this occurs, the role and rights of intermediaries are recognized and established. Similarly, intermediaries are given the space and authority to develop the tools they require to add efficiency to the process. As sophistication grows, for both practitioners and regulators/administrators, so does predictability. And with growing predictability one can apply degrees of confidence to possible future events. With that understanding, it becomes possible to plan for some of those possibilities, knowing there will always be human failings.

Develop managerial excellence

Professional management, in the private and public sectors, is essential in today's complex world. Failure to grow and develop managerial excellence leaves one open to failure to plan, to anticipate and cope with the unforeseen. Managerial depth is an important method of reducing vulnerability. This requires the development of institutions vested with the responsibility to grow managers, not just technicians.

Lay secular planks on theocratic platforms

In the same way Christian, Buddhist and Jewish societies have laid secular planks on theocratic platforms, so must Islam. Of course, there are tensions between the implied liberalism of the secularists and the fundamentalism of the theocrats, which are managed relatively transparently in democratic neoclassical economies. The process is enabled by the rule of law, legislative independence, professional managerial depth, strong public institutions, transparent tax collection and distribution, and predominantly secular education systems, and by elected governments managing on behalf of constituents.

More harmonious interpretation of Scriptures

The challenge for Islam is to concurrently develop the social and economic environments through more harmonious interpretation of the Scriptures and according to agreed Islamic principles, and not stifle development with protectionist self interests derived from the status quo of today's *caliphate*.

Forward-looking improvement

Equity is a recurring theme across many religions. Whilst the neoclassical economy has evolved into a democratic capitalist one, it is by no means perfect. Examples of inequity abound, some short term, others longer term. There are many quick fixes proposed, with varying results, but as yet the model has not stabilized, which indicates today's remedies remain inadequate and require constant forward-looking improvement.

Focusing specifically on the government sector, anomalies exist in both the input and output sides of the equation. On inputs (taxes), we have experimented with a range of devices from consumption to income and wealth taxes, with all the right intentions (to make taxes equitable and affordable), and have vacillated between welfare and capitalist states, with no time-tested evidence to support one correct, sustainable model. Perhaps our

Inefficiencies abound

investigation into the Islamic model will provide the answer. When we look at the corruption and fraud that seems endemic in some societies, and the attempts and structures that enable individuals and corporations, and even governments, to avoid paying their fair share of tax, often with tacit government approval, is it any wonder we are searching for a better model. Our search does not justify destroying existing models on the grounds they are inefficient, but it should encourage us to provide solutions to repairing or changing existing models if such actions result in more equitable and efficient models.

On the output side of the equation, similar anomalies and inefficiencies abound. Some are the result of linkages between those vested with the responsibility to govern, and their propensity to reward those that have awarded them that responsibility. Look at any democratic society around election time for some such examples. Others are the result of inefficiencies in the reallocation process, often linked to heavily bureaucratic processes that were created with the right intentions, but developed a life of their own and simply add cost, time and inefficiency to the process. Some come from outright fraud and corruption, ranging from state-directed favours to corruption by officers vested with the redistribution process responsibility.

Perhaps the Islamic Scriptures are too simplistic

However, it is equity in the gathering of taxes and redistribution (post the costs of governing) that drives many economic models, and is a central feature of the neoclassical society in which we live. Perhaps the Islamic Scriptures are too simplistic in prescribing tax rates and their sources – a fixed percentage of income and wealth – that it leads to interpretative opacity, or perhaps it is the extreme complexity that some capitalist societies have developed in the same process that similarly cloud the issue of which is “best”. Neither would deny it is our collective responsibility to be equitable and efficient in the process. As we discussed earlier, it is incumbent on all to work towards the model that best delivers equity to all constituents.

Perhaps it is confusion

Perhaps it is confusion between the role of *zakaat* (voluntary taxes for distribution to the needy) and general taxation (mandatory taxes for distribution to public sector obligations and enabling infrastructure) that has inhibited clear and consistent development of both. Perhaps it is as simple as not accepting human nature for what it is, and what is was that took us from the trees to the stars.

Failure to be efficient and equitable exacerbates the effects of inevitable shocks. As an example, a disruption to inputs, through a fall in society’s income levels or overall wealth due to natural disasters, has a direct consequence on the availability of outputs, and the funds available to manage the process. This can be dealt with in a number of ways, all of which have costs. Is it better to create a pool of savings from which output management can be drawn, and accept lower economic growth in the process of creating that pool, knowing disruption from a fall in output is more disastrous for public sector obligations and the needy than a slowdown?

Financial

Calculating ‘service cost’

Calculating ‘service cost’ of capital in world of supply and demand

An economy is the aggregation of a series of one-to-one transactions. Each of these transactions delivers both cost and benefit to the interacting parties. The parties are aware of possible risks and benefits of the transaction and are prepared to meet the costs associated with the transaction. They are also

Finding a proxy for interest rates

Historical experience suggests compromise

willing to accept the input, and costs, of others, if that input is likely to result in the transaction being enhanced, and presumably becoming more valuable to the parties. It is therefore a simple task to calculate the costs associated with the transaction, and determine post-transaction whether or not the costs were outweighed by the accrued benefits.

Some transactions are seemingly illogical, according to behavioural economists. For example, when asked to predict the probability or likelihood of rain, respondents will frequently give 60%, yet when asked about the likelihood of no rain, will respond with 50%. This is illogical, as the two answers should equal 100%. This is different from the "moral hazard" example such as depositors being assured by a government there is no lender of last resort for their bank deposits, yet nonetheless expecting the government to bail them out should the bank fail.

So the risk in simply bundling all the individual transactions in an economy together, and then making assumptions on the basis of that aggregation, is that one cannot be certain the individual transactions were in fact entered into with a full and complete knowledge and acceptance of the risks and potential rewards by the individual participants, and that the aggregation may not represent an homogenous set of transactions with regard to the assumed awareness.

Finding the right mechanism of measurement

The neoclassical model utilizes interest rates as a tool of both monetary policy (although this is declining with the growing strength and independence of central banks) and for clearing financial markets. But interest rates are not some magical thing. As we described in figure 6, they simply reflect the equilibrium point at which the demand for savings is matched with the supply of savings. Interest rates only become a destabilising tool when the efficient marketplace is restricted, as explained in figure 8.

As there is a wide range of views on the interest rate/usury debate by Islamic scholars, the concept of "service fee" can be used to reflect the equilibrium point of available savings and demand for those savings.

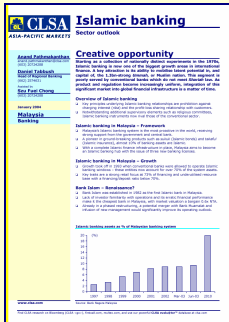
Calculating the service fee draws upon the cost information imbedded in the myriad of individual transactions in an economy. However, the cost of making calculations for each transaction would far outweigh the benefits of knowing that level of detail, and would accordingly breach the Prophet Muhammad's exhortation for man to be expeditious in the use of Allah's resources, and the exploitation of those resources for the benefit of all mankind. The fee can be best calculated by reference to established market-clearing mechanisms and tools.

Historic experience illustrates acceptability of 'service cost'

We can also harmonize the neoclassical economic model with the principal of zero interest rates. Putting aside the synthetic tools used by intermediaries in many Islamic and non-Islamic societies, zero nominal interest rates have a role in a deflationary environment. Money has a time value, and here that time value is nominally zero, but actually positive, as the future value of money is greater as prices deflate over time.

Transactions over the past millennium have allowed for the time value of money and for expected risks, as well as third-party costs. These costs are often built into the transaction, and less transparent, but they do exist.

Potential pool of Islamic savings within reach



Market economy in seventh century

Islamic banking based on 'like for like'

No consensus on interest rates

Islamic banking

It is fair to say the evolution of the Islamic banking industry is still finding its way, as interpretation of Islam’s guiding Scriptures is a hot topic of debate amongst Islamic scholars, governments and practitioners.

The quotation below, from Omar Noman’s *The Profit Motive in Islam: Religion and Economics in the Muslim World*, in reference to Hazrat Khatija, the wife of the Prophet Muhammad, is an interesting starting point in our explanation, and in today’s debates.

Hazrat Khatija was a property owner, a major trader who hired men to work for her. One of the men she hired – to take a caravan of goods to Syria – was to become her future husband and the Prophet of Islam. Thus market principles, private property, commerce and trade were part of the economy into which Islam was born. It should be noted that interest was not prohibited in the transactions that defined this economy.

It would appear the market economy and the equality of women in society and commerce were unquestioned in the seventh century of the Prophet Muhammad – a far cry from some of the interpretations that later found voice in the Islamic world.

Islamic banking is based on the premise that interest, at any level, is exploitive, and cannot be a feature of Islamic banking. It goes back to the historic requirement that the exchange of fungible goods be “gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal and hand to hand”. Interest has a pre-determined rate, and is thus deemed usurious.

The debate on the permissibility of interest is wide ranging, and has not yet achieved a consensus. What is accepted is profit-sharing, on the basis that the outcome of a venture cannot be pre-determined, and the future profit similarly cannot be pre-determined.

Islamic banks have accordingly structured themselves on the liability side to offer three broad types of deposit account:

- ❑ Current accounts – Non-return bearing, designed to provide a safe home for cash, and on demand.
- ❑ Savings accounts – Discretionary-return bearing (typically based on the profitability of the bank), designed to provide a safe home plus possible returns, on demand, but less flexible than current accounts.
- ❑ Investment accounts – Returns based on the performance of the bank’s risk-asset portfolio, varying degrees of risk-return, deposits locked into an agreed maturity/term.

On the asset side of the balance sheet, Islamic banks deploy deposits in three broad types of activities:

- ❑ *Murabaha* – The bank takes ownership of the asset desired by its borrower and sells it to the borrower at a marked-up price for payment at a later date, assuming risk, for the period of asset ownership, in the process;

Leasing is common

- ❑ *Mudaraba* – The bank invests/backs an entrepreneur in a particular venture, for a pre-determined share of profits from the venture (and typically all the losses).
- ❑ *Musharaka* – The bank co-invests with an entrepreneur, similarly sharing in the profit/loss from the venture – usually relative to their respective equity levels.

The second and third activities mentioned above are less common than the first, and are supplemented by variations on the first. Leasing is common, the bank acquiring the asset and receiving regular rental payments plus instalments towards ultimate purchase of the asset by the lessee. A second is a variation on *murabaha*, where payment for the asset purchased by the bank (on the borrower's behalf) is made at a later date (called *bai' muajjal*), and a third (called *bai' salam*) where payment is made today for future delivery of the asset.

This family of lending products looks remarkably like day-to-day banking products, albeit without reference to interest, and a superficial comparison of the two reveals a striking resemblance between mark-up/future payment streams, to prevailing interest/discount rates.

Islamic banking has three distinguishing features

Observations of practice aside, Mohamed Ariff wrote in *Islamic Banking* (Asian-Pacific Economic Literature, September 1988) that Islamic banking appears to have 'three distinguishing features: (a) it is interest free, (b) it is multi-purpose and not purely commercial, and (c) it is strongly equity-oriented.'

Liquidity management is difficult

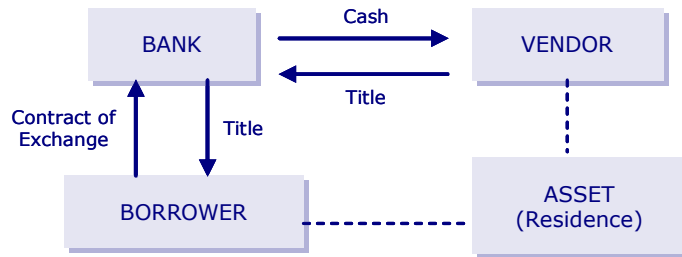
Again, observations indicate the first feature is commonly achieved, although liquidity management is difficult as access to money markets and central bank discount windows is not allowable – interest is payable. The second, some form of social service over profit, is not so clear, and the third is only achieved to the extent the particular bank focuses on taking risk as a principal, being a venture capitalist.

Murabaha – Where the lender/bank takes ownership of the asset being exchanged by two parties, and accordingly assumes risk (for the period of ownership). In practice, the lender keeps the ownership period to an absolute minimum, through simultaneous contract (title passing) signing, and promises to buy (*bai' bithamin ajil*) the particular asset by the purchaser. Nonetheless, the lender/bank accordingly assumes risk, and enters into an interest-free transaction(s) with the borrower/obligant.

An example is a contract of exchange, secured by a charge over the asset required and followed by a "promise to buy" the asset to be acquired, entered into between a lender and borrower in a residential sale and purchase.

Figure 10

The murabaha system



Source: Authors

The asset to be acquired is not necessarily income producing (a personal residence) or acquired for profit. In this example the house is purchased by the bank for a market value of, say, US\$100, and immediately sold to the buyer, who selected the house, and agreed its sale/purchase price, for US\$200 – payable over 20 years at US\$10 pa.

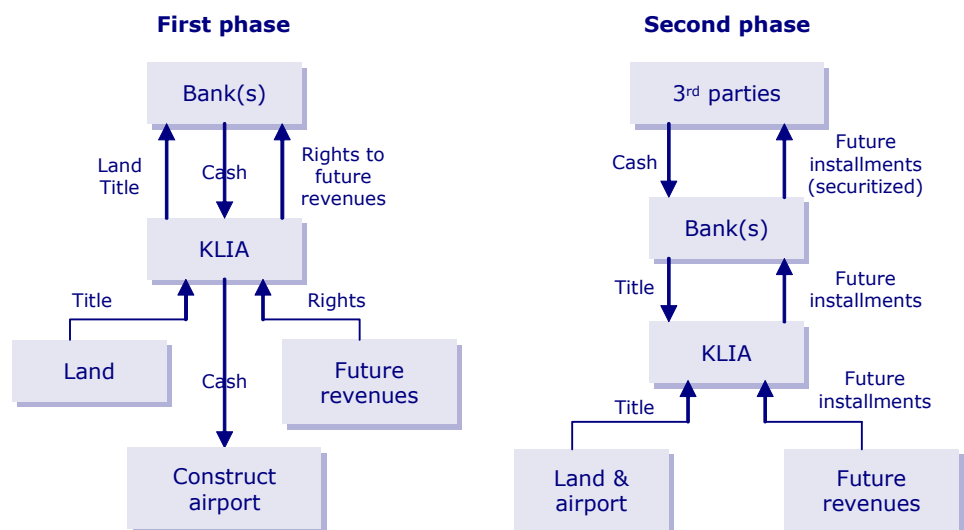
This contract of exchange is a mutually agreed contract, and does not involve interest payments, although the net present value of the annual instalments of US\$10 could be construed to be “interest”. Note that the annual payments could be stripped out (securitized) and individually sold to third parties at market prices (discounted) by the bank, against the borrower’s obligation to make those payments.

Defaults are dealt with by the bank exercising its rights under its charge over the asset and, in the case of shortfalls, additional charges against the residual equity in the asset, for late payments by the borrower.

The Kuala Lumpur International Airport (KLIA) is typical of income-generating infrastructure development in the Islamic world.

Figure 11

Financing structure for the Kuala Lumpur International Airport



Source: Timur Kuran, *Islam and Mammon*

In the first phase, KLIA sold its land and the rights to future income from the airport to its financiers/banks in exchange for cash, which it used to construct an airport from which the future revenues are expected to be generated.

The second phase saw the financiers/banks sell the land, and the airport in the process of construction, back to KLIA, at a higher price – payable in instalments over 20 years – and concurrently securitized those instalment obligations and sold them, at market price discounts to their face value - depending upon the due date of each payment – to third parties for cash.

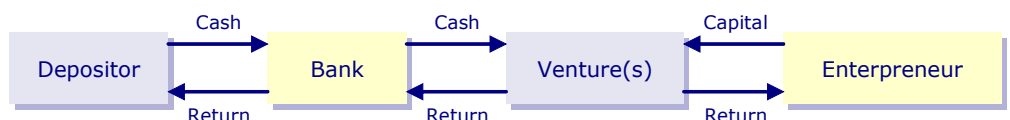
The bank has accepted risk, albeit the phases were executed concurrently, and interest payments are not part of the transactions between the banks.

Mudaraba and musharaka – Where banks acquire capital (or equity) and deposits in order to conduct their lending activities. Some *murabah* deposits are placed on demand, are not eligible for any return – depositors seek security, not return – and are typically termed short-term demand deposits (*al-wadiah*).

Others, *mudaraba*, are placed on the expectation they will be employed in risk-taking ventures, for which profit-sharing from the ventures is anticipated. There are many variations, but the basic theme is investing in a venture with *musharaka*, or without *mudaraba* the entrepreneur investing his own capital. The role for the bank is to bundle depositors and invest in single or multiple ventures.

Figure 12

Turning cash into capital and generation of returns



Source: Authors

- ❑ The future value of the return is not known, pending the outcome of the venture, although the depositor has agreed a percentage of the return up front.
- ❑ The return is net of bank costs associated with the venture.
- ❑ In some instances the bank assumes responsibility for any losses in the venture.
- ❑ The bank assumes responsibility for any negligence in its role as intermediary.

The performance of Islamic banking has been chequered, and clouded in tax and capital adequacy anomalies. Major challenges remain in staff skills levels, depositor retention, management information systems, technology, profitability and stability, and increased competition from global banks with

**Islamic banking clouded
in tax and capital
adequacy anomalies**

Catering to specific needs of Muslim customer base

products designed to look Islam-compliant. However, the potential pool of savings in the hands of Islamic depositors makes for probable progress in adequately dealing with these issues. Independent analysis shows nominal returns – real returns tend to reflect the underlying rate of inflation – on comparable time deposits at Islamic banks are close to those of non-Islamic banks, and both mirror prevailing rates of interest in their respective economies.

The growing presence of Islamic banking will continue, if for no other reason than the banks' intent to cater to the specific needs of its Muslim constituent customer base. What is not clear is whether Islamic banking will, or should, achieve a greater "social" role in its constituent societies. The complexity, speed and competitive nature of finance would probably preclude that role.

A similar enigma has emerged in the world of corporate donations to worthy causes – "shareholder rights" movements are expressing disapproval at corporate management pledging shareholders' funds in this way without specific approval from shareholders for such pledges. The issue delves deep into the well of corporate responsibility towards the community, on which issue the law is silent, and when taken to the cross-border step, digs further into the responsibility of multinationals, and their responsibility to their host communities – in addition to their shareholder home bases.

Within the OECD we have the example of Japan and its concept of *Kaisha*, where the company views as its prime responsibility the provision of a future for all its constituents – employees, customers/suppliers, shareholders and the communities in which it operates. This is quite distinct from a typical US corporation, which views its prime responsibility as being to maximize returns for shareholders, measured quarterly.

We will continue to see growth and sophistication in Islamic banking products. The interest/no interest question will not be resolved in the short term.

Growing sophistication of Islamic financial services sector

Islamic bond (*sukus*) issuance by sovereign and corporate issuers is growing, and of equal significance to their *Shariah*-compliance is the growing sophistication of the Islamic financial services sector in credit-worthiness awareness and corporate governance, both critical success factors for the stability and development of the sector.

Bond issue by the Islamic Republic of Pakistan

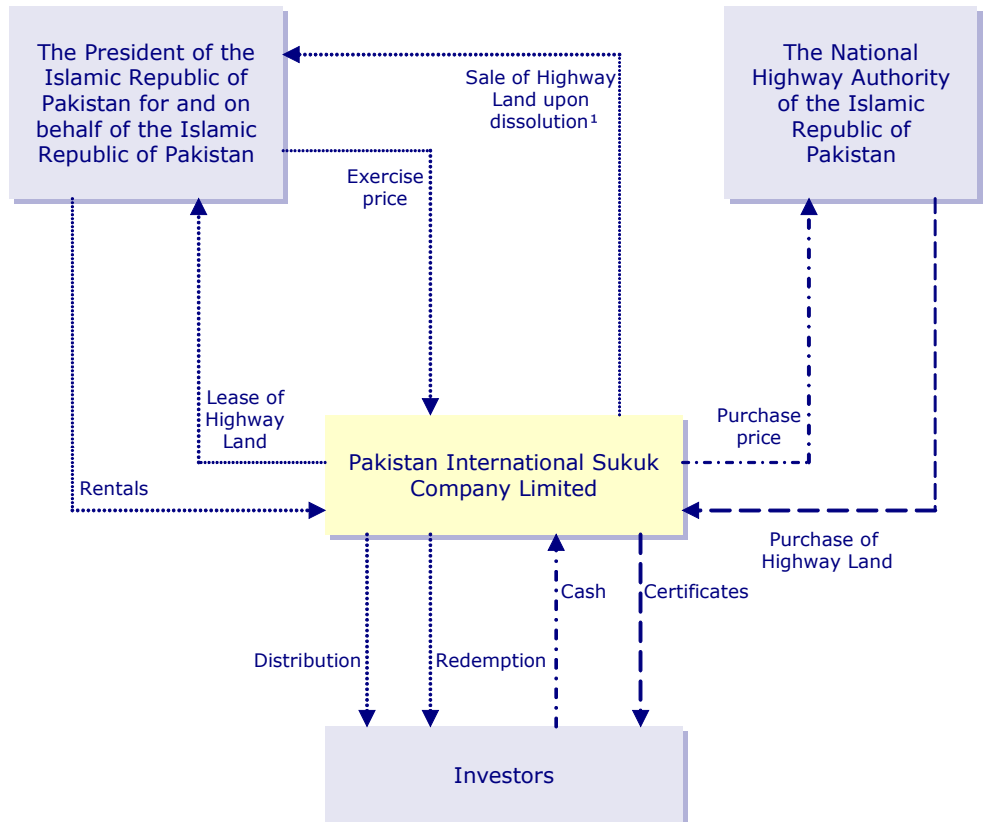
In a final example, we look at a recent bond issue by the Islamic Republic of Pakistan, structured to raise capital for infrastructure development, in this case a highway. Some of the interesting features are the minimum investment size (US\$100,000 – clearly intended for placement to the professional marketplace), the bond is externally rated (giving probable investors a benchmark against which to price the bond) and interest is not payable (in its stead a "Periodic Distribution Amount" based on LIBOR plus margin). Further, the lessee (essentially the government) of the underlying asset pays a "Rental" equal to the Periodic Distribution Amount to the bond issuer (essentially guaranteeing the bond coupons, and ultimate redemption), the Issue is arranged by two well known multi-national banks (plus a local bank), and the issue is certified *Shariah*-compliant.

Expected to attract good investor participation

The issue complies with Islamic banking principles in that it does not involve interest, yet the outcome is sufficiently in accord with conventional banking expectations that it is expected to attract good investor participation. The cash flow chart below further clarifies the Issue:

Figure 13

Cash flow of the transaction



¹ Highway Land will be sold to the President of the Islamic Republic of Pakistan for and on behalf of the Islamic Republic of Pakistan or the National Highway Authority of the Islamic Republic of Pakistan as its nominee. Source: Preliminary Offering Circular Dated 23 December 2004

Implications for Thailand

Thailand's southern three provinces – Yala, Pattani and Narathiwat – are predominantly Muslim. The region was historically part of the Sultanate of Pattani, and was consolidated into Buddhist Thailand in 1908. In the process its scholastic Islamic development became disrupted.

However, even after nearly a century, the region has not been socially or economically integrated into Thailand and is an economic underperformer. There is also an undercurrent of dissatisfaction dating to the absorption of the region into Siam as it struggled to protect its independence amid of the Anglo-French power struggle for political control of Southeast Asia.

Successive Thai governments have largely ignored this anomalous region. In particular, the Thai economic resurgence following the Asian financial crisis of the late 1990s has not been felt in the south, and the growing economic disparity fans already smouldering dissension. The south feels it is being exploited by Bangkok, and that steps taken by government authorities for the betterment of Thailand do not include the welfare of southern Thai society, making it vulnerable to the seduction of secession.

Within this disgruntled community there is the view that religious teachers need to be brought in to raise the economic health and relevance of this minority Islamic community, and they are being actively sought out.

Thai Muslims have naturally looked south to neighbouring Kelantan, the only Malaysian state governed by the Islamic Party of Malaysia (PAS), which has an agenda of *Sharia* law, as a source of teachers and training. Kelantan also contains the threads of Islamic scholarship that have been frequently disrupted since the 1908 absorption into Thailand.

Porous borders and past ambivalence by Malaysia and Indonesia, Thailand's two populous Islamic neighbours, assist the movement of people into the southern provinces advocating independence for the south and the revival of Pattani. Recent comments by former Malaysian prime minister Mahathir Mohammad encouraging a "self-determination" debate for the southern Thai Muslims have drawn opposition from Malaysian Prime Minister Abdullah Badawi and Thailand's Thaksin Shinawatra.

Funds and organization are now coming from the *Jemaah Islamiya* (which purportedly has links with *al-Qaeda*). It sees disaffection in southern Thailand as an excellent opportunity to "stir the pot" and gain international prominence and profile. *Jemaah Islamiya* is *Wahhabi*, a strictly orthodox *Sunni* Muslim sect predominant in Saudi Arabia, which has been active in spreading its particular brand of Islam throughout the developing world, notably in East Africa. Traditionally Southeast Asia's Muslims essentially belong to the more moderate and relaxed *Shafi'i* school of *Sunni* Islam, brought from Arabia, Persia and India in the 11th and 12th centuries, and subsequently positively reinforced with Ottoman support by regular pilgrimages of the relatively affluent Southeast Asian Muslims to Middle Eastern centres of Islamic learning. The *Shafi'i* school is considered the easiest in terms of social and personal rules, characterised by tradition, the consensus of the Muslim community and reasoning by analogy. Its rival is the *Hanafi* school, which is the hardest of the *Sunni* schools and is dominant in the Arab Middle East, India, Pakistan and Afghanistan.

Thailand neglected its Muslim south

No integration after nearly a century

Largely ignored by successive governments

Disgruntled community looking elsewhere

Malaysia's Kelantan a close Islamic neighbour

Porous borders and past ambivalence

Moderate Thai Muslims encountering strict orthodoxy

Violence seen as a tool to force change

As a result of an influx of hard-line, orthodox teaching and pent up feelings of repression and disadvantage, violence is being increasingly seen as an acceptable tool by some in the Islamic community to force change. The initial reaction by the authorities was one of greater violence, badly handled and accompanied by factional posturing of the police and the army. It is clear the authority for the crackdown in the south of Thailand did not initially come from Bangkok, and that local commanders lacked the experience and training to cope with the demands placed upon them.

Risk of escalating violence

We now face the risk of a vicious cycle of escalating violence, which threatens to spread into urban areas beyond the largely rural south. When such a cycle forms, the initial demands for fair treatment become irrelevant, and headline-grabbing violence will take on its own momentum. All parties have now become polarized, with no forum for dispute resolution that any will trust. What is needed is a circuit breaker that will allow the government to establish its "moral authority" over the disputants. The challenge, however, is to create a "moral obligation" within the community directed towards its own future development.

State has failed to create and reinforce values

The role of the state is to create and reinforce values, as every state/nation requires spirituality based on values to provide it with national cohesion, and we can fairly confidently assume that the 80-20 rule applies – most of the community will accept the status quo most of the time. Martin Wolf wrote in the *Financial Times* last November that where new values and concepts are disruptive to the host society:

Dissemination, through education, religious institutions or other means, of values and attitudes that are fundamentally at odds with those of a tolerant democracy cannot be made illegal but must be fiercely combated.

Long-term income generation necessary to displace violence

Economic activities that lead to the creation of long-term income generation and wealth accumulation will displace the ingredients on which violence feeds. Activities need to be based not only on high technology, which China and India will dominate, but on intellectual and social property, and the skills that go with them, as well as cultural assets. This is the wealth – albeit difficult to value in an accounting sense – on which sustainable, long-term value creation must be based.

Our six-point plan

A six-point plan

A significant Islamic population can successfully co-exist with Thailand's majority Buddhist population, and contribute meaningfully to the Thai state. However, it is incumbent upon the Thai state to set the parameters for co-existence, promulgate those parameters and both enable and ensure compliance.

1) Take control under acceptable standards

- ❑ Participation in southern communities by government must occur through all southern institutions – social and religious.
- ❑ Resolution of police/army authority, and removal of any conflict between the two chains of command.
- ❑ Centralized decision making, clearly delegated local authority (police and army), with acceptable codes of behaviour and morals – dictated by the higher moral authority of the central government.
- ❑ Immediate tightening of the border to limit ideological incursion.

- ❑ Support from neighbouring countries must be sought, and publicized – escalating violence will also hit their urban areas.
- ❑ Instigators of violence must be identified and removed – foreign infiltrators publicly so.
- ❑ Amend legislation to allow for proper detention and acceptable interrogation of detainees.

2) Break the vicious educational cycle

Education of its populace is a state responsibility, to both ensure the country's human resource latent talent is provided every opportunity to develop and enhance the wealth of the state, and to ensure the state's intentions for successful co-existence of diverse ethnic and religious segments of its population are met.

- ❑ The state must gain control of *madrassah* (termed *pondok*), teachers and the curriculum, and break the vicious educational cycle.
- ❑ Teacher training and supervision is a state responsibility, and a key part of educational reform in the south.
- ❑ The state should pay for material upgrading of places of worship, and provide its side of the "story" in the local language.
- ❑ The state must take control of *zakaat* collection and distribution to ensure funds go to appropriately constructive use – betterment of the poor.
- ❑ Match every baht raised from the community with one from the state, and in the process institutionalize transparency, accountability and independent audit in both the collection and the distribution of *zakaat*.

3) Economic stimulation in the region

Much of Southeast Asian Islamic debate is consumed with the question of "purity". The state is vested with the responsibility of providing and enforcing a level playing field of good governance and transparency within its Islamic communities as the tools from which wealth can be accumulated by those communities. The accumulation of wealth through meaningful economic activity and ownership adds to Islamic "purity", through the alleviation of poverty and enhancement of intellectual fulfilment.

- ❑ Regional economic stimulation is required, to enable new investment, and should include tax and other fiscal incentives.
- ❑ Integration of the south with greater Thailand through movements of goods and services.
- ❑ Build the enabling infrastructure to facilitate the pathway to the north, and in the process create meaningful employment, consumption and expenditure growth.
- ❑ Such an example might be the construction of an international airport and related infrastructure, as an access gateway to domestic and international investment and tourism.
- ❑ Creation of meaningful employment, especially for youth, is a priority, as are steps to encourage tourism.
- ❑ What is not needed is the Bahrain experience of cradle-to-grave public sector employment and benefits.
- ❑ Local entrepreneurs are to be encouraged and supported – they set the required standards of wealth creation and asset protection.

4) Institutional localization and empowerment

- ❑ Active government efforts to establish Islamic institutions (financial, social and political) under central supervision.
- ❑ Even though such institutions are cosmetically unique, their creation empowers the community and encourages integration through recognized rights and mutually beneficial commerce.
- ❑ Islamic banking, places of worship, sport and the arts, and organized political representation, among others should be encouraged.
- ❑ The end objective is to improve quality of life for the community.

5) Reinforce nationalism and create hope

Diversity has embedded within it the potential to enhance economic value creation in a state. This value will remain undeveloped and unrealized without the state enabling its release through the creation of demand – social consumption demand – that flows from its recognition and encouragement. Such cultural assets exist in the Islamic south, and with state support will create relative and absolute value for Thailand.

- ❑ Conduits to instil hope and meaning are needed.
- ❑ It is important to reinforce nationalism to strengthen the Muslim community's Thai identity.
- ❑ The recent project of 100 million paper cranes and the wider involvement of Buddhist Thais in the southern issue are good examples of the type of initiatives needed.
- ❑ These should be combined with “positive discrimination” to education, employment and investment, to encourage the brightest and the best achievers and the potential of the south – setting an example to which others may aspire.
- ❑ The south must be encouraged to look to the north for kinship, not to Kelantan for some vision of an unattainable Pattani.
- ❑ Similarly, the north must be encouraged to look south, positively, and embrace co-existence.

6) The Royal Thai Government

Accurately pricing the future social value of this region to the state will indicate the state resources that should be applied to the transformation if the region's real value is to be realized, in a time frame that keeps pace with the creation of, and demand for, regional employment.

- ❑ Creation of a specific (permanent) department within the Ministry of Interior is a first step.
- ❑ It must have bright and resourceful staff and be well financed.
- ❑ Its mandate should be to see the south integrated into greater Thailand – socially, financially and politically.
- ❑ It should have tight performance timetables and objectives, and be seen as an important stepping stone for ambitious career bureaucrats.

A significant economic transformation is required in southern Thailand. To ensure the least pain possible in the transformation phase is the responsibility of the state, which requires the application of the state's most capable human resources.

**Southeast Asia could lead
the way to flexible
Islamic societies**

Conclusions

Critics of the economic performance of Islamic societies are quick to claim there is something fundamentally unique about Islam that prohibits its efficient functioning in accordance with neoclassical economic principles. To debunk this myth, the authors have compared each of the elements of the Islamic and neoclassical economic models, and found there to be no such impediment.

The issue is locked in the diverse stages of progress in Islamic societies and their economic states, and the interpretive gap between the Scriptures and their modern application.

As Southeast Asia is demonstrating, the future is bright for flexible Islamic societies. There is no question that Islamic banking is a reality and will grow in efficiency, as will the efficiency of markets across all aspects of Islamic societies.

Impediments do remain, but as governments in Islamic societies come to grips with how to equitably resolve these impediments to prosperity, their economic health will improve in leaps and bounds.

Rising standards of living will address and meet the needs of the economically disadvantaged, and efficient utilisation of the resources entrusted to Islamic societies will result.

By encouraging positive and mutually beneficial economic development, Islam can be turned from the path of all consuming destruction to one of growth and development that fulfils Allah's demand for a fair and equitable society.

The challenge for government, and for investors, is to understand that without sensitive and proactive policies and projects, the cost of valuable resources, both in human and economic terms, will only get higher.

Appendix 1: Glossary of economic terms

bai' bithaman ajil – deferred payment sale. A contract is entered into in which the seller allows the buyer to pay the price of a good at a future date in a lump sum or in installments.

bai' salam – advance payment for goods. The goods must be defined and the date of delivery fixed.

mudarabah – a form of partnership where one party provides the funds while the other provides the expertise and management. Any profits accrued are shared between the two parties on a pre-agreed basis while capital loss is borne by the partner providing the capital.

murabahah – a contract of sale in which the seller declares his cost and profit. Adopted as a mode of financing by Islamic banks and involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definitive profit over the cost which is settled in advance.

musharakah – a financing technique under which the Islamic bank provides funds which are mixed with the funds of business enterprises and others. All providers of capital are entitled to participate in management, but are not required to do so. The profit is distributed among the partners in pre-agreed ratios while the loss is borne by each partner in proportion to respective capital contributions.

riba – an increase which is a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense to the other party.

sukuk – the Islamic equivalent of a debt security/bond.

al-wadiyah – a contract whereby a person leaves valuables for safe-keeping.

zakah – an obligatory periodic levy on all Muslims who have wealth or income above a certain minimum. The distribution of zakah funds has been laid down in the Quran and is for the poor and the needy.

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