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INTERNATIONAL ECONOMIC RELATIONS FROM ISLAMIC PERSPECTIVES

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INTERNATIONAL ECONOMIC RELATIONS FROM ISLAMIC PERSPECTIVES

Proceedings of a Seminar
held in Tübingen, West Germany
from 28 August to 01 September 1988
16 - 20 Muharram 1409H
jointly organized by the
Islamic Research and Training Institute
of the Islamic Development Bank, Jeddah, Saudi Arabia,
Institute for Scientific Cooperation, Tubingen and
Institute for Foreign Cultural Relations, Stuttgart, West Germany

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بسم الله الرحمن الرحيم

IN THE NAME OF ALLAH, THE MOST MERCIFUL, MOST BENEFICENT

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FOREWORD

The seminar on International Economic Relations from Islamic Perspectives was organized in Tubingen, Federal Republic of Germany, during 16 to 20 Muharram 1409H (28 August to 1st September 1988). It was a unique and pioneering academic event in which the Training Division of the Islamic Research and Training Institute (IRTI), an affiliate of the Islamic Development Bank (IDB), collaborated with the Institute for Scientific Cooperation, Tubingen, and the Institute for Foreign Cultural Relations, Stuttgart in the Federal Republic of Germany. The main objective of the seminar was to promote contact and dialogue between Muslim and German scholars and research institutions on economic problems.

The seminar was attended by a host of high level participants representing major educational, cultural and business institutions. Ten papers were presented during the seminar by scholars from IRTI and other institutions worldwide.

IRTI appreciates the great contribution to the seminar's success made by our coorganizers, most notably Prof. Dr. Jurgen Hans Hohnholz, Director of the Institute for Scientific Cooperation and his able assistants, Dr. Karl-Heinz Bechtold, Head, Economics Department and Dr. Maho Aves, Head, Department of oriental and Islamic Studies at the Institute.

The seminar organizers are hopeful that these proceedings will contribute to a better understanding of the problems and issues discussed during the seminar and will also serve as a bridge of understanding between Muslim and Western cultures.

AElGhazali

Prof. Dr. Abdel Hamid El-Ghazali
Director, IRTI

INTRODUCTION

M.A. Mannan

The seminar on "Islamic Perspectives on International Economic Relations", was jointly organized by the Islamic Research and Training Institute of the Islamic Development Bank, Jeddah, Institute for Scientific Cooperation, Tübingen and the Institute for Foreign Cultural Relations, Stuttgart; and held in Tübingen, West Germany from 28 August to 1 September 1988 to exchange views and to initiate a constructive dialogue between Muslim and German Economists for developing mutual understanding on international economic relations from an Islamic Perspective. This brief introduction seeks to provide a broad overview of the proceedings of this seminar, indicating the future lines of academic cooperation.

The ten substantive papers, *six* by Islamic and *four* by German Economists were presented at the seminar, constitute the core of the present volume. These papers both individually and collectively, and the comments and discussions which followed the presentation of papers provide a conceptual framework within which the basic principles, policies, and prospects of international economic relations from an Islamic Perspective can be worked out.

The paper entitled "Principles of International Economic Relations in Islam" by M.N. Siddiqi discusses the Islamic view on international economics. In this paper, attempt is made to derive the Shari'ah-based principles of international economic relation. The paper adopted a deductive approach in its analysis. It is argued that the pursuit of both national and international economic interest must be in conformity with the principles of the Shari'ah which does not allow unfair exploitation of one party by another in any economic transactions. Here the author has identified a number of basic rules of the *Shari'ah* governing both the domestic and international economic relations. While the paper advocated free-trade and free factor-mobility, yet it suggests that given the present climate of protectionism, restriction may be imposed in some critical areas such as foreign exchange, labor mobility etc.

In his paper on "Normative Premises in the Theory of International Economics," E.J. Horn argued effectively that in the face of growing protectionist policy adopted in the area of International Economic relation, gains from free trade can no longer be achieved. As a result there is a shift of emphasis. That is,

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both developed and developing countries are increasingly interested as to how they can gain in international trade through increasing governmental control and intervention. It is argued however, that government of developing countries should carefully limit the range of their interventions which they can manage efficiently. It is to be recognized here that the ability of the developing southern countries to control the flow of their trade and significant investment, in any way, is very limited. For, most of the Southern countries earn a large percentage of their gross national product from trade with the North. Most of the Third World countries have a small internal market and thus depend on the larger Northern markets for the sale of raw materials and primary goods. Furthermore, a large percentage of Southern countries' exports is often concentrated in a single or small number of primary products, which are highly vulnerable to fluctuations in demand for the principal product. Besides, many of the Southern countries that do have' strong export sectors frequently manufacture products, such as steel and textiles, that threaten politically powerful industries in the North. Besides, large percentage of the domestic stock of investment in Third World countries is often owned by Northern investors. This leads to financial dependence in which the currency of the dependent Southern country is directly linked to the currency of the dominant Northern country, which influences both the external and the internal monetary policy of that Southern country. Usually, these economic dependences - trade, investment, money, aid - reinforced by other types of relationships with the North: cultural ties, alliances and treaties. Thus, ability of the developing countries to influence the direction of trade remains very limited indeed.

Khurshid Ahmad, in his paper entitled "The new International Economic Order: Some Reflections from an Islamic Perspectives", stressed the need for new International Economic order based on the principles of universal brotherhood of man, concept of ownership, equality and justice as viewed by the *Shari'ah.* The need for evolving such a system arises due to the failure of North-South dialogue. In this context it is worth mentioning that despite the problems of economic interdependence, the developed market economies of the West have shown considerable solidarity in supporting a liberal, capitalist international economy. The persistence of the shared goal of cooperation was demonstrated by the behavior of the developed states during the money, oil, and trade crises of 1970's and 1980's and their ability to develop an united strategy against the demand for a New International Economic Order and reform by the South that includes all Islamic countries.

Ironically, this interdependence has generated the forces of dependence to a great extent pertaining to North- South system of relations among the developed market economies and the Third World - the less-developed economies. Unlike the Western system, which is composed of relatively similar and equal actors, the North-South system is one of disparity and inequality between North and South in terms of gross national product, per capita level, stage and level of development etc. Hence the need for a new International Economic Order based on Islamic principles as emphasised by Khurshid Ahmad in his presentation.

The paper entitled "Problems and Potentials of South-South Trade with Special Reference to the Islamic countries by Volker Nienhaus argued that collective self-reliance as well as trade-expansion strategies among the OIC member countries may not provide adequate solutions to the problem of their development, due to vast differences in the levels and stages of development in addition to diverse resource endowment. It is argued however, that efforts should be made to obtain preferential trade treatment from the developed countries of the West as this would improve the terms of trade. Experience suggests that it is not easy to obtain such preferential trade treatment from the European Economic Community as suggested by the author. This task may be more difficult in the light of the recent dramatic development in the East-West relationship, the virtual end of the cold war between two superpowers, the failure of the Communist ideology, and emergence of the forces of market economies in the Eastern block countries, the reunification of East and West Germany, proposal for establishment of a separate European bank for Development and Reconstruction of the economies of the socialist block countries and a host of other events. It has serious implications for the Islamic World. East European countries' massive economic reconstruction plan resulting form their move towards free-market economy, may divert Western economic aid form the Third World that includes all the 46 OIC member countries of which 21 belong to the category of the least developed countries.

Then Ahmed EI-Naggar, in his paper entitled "International Islamic Banking in an Interest-based World Financial System: A Theoretical Model", discussed the human psyche with its yearning for wealth and self-realization. For this reason he stressed the need for moulding the behavior of individual in the light of the moral and ethical values of Islamic culture. While reviewing the role of *Qard Hasan* and *Musharakah* as method of financing by Islamic Bank, the paper argued that the *Musharakah* financing can be utilized as a potential weapon for development in the sense that it introduces an element of flexibility in the cost of financing and links the allocation and utilization of fund to economic and social priorities. It may be pointed out here that Islamic modes of financing are not confined to *Musharakah* only. Various modes of Islamic financing and instruments have been developed by the various Islamic Banks. For example, so far twelve modes of financing have been specified by the State Bank of Pakistan which can be classified into three broad categories such as (a) loan related financing, (b) trade related financing and (c) investment related financing. It is to be recognized that assumptions under which the various modes of Islamic financing are to be operated are different from the similar operations under the market economy. Dual notion of accountability provides main guidelines for their operation. Hence the necessity for moulding the behavior of all concerned involved in such operations.

The paper of late Dr. S.A. Meenai (may Allah bless his soul), who died in Jeddah a week before the seminar, deals with the topic - "International Development Banking in an Islamic Framework : Lessons of Islamic Development Bank's Experience" which was read by M.A. Mannan.

This paper tried to highlight some of the lessons of Islamic Development Bank's experience over the past twelve years since its inception and stressed, among others, the need for a substantial expansion in the areas of project financing, development of equity financing, building institutions and developing policies specially in the case of least developed member countries of the Bank, consequently de-emphasizing co-financing which indirectly tends to perpetuate traditional financing practices, including extensive use of foreign trade financing operation, and so on. While drawing an agenda for the future development of the bank, the paper stressed the need to focus on agriculture, low cost housing, food, clothing, medical facilities and education of the poor.

E. Freyer presented a paper entitled "The Debt Crisis: International Financial Institutions and Islamic Countries". In his contribution he highlighted the nature and dimension of this crises in the developing countries with special reference to Islamic countries in particular. It is argued that the debt indicators and debt structures of Islamic countries are heterogeneous in nature. The paper indicated that the main causes of debt burden of Islamic countries are, among others, conspicuous consumption, ambitious development plan, state owned enterprises and high military expenditures and so on. In order to reduce the debt-burden of Islamic countries, the author has suggested a number of measures including reducing extreme fluctuation in exchange rate, converting debts into equity, mobilizing domestic savings, increasing investment in feasible and productive projects and so on.

In their paper entitled "Alternative Strategies of International Financing, Monzer Kahf and Tariqullah Khan reviewed the current forms of external financing, classifying them into debt-creating and non-debt creating flows. The paper argued that Islamic financing techniques develop a strong linkage between servicing external finance and the foreign exchange earning capability of the host country and would have stabilizing effect, on the domestic economy, and ensure equitable distribution of risk and reward. The paper looked with favor the idea of application of Islamic Financing techniques into the area of International Finance as well.

The paper on the "The Contribution of Inter- governmental Institutions to Development in the South Especially in the Islamic Countries: A Critical Appraisal" by A. Ghani Ghaussy reviewed the emergence of international institutions of the developing countries with special reference to Islamic countries. It is argued that the theory of collective self-reliance provided the fundamental basis for establishment of various multilateral inter-governmental institutions that includes Islamic Development Banks, development financial institutions, multilateral government and semi-governmental institutions in various sectors of the economy. The paper also reviewed the role of multi-national corporations.

In Ziauddin Ahmad's paper entitled "Islamic Financial Institutions and Their Contributions to Trade and Development" read by Abdul Kadir Deria, it was demonstrated that Islamic banking provides a viable alternative to conventional banking despite the fact that Islamic banking is still in its infancy. It was pointed out that Islamic banks have used their funds largely in financing local and foreign trade. It is however, stressed that Islamic banks should participate in financing agriculture and industry for the generation of income and employment in the Islamic countries.

These ten scholarly papers which cover a wide range of topics can be divided into three broad areas such as (a) Islamic view of International Economics and Economic order, (b) International and Infra Islamic countries' trade and finance and (c) International Financing of development. These papers, individually and collectively and the comments and discussion that followed provided an unique opportunity for exchange of views between Muslim and German scholars on Islamic perspectives on International Economic Relations. This seminar generated a number of hypotheses for conducting research relating to Islamic alternatives in trade financing and debt management, tied aid, access to credit facilities to least developed countries and so on. This Seminar has opened up an opportunity for joint research between the Muslim and German economists.

The significance of this Seminar lies in recognizing the importance of the study and research in the area of Islamic economics, banking and finance in Germany. It becomes evident from the fact that one of the recommendations stressed the need to form a study group on Islamic economics, to further the development of the subject. The scholars also felt the need for both establishment of a documentation centre in Germany dealing mainly with Islamic economics and social sciences as well as publications of a periodical in Islamic economics. The Seminar participants also expressed their support for establishing a chair in Islamic economics in any suitable German University. This is a proposal which is worth exploring further, particularly in the light of recent German academic co-operation with Islamic countries in at least two cases: one at the South Asia Institute of the University of Heidelberg where Allama Iqbal professional fellowship was instituted with the support of the Government of Pakistan in early 80's and another at the Institute for the History of Arabic-Islamic Sciences of the University of Frankfurt where a private law foundation was set up under a Turkish scholar in early 80's.

In view of the growing significance of Islamic economic studies and institutions in Islamic countries and communities as well as German-Muslim cross-cultural relations, efforts should be made to promote academic co-operation and dialogue between Germany and Islamic countries. Recently, this has assumed a particular significance in the wake of reunification of Germany.

CHAPTER I

PRINCIPLES OF INTERNATIONAL ECONOMIC RELATIONS IN ISLAM

M. N. Siddiqi*

[In this paper, attempting to derive the principles of international economic relations in Islam, the approach, the writer choses is to start from the universality of Islam and the universal mission of the Muslim Ummah.

It is argued that the pursuit of the national economic interest of the Muslim Ummah must always be in accordance with the principles of Shari'ah which does not allow selfishness nor neglect of moral values in its. relation with others. Furthermore, he argues that those Shari'ah rules which cover inter-personal economic relations do also rule over international economic relations. In section two of the paper he explained a few of these Shari'ah rules such as: Causing damage and retaliating by damage is not allowed; If necessary, the lesser of the two evils shall be chosen; Preventing bad evil is prior to acquiring good; Hardship brings about relaxation; etc.

In the last two sections of his paper, the author argues the case for the pursuit of national economic interest of a Muslim state while formulating its international economic policy. The basic point is that freedom of international trade should always be the first and predominant principle. However, the public interest of the people would impose restrictions on this principle. There are several areas where such restrictions may be acceptable. In the opinion of the author these areas include foreign exchange, movement of goods, capital and labour, employment and price stability, etc. - (Editors)]

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The author gratefully acknowledges the comments made by Professors Anas Zarqa, F. R. Faridi, M. A. Elgari and Ausaf Ahmad on an earlier draft of this paper. Thanks are also due to the Review Committee of the Seminar for their comments which has contributed to further improvement in the paper. Discussion following presentation of the paper at the seminar has helped in the final revision.

I

Introduction

This paper studies the framework for relations between man and man provided by the Islamic worldview of *Tawhid* and man's vicegerency. Since the grouping of men into nations is a matter of convenience,international relations should also be infused with the spirit of universal brotherhood and mutual support. International economic relations should serve the goals of need fulfilment and progress with freedom from tyranny. They should secure maximum cooperation for the realization of human welfare at the global level, while giving due weight to national and regional preferences. The objective of international economic policies of Islamic nations should be a just and equitable world order most conducive to the choice by individuals and nations of the way of living willed by Allah, which would ensure for them success in this life as well as in the hereafter.

The paper is divided into four sections:

Section One notes some relevant texts from the Quran and *Sunnah* expounding the Islamic worldview and emphasizing the basic values of equality, brother-hood, cooperation, justice and benevolence. Islam's mission with humanity is noted as the guiding force in international relations. The section concludes with three major objectives of external economic policy.

Section Two lists some of the *Shari'ah* rules governing economic transactions. It also notes some Islamic legal maxims relevant to the conduct of international economic relations. Given the observance of these rules and maxims, freedom of trade and movement should be the normal policy.

Restriction should be placed only when necessary in view of public interest and with a view to realizing the Islamic objectives of justice and equity, the section concludes.

Section Three examines the major policy issues arising in a nation's pursuit of its economic interests e.g. trade policy, emigration and immigration, capital movements, international monetary relations and developmental strategies in the international perspective. This section discusses the present situation in which the Islamic countries, along with the other developing countries, are reduced to a position of economic dependence and backwardness from which they find it difficult to extricate themselves. Part of the responsibility lies on the economic policies of the advanced industrialized countries. This situation makes it impossible for these countries to adopt free trade policies. There is no alternative to the Islamic countries coming together and, in cooperation with the other developing countries, adopting trade policies and development strategies designed to break the present deadlock.

Section Four focuses on international economic relations in the context of the humanitarian and moral mission of the Muslim *Ummah.* Promotion of human-rights across the globe, special attention towards the Muslim minorities and greater economic integration among the Islamic nations are some of the essential dimensions of this mission whose implications are traced in this section. In conclusion, it is observed that the *Ummah* has to reorder its internal organization and its external relations before it can be able to perform its mission effectively.

I I

Islam's Universal Approach

All human beings constitute a single brotherhood which enjoys a certain dignity and also some superiority over the rest of God's creation.

> "Now, indeed, we have conferred dignity on the children of Adam, and borne them over land and sea,and provided them with sustenance out of the good things of life, and favoured them above most of Our creation". (17:70)[1]

> "Verily, this Brotherhood of yours is a single Brotherhood, and I am your Lord and Cherisher: therefore serve Me (and no other). (21:92)[2]
> The Prophet, peace be upon him, has affirmed the same by saying:

> "I am witness to the fact that all servants (of Allah) are brethren (to one another)".[3]

He has exhorted the believers to treat all men equally caring for their good as they care for their own.

> "A man does not believe unless he likes for his brother what he likes for himself".[4]

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1. The numbers in parentheses refer to the Chapter (Surah) of Qur'an followed by the number of the verse. All translations are, unless otherwise specified, taken from Muhammad Asad, The Message of the Quran, Dar al Andalus, Gibralter, 1980.
2. Abdullah Yusuf At, The Holy Quran, Text, Translation and Commentary, Leicester, The Islamic Foundation, 1978. Also see verse (49:13).
3. Abu Dawud, Sunan, Kitab al Salat, Bab ma yaqul al rajul idha sallam.
4. Bukhari, Sahih, Bab min al iman 'an yuhibba li Akhih...

The earth with all its resources is a common heritage of mankind. Human life with all its endowments, and the differences therein, is in the nature of a test. (6:165; 7:10):

"Hallowed be He in whose hand all dominion rests, since He has the power to will anything. He who has created death as well as life. So that He might put you to test (and thus show) which of you is best in conduct, and (make you realize that) He alone is almighty, truly forgiving". (67:1-2)

Emphasis on Justice and Fairness

God likes to have order on earth and justice and fairness in human relations.

"Call unto your sustainer humbly, and in the secrecy of your hearts. Verily, we love not those who transgress the bounds of what is right: hence, do not spread corruption on earth after it has been so well ordered. And call unto Him with fear and longing: Verily, God's grace is ever near unto doers of good". (7:55-56)

Covenants should be honoured, conventions followed, rights recognized and aggression shunned. Every one should willingly concede to every one else what is his due.

"... And be true to every promise, for, verily, (on judgement day) you will be called to account for every promise you made. And give full measure whenever you measure, and weigh with a balance that is true: this will be (for *your own)* good, and best in the end".[1] (17:34-35)

Justice requires equality of rights and giving full measures to others.[2] All entitlements should be justly recognized and yielded without any discrimination.

"Behold God bids you to deliver all that you have been entrusted with unto those who are entitled thereto and whenever you judge between people, to judge with justice". (4: 58)

. God's universe is endowed with balance and equilibrium. The society of men needs the same. Let men learn to live in peace by mutually recognizing each others rights and giving everyone his due.

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1. Also see (16: 90-93).
2. See (11: 84, 85).

> "And the skies has He raised high and has devised (for all things) a measure, so that you too (o men) might never transgress the measure (of what is right): Weigh, therefore, (your deeds) with equity and cut not the measure short. And the earth has He spread out for all living beings". (55: 7-10)

God's purpose in appointing messengers from amongst men is to enable men to live with justice and equity (57:25). All the above noted principles; brother-hood, shared heritage and a shared destiny, fair dealings and mutual recognition of rights, fulfilment of promises and cooperation - are directed towards the establishment of a just and equitable world order. In the later part of this section, we shall focus on some of the *Shari'ah* rules relating to economic transactions that are designed to realize this objective. But before doing so, we need to consider the nature of the Islamic community whose external economic relations are the subject of this study.

The Muslim *Ummah* and its Mission

Muslims constitute a single *Ummah* (community). The Islamic injunctions studied above are addressed to every individual Muslim as well as to the Muslim community as a whole. The wording of some of these injunctions might give the impression that all Muslims are duty bound to remain united under a single political leadership as they were during the time of the Prophet. But the *Shari'ah* does not explicitly prohibit multiplicity of political organizations, as long as the law of God *(the Shari'ah)* remains supreme, for sovereignty belongs to Allah alone. Even though the modern concept of sovereign nation states is alien to Islam, multiplicity of Muslim states is acceptable, provided these states function within the framework of Islamic law.

At the present about two thirds of the *Ummah is* divided into more than 44 nation states, while more than one third of it live as citizens of non-Muslim states. Theoretically, if not in reality, they still constitute a single community bound by the law of God. All these Muslim states and Muslim minority groups in non-Muslim states are addressed by the injunctions studied above, each duty-bound to live upto them to the best of its capacity, as ordained by Allah.

> "So keep your duty to Allah as best as you can, and listen, and obey, and spend; that is better for your souls..." (64:16) [1]

Each Muslim state individually, as well as the group of Muslim states collectively, are under obligation to conduct their economic relations with the non-Mus-

1. M. M. Pickthall, The Glorious Quran, Mecca, The Muslim World League, 1977.

lim world, and the individual non-Muslim states, in accordance with the above principles. They are, indeed, duty bound to maintain brotherly relations with one another and cooperate with one another in 'discharging the universal mission of the *Ummah,* to be noted below. The Muslim states are also obligated to care for the religious freedom, human rights and economic well-being of their Muslim brothers living as minorities in the rest f the world. All this necessarily follows from the supremacy. of the *Shari'ah* in. the conduct of a Muslim state and its external relations. The Islamic. doctrine of collective duties *(fard kifayah)* makes, need fulfilment and protection of every Muslim a collective obligation of the entire *Ummah.* Hence, the external economic relations of Muslim states should be conducted in a manner conducive to the recognition by other nations of the just rights of their Muslim subjects and to removing any obstacles in the way of. exercise of these rights. Muslims living in non-Muslim states are also duty bound, individually as well as in groups, to deal justly with all, to give every entity its due, to care for the good of their countrymen and sincerely to work for the good of mankind.

As noted above, the integrating force is the common allegiance to the *Shari'ah* which will make all the constituent parts of the contemporary Muslim community, the nation states as well as the Muslim minorities, serve in unison, the Islamic mission which we now proceed to study.

The Muslim community is a moral community. They have to conduct themselves morally. They are 'also charged with a mission relating to mankind as a whole.

> "You are the best community that has ever been brought forth for (the good of) mankind: you enjoin the doing of what is right and forbid the doing of what is wrong, and you believe in God..." (3:110)

> ,.... and that there might grow out of you a community (of people who invite unto all that is good, and enjoin the doing of what is right and forbid the doing of what is wrong: and it is they, they who will attain a happy state". (3:104)

> "And thus we willed you to be a community of the middle way, so that (with your lives) you might bear witness to the truth before all mankind, and that the Apostle might bear witness to it before you. (2:143)

We can easily identify three distinct, though closely interrelated, items in the global agenda before the *Ummah* as laid down in the above verses: To exemplify

Islam through its own conduct (= being witness), to enjoin the right and forbid the wrong, and to work for the good of mankind (as implied by the Arabic prefix *li (* = for) in the first quoted verse and the word *khayr (* = good) in the second one). The requirements of the first two items are obvious: the community should never adopt an immoral posture; it must conduct all its affairs, including international economic relations, in accordance with the principles of morality and justice. Working for the good of mankind lays explicit emphasis on what is already implied by a moral stance, i.e. caring for the material well-being of all men. The *Ummah* cannot be indifferent to poverty, hunger and disease anywhere in the world as it cannot ignore tyranny, denial of human rights and persecution on religious grounds. It must care for all men: their need fulfilment and their dignity.

This concern of the *Ummah* for justice and equity and for mankind's material well-being is underlined in many verses and traditions which cannot be cited here due to limitation of time and space. We will note here only three traditions from the Prophet which clearly indicate his concern for the material well-being of people living outside his territorial jurisdiction.

Mawardi reports a tradition from the Prophet, narrated by Abu Huraira, which says: "Once bad remarks were made about the non-Arabs before the Prophet. The Prophet advised against doing so and said, "Do not abuse them because they developed the lands of Allah and (as a result) the servants of Allah could live in those lands".[1]

The Prophet never hesitated to extend material help to people in distress, even when they happened to live across the borders. It is reported that once he sent five hundred dinars to be distributed among the poor of Mecca (before it came under his rule) who were suffering from a famine.[2] During the same period when the supply of wheat from Yamama to Mecca was stopped at the behest of an influential chief, Thumama, who had recently embraced Islam, the Meccans appealed to the Prophet in the name of kinship and good relations. The Prophet wrote to Thumama to let them have their supplies as usual.[3]

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1. Mawardi, Adab al Din wa'I Dunya, p. 115, Beirut, Dar lhya' al Turath al 'Arabi, 1979.
2. al Sarakhsi, al Mabsut, Vol. 10, p. 92, Beirut, n.d. also, al Sarakhsi, Sharah Kitab al Sayr al Kabir li Muhammad bin al Hasan al Shaybani, Vol. 1, p. 96, edited by Salah al Din al Munajjid, Cairo, 1971.
3. Ibn Hisham, Sirat al Nabi, Vol. 4, p. 316, Beirut, Dar al Fikr, n.d.; also al Asqalani, Fath al Bari Sharah Sahih al Bukhari, Vol. 8, p. 88. Beirut, Dar al Ma'rifah, n.d.

Objectives of External Economic Policy

It is 'possible to deduce from the above discussion some policy objectives 'for the economic relations of a Muslim nation with other nations. These are three:

i) Preserving and promoting the economic interests of own people, priority attaching to need fulfilment[(1))]

ii) Observing the *Shari'ah* rules relating to economic transactions with a view to ensuring justice and equity.

iii) Strengthening the Ummah and serving the mission of the Islamic community in cooperation with other Muslim peoples by exemplifying Islam, communicating its message and promoting human welfare at the global level.

Highest priority attaches to the third objectives as it defines the *raison d'etre* of the *Ummah.* Observance of *Shari'ah* rules and ensuring justice takes precedence over national economic interests which should be promoted within the framework of Shari'ah rules and the Islamic mission.

We discus these objectives and their implications for international economic relations in the following sections. First, we discuss the *Shari'ah* rules relevant for the subject under study.

III

Shari'ah Rules Governing Economic Transactions

Islamic *Shari'ah* does not have separate ethical norms for dealing with aliens. Muslims are bound by the same rules of conduct irrespective of the beliefs of those they are dealing with. A brief summary of the *Shari'ah* rules governing economic transactions is given below. For details one has to consult some of the standard legal compendiums of Islamic law.

All economic transactions require willingness of the concerned parties with the provision that the goods and services transacted do not belong to the prohibited category and the transaction is free from the following corrupt practices:

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1 The theoretical background for this objective has not been explicit in the above discussion since some literature is already available on the subject. See for example, M.N. Siddiqi, "Guarantee of a Minimum Level of Living in an Islamic State" in Munawar Iqbal (ed.) Distributive Justice and Need Fulfilment in an Islamic Economy, Leicester, The Islamic Foundation, 1988, pp. 251-86, and M. N. Siddiqi, "Public Expenditure in an Islamic State" Economic Journal, Government College, Lahore, Vol. XIX, Nos. 1 & 2, 1986, pp. 1-36.

1. *Riba* i.e. interest on loans and exchange of unequal quantities of similar fungibles. Gold or silver or a particular paper currency must be exchanged in equal quantities. When gold and silver or different paper currencies are exchanged for one another, the quantities can be unequal but the exchange must be simultaneous.

2. *Qimar* i.e. gambling, bet and wager. The essence of gambling is taking a risk deliberately created or invited, which is not necessary to economic activity, to gain thereby.

3. *Ghaban* i.e. fraud, especially that relating to the characteristics of a product.

4. *Ikrah* i.e. coercion, or imposing a contract, or a condition therein, on an unwilling party.

5. *Bay' al mudtar* i.e. exploitation of need e.g. by charging an exorbitantly high price.

6. *Ihtikar* i.e. withholding supplies of essential goods and services with a view to raising prices.

7. *Najsh* i.e. raising prices by making false bids.

8. *Gharar* i.e. hazard or uncertainty surrounding a commodity, its quantity, price, time of payment, time of delivery, etc. (with the provision that some little *gharar* can be ignored if it is humanly impossible to eliminate it).

9. *Jahl mufdi ila al niza'* i.e. such vagueness about commodity, its quantity, price, etc. as cannot be removed and may lead to dispute.

An Islamic nation's trade with the outside world, its commercial policy, its financial transactions with other parties, and its developmental strategies involving transfer of technology, economic aid, borrowing abroad, etc., all must be free from the above mentioned corrupt practices.

Difficulties may arise, however, in the context of observing some of these rules when the other party is resorting to corrupt practices and harmful policies like riba, monopoly pricing, price discrimination, dumping or harmful restrictions on movement of men, materials, monies, services and ideas. In such situations, Islamic nations would be allowed to protect their interests through suitable measures including reciprocal restrictions. They may also justifiably resort to joint action directed at ensuring justice and preventing oppression.

Another type of conflict may arise when the realization of a particular national interest *(maslaha)* involves some damage *(darar)* to another nation. As we shall note below the jurists have laid down certain general rules to guide the decision makers in such conflict situations: It should be noted, however, that the temporary disadvantage to a party caused by fair competition among traders does not constitute a damage as it eventually serves the public interest (see Article 26 of the *Majalla* quoted below).

There may also arise exceptional situations in which the observance of a particular *Shari'ah* rule might expose a nation to extreme hardship and unbearable losses. Such a situation has to be resolved by discretionary policies, decided upon by the social authority after due consultations, in the light of certain *Shari'ah* rules of a general nature. Some of these rules are noted below. '

The legal maxims noted below are all taken from the Ottoman *Majalla.*[1]. They represent a wide consensus of jurists and find support in every school of Islamic law. In many specialized works by jurists belonging to different schools of Islamic law they have been substantiated by the text as well as by the spirit of their original sources of Islamic law, i.e., the Quran and *Sunnah.* Some of the maxims deal with harmful effects of actions or damages. They seek to minimize their incidence and give precedence to removal of public damage.

i) Causing damage[2] and retaliating by damage is not allowed. (19)
ii) Permissibility (of an action) by *Shari'ah* rules out liability (to its consequences). (91)
iii) Damage shall be removed. (20)
iv). A damage shall not be removed by doing a like damage. (25)
v) Severe damage may be removed by doing a lighter damage. (27)
vi) A private damage shall be tolerated in order to prevent a public damage.(26)
vii) A damage shall be removed to the extent possible. (31)

Another set of maxims deal *with masalih* and *mafasid* i.e. goods and bads, or utilities and disutilities. They help the decision maker in resolving conflict situations.

1: Compiled between 1869 and 1876. For Arabic text with commentary see, Al Hayder: Durar al Hukkam Sharah Majallat al Ahkam, 2 Vols. Beirut, n.d. For an English translation see C. R. Tyser: The Majelle, Lahore, Law Publishing Company 1980. The numbers in parentheses that follow the texts quoted below correspond to the numbers of the clauses in the Majalla.

2. Arabic: darar.

viii) When there is an (unavoidable) choice between two bads,[1] the remedy of the greater one is sought by choosing (to do) the smaller one. (28)

ix) (If necessary) the lesser of the two evils shall be chosen. (29)

x) Any action (by the Social Authority) affecting the people shall be in public interest.[2] (58)

xi) Preventing bads is prior to acquiring goods. (30)

Lastly, we note three maxims dealing with exceptional circumstances.

xii) Hardship brings about relaxation. (17)

xiii) Necessities make lawful what is (normally) prohibited. (21)

xiv) What is permitted out of necessity is limited to the extent necessary. (22)

Read together in the context of international economic relations, the two sets of rules cited above are clear in their purpose and intent. These relations should be just and fair and every one should avoid adopting policies harmful to others. If and when any party adopts harmful policies the aggrieved party has a right to protect its interests and retaliate, but the best policy is to prevent such action through joint action and international agreements. Also, if and when observance of a *Shari'ah* rule causes extreme hardship to a people, that particular rule may be put in abeyance till a way out is found. This is quite clear in the light of the last three maxims noted above.

Special importance is attached to international agreements. When an Islamic nation, or the group of Islamic nations, willingly enters into any agreement with non-Muslim nations they should abide by it and fulfil all obligations arising from it. Presently, all Muslim countries are party to a large number of international agreements as members of the United Nations Organization and its subsidiaries. They are also members of the Organization of Islamic Conference (OIC) and some other regional organizations. Unless any of these commitment is, on scrutiny, found to be ultra vires of *Shari'ah,* or to have been secured under duress, Islamic nations should fully meet them in the interest of a just world order.

It should also be noted that some of the above mentioned maxims (e.g. iii, v, vii and xi) provide a ground for imposing economic sanctions against erring parties.

We shall now proceed to discuss the first of the three policy objectives noted above: How an Islamic nation could preserve and promote the economic interests of its peoples in matters relating to foreign trade, exchange rates, capital movements, emigration and immigration, economic aid, etc. etc.

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1. Arabic: *mafsada.*
2. Arabic: *maslaha.*

IV

Promotion of National Economic Interests

Freedom to Trade

God has permitted trade and encouraged mobility for that purpose.

"God has made buying and selling lawful". (2:275)

"And when the prayer is ended, disperse freely on the earth and seek to obtain (something) of God's bounty .... " (62:10)

"And He it is Who has made the sea subservient (to His laws), so that you might eat fresh meat from it, and take from it gems which you might wear. And on that (very sea) one sees ships ploughing through the waves, so that you might (be able to) go forth in quest of some of His bounty, and thus have cause to be grateful (to Him)". (16:14)

Any restriction on freedom of trade and movement of factors of production would therefore require some justification. Such a justification can come only on the basis of public interest *(maslaha).* Some of the circumstances justifying restrictions on the basis of national economic interests or on Islamic ideological grounds are noted below. But the basic position remains that of freedom of trade and movement. Men are free to trade what they wish at the prices they wish. They are also free to move when and wherever they like. They are also free to hold their wealth in any form they like and to invest their savings where they like, provided they observe the *Shari'ah* rules noted above.

What is true of trade and mobility of factors of production is also true of rates of exchange between currencies. They are left to be determined by the market forces of demand and supply, unless there is reason to control them.

The state can intervene only to prevent violation of *Shari'ah* rules and in order to protect and promote public interest *(maslaha).* Modern conditions necessitate taking a macroeconomic view of national economic interests. Public interest cannot be protected in an ad hoc manner, proceeding case by case. Domestic goals relating to employment, need fulfilment and equitable distribution and the objective of maintaining a reasonable degree of stability in prices constitute essential dimensions of a comprehensive view of public interest.

Since state intervention in order to protect or promote public interest generally involves restraints on individual freedoms, the crucial thing is the mode of decision making i.e. who identifies public interest and the measures necessary to protect or promote it. In accordance with the Quranic prescription: "and whose rule (in all matters of common concern) is consultation among themselves" (38:42), a decision should be arrived at through consultation at the appropriate level. Such consultation can ensure that the interests of all concerned are taken 'into consideration without any discrimination. Open discussion of the issues involved, in order to give every one a chance to be heard, followed by efforts to arrive at a consensus in the relevant consultative body are necessary for this purpose. In the context of international economic relations, it is mostly the consultative body at the national level which will be involved. But in some cases the nature of the issue may call for a decision at some regional or international level to which nations may voluntarily commit themselves.

In the contemporary world, we have a large number of nation states, some of them grouped together into regional economic blocks, pursuing their diverse economic interests, sometimes to the disregard of similar interests of other nations. The world is dominated by a score of economically advanced countries whereas more than 130 developing countries lag behind in every respect. The Islamic countries mostly belong to the group of poor and weak countries which can hardly afford to expose themselves to free trade, free mobility of capital and free convertibility of currency in view of the harmful economic and political consequences of doing so. They. have to adopt a number of restrictive and regulatory policies in order to survive and develop. There are difficult choices to be made in the context of transfer of technology, capital movements, multinational corporations and monetary integration. It is not possible to discuss all these problems in this paper. Moreover, specific policy options have to be exercised in the overall context of gaining strength for the Islamic community and decreasing their dependence on non-Muslim nations. This is an ideological and political necessity. Below, we shall list and briefly review some of the major issues in the perspective of the *Shari'ah* rules stated above.

Issues in the Pursuit of National Economic Interests

- Restrictions on trade through tariffs, quotas, etc.
- Protection of home industries in any other way.
- Restrictions on the movement of labour, the problem of 'brain drain' and immigration policies.
- Restrictions on capital movements, on investment abroad and on foreign investment in the home country. The issue of integration with the world capital market.
- Restrictions on foreigners owning property and managing enterprises in the home country; the issue of the multinationals.

- Allowing foreign equity participation, quasi-equity arrangements, leasing arrangements and other 'new forms of investment'.
- Borrowing abroad and/or lending abroad at the public and private levels:
- Allowing multinational banking.
- Intervention in the exchange market and controlling the external value of the currency.
- Allowing free convertibility of currency.
- Integration with the .world monetary system or insulating the domestic economy through independent management of money.

  Policies relating to employment and price stability in the context of inflationary or deflationary pressures originating in the external sector of the economy.
- Distributive policies and their requirements in relation to taxation of foreigners and foreign assets of citizens, etc.
- Development strategies: export promotion versus import substitution. . .
- Seeking foreign aid or giving aid to others. -
- Transfer of technology.
- The desirability of self-sufficiency in food and other strategic materials: the political and ideological reasons for lessening dependence.
- Regional economic integration: economic unions, clearing unions,customs unions, etc.
- Inter-Islamic economic cooperation and its implications for regional and inter-national economic relations. The issue of an Islamic Common Market.
- Multinational commodity agreements and cartelisation.

The above list of issues; by no means exhaustive, is formidable indeed. A detailed examination of each issue in the light of the *Shari'ah* rules and Islamic legal maxims noted above would be needed in order to arrive at some conclusion. This is not possible in view of the limited space at our disposal. It will be noted, however, that only some of the above issues involve the *Shari'ah* rules governing economic transactions. Most of them involve the calculus of *maslaha* and *mafsada* on which the above mentioned legal maxims throw some light. As one goes down the above list of issues, with the actual condition of present day developing Islamic countries in mind, one feels that a case for free trade policies is not always obvious. There are important *masalih* (public interests) to be protected by regulating capital movements and transfer of technology, for example. It is not possible, however, to prescribe policies valid for all Islamic countries all the time. Actual choice of policy should be based on' the circumstances an Islamic country faces at a particular time.

In what follows we will briefly review some of the above issues assuming similar circumstances facing the developing Islamic countries.

Trade Restrictions and Protectionism

Economic theory has identified the 'infant industry argument' as the only valid ground for protection from a world point of view.(1) Protection through appropriate tariffs on the import of the relevant goods allows a domestic industry sufficient time to develop and compete with the world industry. In practice, however, vested interests tend to prolong protective measures to the disadvantage of the national economy. It is also argued that a production subsidy coupled with an equal tax on consumption serves the domestic industry better than import restriction. Protection is also justified when the protected industries are likely to generate 'externalities' from which other home industries are likely to benefit.(2)

Tariffs can be an effective means of improving terms of trade. The terms of trade of the primary goods producing countries have been declining since the beginning of this century.(3) Unless there are international agreements to protect the interests of the primary goods producing developing countries, they have no choice but to use tariffs and resort to other joint actions in order to improve their terms of trade.(4)

Trade restrictions are also justified in retaliation to similar restrictions imposed by the other party. Import duties were first introduced in Islam by Caliph Umar when Muslim traders complained to him that other countries are collecting duties from them at the entry points to those countries.(5) If other countries do not impose any duties the Muslim country is also advised not to impose any duty.(6) But economic theory has warned of 'beggar thy neighbour' consequences of such policies, which point should receive due consideration in the calculus of *maslaha* and *mafsada* in any particular case. As a matter of fact, free trade policies can flourish only as a result of international agreements which provide sufficient incentives to those countries which see an advantage in protectionist policies.(7)

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1. C. P. Kindleberger: International Economics, Homewood, III. Richard d. Irwin Inc. 1968, p. 128.
2. Paul R. Krugman, "Is Free Trade Passe", Economic Perspectives, Vol. 1, No. 2, Fall 1987, pp. 137-38.
3. Enzo R. Grilli and Maw Chung Yang, "Primary Commodity Prices and the Terms of Trade of Developing Countries: What the Long Run Shows", The World Bank Economic Review, Vol. 2, No. 1, Jan. 1988, pp. 1-47.
4. John Spraos, Inequalising Trade, A Study of Traditional North/South Specialization in the Context of the Terms of Trade Concepts, Oxford, 1983.
5. Abu Yusuf, Kitab al Kharaj, Cairo, Dar al Isiah, 1981, pp. 275-76, No. 299; Abu 'Ubaid; Kitab al Amwal, Beirut, Dar al Fikr, 1975, p. 635, No. 1636 and p. 638, No. 1653.
6. Majid Khadduri: The Islamic Law of Nations, Shaybani's Siyar, Baltimore, Maryland, John Hopkins Press, 1966, pp. 174-75.
7. Harry g. Johnson, International Trade and Economic Growth, Cambridge, Mass. 1967, p. 55.

Restrictions on the Movement of Men

Restrictions. on citizens of other countries 'coming to take jobs in the home country are placed on the ground of the unemployment existing in the home country. Since existing differences in the levels of skill have historical roots and cannot be removed in the short run, these restrictions may be justified in view of the ultimate responsibility of the state to provide jobs and to take care of the needs of it is citizens when they are. unemployed.

Restrictions on skilled manpower moving out to take jobs abroad (brain drain) may be justified on the ground of national needs, inability of the country to pay wages comparable to the world market[1] and the fact that national resources have been invested in creating those skills.

• The first argument loses its relevance if there is a labour shortage at home. The second argument collapses if suitable jobs for highly qualified people are not available at home. Entry of foreign labour may raise productivity at home and pressurize domestic labour to improve skills. Remittances by nationals working abroad have been a significant source of foreign exchange for many developing countries in the last two decades. In any case, the cure for brain drain is adequate manpower planning and not restrictions on mobility which are also difficult to impose.

We can, therefore, conclude that the economic arguments for restrictions on the mobility of labour and professionals are at best temporary in nature. Freedom of movement is a fundamental right of every individual and the world as a whole stands to gain by it. ,

This leaves out the cultural ground for restricting the movement of men into and out of an Islamic country. An Islamic society with a good standard of commitment need not restrict such movements as they have historically been a means of spreading Islam. Temporary measures covering specific categories of people and countries may, however, be justified in order to avoid risky exposures to un-Islamic cultural environments and on security grounds.

Any restriction placed on the entry of a Muslim individual into a Muslim country can be justified only on economic grounds, if any. Seen in the context of the desirability of greater economic integration among Islamic countries, the economic grounds for restricting the movement of Muslims within the world of Islam can, at best, be of a short term nature.

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1. R. N. Cooper, Economic Policy in an Interdependent World, Cambridge, Mass. 1986, pp. 108-12

Capital Movement

Should individuals be free to invest their savings in other countries and to own assets located abroad? should foreigners be allowed to invest in a Muslim country, own property, run factories, etc.? Should it make a difference if the foreigner is a Muslim? Should capital funds be allowed to move freely across borders in search of maximum profits - and security? Economic theory has generally supported the case of freedom in all these respects, but the practice in almost all developing countries is that of strict regulation and control. Muslim nation states, too, do not relax any of these rules in favour of Muslims.

The developing countries' fear of flight of capital and dominance by foreigners, which is responsible for the above mentioned restrictions, is not unjustified. Automatic functioning of the world capital markets is sure to benefit the stronger, larger and better informed parties - all located in the advanced countries - to the disadvantage of the weak, poor and capital-starved developing countries who can offer neither security nor stability. The state steps in, therefore, to manage the capital market and regulate the role of the foreigners in the interest of capital formation at home. Foreign investment by nationals is generally not allowed. Foreign private capital is welcome in some countries, but others prefer official aid. Multinationals are allowed with conditions relating to local participation and transfer of technology. Other regulations abound, but the more there are the more they tend to favour a small section of businessmen at home making life more difficult for the rest. If the purpose of these regulations is to keep investment policies in line with national priorities, it should be clearly laid down and then let foreign investors enter the domestic market. It will also serve the interest of the Muslim countries to create conditions favourable for greater mobility of capital within the group of Muslim countries. Lack of such conditions has been the major cause of the Muslim capital's flight to the west.

Some regulation of the capital market is also necessary to keep it free from interest, gambling and other corrupt practices listed in the previous section. Special attention has to be paid to speculative movement of funds which, as Keynes remarked half *a century ago,* "threaten disorganizing all *steady business".*[1]

Foreign private capital should be welcome in Islamic countries on a profit-sharing basis. A host of new forms of investments are available which do not involve interest or any other corrupt practices noted earlier. Leasing also provides a secure basis for acquiring capital equipment from abroad. Prohibition of interest in effect removes lending and borrowing as the basis of capital movements, so

1. The Collected Works of John Maynard Keynes, Vol. XXV, Cambridge University Press, 1980, p. 31.

far as the Islamic countries are concerned. A Muslim nation should neither lend nor borrow on interest. But loans without interest can still have a role in multinational banking as well as in-the transactions between the central banks.

Economic aid in the form of interest free loans may also assume greater proportions given increased cooperation between the Muslim countries.

It is only in extreme need and under exceptional circumstances that a Muslim nation may invoke the last mentioned legal maxims noted above to justify, temporarily, interest-based borrowing from other nations, foreign commercial banks or international financial agencies. The issue of outstanding foreign debts apart, Muslim nations should strive to do away with foreign borrowing in future by switching over to profit-sharing and leasing arrangements with their creditors. To the extent it is not possible to do so they have no option but to cut their (public) expenditures and rely on increased inter-Islamic cooperation for meeting their financial needs. Removal of impediments to the inflow of private business investment from outside can also help them a lot.

International Monetary Relations

What kind of a monetary system we envisage for a contemporary Muslim country? Shall it be an- automatically functioning system with no restriction .on convertibility of currency, no control of exchange rates, no curbs on multinational banking and full integration with international monetary system? Or, it will be a managed money with limited facilities for convertibility, a controlled exchange rate and a regulated banking sector so that the authorities have ,an effective control on the domestic money supply. It is the latter scenario which obtains in almost all contemporary Islamic countries. The reasons are not far to see. The world monetary system is presently in a chaotic state. The collapse of the Bretton Woods system and the freely floating dollar has removed any semblance of an international monetary system and no agreement is in sight for instituting a new world monetary order. The suggestion of a return to gold as the basis of money, both domestic and 'international, is ill-conceived as the so called gold standard never really provided a fully automatic monetary system.(1) In any case, gold. cannot meet the expanded needs of mankind for a medium of exchange and an international reserve. The idea of a world central bank with a fiat money acceptable to all nations is also not good as it simply transfers the difficult task of managing money from the national authorities to an international authority. Such a centralized management will be an impossible task in view of the diverse interests of the individual nations.(2)

1. R. N. Cooper, The Gold Standard: Historical Facts and Future Prospects-Brooking Institution Paper 1, 1982, pp. 30-36, and p. 48.
2. Robert Z. Aliber, The International Money Game, Basic Books, 1987, pp. 207-10.

Till such time as mankind can envision a world monetary system acceptable to all nations, rich as well as poor, strong as well as weak, there is no alternative to nationally managed monies supplemented by regional and international cooperative arrangements directed at specific ends such as orderly changes in exchange rates, easy supply of international credit and efficient clearance of claims, etc.

It is realistic to assume that central banks and national governments can no longer exercise tight control on exchange rates and domestic money supplies except at a high cost in terms of production and employment. It should also be noted that no modern economy can simultaneously ensure domestic price stability, full employment and a stable external value of the home currency.[1] Differential rates of productivity changes in the countries of the world and changing expectations make it an impossible task. The order of priorities and acceptable degrees of trade off between the three objectives cannot be the same for all countries. It depends on the position of a country in the world economy, the relative size of its external sector and the extent of unemployment in the home economy.

Freely floating exchange rates hurt the interests of developing countries which are obliged to import more than they export. Their task is made more difficult by the resulting uncertainties in the capital market. They need a regime of fixed exchange rates to plan their development. Under the present circumstances, it would be in their interest to circumvent the international monetary system and world capital market by evolving parallel institutions to cater to their needs. Expansion of trade between themselves and dealing with the developed countries as a group through their own monetary institutions may decrease uncertainties and lessen their need for international reserve currencies.

In a free economy with a relatively small external sector, domestic stability should take precedence over exchange rate stability. If the external sector dominates then the exchange rate becomes more important. Full employment policies and welfare services cannot be maintained with declining real production and shrinking international trade. Inflation is sure to frustrate these policies sooner or later. Islamic countries will understandably be under popular pressure to guarantee job opportunities and need fulfilment. But the experience of the developing countries during the last four decades has proved that these objectives cannot be realized through deficit financing. Expanding real production through higher productivities and larger international trade is necessary for that purpose. This leads us to the issue of proper development strategies which we proceed to examine in the context of international economic relations.

1. Paul Davidson, International Money and the Real World, New York, John Wiley & Sons, 1982, p. 155, also p. 239.

Development Strategies in the International Perspective

The dual economy approach- a small urban capitalist sector geared to the . world economy with the hope that it will pull along the remaining backward sectors - has miserably failed. In any case, it does not suit the egalitarian and participatory temper of an Islamic economy. National development should mobilize the entire population, urban as well as rural, through assuring every one - the peasant, the wage labour, the entrepreneur and the capital owners - that the fruits of their contributions to the national product will flow back to them in good measure. The normal material incentives to work, save and invest need also to be buttressed by the Islamic urge to strengthen the *Ummah,* decrease dependency and serve the Islamic mission. Corruption should be eliminated and a truly consultative political process should restore the trust of the populace in the decision making at the national level.

In the international context, the unsuccessful experience of many developing countries with a. policy of import substitution has led to a preference for export promotion as the best strategy. But the efforts of the developing countries in this regard are largely frustrated because of the refusal of the advanced countries to let their products in. Developing countries are no longer content being producers of primary commodities because of the deteriorating terms of trade for these commodities. The impasse can only be broken through international agreements since the capacity of primary goods' producers to dictate their will through cartelisation is very limited and, at best,' transitory. These countries have to diversify into the production of manufactures. This would require group action designed to enlarge the market and ensure greater specialization within the group so that economies of large scale production can be enjoyed.

As often is the case with international economic relations we have a situation in which the good of all can be best realized by generally agreed fair arrangements. But such an arrangement fails to materialize because individual nations, or groups of nations, find themselves in a position to secure larger gains through a different policy. The history of the UNCTAD and the GATT bears eloquent testimony to this. There is no alternative, however, to working patiently for universally acceptable fair arrangements, especially in view of the fact that. the perception. of what is fair differs from nation to nation, group to group.

There is a wide scope for regional economic cooperation among the developing countries. This should especially apply to the Muslim countries in North Africa, West Asia and South East Asia forming geographically contiguous regions. Clearance unions and payment unions can help promote inter-Islamic trade. A currency union could be still the more helpful. The issue of customs union and eventually that of an Islamic common market should receive greater attention that it has received so far. We note them here to underline their importance in the absence of universally acceptable arrangements in the fields of trade and finance. It will be a good gesture to invite the other neighbouring developing countries to join these Islamic groupings unless there are strong political or cultural reasons applying to a particular case. More often than not, cultural considerations can be taken care of in other *ways,* and what is more conducive to resolving political conflicts than the opportunity of making solid economic gains throuah mutual cooperation?

Presently, the Muslim countries in Africa, West Asia and South East Asia are already members of some regional groupings, besides their being members of the OIC and its subsidiaries. There is no essential conflict between greater economic integration between Islamic countries and their participation, alongwith the neighbouring non-Muslim countries, in the respective regional organizations. Their economic problems are similar, and they need a joint strategy in dealing with the dominant advanced industrial countries and for securing just international agreements.

V

Demands of the *Ummah's* Mission

We now turn to the third objective of international economic relations in Islamic perspective which requires Muslim people to strengthen their mutual bonds to extend material help to other peoples who need help and to popularize Islamic ideas and values among them. A Muslim nation, and the group of Muslim nations, can play this role better if they are, economically, in a position to give to others rather being obliged to take from them. The more they need other peoples' help the less credible their call to Islam becomes. The first requirement of this policy norm is, therefore, for the Islamic nations to minimize their dependence on others.

Some Islamic countries are in a position to spare some resources for the poor developing countries. Even the average ones should make some sacrifice to relieve extreme poverty and sufferings elsewhere. They should do so individually as well as collectively through such institutions as the OIC and the Islamic Development Bank. The rich ones should contribute generously to the agencies set up for these purposes.

The existence of sizeable Muslim minorities in many countries of the world assumes special significance in the context of the Islamic mission. The highest priority attaches to ensuring human rights and freedom to live in accordance with

Shari'ah. This could be done by the Islamic nations through maintaining -good bilateral relations with these countries and exercising vigilance through the United Nations Organization. The treatment that the non-Muslim minorities living in the Muslim countries receive is' of crucial importance in this context.

It should be the endeavour of the Muslim countries to extend all possible help to the Muslim minorities to enable them improve their skills and educational standards. Encouraging Muslim-managed enterprises through participatory finance and favourable treatment to Muslim job seekers from the minority countries could also help improve their economic conditions.

The mission involves much more. Muslim nations have to demonstrate, especially in the conduct of international economic relations, that they care for man's freedom from :tyranny and hunger more than they care for national glory and material progress. They should be willing, therefore, to buy peace and freedom *for others* at the cost of some of their own economic interests. Even their alliance with the third world developing countries in order to secure a better deal from advanced countries should not deteriorate into an all out confrontation. Their love and care must encompass all human beings.

But the fact remains that the *Ummah* cannot play its desired role unless it reorders its internal organization as well as its relations with the rest of the world. In this latter context, its present state of dependence and backwardness can be ended only by planned efforts in cooperation with the other developing countries trapped in a similar situation. Free trade or laissez faire will not end the domination of the weak by the strong. .

Internally, individual Muslim countries are at present closely linked to the dominant industrial economies than they are linked with one another, through trade and factor movements. This is not how Islam conceives the relationship of Muslim peoples among themselves. This is against the economic and political interests of the *Ummah.* It keeps it weak and vulnerable to cultural, economic and political domination by anti-Islamic and un-Islamic powers. The strength of the *Ummah,* its defense from external threats, and the imperative of its taking the position of exemplifying Islam and calling toward it, necessitate if not unification, at least greater integration: social, economic and political.

It is way beyond the scope of this paper to discuss how such a reordering can be effected. Greater economic and political integration between the group of Islamic nations is, however, a must in this regard so that the external economic relations of the *Ummah* are largely channelled through the group organization at a collective level. This would secure for the group of Islamic countries not only better terms of trade but also save its individual members from the state of total dependence on the developed countries in which many of them find themselves at present. The idea of an Islamic common market deserves special attention in this regard. It would provide a market large enough for realizing gains from free trade by way of specialization and large scale economies. The details of Islamic market must, however, be so designed that these gains are shared equitably by the poor and rich members of the group. Special arrangements will also be needed to enlist the cooperation of the other developing. countries, especially those neighbouring the Islamic countries in Africa and Asia. As noted earlier, there are several regional groupings comprising Islamic and non-Islamic developing countries. The Islamic common market has to accommodate the existing arrangements unless ideological and cultural consideration necessitate some modifications.

Conclusion

In conclusion, we may reemphasize the universality of the Islamic approach to international economic relations. Islam emphasizes brotherhood and cooperation, justice and fair dealings. The Muslim *Ummah* must order its internal and external economic policies in accordance with the *Shari'ah* and stand united in calling towards Islam and exemplifying it. Islam favours freedom to trade and restrictions on movements of men do not fit with its universal approach. But, for the time being, the domination of the world economic scene by a score of advanced industrial countries makes it imperative for the developing Islamic countries, alongwith the other developing countries, to regulate the movements of capital and labour and protect their industrial sector. The *Ummah* should, however, focus on its humanitarian and ideological mission with humanity and regard economic strength as a necessary means to that role.

Glossary of Arabic Terms

Bay'	Sale.
Fard	Duty.,
Fard Kifayah	A duty whose discharge by some, so that the purpose is served, absolves the remaining from the obligation to perform it.
Ghaban	Fraud; Cheating.
Gharar	Hazard.
Ihtikar	Withholding supply.
Ikrah	Coercion.
Jahl	Ignorance; Lack of knowledge.
Khayr	Good.
Mafsada	Bad effect; Corruption.
Mafasid	Plural of mafsada.
Maslaha	Good effect; Benefit; Advantage.
Masalih	Plural of maslaha. Makikng false
Najsh	bids.
Qimar	Gambling.
Riba	Increase (on principal); Interest; Usury:
Shari'ah	Islamic Law.
Tawhid	Unity; There is no God but Allah.
Ummah	The community of Muslims.

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Discussion

M.A. Mannan (Chairman)

The paper represents the basic principles of *Shari'ah* in the area of international economic relations. However, I have some observations which need further clarification.

The author has made the observation that Islamic community is essentially a moral community. I agree with him to some extent that in each society, there are certain overall concerns which guide the economic and social relationships. In Communist society, it is the political imperatives, in market economies, it is the material imperatives, in Islamic society it is the moral imperative which regulates these relationships, but that should not give the misunderstanding that we make separation between secular economic activities and moral values. All these are inter-related into a whole. That is the most important element which has been mentioned in the paper, but not focussed.

In the first part, Dr. Siddiqi has given the ideals. Then he has given an overview of the contemporary economic analysis and practices. Perhaps it is desirable to relate the principles to the practices, so the problem of transition would be well addressed. For instance, he gave an example of protectionism. Now on the one hand we need a free movement and on the other hand protection. Why ? Perhaps it would be more instructive for a man like Dr. Siddiqi to analyze some of the problems indepth and give us the criteria of the condition of necessity because under condition of necessity, some variations may be tolerated.

It would be instructive to know how to operationalize these principles. For example, in an Islamic State, a minimum level of living is to be provided to every one. But except a few Islamic countries, no country is in a position to provide that minimum level of living to its people. However, there should be some minimum level that has to be provided. What are those packages ? It is the economist and the social scientist who should come forward and give that optimum level of provision. Hence, what set of conditions is needed to achieve those ideals ? Perhaps there we can identify a zone of cooperation at the international level. The paper would be more useful has the author made that point clearer.

Otherwise I agree with most of the observations made by the author about the role of the Islamic *Ummah.* He has beautifully mentioned that it must be seen that Islam is the best religion for betterment of humanity. We do not claim that we are the best. We say that this is our Islamic view point. There are quotations in the Quran and the Sunnah in this regard. Once you understand that, perhaps we are in a better footing to appreciate each other. Therefore, some observations of Dr. Siddiqi which project the Muslim *Ummah* as universal and the best community should be seen in that line.

A Participant '

I think there may be a conflict of principles in certain cases. Suppose a country where economic situation is so that there is a massive outflow of capital. This outflow of capital is the capital that will be invested which as Dr. Siddiqi has rightly mentioned and perhaps it will be invested abroad and will bring income from abroad. So, the national income will increase and the population may be happy with that. However, the government wants to industrialize this country and needs capital. It is, therefore, not happy with this trend whereas from the overall interest of the Ummah, this outflow of capital would improve the general efficiency of capital used within this community. The question arises, whose public interest is' this? That of the *Ummah;* that of the government or that of the people of the country?

M.N. **Siddiqi**

Regarding Dr. Mannan, I think it is a good idea to emphasize the principle of interest which is a recognized principle in the Islamic law for certain deviations from' the ideal for certain period of time. But equally important is noting that a transition from the reality to the ideal should no doubt be defined but we must. also be ready to accept the fact that the idea may never be fully materialized. What human beings can afford to do this, is to continue striving towards the idea. If we think that we must ensure its realization; I think we are asking too much. Regarding all the deviations, which are in the second part of the paper from the first part, rightly it has been pointed out that they have been justified on the ground of public interest and naturally the question arises whose public interest is involved ? My answer is, the public interest of the humanity. However, once you accept the division of humanity, first in the Islamic community and the rest of the world and then into States within the two groups you have to concede something under this recognition as follows. Either you reject this recognition or you concede it will deepen the relationship between the Islamic community and the rest of the world. We can conceive different scenarios. One extreme would be confrontation and hostility and the other extreme would be entirely peaceful coexistence because neither side is impeding the flow of ideas and freedom 'to preach, profess and practice religion and there is no need to fight on these issues. Essentially, freedom is being granted by everyone to accept certain ideas if the wish to do so.

Naturally, in the first scenario of confrontation and hostility, the community will look inward and will defend public interest in terms of itself most of the time. The interest which relate, for example to the use of space etc, the use of remaining things which by their very nature are common to the humanity and even if you accept division, you cannot divide space or other aspects of existence on the globe. Then, when it comes to within Islamic community of nations, you have to face the reality of 45 sovereign States and one third of the Muslim *Ummah,* more than 40%, may be living outside these 45 countries as minority, sometimes as big as one hundred million in other countries. Therefore, their interest have also to be taken into consideration in defining public interest.

But again if you have conceded and accepted the existence and continuation of Muslim sovereign States you have to concede to them some rights to define public interests, sometimes in terms of their national entities. For example, no national entity will accept total dependence for its food supply on outside because something may happen and the supply may be stopped. It cannot face the prospect of starving because of some political or military developments which may not be within its power to prevent. Therefore, for the sake of those contingencies, it will plan for some agricultural development; some production of food grains etc., even though the comparative advantage is against this. What applies to supply of essential food grains may also apply to lot more things. Sometimes, it may apply, unfortunately, to weapons. We have to look at the realities. I say again that in the ideal world, public interest is the interest of humanity. Then the second stage. It is the interest of the community. Then the third stage. It is the interest of the individual Muslim nation states. The wise thing would be never go to extremes and always focus on the ideal, that is, do the immediate necessary, conceive the immediate necessary to the powerful necessitating circumstances which are forcing you to narrow down or focus but always strive to break lines of them and strive to reach the ideal.

The Chairman has rightly pointed out that it is not only necessary to define the criteria for interference, it is equally necessary to define who will define that criteria. I may point out that there is a lot of procedure in the Quran and *Sunnah* and that is for all matters which are not directly governed by the textual laws of Quran and *Sunnah* and these are the matters which we are considering of this nature. A consultative process of decision-making is ordained what we call *'Shura'in* Arabic, that is, consultation at the appropriate level should decide on issues which are of this nature. For example, defining public interest in a particular situation. The representative body in any State may be a parliament. It may be another body. It may take the decision by majority of votes. The decision by majority rule is not alien to Islamic thought. It has been established in the earliest period of Islamic history because man has only two ways of decision-making available to him. One, God in His wisdom has laid down certain decisions regarding the freedom of man in his own interest and say, you do not indulge in *Riba, you* do not indulge in *Qimar,* etc. These are decisions made for us by the Divine. We accept them. That is what Islam is. The rest, man has to make himself. Now the Prophet (Pbuh) not being amongst us, the direct communication with the Divine is out of question. Man is thrown on his own resources. So everyone strives his best, presents his argument but when it comes to decision-making, no civil person, be he the *Khalifah,* the ruler or the elected President or Prime Minister, is given the right to veto. The body decides by majority of votes. The next generation; on any neighbouring government may take a different course is equally admissible. We have United Nations, we should strive to strengthen it so as to make it a decision-making body in matters relating to the entire humanity. All Muslim States are members of that organization. Earlier I have quoted some verses that it is binding on Muslim individuals or people when they enter into a covenant or an agreement, they should respect that covenant. If it is not proper, they should get out of it but as long as they are there, such covenants are to be observed.

Lastly, when discussing freedom of movement and freedom of ideas, etc., definitely I will refer to the same hierarchy for the world as a whole because when God mentions humanity in the Quran He did not restrict it to the followers of any religion or members of any community. The groupings are pointed out as a matter of convenience. So the freedom of movement, etc., should apply to all nations, and all geographical regions. But again it depends on the political scenario and the compulsions of circumstances. So much so that sometimes movement between two Muslim countries, as we find it today, i.e., movement of labour, movement of capital, etc., may be restricted. Sometimes justifiable under necessity. and in the name of public interest. In our enthusiasm to apply universal ideas and ideal categories, we cannot wash-away the existing realities. If we. do not like 'a particular reality, let us take the simple view of it. Some Muslim countries do not allow labour from neighbouring Muslim countries to enter freely and take residence in this country. You' are free to say it is thoroughly unjustified, but listen to the case of that 8 million people. What is going to happen if it allows 20 million people to come from outside and overwhelm the local population ? Can you justify this type of freedom ? Therefore, when rejecting an existing reality in the name of Islam, we owe substantial reasons and arguments, moral as well as economic, as we need establishing a particular Islamic principle. May be this topic will come up again. Therefore, I leave the floor for more questions and may come back to it again.

Volker Nienhaus

I had some difficulty in understanding the expression you have made regarding the economic policy of an Islamic State. But if we look at the foreign investment problem, we see that all the Islamic countries are competing to get foreign investment from industrialized countries. Although these countries adhere very much to Islam, may be more now than in the past, e.g., Pakistan, Morocco, Tunisia, Egypt and many other countries, they compete for Western foreign investment. Is that not un-Islamic according to the definition of public interest? Don't we need more concrete steps, more studies in the reality of today giving possible solutions? Also I think the tendency of dependency as we see it today is more in the inter-national diversion, capital, technology, etc., we are powerless how to deal with them. So, I think if we want to come to results here, we have to go to the reality and how Islam and Islamic values can give a help?

Aziz Alkazaz

In his paper Dr. Siddiqi mentions the universal Islamic approach and gives us a lot of issues in the pursuit of national economic interest. Nationalism is a European idea and rather a young idea which did not exist just 200 years ago. Is it not alien to the universal Islamic approach?

M.N. Siddiqi

I strongly endorse the remark that we need much deeper research, especially more empirical research, very narrowly focussed research on very specific issues, not at the general level of the Islamic world as a whole but on country by country basis. Unfortunately, the situation is that the life of economic issues relating to the Muslim countries and discussion on them is hardly more than 30 years old. Most of the Muslim countries gained independence during the 50s, even early 60s. For the first 20 to 25 years, I do not think any body bothered about making this discussion in the Islamic perspective. It was the aspiration to discuss them as any economist in the West would have discussed them. The trend and realization that we need to look to these issues in an Islamic perspective, is therefore hardly 10 years old and if you look at the literature on Islamic economics during the last 15 to 20 years, the issues relating to the trade or even development of particular regions, you will see that they do not find much representation in the literature. They are very few. You may get a dozen paper and not more. The economists and intellectuals in the Muslim world do not feel at ease in thinking as Muslim economists. Not only they shun prefixing economics by any adjective, they shun prefixing themselves by any adjective. They will not like being termed as "Muslim Economists". This trend needs to be changed and a lot of talent in the Muslim world need to realize that they owe to their people and their traditions; to their heritage and perhaps to their faith, to consider some of these issues in the light of Islam. I do not think we have insufficient manpower and resources to meet the demand.

Now I think that the issue whether we go along with the dependency theory and the general Third World trend, or in the light of the universal principle of Islam, we need some bolder issue, accommodating the internationalization of economic life, in general, and especially capital formation and technology, in particular, with the interest of the *Ummah* as we see it. We should be able to do this if given time and more meetings and more scholars like the one we are having now. It is a big challenge and I think it is possible to meet. It is possible to envisage a situation in which our frontiers are opened for capital movement and movement of man and even then we feel that our cultural values are not eroded and our ideological role is not being changed. However, at the present this vision is missing. I do not know of any writer who has presented this vision and spelled it out in detail. We take the surface view. A view taken by people who feel insecure and are not sure of their fate. They hold the view that it is safer to protect yourself. Better not develop than be lost. This is the general tendency I find amongst people like myself. I would rather save my identity and be myself than lose myself and become one of the most developed national entities. I care more for my identity than the quality of my house, my car or my material standard of living. Nevertheless, I am sure there are ways to preserve identity and develop and be at the international level, in a rational manner.

Now the question of universal versus national. Again it is a question of what we are going to do? If we are really going to perform a philosophy or we are going to change the world? If the intention is to change the world in the direction of Islam we should start with the reality. The reality is that there are Muslim nations, fighting with. each other and Muslim nations whose perception is that their economic interests vary from one another. So we cannot ignore this reality and it is on this reality you have to build. We have to educate our people, governments, economists that their perceptions are wrong and that moving towards Islamic universal categories will be in the best long term interest of our own people, our own territories and for the humanity as a whole.

The question about the definition of public interest and who defines it, I will once again say that being Muslim does not free us from the limitations which, all human beings have. We suffer from all the limitations from which humanity suffers, that is, lack of sufficient information, lack of knowledge of future, lack of the capacity to comprehend all the aspects of reality at one go and lack of consensus. So, the, only thing we can do, is we learn the most we can learn from our own heritage, from our own Quran and *Sunnah,* our own discussions and experiments and we can try to make the best out of it in an assembly of people and make the best decision at a particular time and say this is the Islamic decision till you come and convince us that we are wrong or somebody amongst us rises and gives us an Islamic change.

However, I will say again that I have a faith in the procedure. The procedure must be correct. The decision may be wrong but as long as the procedure is correct, there is a guarantee that a wrong decision can be corrected. So Islamic application of the principles of *Darurah* (necessity) and *Maslahah* (public interest) should be relied on at the national level, at the international level, at the inter-Islamic level and we should all strive, Muslim and non-Muslims to do away with bad aspects of nationalism, we should try to remove the strings.

M.A. Mannan

I may complement what Dr. Siddiqi has said in response to Dr. Nienhaus. It is true that in contemporary reality, Muslim countries are competing for foreign investment. However, a distinction has to be made clearly between the Islamic States and the Muslim States because by an Islamic State we mean a state in which principles of *Shari'ah* are applied. The Muslim States, as we see today, are not always Islamic according to the definition of Muslim scholars. As Dr. Siddiqi has rightly mentioned that after a long colonization process, the emergence of these Muslim States is a recent phenomenon. Another important point is that Islamic economics is value loaded. All economic decisions are value loaded. That is, one must start by making an ideal theoretical exposition on the basis of Quran and *Sunnah.* When the ideal is made then it comes to the reality. How it can be reshaped to become compatible with the idea? Coming back to the question of the European concepts, I have just one observation to make here. While the militant concept of nationalism is alien to Islam, human knowledge is a common heritage. What I am trying to say is that a lot of innovations and inventions have been made and we take them as long as they do not contradict the established teachings of Quran and *Sunnah.*

Khurshid Ahmad

We have a very original and thought-provoking paper and extremely valuable discussion on it. I will just touch upon two or three points which have arisen. Firstly, the author has rightly emphasized the moral, universal and altruistic dimensions and without properly emphasizing them the unique Islamic approach cannot be spelled out. The material, the rational and the physical also has to be emphasized and Dr. Mannan was right when he said that the uniqueness of Islamic approach lies in its integrated approach. Whereas the moral and universal has upper hand, the material and physical is very much entangled into it.

Secondly, a lot has been said about the law of necessity. I think, in every legal and social system, law of necessity has some place. In Islam, even within the law of necessity, certain rules and norms have been set. There are situations when even life has to be sacrificed for the preservation of a value, and there are situations where certain commands can be ignored to save life. So even for law of necessity certain rules and norms have been set. In the final analysis, it would be the judgements of the decision-making body which can err but nonetheless a framework has been given. For example; the author has quoted in his paper that Makkah and Madinah were at war. The food supplies to Makkah were stopped to bring about political pressure. It was a political situation, but the Prophet (Pbuh) intervened and said that although we are at war we do not want people to starve. The political battle has to be settled in a different manner, not by squeezing food supplies. So political necessity was overruled and certain human considerations were allowed to prevail. That is how, while the necessity is there, but again there .are certain rules and norms which have to be accepted in the case. There are certain situations where the human consideration, the need of humanity would prevail. There are certain others where the interest of Islamic *Ummah* may have an overriding consideration. This is a perennial problem. If the judgement has to be made by the individual, in an individual context, the individual decides. Otherwise if it is the one who enjoys political power. Dr. Siddiqi has rightly said that Islam wants that this political decision making process must be based on consultation.

Thirdly, about nationalism also, the question is not that new. If we look back we find Greece, for example. There was a conflict between the universal and the particular, the Athenians and the Spartans. They were at war and one. can smell a kind of nationalism; a kind of parochialism; a kind of particularism in that context. Even in Islamic world you will find that during the priod of rightly guided Caliphs there was a universal Islamic State. In Europe we also find that the nation-states of the 18th and 19th centuries do not exist any more. We find a kind of internationalism coming up where they are heading towards a common passport in the European community. In economic matters a lot of integration is taking place. So I feel that while the important problem between universal and particular remains, the contours of the problem and the rigidity with which we had been faced in the past are now being realistic and in this context perhaps Islamic universalism is going to be of some help if there is greater cross fertilization of ideas and efforts.

CHAPTER II

NORMATIVE PREMISES IN THE THEORY OF INTERNATIONAL ECONOMICS

Ernst-Jurgen Horn·

[The prevailing international economic order is based upon the framework and institutions created at Bretton Woods. The developed countries, having a larger weight in the decision making processes of international economic institutions backed by their economic power have been managing the International economic system. This has lead to the demands for New International Economic Order (NIEO). Since NIEO could not be established for various reasons, the developing countries have to live and survive within the present international economic order. An analysis of normative premises of theory of international trade has shown that gains from relatively free trade has lost appeal both in the developing and de veloped countries. New main focus of trade theory is not how countries can mutually gain from trade without government intervention but how a country can gain in international trade from government intervention. The traditional infant industry argument is now being extended to high technology production in the industrial countries. At the end, it is recommended that the government of a developing country "should be careful to limit the range of its interventions to what it can manage both administratively and economically". - Editors]

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I

Introduction

The international economic order, designed at Bretton Woods in 1944, still forms the basic framework for international economic relations. The international economic institutions that were set up - the International Monetary Fund (IMF) for the monetary order, the International Bank for Reconstruction and Development (IBRD or World Bank) for capital assistance, and the General Agreement on Tariffs and Trade (GATT) for the trading order - may have changed somewhat in their function and orientation over the decades since their foundation. But they have remained the preeminent rule-setting institutions in the world economy.

In a historical perspective, it is quite important to keep in mind that the postwar international economic order was deliberately established as a system of its own, separate from the United Nations' organization (UN). And the three main international economic institutions were shaped and dominated by the West-ern industrial countries, with the United States being the principal and leading power of this group. Most socialist countries of Eastern Europe, especially the USSR, declined to participate in the new institutions.(1) Although a considerable number of developing countries(2) were already among the original member states, these countries had little say in decision procedures. In the IMF and in the Bank, the voting shares were by and large distributed according to economic weight as reflected in a country's subscription to the capital stock. In the case of the GATT different rules were applied. Each member country was entitled to have one vote (Art XXV). Except in a few specific cases (accession of new members, waving of member states' obligations) decisions by the contracting parties can be taken by the simple majority of the votes cast. In practice, however, consensus decisions have been the rule, as it is also suggested by the GATT principle of reciprocity in the exchange of "trade concessions" among the contracting parties. Of course, the factual influence of member countries in the GAIT can be expected to depend on their weight as trading power. Therefore the Western industrial countries as a group have ever since largely determined the political agenda in the GATT system.

It may appear, then, that the core institutions of the international economic order are basically rich men's institutions, i.e. that they are, as a matter of fact, dominated by the Western industrial countries (the First World) which in addition are organized in a separate club of their own, the Paris-based Organization for Economic Cooperation and Development (OECD). This raises the question of whether the rules of the international economic order may be biased in favour of the countries of the First World which are, be it for good or bad, managing the system. That this is, in fact, the case, has been suspected by developing countries since long, and time and again this topic has been controversially discussed in the literature, although in mainstream economics the view has prevailed, that the existing world economic order does not, at least not in any systematic manner, discriminate against developing countries' properly defined economic interests. But this definition is of course in itself part of the problem at hand. Are backward countries, for instance, by the very fact of economic backwardness, entitled to receive preferential rather than just equal treatment? Most developing countries have always claimed for themselves a right of such a preferential treatment in the world economic order, e.g. regarding the international regulation of commodity markets, exemption from the principle of reciprocity in trade concessions, or an obligation of industrial countries to provide minimum levels of development aid.

The challenge of the existing world economic order from the side of the developing countries has been carried forward within the system's institutions as well as outside of the system, under the auspices of the United Nations. In the course of the decolonization in the postwar period, the number of sovereign developing countries has multiplied, leading to a vast numerical majority of this group among member states of world organizations. The number of member countries rose to 159 in the case of the UN (as of 1986), to 151 in the case of the IMF and the World Bank, and to 93 in the case of the GATT (with 28 further countries maintaining a de facto application of the GATT after having achieved independence). The organizations of the UN have been the only international economic fora, however, where their numerical majority has provided developing countries a crucial weight in political decision-making. With regard to the established international economic order, the institutional peculiarities of the IMF, the World Bank and the GATT have effectively constrained, or have been used by industrial countries to set limits to, the rise of developing countries' influence. Nevertheless, the political weight has considerably increased within these institutions too, presumably beyond what can be regarded as being backed by true economic weight. It is only in comparison with the situation in the UN that the role of developing countries in the international economic order may appear relatively small.

Given that the prospects for reshaping the international economic order from within the existing institutions were reckoned insufficient, it lay in the logic of things that the developing countries always strived to set up elements of a countervailing (and competing) order outside of this system, preferably under the auspices of the UN where they could bring into effect their numerical majority.(4) The core aim aspired was regularly some kind of international planning and market regulation, reflecting a deep-rooted distrust in the philosophy supposedly underlying the institutions of the established order, i.e., for short, a distrust in the principles of the market economy. Many (or even most) developing countries seem to have ever since held the suspicion that the gains from liberal international economic exchange with industrial countries were unduly accruing to the latter - whatever the reason may be.

The regulation of international markets for primary commodities that are of importance for developing countries' exports, have been the, main focus of such aspiration all the time, starting with the formation of the Interim Coordinating Committee for International Commodity Arrangement (ICCICA) in 1947 which in a sense only took up the tradition of attempts to establish international commodity cartels from the inter-war period. Over time, and despite the disappointing results in the area of commodity markets, the ambitions rose even further aiming at setting up a comprehensive new international economic order (NIEO). The United Nations Conference on Trade and Development (UNCTAD) established as a permanent institution of the UN in 1965, and the United Nations Industrial Development Organization (UNIDO) formally created in 1966, should serve this purpose, in 'the last event intended as substituting for the Bretton Woods institutions in shaping the international economic order. The claims to regulate the. exploitation of natural resources hitherto not underlying national jurisdictions (e.g. sea-bed mining; this is the case of the (euphemistically) so-called "common heritage of mankind" or put more simply, of "common pools were but the avangarde of much broader aspirations to establish a NIEO characterized by politically and hence bureaucratically managed international markets.

Now it is well known that commodity agreements generally have not functioned in the way as it was envisaged[(5)], and that all the efforts to establish a NIEO have basically led to nowhere. It appears, then, that the developing countries will have to come to terms with the existing international economic order and to accept their role within the system, whether they like it or not. This raises a couple of questions that are to be dealt with below. On what theoretical foundations is this order based? What normative conditions must its participants fulfil? What are the implications (or difficulties) that developing countries face under this system? How can developing countries make the best achievements under the current system?

I I

On the Meaning of Normative Premises in the Theory of International Economics

The standard meaning of the term "premises" is usually circumscribed by one of the following phrases (Merriam Webster, Oxford Dictionary): proposition antecedently supposed or proved as a basis of argument or inference; something assumed as taken for granted (presupposition); that which is stated at the beginning as a foundation for reasoning. In a more specific use, the term also denotes the details of property in the introduction to a legal document. The definition speaks for itself and does not demand for further elaboration. It is the conjunction with the adjective "normative", and the reference to the theory of international economics, that needs some discussion(6).

The traditional interpretation of positive and normative economics is (Wong, 1987) that the first deals with the question of "What is?" and the second with the question "What ought to be?" Thus the subject of positive economics is seen as description and explanation of economic phenomena (economic hypotheses that are empirically testable). Normative economics is then the application of positive economics for the purpose of giving advice about practical problems including policy advice in order to achieve certain results. This application usually includes value judgements, in the evaluation of outcomes of economic exchange processes, or in the evaluation of "better" or "worse" process (such as rules, laws, institutions) within which economic exchanges are allowed to take place: The realization of such recommendations will inevitably cause losses (absolute or relative ones) for at least some economic agents.(7) Now the theory underlying particular practical recommendations is of course based on a certain set of premises. The value judgement concerning the expected results thus coincides with a value judgement regarding the premises. Even if a scholar declined to derive any advice for practical problems from positive theorizing altogether, he would not escape the problem of value (or normative) judgement that is embedded in the selection of problems considered and in the choice of premises for his theory; he would only personally restrain from making nromative conclusions.

The point to be emphasized is that the issue of value judgements is not limited to the traditional area of normative economics (practical advice and application). The claim for objectivity in social science in general and for social scientists abstaining - in their role as scientists - from any value judgements in particular that was advanced by Max Weber (1924, 1968) and other members of the younger critical historical school in Germany early in this century, therefore appears too rigorous because it can be hardly translated into operational guidelines for doing research in social sciences.(8) The value judgement debate(9) in a sense has become a kind of never-ending story in the science of sciences. How to deal with value judgements rather than to totally avoid them has been the problem in praxis. A certain consensus seems to have merged, notwithstanding controversial views on particulars, that values, whether ethical, political, or methodological, which influence the selection of problems considered and the methodology applied to address them, should be explicitly acknowledged (Giersch, 1961). In addition, it is generally held that rational discussion about value judgements has been shown to, be possible. Furthermore, a threefold classification of problems with value judgements in social sciences has contributed to the clarification of the issues at hand (Albert, 1965, 1971). These are:

i) the problem of the existence (necessary or not) of basic values in social sciences (comparable to basic constitutional rights and obligations) (von Hayek, 1960);
ii) the problem of valuations in the subject area of social sciences (this is the traditional field of normative economics);
iii) the core of the value judgement problem: this. is the question in how far assertions in social sciences are by their nature value judgements (how to avoid that value judgements impinge upon scientific discourse, once the premises are established).

If the claim that social scientists should pursue their work free of value judgements is limited to the third point, however, the principle is reduced to the rule that scientific results should be open to scrutiny and revision (falsification). This is basically a rule of procedure only that is neutral with regard to value judgements on rules, laws, institutions, etc. i.e. on the premises of analyses in social sciences. But the value judgement problem as such can of course not be resolved by the prescription of rules for the procedure in scientific work.

Taken together the above discussion should have shown that there is not any such thing as a value-judgement-free social science. Its origin in, and its foundation on, some fundamental doctrines (whether moral, ethical, legal, or ideological) cannot be defined away. What can be concluded therefrom for an assessment of the normative premises in the theory of international economics and in the rules of the international economic order? Quite obviously, there is a need to confine the subject to a subset of selected, more narrowly defined questions, simply in order to keep it manageable. Such a choice involves a judgement of relevance. International trade in goods is undoubtedly the center court of international economic relations. For developing countries, the integration into the international division of labor of their economies is a principal target in, and likewise a condition for, the industrialization and development process[10], compared to which international monetary policy and capital/development assistance are of distinctly less importance: In the following the emphasis of the paper is therefore with trade-related issues. In particular, three areas are considered in more detail, (i) the (main stream) theory of international trade, (ii) the rules of the GATT system, and (iii) problems of actual international commercial policies.

III

Normative Foundations and Implications of International Trade Theory

The basic premise of trade theory relates to the underlying economic order of a liberal market (or capitalistic) economy. Its application is in large part not bound to this specific order though. For example, the analysis of comparative cost advantages in international trade is, if the aim is to make best use of limited resources or if it comes to assessing the costs and benefits of politically motivated and directed international exchanges, also relevant for centrally-planned (command) economics. Liberal or free economic order is not to mean a laissez-faire economy in which the role of government is limited to providing essential public goods, such as internal and external security and contract enforcement. In fact, market interventions by governments, the cases for and the consequences of, form a quite important part of trade theory. Furthermore, standard text book models with rather simplifying assumptions, such as (perfect) competition on product and input markets, flexibility of products and factor prices, full employment of all factors of production, and equalization of social and private marginal costs, do not represent the entirety of trade theory, they rather play the role of a methodological foundation only. It is precisely the deviation from such ideal assumptions and the resulting consequences that has been primarily addressed in the more recent development of trade theory, regarding for instance development economics, trade in differentiated products among industrial countries, or trade in high technology products.

What has hardly changed over time, are the basic issues trade theory has been concerned with. These are the three questions:

i) What are the products a country will export or import?
ii) How are the terms of trade between traded goods determined?
iii) How does international trade impinge upon the welfare of individual economic agents, of countries, and of the world as a whole?

The first question quite clearly belongs to positive economics. What will the volume and structure of international trade be like under certain and given circumstances? "The factor-proportions (or factor endowments) theorem" for instance, predicts that a country will export those kinds of goods, in the production of which the factor of production is intensively used that is abundant in this country in international comparison. Here one important assumption is that the factors of production concerned are not internationally mobile. Otherwise factor migration could substitute for goods trade, the cases apart in which factors of production are immobile by their very nature (e.g. natural riches). This is not to mean that factors of production ought to be internationally immobile. The line of argument simply runs from IF (the set of premises) to THEN (the resulting pattern of trade flows). There needs no normative argument be involved in such a reasoning. The question of whether a country should enter international trade and specialize along the direction predicted by the theorem is not touched upon.

The determination of the terms of trade under certain competitive conditions in international markets as *such* is also a matter of positive economics, including the effects of monopolies, cartels, or trade *tariffs* on the international supply of, or demand for, tradeable goods. What-ought-to-be questions need not to be raised at all. But, and this is an import but, the terms-of-trade analysis has to rely on the use of social (aggregated) indifference curves in order to define a offer-demand framework for international markets. Now it can be easily shown that individual indifference curves can be aggregated under rather strong assumptions only without leading to contradictions between social and individual curves; in the last even a resolution for analytical purposes had to take resort to a paternalistic welfare function which would be a normative approach by its nature. Democratic majority decisions - one man, one vote - cannot resolve the problem either because the outcome can be indeterminate if individual indifference curves differ (i.e. it depends then on the agenda of political decision-making what will be chosen as social preferences), if there are at least three economic agents with differing preferences and three possibilities to choose; this is the so-called Arrow paradox (Arrow, 1963). This does not need to pose a critical problem with regard to the terms-of-trade issue as such. Here it is sufficient to use the social indifference curve in the meaning of an average of individual indifference curves. It becomes critical, however, if welfare effects of international trade were to be assessed in a framework of positive economics. Because, in this case affected minority preferences had to be taken into account, value judgements could not be avoided. This would lead the analysis beyond the limits of positive economics.

In a two-country world, the terms *of* trade *of* the exchanged goods will settle somewhere in between the range of relative prices (in terms of opportunity costs) these goods had in the two countries before engaging in international trade, in the state of autarchy. Leaving aside all the technical details about the modelling in terms-of-trade analysis, which can. be done without normative reasoning, it is quite obvious that the theoretical and empirical results are of immediate relevance for the discussion of normative implications. For example, trade theory shows that large countries (or an effective cartel of smaller countries being combined a large supplier or customer) can shift the terms of trade in their favour by imposing tariffs (or quantity restraints) on exportables or importables in cases where they have sufficient market power (optimum-tariff theorem). This is the mirror image of the effects that monopolies or cartels have on the internal market, where they can improve their economic situation at the expense of the rest of the economy, regarded in comparison to a situation without market power. In the case of the optimum tariff, the large country raises its economic well-being at the expense of the rest of the world. This possibility is limited, however, if a countervailing power exists, i.e. if there are countries or country groupings large enough to make the imposition of retortion tariffs effective.

The optimum-tariff argument has even since been the decisive rationale of developing countries' aspirations to set up international regulations of primary commodity markets. The also much discussed arguments of smoothening fluctuations of commodity prices or export earnings (these are two different stories) are flawed in various respects. Fluctuations in export earnings can be transformed into a continuous stream of income spending of commodity exporting countries by using the international banking system as a bufferstock. The smoothening of price fluctuations may under certain conditions make commodity exporting countries worse off (Baron et al., 1977). This would be the case, for instance, if price fluctuations were caused by demand fluctuations in industrial countries (in the sense of shifts of the demand curve over the business cycles). That would imply that in boom periods high export quantities coincided with high export prices, while in recession periods low export quantities coincided with low export prices. Over an entire cycle, price stabilization thus could actually reduce commodity export earnings. Commodity agreements in order to raise export earnings (in terms of purchasing power for imports) according to the optimum-tariff theorem, on the other hand, are economically inferior for the world at large, due to the price-induced decline of export quantities, to an alternative solution with direct capital transfers to exporting countries and without restraints of commodity exports. This is of course a theoretical construction only.

Another example for the immediate normative relevance of terms-of-trade analysis refers to the possibility. that, under rather extreme assumptions though, a country engaged in international trade may come into a situation of "immiserizing growth" (Bhagwati, 1957/58). If conditions are such that technical progress in the production of exportables translates into a strong deterioration of the terms of trade, it can happen in the extreme that rising export quantities can buy less and less importables. This case of immiserizing growth has some similarities with another much discussed issue in the area of terms of trade, namely the question of whether there has occurred a secular decline in the terms of trade for primary commodity exports (for exports of developing countries). Conclusive empirical evidence in support of the decline-hypothesis has not yet been provided. The results of studies in this area have proved highly sensitive with respect to the base years and periods chosen. Both possibilities, immiserizing growth and secular decline of a country's terms of trade for its traditional exportables, obviously pose severe problems for a country affected, and call for a normative (political) response, of which an attempt to artificially revert such trend is, however, but one among others.

The welfare effects of international trade are by their very nature a subject-matter of theory where positive and normative reasoning is almost regularly interfused. The explanation and evaluation of gains from trade and the justification of an open and liberal trade regime in a sense are but the two sides of the same coin. Judgements upon welfare effects of trade, even if they were possible without value judgement, are self-suggesting with regard to normative recommendations. As' a matter of fact, the evaluation of welfare effects usually, and necessarily so, has to include interpersonal comparisons of welfare. The reasons are straightforward. Firstly, as already mentioned, preferences differ across individuals. Secondly, international trade changes relative prices of goods and factors of production, and induces a reallocation of resources. There are winners as well as losers in these process, even if the full-employment assumption is taken to hold and the possibility of adjustment frictions is neglected. Compensation criteria of one kind or another for evaluating net welfare effects for a country do not resolve the value judgement problem, they rather express a particular decision rule chosen only. Thirdly, commercial policy is pursued at the national level and for national purposes - the optimum-tariff case is an example that there may be a conflict between the aim of maximizing a country's (the national) gains from trade and the aim of maximizing the world's (the international) gains from trade.

Policy interventions aiming at correcting the results a free international exchange would have, are a core subject-matter of international trade theory anyhow. Following Corden (1974), the normative theory of trade policy in modern, post-mercantilistic economic thought has evolved in three stages:

i) In the first stage, the gains from trade, in particular the benefits of completely free trade; became appreciated. The great tool of analysis was the law of comparative costs advantages (associated with the name of David Ricardo). This stage dominated economic thought for the whole of the 19th century. It is typical for this stage that an economic policy stance for laissez-faire in general coincided with a trade policy stance for free trade.

ii) Over time, more and more reasons have been advanced why a laissez-faire stance in the economic policy in general and in trade policy in particular may not be optimal for a country, such as that markets are not perfectly competitive, there may be unemployment, the resulting income distribution may not be desirable, there are frictions in structural adjustment, and others more. Besides these qualifications, two arguments against a free trade stance as such were developed, the argument for optimum tariffs, and the (Hamilton-List- Mill-Bastable) argument for infant industry protection. This was the second stage of economic thought.

iii) The third stage of thought was marked by the breakdown of the link between the case for free trade and the case for laissez-faire. The simple generalization of the case for free trade has been more and more questioned by sophisticated arguments for trade protection and other forms of government intervention. There have been numerous arguments for government intervention in the domestic economy of the emerging welfare states of industrial countries, and there have been also numerous qualifications to the case for free trade following the same lines of reasoning. In addition, however, the arguments for free trade have been restored somewhat through the development of the so-called theory of domestic distortions: if free trade leads to undesired results and the cause is with distortions in domestic markets, a first best policy approach would have to deal with such domestic distortions rather than to abandon a liberal trade regime.

To sum up, the faith in the gains from relatively free trade seems to have lost appeal among many students of economics in the postwar period, as compared to the ante-bellum World War I conditions, and not withstanding the momentum of trade liberalization World War II under the auspices of the GATT. Freer trade is at discount in most developing countries. Many developed countries reveal a similar suspicion in their efforts to implement industrial policies designed to strengthen their "international competitiveness". The evolving literature on the theory of international trade which is dominated by scholars from, or by scholar working in, industrial countries, does reflect these tendencies. The traditional foundation of normative trade theory was that countries can mutually gain from trade without government intervention. How a country can or could gain in international trade from government intervention, has become a central topic in trade theory contributions. This is not confined to the case of backward countries (i.e. to development economics). The new theories on strategic trade policies (Helpman and Krugman, 1985; Krugman, 1986; Feenstra, 1988), for instance, extend the traditional Mill-Bastable criterion for infant-industry protection to the case of high technology production in industrial countries, characterized by high R&D outlays as sunk costs, increasing returns to scale, steep learning curves, and imperfect competition.

It appears, then, that in the field of trade theory "anything goes" in the sense that there is not any binding normative premise (except that there are markets that work in a certain manner) or "leitmotiv" like the faith in the gains from liberal trade in the absence of government intervention. There has emerged, however, a strong countervailing power, namely, the empirical evaluation of the effects of government intervention and of the mirror image of the effects of market deregulation. Government failure to perceive problems correctly and to design adequate means to achieve the aspired aims, seems to occur rather frequently (Feenstra, 1988). And there is to be reckoned, of course, the checks and balances built into the international economic order. Most clever prescriptions to increase national welfare at the expense of the rest of the world are bound to fail if other countries retaliate with similar or other defensive measures of their own. This leads to the next section on the rules of the GATT system.

IV

Normative Foundations and implications of the GATT System

As stated in the preamble, the principle aim of the GATT is the reduction of trade barriers and the elimination of discriminatory treatment in commercial policies. To quote the preamble directly:

-"The ... (contracting parties)

> Recognizing, that their relations in the field of trade and economic endeavour should be conducted with a view to rising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods,
>
> Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce, Have through their Representatives agreed as follows:" .

The preamble already indicates an important point: the aim of the GAIT is not a free trade regime but rather a reciprocal reduction of trade barriers and the elimination of discriminatory trade policy intervention.[12] Thus the basic premise is that of the advantages of an open, multilateral trading system, and that lower trade barriers to trade are preferable to higher ones. The reference that is made to rising real income and effective demand, full use of the world's resources and expansion of production and trade, would suggest that:

i) the economic order of the contracting parties is presupposed to be of a (mixed) market-economy type;

ii) government intervention is regarded legitimate in the framework of Keynesian demand and employment management;

iii) the existence of gains from trade is implicitly presupposed, and it is assumed that a liberal open multilateral trading system can contribute to the achievement of the macroeconomic targets mentioned.

The GATT is unique among world economic institutions in that it is formally not really an international organization. Its origin was an agreement of the contracting parties containing a provisional codification on trade relations (30th October 1947) and its provisional application (from 1st January 1948). Thereby only the trade policy parts of the Havana Charter (based on the United States' "Proposals for Expansion of World Trade and Employment" of 1945) were set into force. At that time the establishment of an International Trade Organization (ITO) that made up the core of the Havana Charter, was still pending. The ITO was designed to have far-reaching supra-national political competence, e.g. in order to achieve trade liberalization, to combat monopolies, to expand the demand for commodities, or to coordinate counter-cyclical policies of member states. As the United States finally declined ratification in 1950, the ITO never came into being, and the provisory GATT grew into the role of a permanent international institution with and administration of its own, the secretariat.

Three basic principles form the hard core of the Agreement on the international trading order. These are:

i) the principle of reciprocity;
ii) the principle of trade liberalization, and
iii) the principle of non-discrimination.

All the three principles are already mentioned in the preamble. They circumscribe in a sense an aspired, though distant state of free or liberal trade, and the major regulations outlined in detail in the articles of the Agreement are derived from these basic principles.

The principle of reciprocity means that countries which are favoured by "trade concessions" of other countries should concede equivalent reductions of trade protection. In practice, this principle raises many problems in international trade negotiations regarding the question of which concessions can be regarded equivalent. Furthermore, it reveals an important feature of the philosophy underlying the system. Why is a reduction of trade barriers by one single country labeled a concession, when at least customers of the imported goods concerned in the same country will gain by this measure if not on balance the economy as a whole will gain. The answer is threefold. Firstly, the GATT was designed before the background of a monetary order with a regime of fixed exchange rates (the exceptional case of a fundamental external disequilibrium apart). In such a system, the unilateral reduction of tariffs leads, other things being equal, to a rise of imports and to a deficit in the trade balance. Mutual and equivalent reductions of protection would, it was expected, be largely neutral with regard to the balance of exports and imports. In a regime of flexible exchange rates,and under the assumption that the mercantilistic aim of achieving export surpluses for its own sake is not pursued, this interpretation of reciprocity is obviously of minor relevance. Secondly, the principle of reciprocity seems to play an important role in the political economy of protection. Governments can, it is for instance argued, carry through reductions of protection more easily, if losses of producers under the pressure of import competition are compensated by gains of producers in exporting sectors, and if foreign countries also bear the "burden" of structural adjustments induced by trade concessions. Furthermore, the principle of reciprocity, and the existence of a trading order as such, can be regarded as an (informative) international public good. At least the possibility exists the resistance of national governments is strengthened against claims for protection by national pressure groups. Thirdly, it is a systematic feature of the GATT system that the interests of consumers are not subject of the regulations in detail, although they may be subsumed under the basic objectives stated in the preamble. Reciprocity means reciprocity between gains and losses of producers in the member countries, as induced by trade liberalization.

The principle of liberalization says that no contracting party shall introduce new tariffs or quantitative barriers to trade with GATT members, and that there is a general obligation to reduce existing barriers to trade. There are, however, exemptions from this rule, e.g. safeguard clauses or measures in favour of agriculture.

The non-discrimination principle has its most important application in the rule of most-favoured-nation treatment outlined in Art.I. It refers and other taxes on imports and exports. According to this clause, a member country that grants a trade concession to another member country for a particular product, is obliged to grant the same concession to all other member countries for equal products. A major exception from this rule is given for free-trade areas and customs unions (Art. XXIV).

All in all, the GATT provides a system of international law that guarantees a bounded freedom of contract in international trade for all economic agents(13) engaged therein. The freedom of contract is bounded because of the legitimacy of existing trade barriers at any given point of time that are mutually acknowledged by the contracting parties. The GATT codes are part of national law of the contracting parties. The GATT has, as an international institution, no supra-national executive power to enforce that member states oblige to the rules.(14) Private economic agents that are affected by suspected violations of GATT rules through national governments, can sue these governments at national courts. In the case of disputes between governments on the proper interpretation of GATT rules, dispute settlement may be tried through the institution of GATT panels (or working parties) which can, however, give only recommendations. Countervailing power (the threat of retaliation) in fact has been the decisive instrument in order to enforce discipline in the GATT system.

The effectivity of the international trading order laid down in the GATT is influenced in one way or another by the numerous exceptions from the general rules. The major examples are anti-dumping and countervailing duties (Art. VI), safeguard clauses (in particular Art. XIX), customs unions and free-trade areas (Art. XXIV), the Multi-Fibre Arrangement (outside the GATT codes, but managed under the auspices of GATT) and the exceptional treatment of developing countries (Art. XVIII and Part IV on "Trade and Development"). In the following, only the role of developing countries in the GATT system shall be discussed. Art. XVIII already gave economically backward countries a preferential status from the beginning, providing a wide scope for infant industry protection and trade interventions in cases of emergency (e.g. for balance-of-payments reasons). Part IV on "Trade and Development" considerably extended this exceptional treatment. The contracting parties agreed upon, interalia, that they regarded three major aims as common tasks:

i) raising the export earnings of developing countries;
ii) stabilizing commodity prices, if necessary, on an appropriate level;
iii) improving the access to industrial countries' markets for manufactured exports of developing countries.

Furthermore, trade policy measures in favour of developing countries were exempted from the principle of reciprocity in that industrial countries did not expect equivalent trade concessions from other industrial countries, if they reduced tariff or non-tariff barriers to imports from developing countries. This made it legally possible to introduced tariff preferences for developing countries, as it happened step by step in most industrial countries since 1970 or so.

Now it is well known that the attempts to regulate international commodity markets and to stabilize commodity export earnings of developing countries have not produced any lasting results (except some Stabex-schemes for export-earnings of very poor countries; but the funding of these scheme has, in the case of the EC for example, very muchthe character of development aid).[15] The system of tariff preferences for developing countries, on the other hand, has been introduced on a comprehensive scale. The results, however, are mixed at best.

This has to do with the manner in which the granted preferences have been structured. The ideal case of tariff preferences would be that industrial countries allowed tariff-free imports from developing countries for all products and for all quantities of a particular product. In fact, the industrial countries introduced preference schemes, that very much resemble the organizational super-fine- tuning in regulating textile and clothing imports from developing countries under the MFA. Take the EC's tariff preferences as pars pro toto: they do usually not favour all developing countries, and those favoured not all on an equal basis; they are granted most generously for products where the export capacity of developing countries is lowest; and they provide tariff-free imports only for a certain quota ("plafonds") in which the share of a particular is limited "buffer". Whether import are really tariff-free, in many cases will be sure only long after trade has actually taken place. The costs of uncertainty and administration that such a system causes, are enormous. Moreover, the EC has also established separate preference club under the Lome-Convention.

In the international trading order, the normative claims of exception treatment for developing countries has found consent in principle as well as in the codification of rules. What can be said about the normative implications, then, about the judgement on the results that the exceptional treatment has brought for developing countries? The competence to answer this question and the responsibility to draw policy conclusions is of course with the developing countries themselves in the last event. There is a problem of assignment of causes and consequences involved here. Many empirical studies have revealed that trade liberalization achieved in the various multilateral negotiation rounds .under the GATT, primarily benefitted trade among industrial countries. Could it be that the outcome would have been different, if the developing countries had participated more actively in the exchange of mutual trade concessions on an equal basis, in order to support this export interests in manufactures? These are open questions. After all the GATT did not prevent the surge of the "new protectionism" (characterized by the discriminatory application of non-tariff barriers to trade) in industrial countries since the early 1970's, and the GATT did not prevent the increasingly tighter regulation of industrial countries' textile and clothing imports either, from the Short-Term Arrangement Regarding International Trade in Cotton Textiles (STA) in 1961 to the MFA of today. Nevertheless there seems to be a growing number of developing countries, as has become evident during the preparations of the current Uruguay Round, which expect advantages from giving up preferential treatment, stepwise or altogether.

V

Concluding Remarks: Commercial Policy and Economic Development

The government of a developing country "... should be careful to limit the range of its interventions to what it can manage, both administratively and economically". "both contemporary theory and common sense suggest that, if the argument for infant industry protection is either labour training or research and development, appropriate policy consists in subsidizing these activities rather than mere production, since a production subsidy carries no obligation to carry on either activity" [16]. The theoretical basis for infant-industry trade protection is a weak one indeed. The costs that this trade protection causes for the economy, are real in the first place. There are, in particular,

i) the loss of consumers which is sometimes categorized as enforced savings that could be indirectly beneficial for the process of capital accumulation;

ii) the indirect tax burden that any trade protection of particular sectors imposes on all other sectors, including present export industries, via rising input prices and the exchange rate effects of protection;

iii) the less visible impact of trade protection on productive efficiency and product quality in sheltered sectors.

Substituting subsidies for trade protection causes real costs too. The benefits of infant-industry protection on the other hand, refer to expected - more or less distant - future returns. The case for infant-industry protection is essentially an argument for temporary protection. Hence there must be economies of time - learning by doing - that may be internal or external to the decision-making units, the firms (Corden, 1974). In any event, later returns of infant-industry protection should at least recover earlier excess costs and the foregone interest on such an investment, measured at an appropriate present capital value base. This criterion refers to single cases only, and this is exactly the reason why it cannot be generalized towards the conclusion that the infant-industry argument were conducive to support a general exception treatment of developing countries in the international trading order, and that this. exception treatment were to be regarded as a permanent one.

Notes

1. Poland and Czechoslovakia accepted membership in the IMF and-the World Bank, but withdrew from the Fund and from the Bank on 14 March 1950 and 31 December 1954 respectively. Czechoslovakia was the only original member state from Eastern Europe in the GATT.

2. It is of course a gross simplification to' speak about the developing countries in any context as if these formed a group consisting of rather similar countries. In fact, it is hard to find any key feature that most countries of the Third World have in common. See the corresponding discussion in Glismann et al. (1987), Book III. As a matter of convenience, the term "the developing countries" will be used in the following without adding immediate qualifications. But the reader should keep in mind that this term in almost no case applies to the whole of this highly heterogeneous group of countries.

3. For example, as early as in the year 1965, the contracting parties of the GATT agreed upon the introduction of the amendment of a new PART IV on "Trade and Development", which extended the scope for exceptional treatment of developing countries already provided by Art. XVIII, and came into force in 1966.

4. As Haberler once remarked with regard to the IMF, it is precisely the lack of "democracy" in the Bretton Woods institutions that can be regarded as a prerequisite for their efficient functioning. Any "reforms" that would make the IMF "democratic" and "universal" and its support "automatic" would make it inefficient and ineffective and would lead to its eventual demise as a useful instrument of world economic development. It should not be turned into a satellite or replica of the United Nations". Quote from Meenhaeghe (1985), p. 23.

5. The reasons for the non-functioning of. commodity agreements seem be inherent to the construction of such agreements, usually intended to raise commodity prices. The fixing of a price above the level compatible 'with longer-run market clearance can generally be expected to be to be unsustainable (Baron et al., 1977). Mere producer cartels have generally not had more success. The temporary achievements of the Oil Producing and Exporting Countries (OPEC) in this respect have been but a transitory exemption from the general pattern of failure.

6. The relevance of normative judgements about the functioning of the institutional framework (about economic processes as such rather than only about economic outcomes) is particularly stressed by representatives of the so-called "contractarian political economy". See Buchanan (1988).

7. Further, decision-makers have always to reckon the possibility that such an advice may be mistaken in the sense that the recommended means may not be conducive to achieve the aspired results (e.g. because the premises chosen were not appropriate), irrespectively of the nature of these results which in itself is a matter of value judgement.

8. Just to mention two important possibilities for inroads of value judgements into a per se positive analysis: First, there is the methodological need of explaining much by little (Milton Friedman) in constructing theories or models. The scholar has to choose a starting point (the premises) somewhere, and to take for granted what is lying beyond. And he has to make strong simplifications in his theory in comparison to the real world. Second, the scholar views the world as it is perceived by his perception apparatus, to use a term from evolution theory in biology. This means that his personal values (ethical, political, methodological, etc.) will influence in one way or another his selection of problems to work on, and the ways and means how to broach them.

9. To the history of this debate in Germany see Aldrup (1980), and Adorno et al. (1969).

10. Here the qualification seems in place that the possibility of developing countries deliberately pursuing an autarcky strategy is not taken into consideration.

11. This is of course not to say that welfare economics is not a useful tool in analyzing the effects of international trade. In most cases, the direction of welfare implications for individuals or groups (e.g. industries) is not ambiguous. It is only the comparison of gains or losses in quantitative terms across individuals or groups that requires value-judgement premises. Common sense would further suggest that simple counting in money terms of gains and losses can at least serve as pragmatic approach to prepare the ground for a rational discussion about the value judgements involved.

12. For detailed reviews upon the international law embedded in the GATT system and its evolution over time, including comprehensive bibliographies, see Meerhaeghe (1985) and McGovern (1986). To the weaknesses with

regard to economic effectivity and efficiency that are inherent to the system, see also Glismann et al. (1986):

13. The economic agents in international trade are generally supposed to be private firms. State trading enterprises are treated as an exceptional case in Art. XVII.

14. It has been-argued that efficient dispute settlement would require to set up an International Court of Justice for trade policy matters. This would be effective and efficient only if. the contracting parties agree upon *a priori* that they would accept the ruling of the Court without qualification.

15. It can be argued that if the conditions for establishing an international export cartel for a particular commodity are not warranted, the conditions for establishing an international commodity agreement that includes importing countries, are not warranted either. If the cartel is effective an international commodity agreement would be redundant.

16. Harry G. Johnson (1975, pp. 289 and 298). According to this author (p. 292), classical and neoclassical theory - while accepting the theoretical possibilities - developed three counter-arguments against trade protection for the promotion of infant industries:

    i) Infant-industry possibilities may well exist in established export industries as well as in import-competing industries.

    ii) A subsidy to infant industries be preferable to trade protection because its costs were highly visible and such subject to political review and decision.

    iii) Trade protection for infant industry reasons were, once installed, in many cases never removed again. The governments often failed to implement the transition from import substitution towards export orientation: Infant industry protection thus because a source of continuing economic inefficiency.

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Discussion

M.A. Mannan

It was an excellent paper written in a conventional theoretical framework of the market economics. I do not have any basic quarrel with the theoretical formulation and being a student of international trade, I think it is very stimulating.

Having said this, I would like to make some observations. Foreign aid is a rich man's money given by the rich to the poor country.. That is why Islamic economic dimensions can be injected because there are three basic functions which each society should form, that is, consumption, production and distribution. These three basic economic functions in respect of any society, whether it is socialistic, capitalistic or Islamic, have to be performed. In a broad historical overview, the capitalistic system, is consumption oriented. In Islam, it is a distributive concern. It will influence production and consumption priority. This is a very crucial dimension in Islamic economics i.e. the distributive concern. Therefore, for this particular paper a number of important Islamic economic hypothesis can be developed.

In our view whatever resources belongs on earth belongs to Allah and all the resources of this earth are a trust to mankind. Western Economists have come to understand that there are certain areas which are common heritage of mankind. So this is the zone of cooperation; here we can work to widen our understanding and close hypotheses can be developed.

Regarding value judgment, there is a difference between value judgment and values itself. There are Islamic values. There are western values, values of the communists society, values of the traditional societies etc. I agree that some sort of value judgment is present in all economic premises. Even if we read economists like Cassel we find they have come to the understanding that some sort of value judgment is needed. In terms of this, you perceive economic problem according to the Western values, values brought within the framework of Christianity and Judaism. Our perception of economic problems comes in terms of Islamic values. From where you brought these Islamic values? The answer is that some of the values are given by Allah in the form of Quran. So, there is a place for Islamic Economics. Therefore, though you have mentioned the existence of values, I think you should make a distinction here between the value judgment and value itself. You have mentioned about the theoretical subsidies, welfare of loans and welfare gains. It can further be examined in terms of Islamic values. For example, you have mentioned on page 21(i) Raising export earning of developing countries (ii)

Stabilizing commodity prices, if necessary, on an appropriate level (iii) Improving the access to industrial countries' markets for manufactured exports of developing countries.

You are exporting or importing commodities. The market economists will question the composition of the demand. For whose purpose you are importing? Who will be the beneficiaries? If it is meant for monopoly of business, if it leads to the concentration of wealth to few hands and to the neglect of the vast majority? Will it not violate some of the principal of Islamic *Shari'ah. So* this is a secular statement but Islamic values can enter into and can be judged in the light of Islamic values. For example, monopoly, generally speaking, is hot permissible in Islam. If you are given a choice between the production of a car and a bus, both are the vehicles of transport. In the context of, say, Bangladesh, the bus production will be a desirable priority compared to the car production despite the fact the car production will have better economic returns.

About the normative and positive economics, you will see that even in Islamic Economics, there is a debate whether Islamic Economic is normative or positive. As far as I am concerned I reject both these positions because we do not like to divide Islamic Economics in normative and positive. It is integrated. It is just like whiteness of milk i.e. if you .mix chocolate into the milk, it will become chocolate milk or if you add another color, it will change into that color. So the whiteness and milk are inseparable. Therefore, we would not like to make distinction between normative and positive economics and this is attuned to secular economics. Thus in the Western economics this is well established and a lot of controversy is going on. Economists are reverting back to the idea that in all economic analysis the normative values are there. In fact value judgment, in one form or the other will be there in policy decision in any way. In economic theory percept, they do not like to introduce the values. They say it is a pure science and it should be value free. We do not accept it as Muslim Economists. We see that even the theories cannot be value free. Even the law of diminishing return, law of diminishing utility and even some of the universal laws of economics can be value loaded.

Ernst-Jurgen Horn

During the 60s of this century, a big slogan was that there is no value-free science. That was the slogan of that ,time. On the other hand it is again science that we think the same terrain is not in conflict with the Islamic point of view or from Christian point of view but from the science point of view and our responsibility towards mankind is as a scientist. This might be Islamic. This might be Christian as well.

An important aspect of international economics has failed to figure in the discussion and that is mobility of factors i.e. movement of labor. It so happens that 3 billion or 4 billion people living in the Third World are left out of free mobility of labor. The immigration laws work to the disadvantage of the poor billions of the Third World. For example, if you open the United States of America to the Indian labor, many people will benefit. in the long run. Vijay Joshi in one of his books says "You want poor, small, ill-governed African and Asian countries to open their gates to multi-nationals and foreign capital, foreign goods but you close your doors to Asian labor"! Is it not more rational to adopt liberal immigration policies? Is it not more economical in the long run as everybody will benefit from the cheap labor? American consumers will get cheaper products and some income will flow back from where this labor will come. So I want *your* response to this neglect of one dimension of international economics.

Regarding market failure, it is true that Government failure is no less pernicious than market failure. But we should not forget that market failure in advanced countries, like Federal Republic of Germany and the same in a poor Third World country is different in meaning. Take a simple ingredient, "information" as an example. The ordinary consumer and the ordinary producer in a Western advanced country has lot of information available through the media and there are channels from where you can get the information. The poor countries have no such channels of information. The consumer is ignorant, the producer is ignorant. There is no source from where they can get the information because it has not been collected or organized. Market failure in these circumstances would have an entirely different impact from what it will be in the Western countries. That is why despite awareness of such a thing as government failure, some poor countries have no option. They can mobilize all their resources and put some well informed and well educated people to manage their economies from the government houses in the expectation that their failure will be less pernicious than market failure. This is our case. For example, take Burma where government failure has played havoc with the people. For 20 years from now, Burma was being presented as a case of possible self-sustained growth within the next 10 to 15 years and we have the debacle. Romania, again is a case of government failure in a differing context. However, despite these sad experiences, if you discuss it at a theoretical level, there is a case. If you have a bad market and a bad government, perhaps it is easier to improve the government in the short run than to improve the market.

Lastly, the controversy about terms of trade. There is a controversy I am aware. In my paper I have mentioned some recent studies. Especially I mentioned a paper which appeared in the Third World Economic Review of January 1988 by Enzo Grilli an Maw Chun Yang in their article "Primary Commodity Prices and the Terms of Trade of Developing Countries". According to them, statistics for the whole of the 20 century, beginning from 1901 till 1980 or so have shown that the terms of trade for primary commodities have been declining at an average rate of 0.6% per year. Also a study by John Spraos on "Inequalising Trade: A Study of Traditional North/South Specialization in the Context of Terms of Trade Concepts", published from Oxford 1983 supports the Third World stance that the terms of trade for primary producers have been deteriorating. Even Baghwati has given examples of Kenya and some other countries where even improved productivity in the production of an agricultural commodity like coffee, 'would work to the disadvantage of the producing country because of the trend of the terms of the trade. So I think we cannot dismiss the whole issue by saying that it is controversial. More and more evidences are being cited in favor of those who argue that the terms of trade have been deteriorating. Anyway, the very fact that the perceptions is universal among the third world economists, with a few exceptions, and most of them argue in favor of some sort of commercial policy, some intervention by government in the area of trade with a view to accelerate development, does deserve more analysis and cannot be dismissed only by theoretical analysis. You have to take into consideration some of the evidences, some of the empirical facts they have presented. Unfortunately, I fail to agree with you so far as the general approach of your paper is concerned. I do not think we can buy it from the third world angle or from the Islamic countries angle.

We may not be able to state our reasons as elegantly as you can do, but even if we fail to do so,. I-refuse to concede the argument to'you. Let me refer to you something entirely unrelated which may communicate my point to you. There is a study "Gift, relationship dealing with blood donations". It is old but one of the points it makes is that if we commercialize blood which has to be collected for the patients and if you commercialize the hospital patient relationship, there may not any economic arguments against such a commercialization but the end product is horrible. We may not have the reasons to give to you the type of reasons which are current but the whole thing leads to a scenario which is humanly intolerable. I will say something similar in response to your paper.

Khurshid Ahmad

Thank you for the thought-provoking and challenging nature of your paper. I would have liked to respond in greater detail but because of time constraint I will restrict myself to two or three points. Firstly, basically it is a framework of mainstream economics of the capitalistic order where we are trying to move from the ideal to international market mechanism. The realities of the international economic situation do not really fit into this framework. What has happened to analysis of economics in the context of the failure of competitive model within the capitalistic system. I think a similar effort has to be made to understand the realities of the international economic situation. It cannot just fit into the model of perfect market economy. Secondly, while we are discussing the normative aspects, I find conspicuous by its absence any reference to the political dimension of international trade, international trade policy and international trade theory. I think the work done by Gunar Myrdal on the political issues and international economic theory deserves to be considered and there is a lot which he has presented and which has great meat in it.

Similarly, relationship of values to economics. At one level you have dealt with that very ably but .there is another level and that is what we presume to be positive economics. If we go deeper, we will find that it is based upon a particular concept of man, of his motivation. It is related to a particular concept of law and state. It is based upon a particular concepts of justice. Justice not as a norm but as a process. Now all these processes are assumptions on which the so called positive theory is based. We have to go deeper and bring them to our analysis to really put light on all that we are presenting in the form of economics.

My next point relates to the question of so called democracy in the international vein. Now the parallel between the United Nations and the IMF and the World Bank and why principles of the United Nations cannot be applied to international monetary institutions. I feel it deserves to be examined more objectively and perhaps by giving some weighting to the feelings and thinking of the Third World countries, where the majority of the humanity lives. By merely saying that the two represent different realms, would not solve the issue. One thought that is disturbing the economists, the politicians and the statesmen in the Third World is that unless something is done to influence the international decision-making process it would not be possible to move from the present order to an equitable international order.

Aziz Alkazaz

We have concentrated too much on value judgment and accusation to the scientists especially when he makes value judgment not in an open way. The paper is really a valuable contribution by our colleague as he has worked out the normative foundation and implications of the existing system. But is that really enough? It is not enough. I think the Western economic science concentrated itself too long and too much in the service of the practice-oriented interest of the economy. The questions it dealt with were only oriented towards interests of the existing routes from which financing came, the real question about trade, about international relationship etc. So it was no accident that the pseudo science was really put aside for long time and we see the problems of the destruction of the 'environment or even after the consciousness has become somewhat stronger in relation to old values: We see that the scientists who deal with morality. Also we see a group of scientists here dealing with the Third World problems are, in reality, a small group and it is a common phenomenon that big personalities in the economic science do deal with Third World Problems only when they are 60 or ,65 years of age and they want to go on pension, then they get themselves involved into the Third World problems. There is another big failure of the economic science here. If they legitimize interest by explaining things, using value judgement whether open or not, for example non-adherence to the rules of game by the actors in the industrialized countries. For example, take the free trade theory. When the oil market change in favor of producers, the oil price increase whether too much or not much, enough or not enough. They increase the terms of trade: We have 'seen a campaign against it, may be also to legitimize them even by the use of force' to change the relationship. So I think we need more engagements from Western scientists in the field of normative economics not in the traditional sense of the word but a new quality, not leaving the. role alone to Catholic Church playing a small role in these development policies, a role which can be ignored when they need to do so. I think this is a big room which has to be filled up by the Scientists.

Monzer Kahf

'My first point relates to the use of-the term mainstream economics which was used by-the writer several times. I think this use should be modified a little bit to that of "Mainstream Western Approach to' Economics". It would be more clear to look at it that way. so that we can leave the room open for another approach; an alternate approach to. economics.

The second point is that I tried to look into this paper in terms of principles for international economic relations. When it does the humanistic concept, the concept of the whole humanity stands into the paper especially with reference to the historical perspective-of the economic relations between the north and the south throughout the last two centuries; the morality of transaction and economic relations also in terms of the failure of the market economy introducing certain necessary goods at marketable values within one country as compared to a clear possible failure on the international level between the haves and have-nots. The point that brings this issue is that how much do we want a repetition or a condition or a growth of the practice-of dumping commercial wastes which could be justified economically. Has it been taken.

On the movement of labor, I fully agree with the issue and how would it change the world of today from economic point of view if we do not have this politically imposed limitations on labor.

CHAPTER III

THE NEW INTERNATIONAL ECONOMIC ORDER : SOME REFLECTIONS FROM AN ISLAMIC PERSPECTIVE

Khurshid Ahmad*

[This paper deals with the need for a new international economic order and provides a few proposals from the Islamic point of view. It emphasises the failure of the present pattern of international economic relations between the North and the South, which is dominated by the industrially developed countries. The inability of this pattern of relations to respond to the aspirations of newly independent nations and the collapses of the debt-based international economic relations, especially in the Eighties. The paper suggests that a new international economic order has to be based on a clear answer to four fundamental issues namely, the concept of nature and place of men in universe, the concept of property and ownership, the concept of justice and mechanism for its realization, and the role of Government.

Prof. Khurshid Ahmad states that a basic and fundamental axiom of Islamic system is the oneness of human race, out of which the principles of fraternity, equality and justice are derived. He also emphasizes that Islam is based on the principle of universality of the Divine Law which permits no discrimination between human beings regardless of race, religion, origin, geographical location, etc. He also argues that a new international economic order from an Islamic point of view needs to be based on a concept of redistribution of wealth and income derived from the concept of Zakah, whereby the Divine Law stipulates an unequivocal right to the poor in the wealth of rich. Cooperation between capital and labour should be based on profit and loss sharing instead of being debt-based. In the Appendix he elaborated that salient features of Islam as a total system of life with value oriented approach and universal message. - (Editors)]

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There was a time when the talk of new international economic order produced a long train of hopes and expectations. Then hopes began to be engulfed by disappointments and frustrations, yet they co-existed. In November 1977, the present writer, included himself among those whom the debate on the New International Economic Order (NIEO) left 'with two rather conflicting feelings: hope and disappointment'.[(1)] The last eleven years have multiplied the disappointment and have almost strangulated the flickers of hope that pointed towards the inauguration of a new era. Dr. Mahathir Muhammad, the Prime Minister of Malaysia, echoes the current feelings of a large number of scholars and statesmen when he says: 'But we have to acknowledge now that the New International Economic Order was a non-starter. The developed countries turned it down flat'.[(2))]

While the need for thoroughly reforming 'and ' restructuring the international economic order remains as pressing as ever, if not more, the possibilities and prospects of such a change have become more bleak. There is an almost universal realization that the' debate 'to date has led to more frustration than fulfilment' and this has considerably soured international economic relations between rich and poor countries .... The entire issue has' become a veritable Pandora's' box, and predictably so... the North by and large rapidly regretted the entire affair and hoped that it would quietly disappear'.**[(3)]** South is 'being increasingly criticized for using' it as 'a convenient scapegoat for their own economic problems which; all too often, had 'been brought about' by unsuitable domestic policies rather than by the inequities of the international economic order'.[(4)] The South, on the other hand, has begun to suspect the very bona fides of the domestic policy failure thesis. Shrideth Ramphal, the Secretary General of the Commonwealth,. warns that: ..

> 'Under the guise of "policy dialogue" with the South, there is now evolving - without (it seems) much awareness by the South - quite pervasive control over policy processes of those developing countries that feel obliged to turn to Northern-controlled financial agencies for even limited amounts of assistance. Not only the world moved away from international economic co-operation; it is moving towards a new era of economic domination and dependency'.**[(5)]**

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1. Khurshid Ahmad, 'A Muslim Response' in World Faiths and the New World Order, ed. by Joseph Gremillion and William Ryan. Washington: The International Peace Colloquium, 1978, p. 173.
2. Mahathir Muhammad, 'A Keynote Address to the South' in Crisis and Response: The Challenge to South-South Economic Co-operation, edited by Noordin Sopiee, et. al. Malaysia: Institute of Strategic and International Studies, 1988, p.5.
3. Michael Beenstock, The World Economy in Transition. London: George Allen & Unwin, 1984, pp. 213-215.
4. Ibid.,p. 215.
5. Shrideth S. Ramphal, 'For the South, A Time to Think', in Crisis and Response, op. cit., p. 13.

I hope I am not too pessimistic when I suggest that this is the intellectual climate in which we are discussing rather painfully the question of the new international economic order today.

The Muslim world constitutes a significant part of the Third World. There are forty-five independent Muslim states with over a billion people, of whom around 700 million are are Muslim. Another 350 million Muslims live in other parts of the world. The bulk of the Muslim world straddles from the shores of the Atlantic in West Africa, through Mediterranean and Caspian seas to the heart of Central Asia and the offshores of Arabian Sea and the Indian Ocean. This geographically contagious Muslim mainland contains most of the strategic points of Africa and Asia and many cradle of some of the greatest civilizations of history. There is a second cluster of countries in South and South-East Asia from Bangladesh to the farthest islands of Indonesia. The Muslim World is not merely a geo-political and economic entity, it also represents a historical , ideological and cultural identity.

Most of the countries that go to make up the present-day Muslim world have emerged from a long night of colonial rule. Their politico-economic infrastructure was cast into its present moulds during the colonial period. Despite attaining political freedom, they are still endeavouring to seek decolonialization in the fields of economy, technology, culture and societal relationships.

Muslim people are, by and large, as dissatisfied with the prevailing international economic order as the people of the Third World in general. Built upon centre-periphery relationship, this system has created international hegemonies and resulted in an unjust and exploitative structure of world production, consumption, trade and finance. The most critical issue, however, relate to the process of decision-making in the international field. The Third World countries feel that they have been robbed of sovereignty on thier own resources and of economic self-determination. International institutions where Third World have some say lack political and economic muscle. On the other hand, institutions that are important, are controlled and manipulated by the more powerful nations. The greatest achievement of the rise and consolidation of democracy in the West lies in involving the people in decision-making and ensuring them their political and economic rights. What has been achieved at the level of the nation-states, is yet to be achieved at the level of the community of nations. I would, therefore, submit that the most important issue facing the world today is revision of the international decision-making mechanism. Other changes would follow more effectively if this central question is resolved. Even though the demands for a New International Economic Order (NIEO) are coached in economic terms, its scope is much wider. The political underpinning of NIEO are quite manifest. It has unfortunately become a battleground for different 'worlds'. Instead of eliminating international hegemonies, it has become an effort to replace old hegemonies with new ones.

The web of power is becoming more and more tangled. In a hegemonistic world 'rule of law', 'respect for rights' and justice in relations' remain distant hopes. Unless the world order moves towards a non-hegemonistic relationship these ideals would remain unrealized. NIEO is not merely an economic issue. The political dimension is of critical importance.

While the political and the economic aspects are of crucial significance, the real questions involved are more fundamental - questions ordinarily shirked by the economists as non-relevant. Problems of the international economic order cannot be understood, what to say of their resolution, without examining four fundamental issues which determine the character and the ethos of any system. . These issues are:

a) Its concept of the nature and place of man in the universe and consequently the objectives and mission that inspire man and woman to effort.

b) Its concept of property - the right to, own, acquire, use and dispose of property and the principles governing property relationships.

c) Concept of justice and the mechanism for its realization.

d) Role of Government, including the forms and limits of power.

Economists ignore these questions, by conveniently brushing them beneath the carpet of assumptions with which they are not directly concerned. They try to pick up the thread from the middle. But this is not going to take us very far..

Ignoring the moral dimension explicitly has added to the confusion and made resolution of most of the problems more and more elusive: From an Islamic perspective these. questions have to be faced squarely. It is only in the context of an explicit formulation about these questions that the political and economic .issues of our times can be resolved. Islam's emphasis on an inextricable relationship between the moral; the philosophic, the social, the political and the economic aspects of human life is its most unique contribution to the understanding and the resolution of the crisis of our times.

Before expressing my point of view on some of the elements of NIEO, I would like to emphasize that Islam is a universal religion; It believes in-the unity and equality of mankind. It does not endorse any kind of racial, regional, linguistic or economic discrimination. Prophet Muhammad (Peace Be Upon Him) declared:

'A white has no superiority over a black. An Arab has no superiority over a non-Arab'. [Reported by Ahmad, V.5, p.411]

Islam also reminds that this universe is created by God and given to humankind as a common trust for the fulfilment of its needs. Thus Islam does not like to see First, Second or Third Worlds. It stands for a single fraternity of humankind. That a world may comprise of several sovereign states is not in question, but all inter-state affairs should be governed by principles of justice and equality. That is why the most important element of reform in the World Order is the structure of international decision-making. All other aspects are in fact subservient to it. The present structure of international decision making is by and large based on relative economic and military power. Any effort at reform would be futile until this 'Might is Right' principle is replaced by the principles of justice and equality among nations.

As for the various elements of proposed New Order, practically every one of them - be it the Generalized System of Preference (GSP), the integrated commodity programme or increased foreign aid - depend primarily, if not exclusively, on the economic altruism of the industrial countries. Such policies would continue and intensify less developed countries' dependence on the industrial countries, while one of the goals of the new economic order is to reduce this dependence. How to resolve this dilemma? The answer lies in re-examining the whole strategy of development as it has been expounded and practiced during the last four decades. Conscious and not so conscious efforts at imitating the Western model of growth without examining in depth its relevance to the peculiar conditions obtaining in a country and the unique characteristics of the social system in whose lap all change is engineered.

The aid-debt syndrome is yet another challenge to be examined from some fresh perspective. Despite all lip-service to the moral foundations of aid, the fact remains that the Third World countries are today indebted to the developed world to the tune of $4 1.2 trillion. At the national level, problems of redistribution of wealth and income, of social security and subsistence and welfare sharing have been faced and their solution worked out within a national fiscal framework. Parallel developments at the international level have not seen the light of the day. AT this stage, may I invite you to study the Islamic System of *Zakah* whereby the poor are entitled to a certain share in the wealth of the rich as a matter of right. The Holy Qur'an declares:

'In their wealth there is a right of the poor and needy'. [51:19]

It is not a charity. It is a divinely ordained right of poor in the wealth of the rich. Of course, Islam encourages charitable spending to the maximum extent but that is beyond this compulsory transfer.

With regard to international loans, the Islamic System of Profit-Sharing holds a great promise. It is now being increasingly realized that the present debt crisis is due to interest financing. Interest as, a technique of financing gives rise to an inequitable sharing of risk and reward. All the risk is borne by the borrower while the lender is entitled to a fixed return irrespective of the real outcome of investment. Islam prohibits this mode of financing and replaces it with profit and loss sharing. This arrangement fulfils the needs of borrower while the lender gets back his capital plus/minus his share in profit or loss. The system, is productivity-based rather than solvency-based. In this way every loan-investment automatically creates means of its repayment.

The' issue of transfer of technology also deserves to be dealt with carefully.' The debate on this issue seems to imply as if there is only one kind of science and technology throughout the world which is presently possessed by the West and should be transferred to the less developed countries. This is not necessarily so. It should also be kept in view that often transfer of a technology implies transfer of a culture. Islam stands for a free flow of, knowledge but that does not mean blind transfer of Western technology. Distinction has to be made between a simple *transfer* of technology and *adaptation* of technology to local conditions and needs.

Innovation and not mere imitation is the key to development. And the problem has to be examined from the perspective of technical feasibility and cultural desirability.

The Muslim world does not stand for isolationism or autarky. Our vision of the future world is neither bi-polar nor tri-polar. We stand for the establishment of an economic order whose commitment to efficiency and growth does not lead to the neglect of the demands of justice and equity. The strength of a system is to be judged *by* its capacity to maximize human well-being. The Muslim world is an integral part of the world and would like to be closely related to the developed as much as the developing countries. Economic co-operation between Muslim countries would not be aimed at cutting the Muslim world from the rest, but to re-integrate it with it on a more just foundations. Reduction in dependence does not mean autarky and isolation. It would be a stepping stone to the creation of a world in which there is greater co-operation and inter-dependence. Establishment of a just economic order within the Muslim lands can also act as a stimuli to others to face the economic challenge with greater moral and social consciousness. This would lead to cross-fertilization of ideas and experiences.

It is therefore humbly suggested that the Muslim efforts to seek fresh solution for economic problems by recourse to their own moral and historical traditions may in fact go long way to enrich the totality of the human experience.

APPENDIX

A MUSLIM RESPONSE TO WORLD FAITH AND NEW WORLD ORDER*

For Ahmad, a Muslim and professional economist, changing the world economic order is too serious a matter to be left solely to economists and politicians. The initial mistake has been to separate economics from religion.

He finds Bellah's critique of modern Western ideology illuminating but tainted by the biases of the very ideology he is criticizing so forcefully. Bellah exaggerates the role of the religious charismatic leader, Ahmad contends, and fails to under-stand all the ramifications of religion as a "movement" for social change.

Ahmad then reviews the central themes and issues on the NIEO debate. He finds the facts not much in dispute, and the two chief contending analyses rooted alike in the overall sympathy-framework of their authors. Both analyses give merely partial explanations of the crisis which now pervades capitalism and socialism alike. For him the real failure has been in not asking the right questions, in not treating the universe as a moral order.

Faith communities must not be satisfied with such partial analyses nor with their proposed bargaining packages. Rather, they must call for a basic reorientation in the approach to social change. This approach must provide not merely for a new economic arrangement but also for having it take place within a value-oriented framework of accepted basic ideals, values and principles.

Ahmad concludes with a lengthy description of the meaning and message of Islam and how it proposes to establish a new world order. He explains how Islam is not only an integrated system of life which sees people as God's vicegerents here on earth working out their own destinies in harmony with His will. Islam is besides, in marked contrast with all contemporary ideologies and some religious systems, a movement for total social change with clear guidelines for socio-economic policy. It even provides some of the key institutions and organized social efforts that guarantee the implementation of its proposed policies under disciplined leadership.

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* This paper was presented by Prof. Khurshid Ahmad at a conference on World faiths and New World Orders which was held in Lisbon during 7-11 November 1977 and sponsored by The Inter-religious peace colloqium. Since it was circulated as an addendum to his paper presented at the Tubigen Seminar, it is being published here as an appendix. - Editors.

Ahmad admits that present day Muslim society falls far short of these Islamic standards. Nevertheless, such a model if implemented anywhere in the world would serve as a living example to all people of a new world order. Therefore, he believes that the future prospects for a new world order depend greatly on the social effort that the Islamic movement is presently trying to spearhead. Finally, Ahmad assures us that Islam's strategy for establishing such a world order is not sectarian or exclusive - it consists in inviting all people to take this path irrespective of their color, race, language, nationality, ethnic or historic origin.

I
Introduction

Although an economist by profession and training, I have no hesitation in suggesting that the problems involved in changing the world economic order are too serious and too complicated to be left solely to the economists or the politicians of our time. It augurs well that the religious leaders of four major faith-oriented communities are meeting here to deliberate upon the issues that confront humankind in the context of the contemporary international economic crisis.

My own interest in the subject is rooted in my two major roles, that of an economist and more important that of being a Muslim, a worker in the Islamic movement. Yet, these two roles do not drive my thoughts into conflicting directions; instead my ideas and aspirations,emanating from both these roles converge amicably. Separation between economics and religion has launched economics into chaotic waters on the one hand, and driven religion into isolation from life and its multifarious problems. Fresh efforts are needed to impregnate economic thinking with moral insights. the present symposium can make some contribution towards this challenging end.

I propose to present this paper in two parts. First, I will make a few observations on the subject of the main paper written by Professor Robert Bellah, outlining the relation between faith and the changing world economy. Secondly, I will present my own response, as a Muslim economist, to the overall problem of the . new international economic order.

II
Religion's Place and Role

Professor Bellah's paper is full of stimulating ideas and insights. His formulation of the problem is clear and incisive. That the changing world order could be a challenge to faith-oriented communities is acknowledged on all, hands, but what is not realized generally is that faith can be, and is, a challenge to the changing world order. It is idle to assume that religion is necessarily at the receiving end. This is somewhat typical of the West to always formulate the proposition in a way that would assign a secondary position to religion. It is fashionable to assume that religion must change to give way to the demands of economic and political change. Professor Bellah brings into sharp focus the other dimension, suggesting how faith could be looked upon as a challenge to the changing economic scene and be a positive factor influencing its future dynamics.

Professor Bellah's critique of modern Western ideology has especially interested me. ,His presentation is as thoughtful as it is sharp and trenchant. He has candidly shown the limitations and biases of the Western approach. That helps one to some extent in having a clearer idea about how and why humankind has been plunged into its contemporary crisis. This part of his presentation is illuminating.

I have, however, strong reservations about some of his other observations, particularly the ones about the nature of religion and its role in the solution of human problems. I am afraid his approach remains very much tainted, .albeit unconsciously, by the biases of the Western ideology which he has so forcefully criticized.

The idea of the "mobilization of faith communities" for "direct action", of the "use" of religion "to solve problems of "religion going beyond the articulation and internalization of symbols by creating "new structures" are not necessarily repugnant and self-defeating, as he seems unfortunately to assume. His typology. of religion is very much attuned to the history of the religious tradition of the West. He has failed to comprehend all the ramifications of the movement type. model of religion. He gives an exaggerated importance to the idea of 'religiously charismatic leader' and too little to the social transformation and societal reconstruction that such as approach involves.

I feel strongly that the Islamic model does not conform to any of the three arch-types he has outlined. I will try to elucidate some aspects of the Islamic approach in the second part of my paper, and would like to submit that religion can be a factor of critical importance in our search for a new world order.

III

Islam and the New World Order

A. GROUNDS FOR HOPE AND DISAPPOINTMENT

A careful perusal of the current debate on the New International Economic Order leaves One with two rather conflicting feelings: hope and disappointment. The fact that some of the major incongruities and injustices that characterize relationships between individuals, institutions and nations in our times are no longer being accepted passively as a *fait accompli,* and the fact that the need for changing the present state of affairs is being voiced from all quarters and not merely by the aggrieved parties, give some cause for hope. Smug complacency over the status quo that has held the ground for so long has now begun to dissipate.

This in itself is a significant development, as it opens up new opportunities for review and reappraisal, for fresh thinking and for an examination of alternatives available to humankind, in its search for creative possibilities to rebuild and restructure society and its institutions. This gives rise to new hope, even though it be a tiny flicker. The worry, however, is that this little newborn flicker of light and hope is trembling in the face of confounding winds. The level at which the entire debate is taking place is, to put it frankly and bluntly, quite disappointing.

B. THEMES AND ISSUES IN THE NIEO DEBATE

It would be fair to suggest that the discussion on the New International Economic Order (NIEO) in almost all international forums, academic as well as political, is being undertaken at three levels - descriptive, analytic and prescriptive.

1. The Level of Description

At the level of description, the plight of the Third World is being brought into focus. There is an increasing acknowledgement of the revolting facts of poverty, misery and deprivation, of disease and illiteracy, of death and starvation, of underdevelopment and retardation of growth, of widening gaps in economic well-being and the mounting weight of international debts, of deteriorating terms of trade and depletion or mismanagement of natural resources, of apathy and misdevelopment.

The failure of the development effort made over the last three decades in the underdeveloped world, which contains two thirds of the human race, and the deterioration of relations between the developed and the underdeveloped worlds are being highlighted. The leaders of the Third World are becoming more and more vocal and assertive. Those who speak for the industrialized world are increasingly willing to acknowledge some of these realities, even though still haltingly and with reservations.

There is greater consciousness of the transfer of resources from the Third World to the developed world because of a number of built-in mechanisms in international trade which favour the industrialized world and limit the options open to the Third World. The prices of raw materials have been a very unstable factor, with the result that the relative value of the exports of the Third World has been going down, while that of their imports from the industrialized world has been increasing. Many an effort to stabilize the prices of raw materials has been frustrated because it has been regarded as being against the interests of the industrialized world.'

The first significant effort on the part of the Third World to gain control over the prices of their products has been the case of oil. This attempt to get an economic price of an essential source of energy has been treated as a declaration of war against the industrialized world. Utterly neglected has been the fact that the North has deliberately kept the price of oil much lower than its real economic price and has built its own economic prosperity by keeping this source of energy cheap.

The technological dependence of the Third World on the industrialized world, and the unsuitability of the technology of the North to the conditions of the Third World, is another major theme in the debate. In spite of some transfer of technology, it is claimed that the new technology is unable to act as an internalized agent of growth. Instead, it is producing new technological destabilization, without really meeting the technological dependence of the Third World on the North and as the prices of capital goods are escalating, this technological dependence is also producing financial dependence..

. The hope that foreign aid would act as the chief stimulant to development in the Third World countries has been dashed to pieces. In view of these failures, the Third World countries are asking for a new deal. In the new deal, they are demanding, among others, the following changes:

- A restructuring of the international institutions, particularly of the International Monetary Fund (IMF), the World Bank and the operative organs of the UN, particularly at the Security Council. The first major demand of these developing countries is the restructuring of the international institutions so that they may have a greater voice in economic and political decision making at the international level.

- Their second major demand is for an acknowledgement of national sovereignty over their own raw materials. This would mean that a country, where a certain raw material or source of energy is found, should have the right to own it, to price it and to benefit from it. Presently, these raw materials are either in the hands of multinational corporations, which are not fully under the control of the national governments, or their extraction, development and trade are so much under the influence of the developed countries that the latter are in a controlling position to manipulate prices and supplies. This puts these resources at the mercy of outside forces.

- Their third demand is for revision in the international division of labour. The present situation perpetuates the role of the Third World as producers of raw materials, while the industrialized world specializes in the production of secondary and tertiary goods. It also leads to the type of economic development the Third World is expected to have, with its consequences for the relative shares of economic power allotted to different parts of the world.

- Freedom of movement for their goods, particularly for their manufactured products, but also for agricultural and dairy produce, into West European and American markets is another demand of the underdeveloped world. They insist on access to these markets to accelerate their own economic development while seeking some permanent mechanism to stabilize prices.

- Finally, because the financing of development is becoming more and more difficult, Third World countries are now suggesting some form of compulsory transfer of resources from rich to poor countries through international institutions, as against bilateral aid. Due to the deterioration of the terms of trade, most of the underdeveloped countries are facing balance of payment crises, and foreign aid has failed to provide any real relief.

First of all, "foreign aid" is a misnomer because it is not a grant or subsidy. Almost 90 percent of it is made up of tied loans, extended on commercial terms, and subject to a number of restrictions. The result is that the net benefit is often in favour of the giver more than receiver. The volume of aid is also far below the needs of the developing world. Total foreign aid from the developed world is substantially below the targets set by the UN for the 1960's and 1970's, with the result that the voluntary transfer of resources from the rich to the poor is not taking place. Then too, the burden of external debt has risen excessively high, and quite a significant part of the export earnings of most of the Third World countries is eaten up in service charges and debt repatriation.

This is why the Third World is now suggesting some form of compulsory transfer of resources. There is a general feeling in the Third World that the time has come when, instead of negotiating about each one of their specific problems, they must try to enter into a new deal with the North to restructure economic relations worldwide. And so a number of possible bargaining packages and strategies have been developed to help bring about a new economic order.

2. The Levels of Analysis and Prescription

At the level of analysis and consequent prescription, there is wide divergence of opinion. Even when some of the facts about international economic disorder are not in dispute, there, is great controversy about the factors responsible for them.

Most .economists and statesmen from the rich North emphasize the fact of greater interdependence between different parts of the world and the relative obsolescence of the idea of national sovereignty and autarchy. They throw light on the benefits that the Third World has derived from its contacts with the industrialized world and the continuing help and assistance the North is extending to it. They suggest that natural economic factors are not being allowed to play effectively their proper role and thus' yield their final benefits.

They also suggest that the internal organization of society and the economy in he Third World countries leaves much to be desired, with the result that it obstructs efforts towards economic development. According to this thesis the prosperity of the two is interdependent. The Third World can prosper only if the industrialized world prospers. Anything that damages the North and its economic prospects is bound to adversely affect the prospects of the Third World.(1)

Third World theorists too have now developed a framework for the analysis of the relationship of their countries with the North. As against the North's concept of a benevolent world economy, in which their growth and prosperity results in spreading wealth to the underdeveloped world, the general thesis of these writers is that the industrialized countries constitute the powerful central core of the world economy, while the entire Third World is its weak periphery, dependent upon this center which sucks in resources from the periphery. The result is a hierarchical and exploitative world order with built-in arrangements for the transfer of resources from the underdeveloped to the developed world. Development and underdevelopment are not two autonomous realities, but two aspects of the same process. This state of affairs has its roots in the imperialist mode of production, established during the colonial period and it continues unabated today, although some of its forms and instruments of control have changed. The multinational corporation now figures very prominently as the midwife of this neo-imperialism.

These theorists argue that the Third World cannot reasonably hope to achieve self-sustaining development without breaking away from this system of dependence and bondage.(2) Marxian analysts try to develop this thesis in the context of their own thinking on the nature and dynamics of international capitalism and of imperialism and neoimperialism, while other analysts lay greater emphasis on the elements and structures of dependence without committing themselves definitely to the nature of the system.

The prescription each group offers for the solution of the contemporary international economic crisis emerges largely from their analysis of its causes. Most Northern economists believe that solutions to the problems raised are possible within the overall framework of the present order through more efficient allocation and use of resources, and by transfer payments within the system. The Third World group, on the other hand, insists that structural changes are an essential precondition for any real change in the situation.

C. THE REAL CHALLENGE OF OUR TIMES

This lengthy digression recapitulates the mood and the themes of the debate on the new international economic order. The facts of the situation are not very much in dispute. The 'interdependence' thesis and the 'dependentia' theorem both contain elements of truth, but none of them goes far enough to explain the whole truth. They remain partial in their explanation of the present crisis. Each explanation is very much rooted in the overall sympathy-framework to which the analyst happens to belong, psychologically, culturally and economically.

My contention, on the other hand, is that the crisis is not confined to economic relations and institutions. It is rather an all-pervading crisis, and as such, the real causes will have to be traced in the context of the crisis of civilization and not merely of the economic order. It is too partisan and consequently too unrealistic to assume that the disease is specific to the context of capitalism.

The basic problems that confront us today are very similar, whether under capitalism or socialism. In fact, both these systems are products of the same culture system, Western civilization. Capitalism and socialism are both equally exploitative and unjust. The establishment of a just and humane order for the moral well being of people is snot their primary concern. They deal with different blueprints of mechanistic structures of society. Their real failure has not been their inability to answer correctly some basic questions but their inability to ask the right questions. They do not treat the universe as a moral order. They regard men and women as self-sufficient, and regard material and economic progress as their real objective. They cannot offer as ultimate goals anything higher than material privileges: economic wealth, political power, military strength, international influences. Conflict of interests is built into this concept of life, and is bound to result in a crisis of values.

Because Joseph A. Camilleri, a perceptive analyst of contemporary history, describes this crisis of our times brilliantly, I quote him here at length:

> "The contemporary human crisis is so profound and pervasive that the very attempt to analyze it - let alone resolve it - seems to defy the power of human reason and imagination. The battle for survival is currently being waged by millions of men whose precarious existence is one of poverty, squalor and even hunger. Man's predicament impinges on the future of entire nations that are threatened by external attack or internal disintegration. It dominates the vast network of international relations so delicately poised on the dangerous and ultimately unstable 'balance of terror'...."

Traditional conceptions of time, space and movement have been overthrown by the technological revolution and the shift to an exploitative, power-centered culture. The ensuring social and psychological discontinuity and moral vacuum have produced a severe crisis of conscience and a large-scale flight from reality...

The crisis which confronts twentieth' century man is truly global, not simply by virtue of countless men and women, but in the more far-reaching sense that it permeates and vitiates the whole fabric of human relations and human institutions, and is now distorting man's entire relationship with the natural order.... No human community, no individual, no corner of the globe, however remote or isolated, however powerful or well endowed, can now escape from the disorder which affects the entire planet.... Perhaps we can best describe the global. crisis in terms of a fundamental disequilibrium which severely limits and may ultimately destroy man's capacity for biological and cultural adaptation to his environment.

Among the most common forms of pathological behaviour in modern industrial society, one would include the preoccupation with having and acquiring, rather than with being or becoming; the obsession with the power to dominate rather than liberate; the profound sense of alienation from rather than participation in the wider social reality;-the attitude towards work and leisure as means of killing time rather than creatively living in time, the predisposition to an in-group rather than an out-group psychology which discriminates on the basis of sex, race, creed or nationality; the tendency to resolve conflicts through the use or threat of force.... What distinguishes the super-industrial system - and the global spread of its empire - is the high degree with which social pathology has been institutionalized through the pyramidal stratification of wealth, power and know-ledge, but above all through the growing monopoly of industrial production over the satisfaction of human wants.... The institutional integration of pathological behaviour has now reached such proportions that it is not merely the quality but the very survival of human life which is at risk.... If this is an accurate diagnosis of the serious and deteriorating condition of our civilization, then no piecemeal, provisional, or parochial remedy is likely to prove efficacious. It would appear that in order to sustain the organic evolution of the human species it will be necessary to develop perspectives and responses that are both radical and global in inspiration".[3]

D. A NEW WORLD ORDER - NOT JUST NIEO

In the face of this real challenge to humankind today, all men and women of faith must state with all the force at their command that the real issue is not simply one of a new international economic order but of a new world order, based on a new concept of the human person and a different vision of society and of the destiny of the human community. Any effort at reform under the inspiration of the world faiths in general and of Islam in particular must start by correcting this perspective for understanding the human predicament.

The real need is not to seek concessions here and there to bring about some changes in the superstructures. It is rather to reexamine the foundations on which the entire structure of society and the economy is built and the ideals which the culture aspires to achieve. The crisis in economic and political relations is the natural outcome of those ideals and the structures which have been built to realize them. Islam, therefore, suggests that it is only through inviting humankind towards a new vision of man and society that its house can be set in order. This calls for a basic change in our approach. This change of approach must contain the following elements:

1. More than a New Economic Arrangement

The real problem is more basic and covers a much wider area than that of mere economic crisis. As such the economic crisis deserves to be examined in the wider context of the overall human crisis - of the crisis of civilization. Our objective should be to strive for the establishment of a just and humane world order and not merely to create a new economic arrangement. This cannot be done in isolation from the totality of the human situation.

2. A Value-Oriented or Moral Approach

Economic analysis provides valuable insights but it is idle to assume that even economic problems can be solved merely by resort to the tools of economic analysis and policy. People's efforts to solve economic problems by isolating the economic from the total matrix of the moral are collapsing in futility. Economic science is moving deeper and deeper into the throes of a crisis. For it crisis in a science is symbolized by its continued inability to meet the challenges that confront it, then few would disagree that economics is in serious trouble. - -

The phenix-like rise of macroeconomics from the charred debris of the crash of the 1930's generated a new confidence and valor among economists. A solution to almost every problem seemed within sight. All looked green in the valley of economics. This confidence has proved false and short-lived. Not only the old problems have remained unsolved; new ones have emerged with threatening overtones. Mass poverty; frustrated take-offs in development; increasing disparities at regional, national and international levels; coexistence of hunger and affluence; irrational use of non-renewable resources; incongruity between technology and developmental needs; unsuitability of production and consumption processes to environmental needs; exploitation of the poor and the afflicted by the rich and powerful; inflation and stagflation; structural deformities in relations between developed and developing countries; all of these and many more problems fail to be tackled within the framework developed by post-Keynsian economics. This is being realized even by those economists who had earlier thought that their sophisticated economic models could now deliver the goods.

'Nobel Laureate, Paul Samuelson, for example, of the Massachusetts Institute of Technology (MIT) laments the disarray into which economic theory has fallen. He warns "there are no signs that we're converging towards a philosopher's stone that will cause all the pieces to fall neatly into place." Professor Otto Ecksteinof Harvard says, "We are always one inflation too late in specifying the exact form of the price-forecasting equation". And Robert Heilbroner goes a step further when he says, "Economists are beginning to realize that they have built a rather elaborate edifice on rather unsubstantial narrow foundations."

The predicament of economics has been searchingly examined *by* Kurt Dopfer in his "Economics in the Future: Towards a New Paradigm".(4) The near consensus that emerges is that what is needed to salvage "the duck of economics" from the "tangled weed" in which it is stuck at the bottom of a rubbish-ridden pool to use Veblen's analogy - is not just some new interpretation of this or that economic theory or some changes within the current paradigm of economics. There is, rather, need to change the paradigm itself and to move towards a new paradigm under which economic problems can be approached not as economic problems in isolation but in the context of an entire social system and as part of the overall moral problem.(5) What is needed is a widening of our approach from merely an isolated economic approach to a moral approach within which the technical aspects of the economic. approach are fully assimilated.

Our approach should be value-oriented. In economics, as in any branch of human activity, there is an area which deals with technological relationships. But such technological relationships per se are not the be - all and end - all of a social discipline. Technological relationships are important and they should be decided according to their own rules. But technological decisions are made in the context of value relations. Our job is to weld these two areas together, to make our values explicit and to assign to them the role of an effective guide. It is only through a thorough understanding of the social ideals and values of religion and of a realistic assessment of one's socioeconomic situation - resources, problems and constraints - that faith-oriented communities can develop a creative and innovative approach to change.

This approach would be ideological as well as empirical and somewhat pragmatic. Pragmatic not in the sense that ideals and values can be trimmed to suit the exigencies of the situation, but rather pragmatic in the sense that ideals and values are to be translated into reality in a practical and realistic way.

3. A Unique Approach to Social Change

The real objective which inspires faith-oriented communities is not a package of economic and political concessions or even some changes in the economic superstructure but the construction of a new world order, with its own framework of ideals, values and foundations. The approach of faith communities to social change has to be unique.

The Western approach has always assumed that radical change can be brought about by changing environment. That is why emphasis has always been placed on change in structures. This approach has failed to produce proper results. It has ignored the need to bring about change within men and women themselves and has concentrated on change in the outside world. What is needed, however, is a total change within people themselves as well as in their social environment. The problem is not merely structural, although structural arrangements would also have to be remodeled. But the starting point must be the hearts and souls of men and women, their perception of reality and of their own place and mission in life.

4. The Islamic Approach

The Islamic approach to social change takes full cognizance of these three elements. For Islam,

- Social change is not a result of totally predetermined historical forces. The existence of a number of obstacles and constraints is a fact of life and history, but there is no historical determinism. Change has to be planned and engineered. And this change should be purposeful, that is, a movement towards the ideal.

- Man is the active agent of change. All other forces have been subordinated to him in his capacity as God's vicegerent and deputy *(Khalifa)* on the earth. Within the framework of the divine arrangement for this universe and its laws, it is man himself who is responsible for making or marring his destiny.

- Change consists in environmental change, and change within the hearts and souls of men and women - their attitudes, motivation, commitment, their resolve to mobilize all that is within them and around them for the fulfillment of their objectives.

- Life is a network of interrelationships. Change means some disruption in some relationships somewhere. So there is a danger of change becoming an instrument of disequilibrium within men and women and in society. Islamically-oriented social change would involve the least friction and disequilibria, with planned and coordinated movement from one state of equilibrium to a higher one, or from a state of disequilibrium towards equilibrium. Innovation is to be coupled with integration. It is this unique Islamic approach which leads to revolutionary changes' through an evolutionary trajectory.

These basic changes, if implemented, will revolutionize our approach to the problems of a new world order.

E. ISLAM: ITS MEANING AND MESSAGE

I would now like to briefly explain what Islam is and how it proposes to establish a new order.

1. No Departmentalization of Life

Islam is an Arabic word. It is derived from two roots; one. salm, meaning peace and the other *SLM,* meaning submission. Islam stands for "a commitment to surrender one's will to the Will of God" and 'as such be at peace with the Creator and with all that has been created by Him. It is through submission to the Will of God that peace is produced. Harmonization of our will with the Will of God brings about harmonization of different spheres of life under all-embracing ideal. Departmentalization of life into different watertight compartments, religious -and secular, sacred and profane, spiritual and material, is ruled out.. There is unity of life and unity of the source of guidance. As God is One and Indivisible, so is life and our human personality. Each aspect of life is inseparable from the other. Religious and secular are not two autonomous categories; they represent two sides of the same coin. Each and every act becomes related to God and His guidance. Every human activity is given a transcendent dimension; it becomes sacred and meaningful and goal-centered.

2. A Worldview

Islam is a worldview and an outlook on life. It is based on the recognition of the unity of the Creator and of our submission to His will. Everything originates from the One God, and everyone is ultimately responsible to Him. Thus the unity of the Creator has as its corollary, the Oneness of His creation. Distinctions of race, color, caste, wealth and power disappear; our relation with other persons assumes total equality by virtue of the common Creator. Henceforth, our mission becomes a dedication to our Creator; worship and obedience of the Creator becomes our purpose in life.

3. Divine Guidance

The Creator has not left us without guidance for the conduct of our life. Ever since the beginning of Creation, He has sent down Prophets who conveyed His message to humankind. They are the source for finding God's will.

Thus we have the chain of Prophets beginning with Adam (peace be upon him) and ending with Muhammad (peace be upon him). Abraham, Moses, Noah, John, Zechariah and Jesus (peace be upon them) all belong to this golden chain of Prophets. Prophet David, Moses, Jesus and Muhammad (may peace be upon them all), brought revealed books of guidance with them. The Qur'an, the Book revealed to the Prophet Muhammad, is the last and final of these books of guidance. The Qur'an contains the word of God. In it is preserved the divine revelation, unalloyed by human interpolation of any kind, unaffected by any change or loss to the original. In it is distilled the essence of all the messages sent down in the past. In it is embodied a framework for the conduct of the whole of human life. There are explicit criteria for judging between right and wrong; there are principles of individual and collective conduct. In it are depicted the human follies of the past. In it are warnings for humankind, and in it are assurances of continued guidance for those who seek God's help.

The Qur'an has depicted a path, the Straight Path *(Sirat* ul-Mustaqim) which when followed revolutionizes the whole of life. It brings about a transformation in character and galvanizes us into action. This action takes the form of purification of the self, and then unceasing effort to establish the laws of God on earth, resulting in a new order based on truth, justice, virtue and goodness.

4. God's Vicegerents

Men play a crucial role in the making of this world. They act as God's vicegerents *(Khalifa)* - His deputies and representatives on the earth. They are morally prepared to play this role. Success lies in playing it properly, by enjoying what is right and forbidding what is wrong, by freeing people from the bondage of others, by demonstrating that a sound and serene society can only result if one harmonizes one's will with the Will of God. This makes seeking the Creator's pleasure one's purpose in life, treating the whole of Creation as one's partner, raising the concept of human welfare from the level of mere animal needs to seeking what is best in this world and what is best in the Hereafter.

This is the Islamic worldview, and its concept of men and women and their destiny. Islam is not a religion in the Western understanding of the word. It is at once a faith and a way of life, a religion and a social order, a doctrine and a code of conduct, a set of values and principles and a social movement to realize them in history.

5. No Priesthood

There is no priesthood in Islam, not even an organized 'church'. All men and women, who are committed to this ideal, are expected to live in accordance with its principles and to strive to establish them in society and history: Those who commit themselves to Truth try to see that Truth prevails. They strive to make a new world in the image of the Truth.

6. A System of Life

Islam, as a system of life, prepare us to play this role and provides us with guidelines for the development of a new personality and a new society. For the purification of. self there are prayers *(Salat)* performed five times a day in the confines of the home and in congregation in our mosques, strengthening our commitment to God, refreshing our loyalty to truth, reinvigorating us to work for the realization of our ideals. Prayers is supplemented by fasting *(sawm)* for the achievement of these objectives.

If prayer and fasting integrate us with God and provide us with the spiritual discipline we need to become godly in the midst of the rough and tumble of life, *Zakah* commits our wealth - our worldly resources - to the achievement of divine purposes in the socio-economic realm.

Zakah is a monetary obligation. Every Muslim who possesses more than a certain minimum amount of wealth has to contribute at least a certain percentage of his/her total wealth for welfare functions within society. It is not a charity; it is a religious right which the rich owe to the needy and the poor, and to society at large. But the spirit of this compulsory contribution is that it is paid by the rich as an act of worship and not merely as a tax.

This is how all that Muslims have, soul, body or their belongings, are harnessed for the service of virtue, justice and truth. It is also obligatory on Muslims to visit the Ka'ba at least once in their lifetime for Hajj (pilgrimage). This, among others, is an index of the unity of the Muslim community *(Ummah),* a community of faith and a symbol of the unity of humankind. A universal order can come into existence only on the basis of a universal faith and not on the basis of commitment to the 'gods' of race,color, region or riches. The ideal of human brotherhood seeks actualization in Islam.

7. Unique in Values and Principles

A new model of human personality and a new vision of human culture are here presented. Science and technology are developed but they are not directed towards destroying either nature or our abode therein; they add to our efficiency as much as to life's sublimity. Islam aims at a new harmony between man and nature and between man and society.

The uniqueness of Islamic culture lies in its values and principles. When Muslims, after an illustrious historical career, became oblivious of this fact and became obsessed with the manifestations of their culture, as against its sources,they could not even fully protect the house they had built. The strength of Islam lies in its ideals, values and principles, and their relevance to us is as great today as it has been in history. The message is timeless and the principles Islam embodies are of universal application.

F. ISLAMIC ROLE IN THE ESTABLISHMENT OF A NEW WORLD ORDER

In our search for a new world order today, Islam emphasizes that we must aspire to a new system of life which could approach human problems from a different perspective, not merely from the perspective of limited national or regional interest,but from the perspective of what is right and wrong, and how best we can strive to evolve a just and a humane world order at different levels of our existence, individual, national and international.

That the present order is characterized by injustice and exploitation is proved beyond any shadow of doubt. But, Islam suggests that the present order fails because it is based upon a wrong concept of man and of his relationship with other human beings, with society, with nature, and with' the world. The search for a new order brings us to the need for a new concept of man and his role. From the viewpoint of world religions in general, and of Islam in particular, the focus of the discussion must be shifted to a new vision of man and society, to an effort to bring about change at the level 'of human consciousness, of values, leading to new cultural transformation.

1. A Movement-Oriented Approach to Religion'

Islam is a movement for social change. It not only gives a clear concept of society and the modus vivendi of bringing about the coveted change in history, but it also gives clear guidelines for socio-economic policy, for some of the key institutions that guarantee the implementation of that policy, and an organized social effort under disciplined leadership to see that these objectives are achieved in space and time. -

Muslims have this movement-oriented approach to religion. This model operates at three levels, that of the individual, of society and of the world. First, unless the individual has a new faith, a new consciousness and a new perception of his/her own role, required changes cannot be brought about. second is the level of society. Initially it may be at the national level but later at the level of the whole world. The Islamic strategy is that it starts with creating a new consciousness in the individual, who imbibes its values and strives to work for the establishment of a just life; not on the basis of expediency or to seek personal or group interests, but-to do-what is right and just. The Qur'an shows us how an individual problem has to be approached at the universal level when it says that if one person is unjustly killed, this is tantamount to killing the entire human race, and what whoever saves one single life saves the whole race.[6] This is how an individual incident is transformed into a world problem, how an event moves into the realm of values.

2. Clear Guidelines for Action

Islam is not a defense of the status quo. Instead, it is a critique of human life, including the lives of Muslims and the organization of Muslim society. The present day Muslim society falls far short of Islamic standards. Thus we believe that Muslim-society has to be changed in order to establish those social, economic and political institutions which would establish justice in human relations. Islam wants to bring political power under the control of its moral ideals. Such a society and state would be established as a result of a social movement directed towards Islamic revival. Then the Muslim world would be in a position to play its ideological role in the. world, by making its own resources available to build a model society where it has political power, and then by sharing it with others in the interests of justice, acting on the same principles as the Prophet used when he helped the famine-stricken people of Makkah who were politically at war against him.

The Islamic State was not at war with human beings as such, but only with the institutions which represented belligerent political power. This may help lead humankind towards the model of a new world order where justice will be done to all, friends and foes alike, and where wealth will be shared with the needy not because it is expedient but because this is just.

Zakah is a right of the poor. According to the Qur'an, those who do not help the needy or who scorn the orphan are committing the crime of denying *Din,* the Islamic way itself. This idea of the sharing of wealth as a right is a revolutionary idea. It is with these insights that Islam enters this debate and gives to it a new direction, a new perspective and also clear guidelines for action. In the light of these guidelines a strategy for change can be formulated. A new just order is not merely the need of Muslims, it is a need of people everywhere, in the West as well as the East.

3. Islam - More than a Religion

Islam is a faith and a way of life. It provides a definite outlook on life and a program for action, a comprehensive milieu for social reconstruction. It reshapes the entire personality of men and women and produces a new culture and civilization. It is deeply concerned with their moral and material existence, their psychological attitudes as well as their socio-economic behavior patterns. All aspects of individual and collective life are developed in a harmonious fashion, within the framework of overall human development known as *Tazkiyyah*[7] (purification).

Islam influences people at different levels of their existence: belief, motivation, personal character, individual behavior, social institutions, collective action. That is why it is more correct to say that Islam is a faith, a way of life, a process of change, and a social movement for the construction of society and the establishment of a just world order, not just a religion.

4. Basic Values for World Order

The basic values on which this world order is established are as follows :

Tawhid (God's Unity and Sovereignty)

This is the foundation on which Islam's worldview and its scheme of life is based. It lays the rules of God-man and man-man relationship. *Tawhid is* not merely a metaphysical doctrine. The human approach to social reality is an inextricable part of this belief. The establishment of justice in human relations is a demand of this faith. Belief in God's Unity and His Sovereignty means that all human beings are equal, and that their rights *(Huquq al 'Ibad)* are a natural extension of God's rights *(Huquq Allah).* The Qur'an says:

> "Have you observed him who denies the din?
> (the faith and religion, the divine law) He is the
> one who spurns the orphan, Does not urge the
> feeding of the needy. Bitter grief to worshipers
> ' Who are neglectful of their prayers;
> Who would be seen in prostration Yet
> refuse kindnesses and charity".[8]

Khelafa (Vicegerency)

Islam defines our status in the world as that of God's vicegerents - His deputies and representatives. Everything that exists is at our disposal for the fulfillment of this role and is like a trust in our hands. This means that we are not the masters. We are God's 'agents and our primary concern should be fulfillment of the Will of the Lord. We are in the position of trustees in respect to all that is in the universe, our own personal faculties and all our possessions and belongings. All authority is to be exercised within the framework of this 'trust and we are accountable for whatever we do.' This principle stipulates our active participation in life and invites us to treat the entire creation, not as foe, but as partner and friend, made to fulfill the same objectives. The Islamic concept of man's equality and brotherhood and the creation of the ideological fraternity of the *Ummah* (the community of faith) are essential elements of this principle of *Khalifa,* our trusteeship and stewardship.

Establishment of Justice Among Human Beings

Establishment of justice among human beings is one of the basic objectives for which God raised His prophets and sent down His guidance.[9] All human beings have rights upon all that God has provided and thus God's bounties are to be shared equitably.(10) The poor and the needy have a right upon the wealth of the rich and of society.(11) They must be helped and enabled to participate in the struggle for living with skill and honor.

Political and Economic Power Are Not Evil

It is a part of our religious mission to harness them for the fulfillment of moral objectives. Instead of remaining instruments of oppression and exploitation, they must be made to serve the ends of justice and to promote good 'and virtue and to forbid evil and vice.[12]

There Are No Intermediaries Between God and Man

God's guidance is available in the form of His Book, the Qur'an and the life-example of His Prophet, the *Sunnah.* They clearly state the ideals, values and principles that we need to build our individual and collective lives on truth and justice and there exists in this guidance a built-in mechanism to meet the demands of changing times. Evolution is possible within this framework. Only the divine law is eternal, all human expedients are temporary and time-bound. Pursuit of the divine law is the guarantee against human arbitrariness and relapse into injustice.

Islam's All-Embracing Approach to Rebuilding World Order

These are the basic principles on which Islam wants to rebuild the world order. The first contribution that Islam wants to make is at the level of one's approach to this problem. Islam adopts an all-embracing approach, based on a spiritual appreciation of reality. It approaches men and women in the context of their total existence, in relation to their Creator ad His entire creation. It admits of no dichotomy between matter and spirit, nor between physical and moral. It welds the religious with the secular and treats life as one integrated and harmonious whole.

Islam stands for total change, as against all contemporary ideologies and some religious systems which are content with partial change. It purifies the individual and reconstructs society, making both the individual and society achieve a still higher ideal: fulfillment of the Divine Will.

Its approach is based on values and not on the demands of expediency, personal or national. Its outlook is positive and constructive, and not just negative or destructive. It seeks the person's total welfare - moral, social an economic. It stands for the realization of justice in all aspects of human living. It upholds the principle of universal good and justice and invites the entire human community to work for its establishment. It affirms the integrity of the individual and sanctity of his/her human rights, as rights guaranteed by the Creator and tries to establish a social order wherein peace, dignity and justice prevail.

Islam's Strategy for Changing World Order

'Islam's strategy for the establishment of such a world order consists in inviting all human beings to take this path, irrespective of their color, race, language, nationality, 'ethnic or historical origin. It does not speak the language of the interests of the east or the west, of the north or the south, of the developed or underdeveloped. It wants the new order to be established for all human beings in all parts of the world. Through this universal approach Islam wants to bring about a new consciousness of the ideals and principles on which the house of humanity should be rebuilt and invites them to spell out its implications for the reconstruction of human thought and policy.

Islam also launches a social movement, an international movement involving all those who accept these ideals and values to establish the new order. Islam is eager to establish the new model. in any part of the world. If it reconstructs its social order on these principles, the Muslim world could be the living example of this new order. But the present reality of the Muslims is far removed from the ideal. Once this model is established in some part of the world, this experiment can be shared with all the rest,as sunshine is shared by all. The prospects of this depend very much upon the Islamic movement that is trying to spearhead this social effort for the establishment of a new world over.

Footnotes

See Richard N. Cooper, The Economics of Interdependence: Economic Policy in the Atlantic Community, New York: McGraw Hill, 1968: "Economic Interdependence and Foreign Policy in the Seventies", World Politics, 24th January 1972, pp. 159-81; and "Macroeconomic Policy Adjustment in Interdependent Economics", Journal of Political Economy, 83, February 1969, pp.. 1-24; Fred C. Bergston, The Future of the International Economic Order: An Agenda for Research, Lexington, Mass.: D.C. Heath & Co., 1973; Harry G. Johnson, International Economic Questions Facing Britain, the United States and Canada, British North America Research Association, June 1970; Raymond Vernon, Sovereignty at Bay, New York: Basic Books, 1971.

2. See Raul Prebisch, "Commercial Policy in the Underdeveloped Countries". American Economic Review, 49, May 1959, pp. 251-73; Andrew Grunder-Frank, "The Development of Underdevelopment", Monthly Review, 18 September 1966, pp. 17-31; Gunnar Myrdal, Development and Underdevelopment, Cairo: National Bank of Egypt Fiftieth Anniversary Commonwealth Lectures, 1956; Benjamin J. Cohen, The Question of Imperialism - The Political Economy of Dominance and Dependence, New York: Basic Books, 1973; Osvaldo Sunkel, "Big Business and "Dependentia": A Latin American View", Foreign Affairs, 50, April 1972, pp. 5111-131; Stephen Hymer, "The Multinational Corporation and the Law of Uneven Development", in Economics and World Order - From the 1970's to the 1990's, edited by Jagdish Bhagwali, New York: Macmillan, 1972.

3. Joseph A. Camilleri, Civilization in Crisis:Human Prospects on a Changing World, Cambridge: Cambridge University Press, 1976, pp. 1-2; 5; 9; 11; and pp. 179-180.

4. Kurt Dopfer, Economics in the Future: Towards a New Paradigm, London: Macmillan, 1976.

5. See also, E.F. Schumacher, A Guide for the Perplexed, London: Jonathan Cape, 1977, pp. 135-154.

6. The Qur'an, 5:32.

7. The Qur'an, 2:129, 151; 19:9-10; 87:14.

8. The Qur'an, 107: 1-7.

9. The Qur'an, 57:25.

10. The Qur'an, 14:33 – 34.

11. The Qur'an, 51:19.

12. The Qur'an, 2:143, 3: 110, 17:80-81.

CHAPTER IV

PROBLEMS AND POTENTIALS OF SOUTH-SOUTH TRADE WITH SPECIAL REFERENCE TO THE ISLAMIC COUNTRIES

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(This paper provides theoretical discussion on alternative path to industrialization, and development available to the South (developing) countries with regard to trade strategy. The author argues both collective self-reliance strategy as well as trade expansion strategy do not provide adequate solution to the problem of economic development in the South by means of trade since such strategies do not serve the interests of the countries of the South whether they are outward oriented or inward oriented in their trade and development strategies because of several reasons he dwelt on in the first section of his section of the paper.

He argues that for both inward oriented, import substitute development strategy as well as for outward oriented export-based development strategy, liberalization of trade would provide better opportunity for industrialization and development, as it enhances transfer of technology, economics of scale, and better division of labour in both types of countries. Lastly, the author tries to apply this theoretical framework to the member countries of the Organization of Islamic Conference (OIC) suggesting that both collective self-reliance as well as within member countries trade expansion strategies may not be suitable for these countries, because of disparities in their economic structures as well as geographical location. Alternatively he suggests a collective effort by the OIC member countries to liberalize trade with the North, especially the Economic Community (EC) countries. He argues that the OIC member countries would benefit economically and for improving their terms of trade. For that, he argues that a collective political effort to obtain preferential treatment in EC countries may be not only desired but also feasible. (Editors)]

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Introduction

The expansion of South-South trade is on the agenda of international conferences for decades; the 1960s saw the emergence of several regional cooperation and integration groupings striving for an intensification of their economic relations in general and of the intra-group trade relations in particular. The results of These efforts, however, are not too impressive. After some initial trade expansion, the share of intra-group trade in total trade often stagnated or even declined (see table 1).(1) In most South groupings, the level of intra-group trade has been rather insignificant; it reaches more than 20% only in two cases. The Islamic countries are no exception from this general rule.. The Organization of Islamic Conference (01C) was established in 1973 and the Islamic Development Bank (IDB) in 1975. Intra-Islamic trade stagnates at approx. 10% of the total trade volume of the Islamic countries (see table 2).

This paper consists of three sections. First section deals with objectives of a South-South trade expansion and their relations to the general inward- or outward-oriented trade and industrialization strategy. Depending on this orientation, the various measures of South-South trade expansion have different importance. Second section reconsiders the standard arguments for South-South trade and differentiates between inward-and outward-oriented countries. Third chapter draws some strategic conclusions with special reference to the Islamic countries.

1. See also Thomas Straubhaar: "South-South Trade - is Integration a Solution"?,in: Intereconomics, Vol.22, No. 1, Hamburg 1987, pp.34-39. An exception from this general trend is ASEAN where the intra-group trade increased substantially.

Expansion of South-South Trade for World Market Integration or Collective Import Substitution

The expansion of South-South trade can follow - roughly speaking - two different strategies with different goals and instruments.

- A collective self-reliance strategy may be followed. It aims at reducing the dependence of the South on markets in the North. Measures are taken to divert trade flows and to substitute North-South trade by South-South trade. This kind of deliberate trade diversion requires a preference for suppliers in the South and a discrimination against imports from, and exports to, the North.

- or alternatively a trade-related industrialization strategy may be pursued whose aim is the promotion of industrial development through the expansion of South-South trade especially. in manufactures. Measures are mainly directed toward trade creation within the South. Trade creation implies the removal of various barriers which restrict South-South trade (e.g. high customs duties, insufficient infrastructure) but does not require a deliberate discrimination of North-South trade.

In reality, elements of both strategies may be mixed, but for analytical purposes it is useful to keep them separate.

A collective self-reliance approach may look attractive for countries which follow the same approach in their national development policy and have implemented an inward-oriented import substitution strategy for industrial development. The size of the national market restricts the range of industries that could be set up meaningfully. Regional integration enlarges the size of the national market, broadens the scope of feasible industries and opens opportunities for gaining economies of large scale production. It is often argued that integration among developing countries is the continuation of national import-substitution on a regional level. In such groupings, a common external protection of regional markets is at least as important as the removal of internal trade barriers.

The import substitution strategy diverts demand from international to local sources. A main instrument is protective import tariffs (and quotas). Since competition in protected domestic markets is less strong than in international markets, and since local prices are higher than world market prices, domestic producers will prefer production for the local market and ignore exports. Exports are further discouraged by the high cost of tariff-burdened imported inputs. In addition, export potentials are reduced by overvalued exchange rates. There is no need to discuss all the problems of such an inward-oriented trade strategy here.(2) It is sufficient to realize that there are fundamental differences between this and an outward-oriented trade policy.

The outward-oriented policy does not discriminate between production for the domestic and for the international market; import duties are lower and domestic producers are much more exposed to (international) competition. For outward-oriented countries, the removal of import restrictions 'of other South countries may be beneficial, but for producers who supply the world market, this will hardly be a significant enlargement of the market. Outward-oriented countries who have found their place in the world markets, i.e., who successfully compete with producers in Northern countries, should basically have the ability to export to developing countries if their products are not burdened with heavier duties and taxes than those of exporters from the North. Preferential tariff rates or even duty free access to markets of other developing countries would hardly boost the exports of the outward-oriented countries: If they have already supplied the markets in tariff reducing countries, there will be no completely new outlets for them. Their exports may increase, but only to an extent that is primarily determined by the price elasticity of the demand for imported goods in the tariff reducing country.

A somewhat more optimistic assessment of the trade effects of tariff reductions or integration among developing countries is possible if one considers the following:(3)

- The major outlets for outward-oriented South countries are in the North.
- These South countries export items - including certain manufactured goods - which are imported by other developing countries.
- The developing countries, however, import the manufactured goods mainly from industrial countries and only to a very limited extent from South suppliers.
- The fact that South countries can export manufactured goods to the North shows that their prices are competitive.

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2. For more details see, for example, World Bank: World Development Report. New York, etc. (Oxford University Press) 1987.

3. See M.Newson,D.Wall: Policy and institutional Obstacles to South-South Trade in Manufactures, UNIDO Document No.UNIDO/IS.584,19 December 1985.

Since tariffs of developing countries may be high but usually do not discriminate against other South countries, one may conclude that there must be other factors which impede the expansion of South-South trade even in cases where South producers can compete with North producers in the markets of the industrial countries. These factors increase the effective price for supplies from South countries. Whether preferential reduction of tariffs in South for South countries will compensate for these price increasing factors fully, partially or just marginally is a question that cannot be answered in general. But greater the compensatory effect and larger will be the potential for trade expansion on the side of the outward-oriented South countries.

Non-tariff factors which effectively restrict an expansion for South-South trade are the following:[4]

- High transportation costs: Especially in those developing countries which formerly were European colonies, the transportation infrastructure was tailored to the needs of colonial trade. The links in transportation and communication are often much better between North and South than between neighbouring South countries. In some areas, differences in national and also international (commercial) languages (e.g. French Vs. English) cause additional problems.

  <u>Different exchange rate policies</u> Most developing countries link their currency to the currency of their major trading partners in the North (e.g. US-Dollar or French Franc) or to a basket of international currencies. Therefore, fluctuations of exchange rates can be often more pronounced between neighbouring South countries (linked to different currencies or baskets) than between a South country and its most relevant economic partner in the North.

  <u>Tied bilateral aid</u> Bilateral development aid (in particular project aid) from countries in the North is often granted under the condition that capital goods, machinery and equipment are purchased in the aid giving country. The distorting effects of tied aid can become significant especially in poorer South countries where aid from the North contributes substantially to the financing of imports of manufactured, non-consumer goods.

  <u>Transnational</u> <u>corporations (TNCs)</u> In many developing countries subsidiaries of TNCs from Northern countries control substantial parts of

4. See M. Newson, d. Wall, op. cit., pp. 9 - 15.

production and trade in manufactures, and subsidiaries or licensees - in the South often have to use imported inputs from the parent corn-panies in the North instead of inputs from other South countries.

Lack of information Importers in South countries often have no sufficient information about products, especially manufactures, that could be supplied at favourable conditions from producers in South countries. Marketing strategies of South producers must be improved and the exchange of commercial information needs an intensification.

Weak technical support and 'after sales services' More complex capital goods and machinery require technical support and-maintenance services from the supplier after sales and installation. Companies in the North often have more qualified service personnel and more sophisticated logistical systems for the supply of spare parts. Foreign exchange and travel restrictions in South countries can impede the mobility of service units.

Lack of export credit facilities Western suppliers can offer customers ' in South countries not only short-term but often long-term export credits (sometimes at subsidized rates from governmental export banks). Such credits allow investors in the South to establish production enterprises and to pay for imported capital goods; machinery and equipment after the new plant has started production' and earned income. For developing countries, where foreign exchange shortages constrain import possibilities, supplier export credits are an essential precondition for imports. Adequate financing facilities for imports from South suppliers are rarely available. This lack of export financing facilities is held to be one of the most restricting factors for the expansion of South-South trade in more sophisticated (non-traditional) products.

For the industrial development of South countries, exports of more sophisticated non-consumer manufactured products like engineering goods are of foremost importance. Unfortunately, the trade impeding factors are of particular relevance with respect to these items. It should be noted, however, that the discussion of trade impeding factors is of principal importance for outward-oriented countries only since these countries are alone in a position to compete with exporters from the North on markets in the South, and the factors listed above explain why they are in an inferior position. Countries which follow an inward-oriented and import-substituting policy can hardly compete successfully with suppliers from the North.

For outward- and inward-oriented developing countries, the main concerns with respect to South-South trade are basically different, though not necessarily contradicting:

- For outward-oriented countries, strategies for the liberalization and promotion of South-South trade will not increase the market size substantially. Liberalization measures, such as preferential tariff reduction or removal of quantitative import restrictions, quotas, have mainly the effect of a partial or full compensation for various disadvantages of South supplies competing with exports from the North in markets of the South. Depending on the price elasticity of import demand and the type of impeding factors, trade liberalization may not be sufficient and other measures, such as improvement of the transportation and communication infrastructure or establishment of export financing institutions, may even be more important. Outward-oriented South countries would gain from trade creation and better chances for international specialization and intra-industry trade.

- Inward-oriented and import-substituting countries cannot compete with North suppliers. Their concern is not with the compensation of disadvantages in international competition, but with the continuation of the import-substitution strategy within a larger group of countries. This requires some form of integration or at least harmonization of trade and industrialization policies because the protection of domestic industries against competition from third country suppliers is an essential element of the import- substitution policy. Another feature of import substitution is the discrimination against exports to third countries. The possible gains from collective import-substitution are much less clear than the gains from trade creation in the case of outward-oriented countries.

With respect to groupings of import-substituting countries, the argument of market enlargement has some relevance. The gains of a collective import-substitution policy may be cost reductions due to improved (static) efficiency by economies of scale. But these gains may need to be balanced with losses of several industrial productions: A country can reap economies of scale only if its industry X (e.g., textile or footwear) can supply the enlarged protected market of the group. But it is very probable that the same industry X was also set up behind protective walls in other countries of the group. If the level of efficiency in these countries is lower than in the first country, the market will then be taken over by the first country and the other countries will have to give up these lines of production. But they will agree to such restructuring and loss of industry X only if they have at least one other industry which is more efficient in their own hands in the rest of the grouping so that this industry can expand. This will result - for the group

.as a whole - in a level of efficiency that may be well above the former level under individual import-substitution strategies, but the level of efficiency of suppliers on the world market will hardly be reached.

If industrialization is a goal of national governments and if a country has no industry which can succeed in an intra-group competition (but has comparative advantages in non-industrial sectors) or if the expansion of the superior industry will be much less than the loss of production in other industries, such a country will hardly be willing to become a member in this group for obvious economic reasons. If the other countries want to win this country as a member for political reasons, they will. have to offer some compensation. One strategy may be that industries which shall be set up in the group for the first time, will be allocated to this country, but such an approach requires a rather elaborate system of planned industrial specialization.(5)

If it is realistic to assume that import-substituting countries have set up a rather limited number of industries which are quite similar, but inefficient compared to world market suppliers, the probability of industrial net losses for potential member countries rapidly increases with the number of members in a group which strives for collective import-substitution. A collective inward-orientation seems to be an economically feasible trade strategy only for relatively small groups. Against this background, it is rather necessary to reconsider the standard arguments in favour of economic integration (= trade liberalization) among developing countries as well as to draw some strategic conclusions with special reference to the Islamic countries.

II

Gains from Trade Expansion and Integration Reconsidered

Cooperation and integration among developing countries and expansion of South-South trade esppecially in manufactures are generally accepted' as adequate strategies for fostering industrial development.[6] But adequate strategies

5. The problems of such a strategy cannot be discussed here; for a critical assessment see Volker Nienhaus: Integration- Theory and Problems of Integration Policy in the Third World, in:Intereconomics, Vol.22, No. 1, Hamburg, 1987,pp.41-48.

6. A collection of 'classical' articles on integration is Pradip K.Ghosh (ed.): Economic integration and Third World Development, Westport, London (Greenwood Press) 1983; for a textbook treatment, see Peter Robson: The Economics of International Integration, London (George Allen & Unwin) 1980. For reports on practical experience with South-South cooperation and integration see, for example, Altaf Gauhar (ed.): Regional Integration - The Latin American Experience, London (Third World Foundation) 1985; Ervin Laszlo (ed.): African and Arab Co-operation for Development, Dublin (Tycooly International Publ.) 1984; United Nations Economic Commission for Western Asia: Economic Integration in Western Asia, London (Frances Pinter) 1985.

of integration and trade promotion and their will differ depending on the trade and industrialization policy of the respective group of countries.

Trade diversion: Trade diversion as a consequence of the establishment of a preferential or free-trade area (or a customs union) means that imports are diverted from lower-cost sources outside the group to higher-cost suppliers inside the group. Compared to a free trade situation, this is a negative welfare effect.

If outward-oriented countries are characterized, inter alia, by relatively low external tariffs, this negative welfare effect will be of limited quantitative relevance only. Further, worldwide free trade is an ideal but not a realistic alternative to be used as a measure for the evaluation of 'real world' policies. In outward-oriented countries where export industries use imported inputs, discriminatory removal of tariffs would not directly affect the international competitiveness of export industries: While formerly all imports were tariff burdened, now some imports (from other integration countries) will become even cheaper. However, the government forgo customs revenues, and its reaction as to levying of additional taxes, reduction of expenditures, inflationary monetary policy, etc., determines where, how and to what extent export industries may be affected.

Trade Diversion In inward-oriented countries, trade diversion, i.e., delinking from the world markets, may be one of the main objectives of integration. Static welfare effects and efficiency criteria play only a minor role; the main concern is the establishment of domestic intra-group industries even if they produce at costs substantially above the world market level. The hope is that, in the long run, benefits from industrialization may outweigh the short-term welfare losses.(7)

To summarize, one may say that outward-oriented countries may have some reasons to limit trade diversion, while inward-oriented countries could follow a policy that aims at a maximized trade diversion.

Trade creation Trade creation means that goods which were formerly produced domestically are now imported.

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7. There are serious doubts that industries which were set up behind high tariff walls will ever reach a level of efficiency comparable to world market standards, and there are even more doubts whether protected industries will ever develop such a dynamism that they can keep up with the world markets. The main reason for this skeptical assessment is that there are - neither on a national nor on the level of an integration grouping - convincing reasons at hand why a once granted high protection will later be reduced sufficiency.

- Outward-oriented countries should welcome or at least have no serious objections against trade creation policies - irrespective who the trading partner is: another developing country or an industrialized country.

- Inward-oriented countries will accept trade creation only if their increased imports will be balanced by a 'reciprocal' increase of their exports; that implies that trade creation should be restrained to intra-group trade.

Economies of scale The enlargement of the market beyond national borders would allow export producing industries to increase their output. This reduces the cost per unit due to improved efficiency.

- For outward-oriented couritries , this is not a strong argument because their export industries are already producing not just for the national but for the world market.

- For inward-oriented countries, the enlargement of the market may take place and economies of scale may be realized. However, the enlargement of the market and the overall improvement of efficiency does not imply that all member countries of an inward-oriented integration grouping will benefit by an expansion of their industries. It may be that the expansion of industries will occur in only a few of the member countries while industrial capacities will shrink in others.

This means that where the economies of scale argument, that enlargement of the market will improve efficiency of production on the group level, is valid, it is not alone sufficient to justify a respective trade policy. National governments are not primarily interested in the efficiency and welfare of the group but of their individual countries, and for them, the level of industrial production is a part of this welfare. Thus, distributional aspects must be added before costs and benefits of integration can be evaluated.

Dynamic competition The removal of trade barriers within a group of countries will intensify the competition, and more competition may lead to dynamic effects like more innovation and technical progress.

- Producers in outward-oriented countries are already exposed to the competition from the world markets; South-South trade policy will not add much to this.

- Producers in inward-oriented countries are not in a position to compete with producers from the world market; therefore, the national protection will be continued after integration on a regional level. Usually there is a gap even between the most efficient producers within an inward-oriented group and world market producers. Therefore, innovations and technical progress within the group will result more from adoption of developments in the world market than from dynamic efforts of the intra-group producers. Further, it is by no means clear that integration among inward- oriented countries will lead to more competition. It may well be that regional monopolies emerge, i.e., that for a given item the whole integration market will be served by suppliers located in only one country. The national government of this country will have no special interest in a strong competition among producers because a collective monopoly strategy could bring advantages for its own country: Profits and employment may be higher than under competitive conditions, but the costs for these inefficiencies can - via higher prices - be largely externalized to the consumers in the other integration countries.(8)

Better division of labor Integration should open possibilities for a better allocation of given resources and for additional inflow of resources from outside. This will lead to improved division of labor, more specialization and increased efficiency of production.

- Outward-oriented countries are already integrated into the international division of labor. They participate in intra-industry specialization and trade. If an outward-oriented country can successfully compete with producers from industrialized countries, it probably will be an attractive location for foreign direct investments. If this country joins a group where internal trade restrictions shall be removed, this may be an addition to the attractiveness of that country for foreign direct investments but this addition will not be dramatic.

- If inward-oriented countries form an integration, they will not only remove internal trade restrictions but protect this enlarged market against products from third countries. The combination of enlargement plus protection of the market may attract foreign investors, foreign direct investments are permissible at all, which formerly were not interested in investments in one of the smaller segregated and equally protected markets. This can improve the efficiency of production within the inward-oriented group. Therefore, such foreign direct investments may be judged as improvement of the international allocation of resources, but one must not forget that the flow of foreign investments was not directed by comparative advantages but by the level of protection and the size of protected markets. This is hardly a real contribution to a better international division of labor.

8. This has been elaborated a little more in V. Nienhaus: Integration Theory.. op.cit.

Improved terms of trade Many developing countries suffered from deteriorating prices for their export goods and increasing prices of imported items. Integration is sometimes proposed as a means to strengthen the position of the developing countries on the _world markets and to improve their. terms of trade by a concerted trade policy.

- At first glance, it seems that deteriorating terms of. trade are a problem primarily for those countries who relied on the world market and followed an outward-oriented policy. However, one has to take into consideration that outward-orientation does not mean just the maximization of export and imports but that it includes a particular industrialization strategy and that it is directed toward a more diversified export structure with special emphasis on exports of non-traditional manufactures. Countries which have success-fully implemented such a strategy in the past were much less affected by decreasing prices of raw materials and primary commodities, and they partially even benefited from more stable or increasing prices for manufactures.

- The industries of inward-oriented countries are inefficient compared to world market standards; therefore, the import-substituting countries- which could suspend imports completely and in some case have experienced increasing needs for imports- are forced to export primary commodities and raw materials to finance their imports. Thus, this group of countries is, on the average, more seriously affected by the deterioration of commodity prices.

But irrespective of which group of countries suffered more from developments in the world markets, there 'are several other reasons why integration is not a convincing approach to improve the terms of trade.

- The improvement is expected as the result of a more concentrated supply which gives some 'monopolistic' power to the developing countries. Such a strong market position of the developing countries might at best be possible for raw materials and primary commodities, but certainly not for manufactures.

- To exploit the market power, a concentration or pooling of the supply is ' necessary, but this is not implied by integration.' Even if exports are not in the hands of private entrepreneurs but of state trading organizations, there are still several exporters supplying the world market with goods from the grouping.

- Concentration or pooling will be the result of a common policy against third countries: such a policy is like a cartel strategy but has nothing to do with integration in its original sense. For a successful cartel strategy economic integration among the participating countries is not required. The best example for a cartel of non-integrated countries is the OPEC.

– Even an effective cartel, which is very difficult to organize and even more difficult to maintain, cannot dictate both prices and quantities. It can either fix the prices or the quantities, but the other parameter will be determined by the demand. This, again, can best be illustrated by the OPEC cartel. Therefore, even a cartel cannot eliminate the dependency of South countries on world markets, in particular in case of shifting or weak demand in the North.

Better bargaining position Exports of developing countries became increasingly subject to protectionist practices in the North. The expansion of South-South trade would, on the one hand, contribute to the creation of a more integrated and stronger South block which has a better position in negotiations with the North about trade issues. South trade would open new trading opportunities which can develop more steadily, with less unexpected interruptions, and without suffering from protectionism.

– The new protectionism in the North is a reality. But this protectionism is not only directed against the South but also against other industrialized countries. The trade disputes between EC and USA and between EC and Japan may be quoted as examples. For the EC, and USA and Japan, any grouping of developing countries would never become more important trading partner in the foreseeable future. Further, even if a strong South block could press on the North in international negotiations, e.g., in the framework of UNCTAD or GATT, and could get verbal concessions from the representatives of the North, one should not overestimate the relevance of such declarations to the practical national trade policy in the North.

– One should keep in mind that protectionist measures are taken selectively. Countries of the North do not protect their industries in general or in total. Protection is granted to a limited number of 'sensitive' industries, such as textiles, steel, coal-mining and shipbuilding. [91] The general attitude of important groups of Northern countries like the EC towards manufactures imports from the South is quite favourable.[(10)] For their manufactures, a large number

9 Several attempts have been made to quantify and specify the protectionist challenge; see, for example, World Bank: World Development Report 1987, op. cit., pp. 133-153, or UNCTAD Secretariat: Protectionism and Structural Adjustment - Background Note, UNCTAD Document TD/B/1126/Add.1, 22 January 1987.

10. The EC has set up a very restrictive trade regime for agricultural products, and there is a similar set of instruments for coal-mining and steel in periods of obvious crises. But for other industries, nothing comparable exists.

of developing countries enjoy a duty free access to the European. market, ' and for other developing countries preferential tariff rates are applied. This point will become relevant again with respect to strategic considerations in the third chapter below.(11)

Protectionism in the North may cause frictions in South-South trade if protectionism in the North reduces the exports' of some South countries, the import capacities of these South countries decline, then these countries may also cut back their imports from other South countries. Even if South countries had no trade relations with the North, their South trade is affected by protectionism in the North. Experiences in Latin America have shown that in cases where the import capacities of South countries get, restricted they first cut their imports from other South countries - even if they' are all members in an integration grouping with internal preferential or free trade. The reason is that many items imported from other South countries are similar to what is or has been produced in the restricting country' while it is very difficult if not impossible to substitute more sophisticated imported capital goods, machinery and equipment by locally produced items.

Finally, the implicit or explicit assumption that protectionism is only a phenomenon of trade policies in Northern countries must be refuted as unrealistic. On the contrary, the history of integration groupings in the South is full of examples for nationalistic behaviour of governments and recourse to protectionist measures. The uneven distribution of costs and benefits of integration is a permanent source for quarrels and disputes. If one takes into consideration the special situation of many South countries, then national 'egoism' and recourse to protectionist measures seem to be even more probable in the South than in industrialized countries: The micro-and macro-economic costs of industrial restructuring are much higher in the developing countries where technical knowledge and qualified manpower are lacking and capital and foreign exchange shortages are chronic.

This gives governments very strong incentives to defend and protect existing industries.(12)

Reduced dependence on world markets South-South trade could reduce the dependence of developing countries on the world markets and could create favourable conditions for more autocentric development

11. See especially. section (27) of this paper.
12. For a specification of trade control measures applied by South countries (not necessarily only for protectionist purposes) see UNCTAD; Handbook of Trade Control Measures of Developing Countries. 1987, New York (UN Publications) 1987; see also IMF: Exchange Arrangements and Exchange Restrictions - Annual Report 1987, Washington (IMF) 1987.

- For outward-oriented countries, this is not a meaningful approach. For them, expanded South-South trade is not an alternative but a supplement to North-South trade. For these countries, exports to North markets are much more important than exports to South markets, and they do not strive for a more autocentric development. If the South-South trade would expand, this would broaden the scope of outlets for the outward-oriented countries, and a more diversified (regional) export structure would reduce the vulnerability of these countries.

- Inward-oriented countries have often tried to implement a more autocentric development in their national development policies. Their recent interest in more South-South cooperation shows that they came to accept that international economic relations can be beneficial at least under certain conditions. South-South cooperation of inward-oriented countries reduces the high costs of import-substitution policies and opens possibilities for the utilization of comparative advantages in relation to other countries of the group. Once this is accepted, the question must be asked whether it would not be possible to design a development strategy which exploits the comparative advantages even to a larger extent - by a shift from inward - to outward-orientation. For most countries, it should be possible to formulate a sensible outward-oriented development and trade strategy, even if there is selective protectionism in the North.

If one is not convinced that 'autocentric development' is a meaningful strategy and that better outward-oriented alternatives are possible, then the reduction of dependency on the world market seems not only undesirable but also impossible. It may reduce some risks, but it certainly reduces many chances.

- As long as imports from the North cannot be suspended, exports to the world market are necessary to earn the foreign exchange needed for these imports. In this respect, the dependence on the world markets continue. It should be noted that world market conditions are not, as it. is often explicitly or implicitly assumed, 'dictated' by the North countries but are the result of decentralized export and import decisions with a large number of industrialized and developing countries both as exporters and importers.

- If an outward-oriented strategy is a realistic alternative to inward-orientation as it is assumed to be for most developing countries, world market 183 determines the opportunity costs of import-substitution or autocentric strategies. This type of dependence will always exist, even if all economic relations with North countries were cut off. One should not underestimate how powerful this type of dependence may be in the long run. The obviously high costs of the inefficiency of the 'traditional' central planning systems in

Eastern European socialist countries led to political pressure and forced the governments to revise or even change the economic systems in the mid 1960s (e.g., the introduction of a socialist market economy in Hungary or the attempt to liberalize the system in Czechoslovakia) and again in these days. There are two examples for changes from inward- to outward- orien-tation in South and even in Islamic countries, for example Pakistan and Turkey in the 1980s..

For a conceptional comparison it is important to see risks and chances of both strategies and not to confront the risks of the, one with the chances of the :other. While advocates of an autocentric approach see the dependence on world markets as a risk and the South-South cooperation as a chance, proponents of an outward-oriented strategy take just the opposite point of view: The integration into world markets opens many chances for. development while an institutionalized and inward-oriented South-South cooperation or integration may be very risky. In its own development, a member country in an 'autocentric South group' depends strongly on the policy of a small number of other member countries, and it would be very dangerous to believe that something other than the own development is the main goal for the governments of other countries: Thus it is not only the relatively small size of the group that limits the possible gains from integration; but the national interests of the other countries too. If this is ignored, quarrels about distributional issues may block further progress of collective inward-oriented strategy In inward-oriented groupings, development is not a result of decen_tralized market forces but of political incentives and governmental planning. In this respect, the member countries may differ substantially in their political weight or power. For smaller countries, this is an additional, element of risk.

To sum up, one can say that the theory of economic integration cannot prove that trade expansion and institutionalized cooperation between South countries will bring net gains for all participating countries, if the level of national industrial production is of any relevance. Distributional aspects have not been treated sufficiently in the theory, and the implications of different trade, development and industrialization strategies with 'regard to the costs and benefits of South-South trade have also not received due attention. Nevertheless, it seems possible to draw some strategic conclusions in general and with special reference to the group. of Islamic countries.

III

Strategic Conclusion with Special Reference to Islamic Countries

Although a preference for an outward-oriented policy should have become apparent, so far the outward- and inward-oriented strategies were presented as two alternatives for developing countries to choose from.

This, however, is not generally true, and for the group of Islamic countries, i.e., the OIC, an inward-oriented strategy is not an option at all.

- It was pointed out that inward-orientation implies discrimination against exports and requires a common protective policy for import-substituting industries. It was further emphasized that no country would be willing to suffer a net loss in industrial production after joining an inward-oriented grouping so that the regional distribution of industrial capacities becomes a matter of difficult political negotiations. These negotiations are more difficult and the rules or mechanisms for intra-group compensation are more complex, the larger the number of participating countries is. Things get even more complicated if the participating countries differ widely in their economic characteristics (e.g., size of domestic markets, etc. resources and productive factors endowments,level of development and industrialization). It is beyond imagination to envisage negotiations and compensation systems for a group of such a size and heterogeneity as the Islamic countries:

- Their number is 45 and they are spread from North-West Africa to South-East Asia. The population of the smallest countries is less than 1 million and of the largest countries around 100 million people.

- The GDPs range from less than 1 to nearly 100 billion US$. The per capita income is in the poorest countries 150 US$, while it is more than 10,000 US$ in the richest countries.

- Agriculture dominates in many Islamic countries, but several among them have a better developed manufacturing sector, while the wealth of a few countries springs from the extraction of natural resources.(13)

13. Figures for 1985, taken from World Bank: World Development Report 1987, op.cit., statistical appendix; More indicators for the industrial development and structural change in the industrial sector of South countries can be found in UNIDO: Industry and Development - Global Report 1986, Vienna (UNIDO Publications) 1986.

There should be a strong opposition against an inward-oriented policy for the Islamic world from two groups of Islamic countries:

- The first group consists of those countries which have adopted an outward-oriented strategy that resulted in a markedly better economic performance than the previously followed inward-oriented strategy. These countries have their main markets in the North, and although they may have much sympathy for an expansion of South-South, especially intra-Islamic trade, they will not accept the export-discriminating implications of an 'autocentric' or 'collective import-substitution' strategy since they would lose more in the North than they could gain in the South.

- The second group is those countries which would basically favor a delinking from the world markets and an inward-oriented policy, but they have reasons to fear that their comparative advantages, even in relation to the other Islamic countries, do not lay in industrial production. Their so far nationally protected industries ' would not survive the intra-group competition 'and it is hard to imagine' how an adequate , compensation for this net loss of' industrial capacities could be found.(14)

An outward-oriented policy is also not a realistic option for the OIC. Several reasons can be given:

- For the industrially least developed countries, any strategy that leads to a liberalization of intra-Islamic trade will be hard to accept whether it is generally inward- or outward-oriented.

- Countries with stronger import-substituting industries which would not fear 'competition with other Islamic countries may decline the reduction of level of protection against third countries which would be part 'of an outward-oriented trade policy.

- Finally one could argue 'that an outward-oriented policy is not specifically designed to promote intra-Islamic trade but only that should be the concern of the OIC.

The last argument, however, is not a very strong one: An outward-oriented strategy is of course not specifically designed to promote South-South or infra-Is-

14. On 'traditional' compensation schemes and a new proposal for a 'customs-drawback union' see Volker Nienhaus: Economic Development through Regional Cooperation - A Customs-Drawback Union of Islamic Countries, in: Journal of Islamic Banking and Finance, Vol. 4, No. 3, Karachi 11987, pp.7-31.

lamic trade. However, there are strong theoretical and empirical reasons to expect that the volume of South-South or intra-Islamic trade (not necessarily its share in a country's total trade) will expand most when a country can successfully establish industries which gain a competitive edge on the world market.[15]

Neither inward- nor outward-orientation seems to be a suitable option for the OIC. This somewhat surprising or confusing result needs a few words of explanation. Most institutional arrangements for South-South cooperation emerged from negotiations of a few countries which had a similar understanding of development and trade strategies. If there was a 'common denominator', countries who accepted it could form a cooperation or integration grouping, and countries with a different understanding stay aside. One may say that the strategy was given and the appropriate members were looked for. In the case of the OIC, the situation is the opposite: the members are given and the appropriate strategy is looked for. Unfortunately, there is no guarantee that an appropriate strategy exists at all.

If neither an outward- nor an inward-oriented policy is the appropriate strategy, then one has to look for other strategies which may be less ambitious or encompassing but can be put into practice. The critical issues are internal liberalization of trade and external protection of national industries.

> A feasible policy must give member countries the choice to continue their import-substitution policy and the protection of their industries. In this case, unconditional internal trade liberalization seems impossible. Any liberalization had to be combined with compensations for those countries whose industrial production will be negatively affected by the removal of internal trade barriers. But since it seems to be very difficult to create a feasible compensation system, measures for a general and unconditional intra-Islamic trade liberalization will hardly have a chance to be adopted unanimously.[16]

However, the more advanced and outside-oriented Islamic countries may unilaterally reduce the barriers for imports from other Islamic countries.

- The national industries of these outside-oriented countries should not be affected seriously by the reduction of protection against other Islamic countries. On the one hand, the level of tariffs may already be relatively low. On

15. See W. Newson, D. Wall, op.cit., pp: 27-30, **35-37** with further references.
16. It is noteworthy that so far the OIC has not developed a program for trade liberalization. Liberalization is of relevance only with respect to factor movements, i.e., labour migration and capital mobility.

the other hand, the non-tariff trade impeding factors (which Were listed in the first chapter) are still in force. And finally one can expect that industries in these countries are generally more efficient than industries in the less advanced Islamic countries.

- Although countries which reduce trade barriers may not be hurt too much, better access to markets in other Islamic countries may have a stimulating effect on the industries of the less advanced countries.

- Even if the economic impact of such unilateral moves toward intra-Islamic trade liberalization is very limited (i.e., the costs for the reducing countries and the benefits for the now privileged countries are low), such an act may have a symbolic value. It shows the inclination of the more advanced Islamic countries to the idea of *'Ummah'* and of Islamic economic cooperation. This may have some relevance not only within the Islamic world, but for the relations of the 'OIC with other international organizations and institutions.

Although, for the time being, trade liberalization cannot be realized within the OIC because it would hard the interests of some countries, trade promotion may be a sensible option: Trade promotion does not harm those countries which do not want to take part in intra-Islamic trade but it offers opportunities for those which wish to do so.

First secton indicated where trade promotion activities should be directed to, e.g.:

- reduction of transportation costs.
- improvement of communication facilities,
- export credit facilities.

There are various activities within the OIC system (including those of legally independent institutions like the Islamic Chamber of Commerce, Industry and Commodity Exchange or the Islamic Development Bank) which cover, with varying intensities, most of the fields of direct promotion of South-South trade from the organization of Islamic trade fairs to financing facilities for intra-Islamic trade.[17] In addition, the OIC is trying to create a legal framework that is favourable for intra-Islamic investments (joint ventures) and labor migration between Islamic countries.(18) All these efforts are in the right direction and may help to intensify the economic interrelations in regional sub-groups within the Islamic world.

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17. The Islamic Development Bank (IDB) has increased the utilization of funds for trade finance substantially: But this trend should be examined more closely.
18. On the cooperation and integration efforts of the OIC and on the legal and institutional framework see Volker Nienhaus: Economic Cooperation and Integration among Islamic Countries. Jeddah (IDB/IRTI) 1987.

Unfortunately, all these efforts could easily be obstructed by obstacles to trade resulting from the different monetary policies and exchange rate regimes of the OIC member countries. Table 3 shows how many different exchange rate regimes have been adopted by Islamic countries and how some countries changed their regime in the last few years.

The exchange rate regime along with national monetary policies determines the real exchange rate, i.e., the nominal exchange rate deflated by a consumer . (or another appropriate) price index. As can be seen from table 4 and figure 1, there are some Islamic countries whose currencies showed a relatively steady appreciation trend against the US$ in real exchange rates while the currencies of others depreciated. However, the currencies of a third group of countries strongly fluctuated.(19) With respect to bilateral or 'intra-Islamic' exchange rates, these diverging movements partially compensate and partially reinforce each other. There can be unfavorable trends in the development of bilateral exchange rate movements, but one should notice also the wide and unpredictable exchange rate fluctuations which resulted from uncoordinated interventions of several governments of Islamic countries. Such a climate of monetary instability is certainly not conducive for the expansion of a South-South trade based on comparative advantages and leading to a 'more rational' division of labor within the group of Islamic countries. Therefore, the OIC should recognize the importance of monetary stability and look for possibilities of harmonization or coordination of monetary policies because this is a prerequisite for more integration of the commodity markets. But for the foreseeable futures, there is little hope that the member countries will abandon their autonomous monetary policies (which result in monetary instability and unpredictable exchange rate fluctuations between Islamic countries or/and in trade restrictions in order to maintain politically fixed exchange rates).

Besides the above listed measures for a direct promotion of intra-Islamic trade, the OIC may have another option for an indirect (but may be very effective) trade promotion which, as it seems, has not been utilized very much. However, a classification of this option under the headline "promotion of intra-Islamic trade" is justified only when the proposition that South-South representative intra-Islamic trade will grow when the North-South trade expands is accepted. This option, therefore, requires promotion of South-North trade as a means of gaining strength

19. Such a trend is shown for Egypt. However, one should not rush to conclusions from this trend because Egypt operates a multiple exchange rate system with different rates for different transactions; the table and figure only include the primary rate. In general, these figures should not be overestimated as the calculation of consumer price indices, for example, differ substan- tially between countries and is often politically influenced. Nevertheless, these figures are useful as illustrations and to point out magnitudes and trends.

for the South export. On its turn such strength would make these exports more competitive in the South own markets.

It has been mentioned that the general attitude of industrial countries toward imports especially of manufactures from the South is not as negative as one may believe. Protectionism in the North is no doubt a problem for the South. But this protectionism is selective rather than absolute. Protectionist measures can often be circum- vented by individual ingenuity of South exports or sometimes pushed back by action on the political level. The European Community (EC) is a very large trading block. It is an important, or even very important, outlet for the exports of most Islamic countries. (The 1985 share of the EC in total exports of Islamic countries is given in table 2).

If the OIC could conclude an agreement with EC which assures a duty-free and unrestricted access for manufactured goods from OIC member states to the EC market, the OIC would have opened for some of its members substantial new outlets while for other members an already granted free or preferential access may have been secured. Whether the chances will be utilized or not would then depend on the individual decisions of the OIC member countries.

There are good reasons to believe that such 'an agreement is not totally beyond all realities:

- In December 1984, the EC has concluded with 66 African, Caribbean and Pacific States ("ACP States") a convention, called "Lome III". This convention, *inter alia,* provides for free and unrestricted' access to the EC market to manufacture (with some specified exceptions) of ACP origin. The following 19 Islamic countries are among the ACP States: Benin, Burkina Faso, Cameroon, Chad, Comoros, Djibouti, Gabon, Gambia, Guinea, Guinea-Bissau, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Somalia, Sudan, Uganda:

- Turkey is, already, an associated member of EC since 1963 and has recently applied for full membership. Except for textiles, Turkish manufactures have free and unrestricted access the EC market, however, Turkey has also to abolish tariffs for imports from the EC gradually.

- Since 1974, the EC concluded association agreements with Algeria, Egypt, Jordan, Lebanon, Morocco, Syria and Tunisia. The EC concede unilateral preferences and for some items duty free access to the European market.

- Negotiations on a free trade agreement between the EC and the GCC comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates - are expected to start soon.[20]

- At their 7th meeting (May 1988), the Foreign Ministers of EC and ASEAN - where Brunei, Indonesia and Malaysia are Islamic member countries - recognized the need to eliminate trade barriers.[21]

In addition to the special trade relations with 27 Islamic countries (special arrangements .with GCC and ASEA are not yet in force), the EC introduced a general system of (unilateral and non-discriminatory) preferences for finished and semi-finished products of developing countries.[22] Sensitive items can be excluded from the preferences. On the other hand, the preferential conditions have been improved repeatedly in favor of the developing countries. These include an adoption of the rules of origin to the special situation of regional integration groupings in order to support this form of South-South cooperation.

Thus one can say that almost all Islamic countries have today preferential access to the EC market, but with substantial differences regarding the specific terms and conditions. The OIC may start negotiations about an equal treatment of all Islamic countries. What, in fact, would mean an upgrading of the less favorable preferences to the level of the ACP States.[23] Considering the past attitude of the EC toward individual developing countries and regional cooperation and integration groupings, the chances of success in such negotiations do not look too bad. However, two problems should be realized:

- An upgrading of the EC-OIC relations would imply a (relative) devaluation of existing preferences esp. of non-Islamic developing countries. They may try to obstruct the negotiations. On the other hand, the OIC could improve its bargaining position: There are some African integration groups whose members are ACP states and at the same they are, all or in majority, Islamic countries. As groups with special relations to the EC, they could be won to support to the OIC position. This would certainly give the demand of the OIC more weight.

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20. See Uffe Ellemann-Jensen: "Why is Denmark in Favour of a Free Trade Agreement between the European Economic Community and the Gulf Co-operation Council (EEC/GCC)"? in: Kooperation, No. 5, Wachtberg 1988.
21. See Joint Declaration, Seventh ASEAN-EC Ministerial Meeting, Dusseidorf, 2-3 May 1988, in:ASEAN Newsletter No.27, Jakarta, May/June 1988.
22. A detailed listing of the major products and their major suppliers (in 1984) is provided in: UNCTAD Secretariat: Generalized System of Trade Preferences - Replies Received from Preference - Giving Countries: the European Economic Community (EEC), UNCTAD Document No. TD/B/C.5/ PREF/30,10 June 1988.
23. The case of Turkey must be separated.

- Negotiations of the OIC with the EC require that OIC be able to present itself as an (emerging) integration grouping and not just as a relatively loose assembly of developing countries for the informal discussion of common political, cultural and economic problems. The OIC may draw the attention to its recognition in the UN system and the cooperation of UN organization (like UNIDO) with organizations of the OIC system (like IDB). The OIC has further to improve its image to the general public of the European countries. This means that the OIC needs an adequate representation in Europe and should invest a little in public relations and information.

Even if negotiation with the EC will be time consuming and even if not all goals can be realized in full, a better representation of Islamic countries in Europe should never be to their disadvantage. The hope is that the infra-Islamic trade will gain from an improved position of the (outward-oriented) Islamic countries on the world market. Even if this hope were unjustified, the OIC should consider the costs and advantages of measures which would facilitate a better access to the world markets for those Islamic countries which are willing to follow an outward-oriented policy (without any obligation or direct disadvantages for those countries which want to continue their inward-oriented policy).

Table 1

Intra-Group Trade as Percentage of Total Exports of the Area .

	establ .	**1960**	**1970**	**1976**	**1980**	**1983**
SEAN	1967	21.7	14.9	13.9	17.8	23.1
ALADI	1980	7.7	10.2	12.8	13.5	10.2
ANDEAN	1969 .	0.7	2.3	4.2	3.5	4.3
ECOWAS	1975	1.2	2.1	3.1	3.9	4.1
CACM	1960	7.5	26.8	21.6	22.0	21.8
CARICOM	1968	4.5	7.3	6.7	6.4	9.3
CEAO	1974	2.0	9.1	6.7	6.9	11.6
UDEAC	1964	1.6	3.4	3.9	4.1	2.0
EC	. 1959	34.6	49.5 ,	49.4	52.8	52.4

Source: Figures excerpted from UNCTAD: Handbook of International Trade and Development Statistics (New York, various years) by Thomas Straubhaar: South-South Trade - Is Integ

Table 2

Exports of Islamic Countries to OIC and EC Members
(% of Total Exports)

	OIC 1980	OIC 1982	OIC 1984	OIC 1985	EC 1985
Afghanistan	10.5	9.7	4.7	3.8	15.3
Algeria	0.3	1.3	1.9	2.6	66.4
Bahrain	28.0	31.1	30.2	30.4	4.3
Bangladesh	26.6	22.3	25.9	27.4	17.4
Benin	9.4	23.1	4.7	3.4	92.4
Brunei	1.0	0.4	0.7	1.0	0.0
Burkina Faso	6.3	7.4	2.5	7.1	57.9
Cameroon	3.5	4.6	4.9	2.0	76.0
Chad	7.2	7.3	3.2	4.3	35.3
Comoros	0.0	0.5	3.2	3.3	57.0
Djibouti	69.0	81.4	73.9	86.7	3.6
Egypt	12.2	7.6	6.3	5.7	43.9
Gabon	0.0	1.0	1.5	2.6	52.2
Gambia	22.3	10.3	7.8	9.5	19.6
Guinea	6.9	5.6	8.8	10.6	66.5
Guinea-Bissau	8.8	4.4	1.4	0.9	70.9
Indonesia	0.8	1.1	2.0	2.8	6.2
Iran	6.1	9.7	15.5	15.4	34.4
Iraq	9.2	18.8	15.2	14.9	43.8
Jordan	57.0	44.5	53.1	52.4	4.4
Kuwait	14.4	25.6	15.3	16.3	33.5
Lebanon	69.3	69.8	58.1	54.0	10.6
Libya	4.1	6.5	8.7	7.8	75.8
Malaysia	3.9	4.8	5.1	4.0	14.4
Maldives	13.9	0.0	11.6	0.8	4.2
Mali	4.1	8.7	5.9	8.8	72.7
Mauritania	0.6	1.9	1.2	0.5	71.8
Morocco	7.6	9.3	13.6	13.2	52.0
Niger	18.6	12.9	16.1	14.1	77,1
Nigeria	0.7	0.7	1.4	0.9	55.8
Oman	0.4	0.7	0.5	1.0	3.1
Pakistan	33.5	36.5	37.2	24.8	22.2
Qatar	3.8	5.6	4.3	5.1	15.9
Saudi Arabia	6.2	9.8	13.6	13.5	21.7
Senegal	23.2	14.0	14.8	15.4	43.0
Sierra Leone	0.0	0.5	0.3	0.2	60.2
Somalia	82.7	80.4	79.0	66.6	21.9

	OIC 1980	OIC 1982	OIC 1984	OIC 1985	EC 1985
Sudan	28.	44.3	34.4	41.4	23.5
Syria	8.0	12.0	12.9	8.9	55.5
Tunisia	6.5	7.9	12.0	9.7	69.6
Turkey	22.4	47.8	41.0	42.0	40.2
Uganda	3.3	4.0	1.6	2.0	50.8
United Arab Emirates	9.6	9.1	7.6	8.2	8.0
Yemen, Arab Rep.	51.8	73.6	44.4	25.2	18.0
Yemen, P.D. Rep.	35.5	9.7	24.0	22.2	82.2
Total	**6.8**	**10.2**	**10.8**	**10.5**	

Source: IMF: Directions-of Trade Statistics - Yearbook 1987. Washington 1987.

Table 3

Exchange Arrangements of Islamic Countries (as on March 31)

Country	1979	1980	1981	1982	1983	1984	1985	1986	1987
Afghanistan	A	A	A	6	6	6	6	6	
Algeria	5	5	5	5	5	5	5	5	5,
Bahrain	A	A	A	6	6	6	6	6	. 6
Bangladesh	3	3	5	5	5	5	5	5	5
'Benin	2	2	2	2	2	2	2	2	2
Brunei									
Burkina Faso	2	2	2	2	2	2	2	2	,2
Cameroon	2	2	2	2	2	2	2	2	2
Chad	2	2	2	2.	2	2	2	2	2
Comoros	2	2	2	2	2	2	2	2	2
Djibouti	1	1	1	'1	1	1	1	1	1
Egypt	1-	1	1		1	1	1	1	
Gabon	2	2	2	2	2	2	2	2	2
Gambia	3	3	3	3	3	3	3	3	10
Guinea	4	4	4	4	4	4	4	4	10
Guinea-Bissau	4	4	4	4	4	9	9	9	9
Indonesia	A	A	A	6"	9	9	9	9	9
Iran	A	A	A	4	4	4	4	4	4
'Iraq	1	1	1	1	1	1	1	1	1
Jordan	4	4	4	4	4	4	4	4	4
Kuwait	5	5	5	5	5	5	5	5	5
Lebanon	A	A	A	10	10	10	10	10	10
Libya	1	1	1	1	1	1	1	1	4
Malaysia	5	5	5	5	5	5	5	5	5

Country	1979	1980	1981	1982	1983	1984	1985	1986	1987
Maldives	1	A	A	6	6	6	6	5	10
Mali	2	2	2	2	2	2	2	2	2
Mauritania	5	5	5	5	5	5	5	5	9
Morocco	5	5	A	9	9	9	9	9	9
Niger	2	2	2	2	2	2	2	2	2
Nigeria	A	A	A	9	9	9	9	10	
Oman	1	1	1	1	1	1	1	1	1
Pakistan	1	1	1	9	9	9	9	9	9
Qatar	A	A	A	6	6	6	6	6	6
Saudi Arabia	A	A	A	6	6	6	6	6	6
Senegal	2	2	2	2	2	2	2	2	2
Sierra Leone	4	4	4	4	9	1	4	4	10
Somalia	1	1	1	1	4	8	8	8	8
Sudan	1	1	1	1	1	1	1	5	5
Syria	1	1	1	1	1	1	1	1	1
Tunisia	5	5	5	5	5	5	5	5	9
Turkey	A	A	A	9	9	9	9	9	9
Uganda	4	4	4	9	9	10	9	1	
United Arab Emirates	A	A	A	6	6	6	6	6	6
Yemen, Arab Rep.	1	1	1	1	1	1	1	1	1
Yemen, P.D. Rep.	1	1	1	1	1	1	1	1	1

Source: IMF: Exchange Arrangements & Exchange Restrictions Annual Reports 1979-1987. Washington (IMF) 1979-1987.

1: Pegged to US dollar
2: Pegged to French franc
3: Pegged to orther currency (British pound)
4: Pegged to SDR
5: Pegged to other currency composite
6: Flexibility limited vis-a-vis a single currency
8: More flexible, adjusted according to a set of indicators
9: More flexible, managed floating
10: More flexible, independent floating
A: Exchange arrangements which are classified under 6 or 9 or 10 from 1982 onwards but were classified under 'Other Arrangements' in the years before.

Table 4

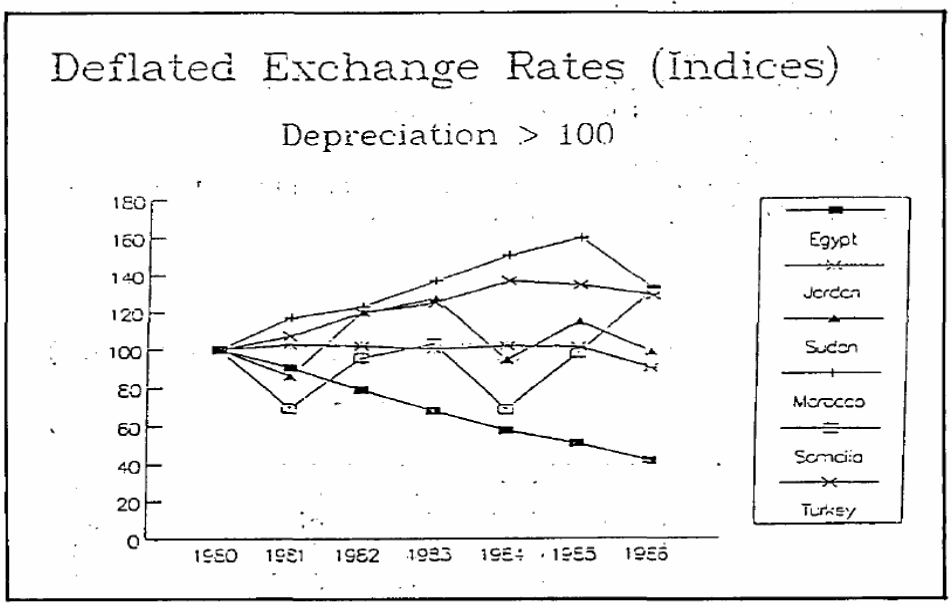
Real Exchange Rate Index (1980 = 100, Depreciation > 100)

Country	1980	1981	1982	1983	1984	1985	1986
Syria	100.0	84.5	73.9	69.6	63.9	54.4	40.0
Egypt	100.0	90.6	78.9	67.9	58.0	51.2	41.8
Sierra Leone	100.0	89.4	75.3	60.6	54.4	58.1	57.0
Algeria	100.0	98.1	97.8	94.7	92.0	83.8	70.7

Country	1980	1981	1982	1983	1984	1985	1986
Qatar	100.0	91.7	86.8	84.4	83.5	82.0	80.7
Bahrain	100.0	89.6	82.3	79.9	79.7	81.8	83.7
Kuwait	100.0	96.0	92.0	89.0	89.3	89.4	86.0
Senegal	100.0	121.4	125.1	130.0	133.3	121.4	87.9
Jordan	100.0	102.8	102.1	100.2	102.1	101.7	90.3
Mauritania	100.0	88.3	84.6	88.2	95.9	102.0	91.3
Malaysia	100.0	96.5	92.4	88.6	86.1	90.9	93.8
Cameroon	100.0	116.2	124.0	123.3	.127.0	128.9	96.3
Gabon	100.0	118.3	122.7	128.8	139.6	133.7	96.9
Nigeria	100.0	93.0	94.7	82.6	62.5	69.2	99.0
Sudan	100.0	85.9	119.8	127.1	94.8	114.8	99.2
Bangladesh	100.0	100.2	109.5	111.4	103.8	103.5	101.3
Pakistan	100	89.4	101.0	105.3	105.8	113.4	114.3
Burkina Faso	119.5	129.1	138.1	151.1	145.3	115.0	
Tunisia	100.0	112.0	117.8	124.2	'131.1	130.4	117.3
Niger	100.0	104.6	113.4	134.8	142.6	148.0	117.8
Saudi Arabia	100.0	99.0	100.9	102.3	105.6	112.2	118.3
Indonesia	100.0	89.8	85.8	105.5	107.9	111.5	121.6'
Turkey	100.0	107:1	119.6	124.8	136.8	134:4	129.0
Somalia	100.0	69.3	95.7	103.3	68.5	98.1	131.7
Morocco	100.0	116.8	123.0	136.7	150.7	159.8	132.9
Gambia -	100.0	108:1	113.0	117.9	131.1	119.3	134.9

Source: IMF: International Financial Statistics, Vol: 41, No.6, Washington 1988. (Exchange rates [period averages] divided by consumer price index).

Fig. 1



CHAPTER V

INTERNATIONAL ISLAMIC BANKING IN AN INTEREST-BASED WORLD FINANCIAL SYSTEM: A THEORETICAL MODEL

Ahmed El-Naggar*

[In this paper the author has tried to highlight the role of Qurud-Hassanah (benevolent or interest-free loans) and Musharakah as methods of financing development by Islamic Bank. The paper argued that these modes of financing can be used to expand economic activities, for the purpose of increasing income, employment and output. The Musharakah financing which establishes a real relationship between the clients and the Bank as partner can be utilized as a potential weapon for development of certain key sectors of the economy as it introduces flexibility in the cost of financing and links the use of funds directly to social and economic priorities. The author has stressed the need to influence the behavior of the clients of the Bank either as savers or investors through the various method of financing so that socio-economic goals of the Islamic economy can be achieved. (Editors)]

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I
Introduction

Islamic Banks are expanding rapidly not only in the Middle East but also in other part of the world as well. The steady increase of the activities of Islamic Banks on the international scale, show that Islamic Banks can play an important role in raising the standard of living of the people.

In its simple form, Islamic Banks may be treated as a financial institutions. But it can be used as an instrument of behavioral change through mobilization of savings and investment spending to achieve a desired socio-economic goal of the society.

The philosophy of Islamic Banks is altogether different from other commercial banks in its economic, financial and commercial dealings based on techniques such as Musharakah, Mudarabah, lease-sale, and so on.

I have chosen to discuss the following techniques of operations:

- Qurud Hasanah: tools for development
- The role of Musharaka financing

Qurud Hasanah: Tools for Development

Islamic Bankers have long believed that one of the best methods of modifying individual behavior toward the goal of building a resource pool for long term investment if through granting productive Qurud Hasanah. These loans are made without collateral requirements which the borrower cloud probably not provide anyway.

Through Qurud Hasanah, a numerically significant section of the population which traditionally suffers from low output, such as labourers and unemployed young people, could be provided with a means to raise their standard of living and become self-sufficient. More specifically, these loans can:

1. Expand the society's economic base.
2. Create potential clients for the Bank
3. Increase savings and help guide consumption properly.
4. Forge improved interpersonal relations among individuals and financial institutions by fostering feelings of mutual co-operation and eliminating exploitation.

5. Combat unemployment
6. Support large industrial concerns by strengthening supports services.
7. Provide training for Bank personnel in the form of experience which is superior to what they would learn in a classroom environment.
8. Inspire confidence in the Bank by sporting families who will later take part in the investment process.
9. Expand markets through the increase of purchasing power.

All these can be achieved through an operation aimed at providing incentives for the beneficiaries to make their resources available to the Bank. Furthermore, Qurud Hassanah has an advantage in that they are relatively simple and inexpensive to administer. They only require, for example, that the Bank set certain conditions for granting the loan. These could include the stipulation that the borrower be a regular client of the Bank, be a member of the community in the area where the Bank is located, possess experience in a specific field, be a practitioner of a profession, or be a person with a good reputation in the area in the vicinity of the Bank. In undertaking this activity the Bank engages in education for development. Viewed from this perspective the concept of " Qurud Hasanah " can be seen as an expressing of solidarity as well as an innovative method of development financing, offering Islamic Bank an opportunity to succeed in an area where many other agencies and governments have failed.

The Role of Musharakah Financing

Musharakah is another form of financing available to the Islamic Banks. This method establishes a relationship between the client of the Bank and the Bank as partner, and not a debtor and a creditor. Its basis is mutual interest and aspirations.

The Bank, for its part, must put all of its resources at the disposal of the client and do its utmost to ensure, the success of the project. The client, on the other hand, must cooperate fully with the Bank, in administering the activity and work to solve problems which might arise.

The positive effects of this type of financing are as follows:

1. It directly rewards and provides more incentive to human labour, thereby drawing nonbankable classes into the productive circle of the economy.
2. It links use of funds directly to social and economic priorities. Since no single rate of interest is given or taken there is great flexibility in the cost of financing. This is a potential weapon for manipulating development of certain sectors of the economy.

3. It achieves a just of means of distributing the return between the investor and the financing agency.
4. It is a type of cooperation and partnership which stimulates human Productivity:
5. It expected to yield a higher rate of return to both parties. This is also an incentive for investments in high-risk projects.
6. It requires that this type of financing should be associated with a project intended to increase the real value for the economy.

It is often argued that *Musharakah* financing, although most suited from both the *Shari'ah* point of view as well as the bank's point of view, will be used selectively and only in those cases where the client is efficient, experienced in the line, and straightforward and honest in dealings and the project is profitable. At the operational level 'one must take appropriate steps to safeguard against possible dishonesty.

It is the task of the Islamic banks to influence the behaviour of the clients in a positive way.

In this connection, I wish to clarify the role of feasibility studies. Since the Islamic Banks are development oriented and a risk-taking partner it puts more burden on them, ensures the feasibility of its ventures. But feasibility studies should not impose additional financial burden on the project's execution, try to find new ways to identify the viability of the projects at a low cost.

The belief that Islamic Banks have come into existence to oust commercial banks from the market is not sound at all. The uprooting of interest which may seem a. religious demand is simply one of the objectives of the Islamic Banks. Islamic Bank is not merely a commercial bank but is also a financial, social and development institution seeking the welfare of both the individual and society.

To clarify this point we would like to mention the following two points:

1. The basis and philosophy according to which commercial banks are operated and run in Islamic countries and elsewhere, are based on purely material conceptions of life having little or no regard to humane relationships. This is contrary to the fundamental principles adopted by Islamic banks which have developmental and social tasks 'to perform through the financial services.

   The fact is that a commercial bank transacts and conducts its dealings on the basis that money is a buyable and salable commodity and that non-spending is a sacrifice to be materially rewarded and it is considered as a sacrifice of commodity which has a price. Hence, there is a necessity to have a money market governed by the forces of demand and supply with periodic intervention of the government.

2. It may be noted here that interest-based commercial bank which was originally developed in Europe to meet its social and developmental need was literally transferred to us with no adaptation. Attempt may be made to remedy any flaw occurring in the course of application. But in my opinion, any attempt to set right the particulars and components of current commercial banks - via the Islamic course will be wasted in vain. This is because commercial banks are not based on the assumptions and economic philosophy on which Islamic banks are supposed to work.

The proper Islamic awareness and consciousness can hardly be incorporated into the affairs of commercial banks.

The history of commercial banks as developed in Europe shows that they have never taken into consideration their responsibilities for the welfare of the society. Their top responsibility lies in fulfilling certain financial requirements of one sector or another according to a policy designated by the benefit and interest of the bank. This sounds logical and proper according to the philosophy of these banks. No one will ever dream of proclaiming that these banks have the capability of facing and confronting problems of the society. This is attributed to the fact that they do not possess the means and the capability for assuming these tasks.

On the other hand, when we deal with Islamic banks, we find basically and completely a different state of affairs in the following ways:

1. Money is not, in my opinion, a commodity. It is in fact a means of exchange and measure of value. This difference by itself is quite significant indeed.

2. The Islamic banks is linked to all sectors of the economy as well as to all sections of the society in one way or another.

   It is expected to influence the behaviour of savers, investors, consumers and producers. According to the Islamic code of life there is no objection to pecuniary incentives, but the members of a community have to manage their financial resources in a socially responsible manner, and, as wealth increases, the responsibility becomes greater. A person should not find enjoyment and prestige in wealth. He finds security in the solidarity of the Islamic society, a society which fills its responsibilities by neglecting or rejecting any deserving individuals in a society.

3. These become clearer when these principles can, among' others, be operationalised through decentralization in decision-making process involving the poor and disadvantaged people.

Inspite of the difference between the Islamic and commercial Banks, a number of transactions, may seem similar. It. is not true that the main objective of the Islamic banks -is to compete with commercial banks. The fact is that the rule of competition and. rivalry does actually exist among the commercial banks themselves. In a fundamental sense, the objectives of the Islamic Banks are different from the commercial banks.

Nevertheless, it is for the benefit of the commercial banks themselves that Islamic Banks should flourish because Islamic banks help development of a banking attitude and socially responsible behaviour on the part of the people needed for clearing barriers of investment and overcoming hindrances impeding develop-. ment.

With their autonomy and independence, Islamic banks are institutions almost like a mosque where dealers, customers, and investors in the field of economies and investment succeed in such a way as to arouse great admiration.

Like commercial banks Islamic banks are also keen on safeguarding all financial institutions in the society, for money *(Mal)* is the backbone of life. From an Islamic perspective, Islamic banks should never let any financial institution be exposed to misfortunes regardless of its system or philosophy because disturbances in the money market will affect all financial institutions. Therefore, Islamic banks should be very keen on establishing and maintaining friendly relations with all authorities responsible for implementing monetary policy in the society.

Since the very characteristic of Islamic banks is development oriented aimed at efficient utilization of all potential human and material. resources more attention should be paid to non-formal training and development of manpower so that a cadre capable of handling the complex problems of Islamic banks can be developed.

As for activities related to financing through *Musharakah* which constitutes one of the major activities of an Islamic- bank,, it should not. be seen as a very unfamiliar difficult operation because such an operation is efficiently conducted at most investment banks under the name of "Unit Trust".

Let us now discuss in some details the structure of the Islamic Banking system.

II

The Structure of Islamic Banking System at Present

After the experience of Local Savings Banks in Egypt early in the sixties and another experience in Pakistan almost in the same period to establish financial institutions operating without interest (which unfortunately did not continue for more than few year for several reasons) a great deal of attention was paid to the idea of establishing Islamic Banks both in the public and private sector. As a result, the Nasser Social Bank was established in Egypt as a Government owned bank to handle social activities. According to its statute, the bank was permitted to practice banking activities without interest. Meanwhile, the subject of establishing Islamic Banks started to be a standing item on the agenda of the Conferences of the Finance and Foreign Ministers of the Organization of Islamic Conference (OIC) countries eventually on the basis of the recommendations of OIC, when Islamic Development Bank was established in Jeddah with an authorized capital of 2,000 million Islamic Dinar (one Islamic Dinar equals one SDR) in 1974, fully subscribed by the Governments of Islamic countries.

This remarkable event was followed by the establishment of a number of Islamic Banks in various Islamic countries in the private sector, although some local governments and semi-governmental bodies become the share holders of some Islamic Banks such as Faisal Islamic Bank of Egypt, Dubai Islamic Bank, and Kuwait Finance House.

At a later stage, three Islamic States namely Sudan, Pakistan and Iran decided to convert their banking systems completely to operate according to Islamic Shari'ah..

Finally, some conventional banks in Egypt, realizing the desire of some of their clients to operate according to principles of Islamic banks, allocated some of their branches to handle only Islamic banking operations. The number of these branches is 59 at present and they belong to 22 conventional banks.

In the light of the above, it may be concluded that the Islamic banking system at present comprises of:

- Local comprehensive Islamic Banking systems
- An International Islamic Bank owned by Governments.

- Private Islamic .banks with equity 'participation by government bodies.
- Private Islamic banks.
- Islamic banking branches of conventional banks.

III

Sources and Uses of Funds in Islamic Banks

In this section, an attempt will be made to discuss the sources and uses of funds in Islamic Banks.

A) SOURCES OF FUNDS

1) Shareholders' equity of Islamic banks is almost similar in nature to the shareholders' equity of conventional banks. However, the. equity in Islamic banks may be relatively larger due to the fact that the Islamic bank is, by nature, a multi- purpose bank directing a remarkable portion of its resources towards medium and long term uses.

2) External sources comprise mainly of :

- Current accounts
- Savings account
- Investment accounts.

While current accounts have the same nature and conditions of those held with conventional banks, the situation is completely different with the investment accounts which are the alternative to term deposits of conventional banks.

Balances of investment accounts are deposited with Islamic banks which are authorized to make use of them under their fill) discretion without any predetermined rate of return whatsoever. The rate of return is calculated for each period of distribution based on the results of the transactions of that period.

However, there are two types of investment accounts :

- Allocated accounts where their balances are used in defined fields of activity such as industry, construction, domestic trade, foreign trade, housing, etc. or used to finance a specific project such as reclaiming and cultivating a piece of land or building a housing complex for sale, etc.

- Non-allocated accounts where their balances are used in various activities within the general investment pool of the bank.

B) USES OF FUNDS

The principles of *Shari'ah* prohibit the payment or receipt of interest and the financing operations of Islamic banks are non-interest bearing (i.e., based on profit and loss sharing) which mainly consist of the following :

1. *Mudarabah* (Participation)

This is a participation between the Islamic bank and its client where the bank supplies the whole funds needed to finance the operation and the client provides management and services needed for the operation. Upon the completion of the operation, the accounts are settled and the realized profit is distributed between the bank and the client according to ratios agreed upon at the time the *Mudarabah* contract is signed. The Islamic bank bears the whole loss if there is any and in such a case the client gets nothing for management and services. The operation's revenues and expenses are monitored through an account opened with the bank and operated jointly by the partners.

2. *Musharakah* (Mutual Participation)

This form is similar to the *Mudarabah* except that in addition to providing management and other services, the client shares with the bank in providing the finance needed. According to the *Musharakah* contract, the realized profit of the operation or the project is distributed as follows:

- A percentage for management and services to the client (sometimes the bank obtains a portion of this percentage in case of participation in the management).

- The residual percentage of profit is divided proportionally between the bank and the client being the suppliers of funds invested.

In case of loss, it is borne by the two parties at the same ratio of their contribution to the funds.

3. *Murabahah* (Mark up)

This is a trading process whereas the Islamic bank purchases goods from a third party at the request of its client and resells the goods to such client on deferred payment terms at a higher price receiving the client's undertaking to pay such price on a future date or dates. In such cases, the Islamic bank may obtain some collateral from the client to ensure payment.

4. Redeemable Participation

This is the Islamic banking alternative to the term of loans provided by conventional banks. This mode of finance helps projects to acquire capital assets. The finance provided by the bank under this form may be seen as decreasing equity. After the proper analysis of the project and the decision of the bank to participate, the redeemable participation contract is signed stating the duration of the participation, when the redemption starts, the amount of the principal to be redeemed every time which should be based on the projections of the cash 'flow of the project and its profitability. Until the full redemption of the participation is made, the bank's funds receive profit (or loss) periodically as other shareholders. The accounts of the financed project are monitored by the bank and in most cases the bank requires to have a role in the management or to be represented in the project's board-of Directors.

5. *Ijarah (Lease* **Financing)**

Islamic principles permit the purchase of goods for subsequent rental. A commercial or individual client wishing to acquire the use of capital equipment may request the Islamic bank to purchase such equipment and obligate itself to rent such equipment from the bank, when acquired. According to the *Ijarah* contract, the client looks only to the original supplier for warranties relating to quality of goods rented. Ijarah financing is based upon financial situation and cash flow projection of the client relating to the utilization of the goods to be acquired. The client pays rent and assumes all risk of loss relating to the goods when he receives their possession under the *Ijarah* contract.

IV

Achievements of Islamic Banks

Though Islamic banks are by all means newly established and operating side by side with conventional banks which have been existing for centuries, they have already made a number of achievements in the economies where they operate particularly in respect of mobilization of savings of a large section of the public who were reluctant to keep their deposits with conventional banks based on interest as found in the case of three Egyptian Islamic banks (Nasser Social Bank, Faisal Islamic Bank of Egypt and the Islamic International Bank for Investment and Development).

Discussion

Ahmed El-Naggar

Some Islamic scholars have said that the interest-free loan in Islam can be considered to be grant, yet on the contrary, it is not. The loan has to be repaid. There is a distinction between loan and grant. Since loan has to be repaid, it follows that loan should be used for productive purpose as a general rule. In Islam there is a provision for benevolent loan intended mainly for consumption purpose.

As for financial contract, that any agreement between two or more parties is valid as long as they are in conformity with the principles of *Shari'ah.* It gives us a scope for fresh thinking in the light of changing circumstances. Therefore, Muslim scholars are free to invent any kind of contract between capital and labour with a view to participate in the productive process. All the parties involved should have equitable benefits for their contribution or efforts. Capital is not cost free in Islam. It is permissible for the owner of the capital to get variable return out of his investment just as a labourer is entitled to receive his due and fair wage.

Volker Nienhaus

I would like to look at the question of ownership a little bit differently. In a joint stock company the share-holders are the owners as they are expected to receive dividends. Others who provide finance without buying the shares do not get the title of the company but they are entitled to receive a return on their investment. Secondly, it was mentioned that sometimes it may be necessary to create debt particularly in the case of projects which are profitable in terms of national currency. If such projects are financed out of foreign fund and a part of the profit is to be paid in hard currency, this transfer problem can create debt.

A Participant

It was pointed out that Dr. Naggar has provided some useful insights into the problems of financing projects in an Islamic framework. If we compare the Islamic modes of financing with those by the western banking system, it would appear that Islamic system is fair and equitable as it encourages participation and sharing in the projects. It is however suggested that given the present circumstances, it may not be possible to have projects implemented on the basis of equity financing at an international level. Therefore, for the interest of the developing countries it is perhaps desirable to mix loan with equity for financing development.

A Participant

Efforts should be made to establish Islamic banking in all Islamic countries. These would help these countries in solving the problem of debt management on the basis of participation and sharing. A number of Islamic countries are heavily indebted. It is to be, considered whether Islamic Development Bank could make any initiative in this direction.

M. A. Mannan

Prof. El-Naggar has raised a number of important points. It should be pointed out that Islamic modes of financing based. on sharing and participation can not be successfully implemented without honesty and financial integrity of all involved - in the process. That is why there, is a need for moulding the behaviour of all concerned through appropriate educational and training programmes.

CHAPTER VI

INTERNATIONAL DEVELOPMENT BANKING IN AN ISLAMIC FRAMEWORK : LESSONS OF ISLAMIC DEVELOPMENT BANK EXPERIENCE

S. A. Meenai*

[After giving a brief introduction on the establishment of Islamic Development Bank in 1973, the author tried to identify some distinctive features of Islamic International development Banking with special reference to Islamic Development Bank (IDB) which apart from the cardinal requirement of conformity to the Shari'ah, has an Ummah wide-approach. It is argued that its task is much more wide ranging than that of other multilateral institutions. The paper tried to highlight some of the lessons of IDB's experience over the past twelve years since its inception and stressed among others, the need for a substantial expansion in the volume of project financing, development of equity financing, assisting member countries in designing projects, building institutions and developing policies specially in the case of least developed member countries of the Bank, the development of new Islamic financial instruments and establishment of a secondary market and consequent de-emphasising co-financing which indirectly tends to perpetuate traditional financing practices, that include extensive use of foreign trade financing operations. Lastly, an attempt is made to draw an agenda for the future development of the Bank and in which it is suggested that future financial has to focus more on agriculture, low cost housing, food, clothing, medical facilities and education. - (Editors)]

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* Late Dr. S.A. Meenai was the first Vice-President of the Islamic Development Bank who died of heart failure just a few weeks before this seminar. This paper was presented in the seminar by Dr. M.A. Mannan.

I

Introduction

The paper seeks to provide an overview of International Development Banking in conformity with Islam by distilling and portraying the experience of the Islamic Development Bank (IDB). The objective is to provide a unified treatment of Islamic International Development Banking to serve as a basis for dialogue and exchange of 'views.

II

Islamic Perspective

While it is generally recognized that the establishment of the Islamic Development Bank and a number of other Islamic banks in the seventies and the eighties is a development of major historical importance, what is not commonly understood is that the *Shari'ah* (Islamic laws) laid down the basic principles. governing the conduct of Islamic finance long before the emergence of Islamic Banks. Indeed, some of the basic principles are as old as Islam itself. For example, charging of interest either on productive or consumption loans is strictly prohibited. In this context, the Quranic precept: "God hath permitted Trade and forbidden usury" [1] serves as the cardinal principle underlying Islamic banking and finance. As described later, the IDB has been engaged in trade financing and interest free loan operations on a large scale.

It has to be recognized, however, that the permission to trade implies the permission to receive lawful and normal profit, under a variety of arrangements as reflected in the Quranic verse:...Once this principle of "trading" is applied to modern modes of financing business and finance, it will be necessary to introduce a variety of arrangements of profit-sharing and participation under different types of financial contracts such as *Mudarabah, Musharaka* (equity participation) and *Murabahah* (cost plus), Bay *Muajjal* (deferred payment), *Bay al-salam* (forward transaction) and leasing.

It cannot be overemphasized that the *Shari'ah* ordains that financial resources be used for the greater interest of the community and for promoting the socioeconomic objectives laid down by Islam. It follows, therefore, that regardless ,of its profitability, financing cannot be made available for projects and ventures

1. Quran, (2:275)

not justified from the Islamic standpoint. At the same time, the Quran has emphasized the importance of benevolent loans. The various financial activities of the IDB by way of loans to member countries and grants to Muslim communities in nonmember countries, and its scholarship program for students in nonmember countries may all be seen as attempts to make its financing conform to the principles of the *Shariah.*

III

Establishment of the Islamic Development Bank

Islamic international development banking may be considered to date back to the establishment of the Islamic Development Bank in 1975. It is true that prior to this a modest beginning in the field of Islamic banking had been made by way of organizing some commercial banks on an interest-free basis. It would, however, be an exaggeration'to claim that any comprehensive model of Islamic banking had emerged. As a matter of fact, the decision by its founders that the Islamic Development Bank must operate in conformity with the *Shari'ah* was conditioned not so much by any past success or breakthrough in the field as by the desire of Islamic countries to order their economic life in the framework of their religion. Thus a Declaration of Intent was issued in 1973 by a Conference of Finance Ministers of Islamic countries calling for an "Islamic financial institution for development and investment" operating on "Islamic principles and ideals". A Preparatory Committee was set up for the purpose. The Articles of Agreement establishing the Islamic Development Bank were approved in 1974 and the Bank commenced its operations in 1975.

IV

A Model and Distinctive Features of Islamic International Development Banking

At the outset it would be useful very briefly to invite attention to the basic features of the Islamic Development Bank so as to serve as a model and background for a discussion of international development banking in an Islamic perspective.

As for objectives and purpose,the Bank's mandate is "to foster economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah".* In regard to functions, the Bank is required to "participate in the equity capital of productive projects and enterprises, to invest in economic and social infrastructure projects, to make loans to the private and public sectors on the basis of a service fee to cover its administrative expenses, to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries; to operate trust funds, to accept deposits and to raise funds in any other manner, to assist in the promotion of foreign trade, to invest suitably funds not needed in its operations, to provide technical assistance, to extend training facilities, to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah,* to cooperate with all bodies, institutions and organizations having a similar purpose, and to undertake any other activities which may advance its purpose".

The necessary condition for membership of the Bank is that the country should be a member of the Organization of Islamic Conference (OIC). As regards financial. structure, the authorized capital of the Bank was fixed at two billion Islamic dinars - one Islamic dinar is equal in value to one special drawing right (SDR) of the International Monetary Fund - and subscribed capital at 750 million IDs, raised to the level of its authorized capital in 1984 and payable in freely convertible currencies acceptable to the Bank. .

. The IDB is specifically required to take into account the needs of the relatively less developed member countries, promote complementarity in the economies of member countries, foster the well-being of the people through economic and social development and the enlargement of opportunities for gainful employment, avoid a disproportionate amount of its resources being used for the benefit of any member, maintain a suitable ratio between _its equity investments and loans, accord priority to projects including joint ventures which promote and strengthen economic cooperation among member countries and not to provide loans to an enterprise in whose equity it has participated.

As for administrative structure, there is a board of governors on which each member country is represented, a non-resident board of eleven executive directors; five of which are appointed, one each by the five countries holding the largest number of shares and the remaining six elected by the rest of the members, a President appointed by the Board' of Governors, one or more Vice-Presidents appointed by the Board of Executive Directors on the recommendation of the President and staff recruited on as wide a geographical basis as possible. The Bank's principal office is located in Jeddah. Its financial year is- the Hijra year. The official language of the Bank is Arabic whereas English and French are used as working languages.[2]

2. Articles of Agreement establishing the IDB.

In this background, an attempt may be made to identify and portray the distinctive features of international development banking in an Islamic perspective.

First, apart from the cardinal requirement of conformity to the *Shari'ah,* it has an *Ummah* wide approach in that the mission assigned to it embraces the Muslim *Ummah* as a whole, including the Muslim communities in non-member countries and is not confined to the member countries alone. Secondly, as an association of developing countries alone, the donor countries do not enjoy the benefits of procurement and increased export earnings and it is the Islamic principle of mutual help and cooperation which binds the donors and recipients-together. Thirdly, its task is much more wide-ranging than that of other multilateral institutions, in that apart from its financing role, it is entrusted with the functions of promoting foreign trade and economic cooperation among Muslim countries and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah.* The IDB has over the years added some new dimensions to its activities such as refugee assistance and running a project for the utilization of sacrificial meat during Hajj.

There are a number of other features of Islamic development banking which provide a contrast with conventional international development banking. As far as objectives are concerned, there is much greater emphasis on social progress and economic cooperation among member countries. The aim is to promote complementarity in the economies of Islamic countries through regional projects and joint ventures. There is special emphasis on meeting the needs of the least developed member countries and the provision of technical assistance.

While in the case of traditional international development banking, loans are the sole means of resource transfer, in Islamic development banking, loans are not accorded the pride of place as they inherently involve interest. Loans have to be made not on the basis of interest but on the principle of a service fee to cover administrative expenses. In the case of certain multilateral institutions, there was a prohibition on equity financing in the initial years. Lately, the Inter-American Development Bank and the Asian 'Development Bank have made a modest beginning in the area of equity financing. True, the International Finance Corporation (IFC) an affiliate of the World Bank, undertakes equity financing on a sustained scale. However, by far the bulk of its financing has taken the form of loans and equity financing has been undertaken in combination with a loan operation, whereby its interests as an equity holder in the project are also partly safeguarded. In sharp contrast, equity financing is one of the principal modes of financing in Islamic development banking.

Another important characteristic of international development banking in an Islamic perspective is that it undertakes lease financing and instalment sales which is not the case with conventional multilateral financial institutions. Again, unlike traditional international development banking, in Islamic international development banking, large scale foreign trade financing is undertaken with a view to promoting foreign trade among member countries and also as a means of placing short term funds which are not immediately needed for project financing. The relationship with national development banks is organized on a different basis than is the case with conventional international development banking. In the latter case, International development banks can provide direct loans to national development banks, which utilize them in their operations whereas in the case of Islamic international development banking, the national development banks, act, so to speak, as agencies authorized to identify, appraise and forward suitable projects for financing by the Islamic Development Bank in accordance with its own policies and procedures. This relationship which is designed to reach small enterprises in member countries through the medium of national development banks .is conducted under what are known as line of equity, line of leasing, line of instalment sales and line of foreign trade financing arrangements. The national development banks are granted a line or amount within which they identify, appraise and commend projects for financing.

Another distinguishing feature of international development banking in an Islamic framework is its .relatively greater dependence on its capital. This is for the reason that, before the Bank can mobilize financial resources by other means, it has to utilize its capital 'resources for its financing operations. Because of the interest prohibition the IDB cannot raise resources from the market in the- way traditional international banks do. At the same time, on account of equity financing and foreign trade financing the tempo of disbursement is faster in Islamic development banking compared to traditional inter- national banking. This intensifies the need for resource replenishment. Here mention may be made of two other features which distinguish International Islamic development banking from conventional international development banking: first the acceptance of deposits from investors and second, the placement of short-term surplus funds in ways other than those followed by conventional multilateral financial institutions which place their surplus funds in government securities, government guaranteed securities, time deposits and certificates of deposits with banks.

V

Application of *Shari'ah*

On its inception, the Islamic Development Bank faced a real dilemma. On the one hand it *was* expected to make the quickest possible start and on. the other hand it was required to operate in accordance with Islamic principles which obviously warranted radical departures from conventional international development banking and needed time to be substituted by new modes of financing and operations. After careful consideration, it decided to move in three main directions namely:

1. To try to become operational in the shortest possible time through co-financing arrangements.
2. To develop the Bank as an international development financing agency.
3. To promote the Bank's role as a truly Islamic institution having a distinct personality of its own.

As far as the first objective was concerned, the Bank was able to become operational in the very first year of its working. This was a considerable achievement viewed in the context of the time taken by conventional international development banks in starting their operations.

As for the second objective, during the twelve years since its establishment the Bank has approved total financing of US dollars 6.94 billion. This is composed of US Dollars 1.80 billion for projects and technical assistance, US Dollars 4.95 billion for foreign trade financing and US Dollars 187.05 million for special operations. Of the total project financing, 34.8 percent was made available in the form of loans, 32.4 percent as lease financing, 16.7 percent as equity, 13.2 percent through instalment sales, 2.6 percent as technical assistance and half a percent as profit sharing. In terms of sectoral distribution, 35.5 percent has gone to industry, 19.7 percent to transport and communications, 18.5 percent to agriculture, 14 percent to utilities and 10.4 percent to the social sector. Of the total project financing, 30.9 percent went to the least developed member countries.

As far as the third objective was concerned, the first major area in which *Shari'ah* had to be applied related to the placement of liquid funds. Much before commencing operations, the Bank had to contend with the problem of placing the sizeable funds it had received as subscription from its members. The initial exploration which was undertaken clearly showed that there was no way of investing or placing these funds in the international money market or with conventional banks which would satisfy the requirements of *Shari'ah.* This led to an effort by the Bank to seek ways and means of placing them at the national level, that is, with member countries. This, in turn, gave birth to what became known as the foreign trade financing operations of the IDB. Simultaneously, it was decided that the placement operations in the conventional manner with banks, must continue until such time as alternative methods could be developed. Consultation with the

Shari'ah scholars led to the conclusion that these placement operations could be considered valid from the viewpoint of *Shari'ah* only under conditions of necessity. In this context, a Special Assistance Account was established in 1399H (1979) for the following purposes[3].

a) Training and research aimed at assisting and guiding member countries to re-orient their economic, financial and banking activities in conformity with Islamic *Shari'ah.*

Provision of relief in the form of appropriate goods and services to member countries afflicted by natural disasters.

c) Provision of financial assistance to member countries for the promotion and furtherance of Islamic causes.

d) Provision of financial assistance to Muslim communities in non-member countries for improving their social and economic conditions.

Apart from employing its liquid funds in foreign trade operations, IDB has been placing part of its surplus funds with traditional banks for utilization in commodity transactions.

Turning to the application of *Shari'ah* to the financing operations of the IDB, it may be noted that the Bank charges a service fee on its loans to cover its costs.

As far as equity financing is concerned, which is an integral and distinctive feature of Islamic development banking, no problems of clash with the *Shari'ah* have arisen and one of the primary reasons for undertaking substantial equity financing operations in the past years despite the high degree of risk attached to them, was to popularize this highly preferred mode of Islamic financing as a vehicle for resource transfer.

As far as leasing is concerned, initially an effort seems to have been made by the Bank to impart an additional degree of acceptability to its leasing operations in two ways: first by ensuring that it was applied to high income yielding projects and secondly by fixing the quantum of the leasing fee in relation to the profitability factor and the cash flow. Lately, a new policy development seems to have taken place in that the leasing arrangement is being applied also to projects which do not themselves yield a revenue. This is on the ground that the leasing fee is just a price or charge for the use of the asset and no more.

More recently, a new mode of financing known as Instalment Sale has been introduced by the IDB which may appear to resemble hire-purchase but in point

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3.: . Twelfth Annual Report of IDB 1407H (1986-87), page 123.

of fact there is a basic difference between them. While under the former, ownership of the goods is transferred to the buyer on the conclusion of the contract, under the latter, the hirer is given the option to purchase the goods which he can only exercise after payment of all instalments. In other words, the instalment sale system is a variant of *Murabahah* or the credit sale.

As far as the foreign trade financing operations are concerned, they are conducted on the basis of *Murabahah* and a mark-up beyond the date when repayment of the entire amount becomes due. The IDB has been utilizing the Special Assistance Account for providing Technical Assistance presumably on the ground that it does not generate a net income of return to the Bank. The total amount approved by the IDB out of the Special Assistance Account from its establishment in 1399H (1979) up to the end of 1407H reached US dollars 187.051 million for 39 operations in various member countries and 43 for Muslim communities in non-member countries.

In addition to financing special operations out of the Special Assistance Account, the IDB has also introduced a Scholarship Program to help students from Muslim communities in non-member countries to receive higher education in engineering, medicine, dentistry, pharmacy and agriculture within their home countries or, when this is not possible, in IDB member countries. The Bank's scholarship is a grant to Muslim communities in non-member countries but at the same it is an interest-free loan *(Qard Hasan)* to recipient students. The graduates are expected to repay the amount of the scholarship that they receive to a trust *(waqf)* to be established by the local Muslim communities after they have completed their studies and found gainful employment, so as to enable more students from their own community to benefit from this program in future. Upto the end of 1407H, 930 scholarships involving 22 countries were approved for implementation including 377 approved for implementation in 1408H.(4)

As far as the *Shari'ah* aspect is concerned, it would, perhaps, be appropriate to point out that the Islamic Development Bank has manifested a genuine concern for implementing the mandate of its founders by voluntarily submitting its operations for review by the *Fiqh* Academy or the *Shari'ah* body which is representative of all the member countries.

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4. !bid, page 128

VI

Lessons of Islamic Development Bank. Experience

We may now turn to some of the lessons emerging from IDB's experience over the past twelve years since its inception in 1975. They are set out below:

1. Though loan financing was de-emphasized in the IDB charter, it has emerged as the largest mode of IDB's project financing over the years. Experience has shown that as the most concessional form of financing and having the needs of the least deve- loped member countries in view, together with their suitability for financing agricultural and economic and social infra-structural projects generally, loans on the basis of a service fee have to be maximized consistent with resource availability. There is need for lengthening the period of the loans and also for adopting a system of graduation by establishing a GNP threshold for loan financing.

2. IDB's experience has shown that as a development financing instrument, equity financing is a highly complex and difficult operation particularly in public sector projects and unsupported by a loan. In view of its importance in Islamic' banking, the IDB proceeded vigorously in the' direction of providing equity financing for development projects. How-ever, the experience proved expensive and many of the projects ran into difficulty. Therefore, it has had to slow down this type of activity and is now engaged in devising corrective measures and safeguards and equipping itself better for undertaking equity financing by directing greater attention to the macro-economic conditions and policies affect-ing the project,- stricter supervision and by trying to link disbursement to project implementation.

3. In' the experience of IDB, leasing and advance sales have proved to be highly useful modes of financing remunerative projects, viewed both from the standpoint of risk and return.

4. Despite its intention to use profit sharing as a development financing instrument, IDB has so far been able to make very little use of it.

5. Notwithstanding its best efforts and having diversified its modes of re-source transfer, experience has shown that the overall level of project financing has not grown rapidly and remains rather low in relation to the needs of its member countries.

6. Over the years the average level of financing per project has not markedly increased, resulting in a mounting burden on the Bank's organization. Experience has demonstrated that the overall operational effort cannot be expanded rapidly without raising the average level of financing.

7. While the IDB has resorted to co-financing as a means of marketing its resources, experience has shown that it has yet to make large scale use of the co-financing weapon for mobilizing and attracting resources from other institutions for projects sponsored by it.

8. IDB's experience has shown that despite its efforts to direct special attention to the needs of the least developed member countries which form the majority in its membership only about one third of its project financing has gone to them.

   In cases where the main bottleneck to the provision of financing is the lack of suitable projects, specially in the case of the least developed member countries, a two fold approach is indicated. On the one hand the shortage of suitable projects may be overcome by a liberal provision of technical assistance and on the other, wherever possible, instead of becoming a prisoner of the project approach followed by traditional development banks, under proper supervision and with adequate safeguards, the Islamic Development Bank may undertake to finance a part of their development program. As demonstrated by IDB's experience, international development banking in an Islamic perspective calls for a flexible approach in regard to the guarantees required from the recipients of assistance particularly from the poorest and least developed members.

9. IDB's experience has shown that one of the major complexities confronting Islamic development banking is that it has to strike a balance between need and credit worthiness. This involves, so to speak, tight rope walking, as the two are not easy to reconcile. Initially, in respect of its foreign trade financing, the Islamic Development Bank was inclined to allow need to take precedence over the repayment capacity of the recipients. This unfortunately, led to delays and defaults in repayments and the Bank realizing that such a situation led to the denial and loss of even project financing to the concerned countries, was forced to revise its attitude thereby according greater importance to the credit worthiness factor. It is not unreasonable to expect that member countries in meeting their obligations to multilateral institutions would accord an equal if not

preferential treatment to the IDB as the Islamic institution instead of giving it a lower priority and expecting it to show greater patience in regard to overdues.

10. Though the IDB has been endeavouring to use other methods such as an Investment Deposit Scheme, Islamic banks' portfolio and an Investment Trust Scheme, so far it has had to depend heavily on capital increases as the primary source of resource mobilization: -

11. Experience has shown that the task of devising methods of resource mobilization and replenishment as also placement of short term funds in line with Islamic principles is even more difficult and complex that the marketing or provision of financing in ways which do not seem to violate *Shari'ah.* The success of Islamic development banking depends crucially on the development of suitable techniques and modes of resource mobilization free of *Riba.* Without a well- developed system of resource replenishment in line with Islamic principles, -the resource needs of member countries cannot be met and an adequate program of financing cannot be mounted. What is clearly warranted are hot efforts to use the traditional method of mobilization with marginal change but the development of new Islamic financial instruments and the establishment of a secondary market for these instruments. .

    It is worth mentioning that-"the IDB is cautiously moving in this direction by developing suitable instruments based on Islamic principles and by utilizing the potentialities of the financial markets in Islamic countries. The year 1407H (1987) witnessed the emergence of two. innovative schemes: the Islamic Banks Portfolio - which its already in operation and the IDB Unit Trust which is currently in an advanced stage of development. Both schemes share certain common characteristics. They are Special Funds (Investment Pools) established within the framework of the Bank's Articles of Agreement and managed by the Bank which floats • certificates representing ownership by the assets and which the IDB is committed to repurchase under certain conditions. On the other hand, the Islamic Banks Portfolio is unique in the sense that it has an initial capital subscribed to by the majority of Islamic banks and it is run under the restricted *"Mudarabah"* concept_ whereby representatives of the capital-owners would determine the general policies and the investment policies of the fund".[(5)]

5. Twelfth Annual Report-of IDB 1407H (1986-87), pp.79-80

12. An important feature of Islamic development financing is that instead of making it a global operation, resource mobilization has to be conducted in a compartmental fashion hitched to different modes of financing.

13. IDB's experience has shown that as far as the organizational structure and management is concerned, having regard to its wider functions such as equity financing, it appears that the Islamic International development bank must have a more decentralized organizational structure and a much stronger local presence than is the case with the conventional multilateral institutions.

14. Experience has demonstrated that in Islamic development banking, there is much greater need for developing a capacity for project identification and generation in line with the socio-economic objectives laid down by Islam. It is only thus that projects which reflect Islamic priorities can be developed.

15. By virtue of its complex task, Islamic development banking needs a highly competent organization and dedicated professional staff untarnished by political considerations and imbued with a burning desire to serve the *Ummah.*

16. Co-financing is undoubtedly a useful way of marketing resources and becoming operational quickly. At the same time it needs to be realized that indirectly it tends to perpetuate traditional financing practices and policies and has the effect of retarding progress and relieving pressure for originality and path breaking innovations in line with Islam which alone can promote the development of a distinctive system of international development banking in conformity with Islamic principles, ideals and values.

17. While the IDB has made extensive use of its foreign trade financing operations they cannot be regarded as an ideally suited mechanism for the purpose as foreign trade financing has become an integral and permanent feature of IDB's ordinary operation and, therefore, the surplus funds cannot be released from them unless substituted by an injection of funds from outside.

18. Experience has shown that an important and vital challenge facing Islamic development banking is the formulation and execution of a program and action plan to assist the capital rich members, which do not need financing but are in need of stepping up their economic development.

Though these countries do not benefit by way of larger export earnings resulting from procurement flowing from IDB financing, they have made large contribution to the Bank's capital and it is towards these countries that the Bank will have to direct its resource mobilization efforts in future.

19. Experience has shown that in Islamic international development banking, it is virtually important to develop a capability for self-evaluation so that the lessons which emerge can be built into subsequent operations. 'There has to be a premium on learning from mistakes so that they are not repeated.

VII

Agenda for the future

Finally, an attempt may be made to lay down an agenda for the future development of international development banking in an Islamic framework.

It is important to realize that besides steering clear of interest; Islamic development banking must necessarily have a moral dimension in its operations and policies in that it must operate in consonance with the value system of Islam and in furtherance of the socio-economic goals prescribed by it such as the welfare of the people and relief of their hardships.

Financing has to focus on agriculture, low cost housing, food, clothing, medical facilities and education. Projects designed to meet the essential needs of the community have to be financed to the exclusion of luxury and non-essential items. In project identification, there has to be much greater application of social analysis which deals with the impact of projects on people. One of the important requirements is the preparation of a manual of project evaluation in line with Islamic principles..

In an Islamic perspective, the international development bank has to follow a basic needs approach and a policy of non-involvement in prestigious projects not likely to benefit the masses. There has to be greater emphasis on social development, equality, Islamic values of cooperation and solidarity and a low income poor country approach so that even in absolute terms largest resources are directed to poverty alleviation and social development in the least developed member countries. Islamic development financing requires emphasis on building infrastructure and basic services.

As far as policy objectives are concerned, the raising of national income, improving its distribution, increasing employment, reducing dependence upon external assistance and the achievement of self-sufficiency must enjoy priority in Islamic development banking also. At the same time, it seems that in Islamic International development banking, it is more appropriate to aim at devising a policy framework which would provide incentives for desired behaviour from private entrepreneurs and an overall program for the public sector instead of a highly elaborate plan for the whole economy with undue reliance on physical controls. The real effort must be to design a long term strategy for the realization of the basic goals of the Islamic economy based on a partnership between the public and the private sectors.

It is well known that one of the principal threats to a country's development is its inability to adjust its development program particularly in the public sector in accordance with the availability of resources. This threatens growth, leads to inflation and causes a balance of payments crisis. The international development bank in an Islamic perspective .would be rendering a real service specially in the case of the least developed member countries, with a weak policy apparatus, by placing stress on gathering of basic data and effective policy coordination.

It cannot be overemphasized that international development banking in an Islamic perspective must have an ideological base and a moral dimension where need must take precedence over credit worthiness: In fact, one of the dilemmas faced by Islamic development banking is that based as it is on the urgency of need rather than credit worthiness and financial strength of the borrower, the risk of default is greater. On the other hand in the interest of resource mobilization at a reasonable costa good financial track record is vital. The only feasible alternative, therefore, is to strike a mean between these two conflicting factors by taking into account the quality of economic management and willingness to pursue appropriate policies for poverty alleviation as factors which tend to offset their low credit worthiness.

As far as decision making is concerned, having regard to the Islamic principles and value system, the Islamic international development bank has to be based on a well-balanced system of voting power. If the voting power cannot be distributed equally, in the interest of broad based decision making the proportion of the basic votes accorded to each member has to be much higher than the entitlement of vote derived from the amount of capital subscribed. In this regard, it is interesting to note that in the case of the World Bank the trend has been against concentration of voting power. Over the years, US voting power has been almost halved from 37.5 percent to 19.5 percent and it is not infrequently outvoted in Board meetings.

As for the capital structure, it is worthy of consideration whether Islamic development banking may not also adopt the option of callable capital. It will have a two fold advantage. First, the member countries will not have to hand over the callable capital and to this extent the burden on them will be less. Secondly, the callable capital backing would certainly strengthen the safety or credit worth-iness aspect for those investing in its operations. Initially it was understandable that the callable capital was avoided and the entire subscribed capital had to be paid up so as to provide an adequate resource base for the Bank's operations. However, the situation has changed over the years in that the member countries developments in the oil market, their capacity to contribute more cash to the Bank by way of capital has been impaired. In such a situation, it would no be out of place to consider introducing a callable capital element in Islamic development banking. The would Bank has a subscribed capital of 85 billion dollars only 8 percent of which is paid up.

The international development bank in an Islamic perspective is expected to play an aggressive and highly active role in the spread of Islamic banking. On the one hand it has to take a leading part in designing a banking model for the entire Muslim world to follow which is not merely free of interest in the legal and formal sense but totally and really removed in spirit from the traditional banking system. On the other, it has to use its resources, expertise and leverage for promoting the establishment and growth of Islamic banks. Islamic development banking involves that the development bank must try to advise and influence member countries in policy matters and the evolution of an economy in accordance with Islamic international development banking has to seek to help the growth and welfare of the member countries in an Islamic framework. An effort should be made to provide financing tied to policy changes and to emphasis the need for a bias in favour of Islamic objectives and values.

It is expected of the Islamic development bank that is should encourage recipients to adopt Islamic modes of financing. So far profit sharing operations in international development banking have not expanded largely because member countries do not offer such projects.

The international development bank in an Islamic perspective must also play an active advisory role in relation to its member countries. Besides offering traditional advice for establishing a macro-economic policy framework composed of a realistic exchange rate policy, a low rate of effective protection for industry, a realistic agricultural pricing policy, application of cost recovery principle in pricing public utilities and infrastructural services and controlling inflation and avoiding real wage increases, unsupported by increased productivity, it must urge its member countries to pursue the socio-economic objectives and values prescribed by Islam.

The Islamic concept of growth is far more comprehensive, embracing as it does, moral, spiritual and material aspects of human life. Its sole objective is not the maximization of growth of national income per se, irrespective of its effects on income distribution and social welfare. It is the duty of the international development bank in an Islamic framework to sell this philosophy to its member countries as a policy reformer.

To sum up, the prospects for Islamic international development banking depend greatly on its success in achieving a substantial expansion in the volume of project financing, formulation of a program for assisting capital rich member countries, development of equity financing as means of transferring development resources, playing a catalytic and really active role in the promotion of Islamic banking, an effective policy role in urging member countries to help their growth and social welfare in an Islamic framework, assisting member countries in designing projects, building institutions and developing policies in conformity with Islam, evolving effective methods of resource mobilization and placement of short term surplus funds which instruments which accord with the shari'ah and the creation of a secondary market for them, greater use of profit sharing arrangements for development financing, formulating Islamic guidelines for the identification and appraisal of projects, evolving innovative approaches in an Islamic perspective and last but not least, providing a forum in which Muslim countries meet to discuss their economic problems and social issues with a view to promoting maximum cooperation in tackling them.

CHAPTER VII

THE BEST CRISIS: INTERNATIONAL FINANCIAL INSTITUTIONS AND ISLAMIC COUNTRIES (1)

E. Freyer *

[It is argued that the debt crisis has assumed its serious proportion in many Islamic countries. It was pointed out that many developing countries are caught in vicious circles: for servicing their debts and paying interest, they have to take new loans to meet repayment schedule, i.e., transfer an ever increasing portion of their own resources, which are urgently needed for development. The debt indicators and debt structures of Islamic countries are heterogeneous and also different compared to all developing countries: The official and concessionary nature of Islamic countries external debt has generally resulted in a relatively low debt servicing burden. It is pointed out that most debt of Islamic countries are of long term nature. Saudi Arabia, Kuwait, UAE and Qatar represent the major sources of these financial flows. The author argued that the main internal causes of Islamic countries foreign debts are: Excessive consumption, ambitious development plans, state owned enterprises and capital flight and high military expenditures. External factors (i.e. high oil prices) are very important for increasing foreign debts. In order to reduce the debt-burden of Islamic countries the author has, among other things, suggested a number of measures that include- (i) Reducing extreme fluctuations in exchange rates increased conversion of debt into equity, (ii) Mobilizing additional financial resources (i.e. domestic savings) and improving the efficiency of the financial institutions, (iii) Increasing financial support from official OECD institutions and technical cooperation, iv) Increasing investments in human resources, and (vi) Maximizing borrowing for feasible productive projects and investment – (Editors)].

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I
Introduction

We are all aware that in 1982 the world's debt crisis intensified when Mexico declared its inability to service its foreign debts.. This debt crisis was further complicated by severe debt-servicing difficulties faced by many other Latin American and Developing Countries (DC).

Despite the growth oriented adjustment in DC and the growth in Industrialized Countries (IC) total Developing Countries' external debt estimated by the World Bank' to have' reached $ 1,190 billion at the end of 1987; up from $1,120 billion for the Year before and is projected to reach $1,245 billion in 1988. In reality, the obligations of the developing countries probably-are much higher than this figures because of difficulties to collect data and deficiencies of the international statistics which do not include "military" loans.

Table 1
The Growth of External Debt, 1981-88
(US $ Billions)

	1981	1982	1983	1984	1985	1986a	1987b	1988b
DRS Reporting Countries	672	745	808	877	949	1,021	1.085	1.135
Long Term Debt c	498	557	639	714	784	871	930	980
From official sources	181	200	222	257	296	343	375	405
From prices Sources'	317	357	417	457	489	528	555	575
Short-Term Debtd	159	168	138	130	128	110	113	155
Use of IMF Credit	15	20	30	33	38	40	42	
Other Developing Countries	83	86	86	81	89	99	105	110
'Total External Debt	755	831	894	958	1,038	1,120	1.190	1.245
		*69	72	75	85	95		102

a. for 1986 are preliminary
b. Data for 1987 are estimated and for 1988 are projected
c. Data for Poland are included only from 1984 onward.
d. Data reflect the known rescheduling of some 545 billion of short-term debt to banks into long-term debt in 1983-86.
e. Includes data for developing countries that do not report through the DRS and for those that report in a form that does not permit publication in the standard tables; excludes debt of the high-income oil-exporting countries.
* Arab countries.--
Source: World Debt Tables 1988

Net lending flows (New loans minus principal repayments) at US$ 26 billion were slightly higher in 1987 than in '1986, but were barely 40% of the average level of net flows to developing countries between 1983 and 1988. Official lending is around US$32 billion between 1987 and 1988. Although private lending is expected to recover in 1987-88 from the extremely low recorded in 1986, at an average of US$12 billion annually it would still be some 25% lower than in 1983-85 and only 1/7 of the level at the beginning of the decade (see Annex: 1). The World Bank estimates net negative transfer (the excess of the debt service over new loans) to have dropped slightly in 1987, but still amounted to US$29 billion.

This caused vicious circles: for servicing its debts and paying interest developing countries have to take new loans to meet their repayment schedule, i.e., transfer an ever increasing portion of their resources, which are urgently needed for (basic) consumption and investments. The severe retardation of growth (over 30% declining real GNP/per capita) in many developing countries from 1980-86 to meet IMF-conditionalities put further burden on the poor country having its adverse political, social and ecological consequences.

I I

Ethical and Historical Perspectives of Debt Burdens

In the West, the ethical foundations of the international financial system has its roots in Christianity, which stood for a universal brotherhood of man and prohibition of interest although it allowed interest towards strangers (e.g. jews). Also in Islam "Riba" (i.e. interest) is prohibited according to the holy Q'uran 2:275-279.

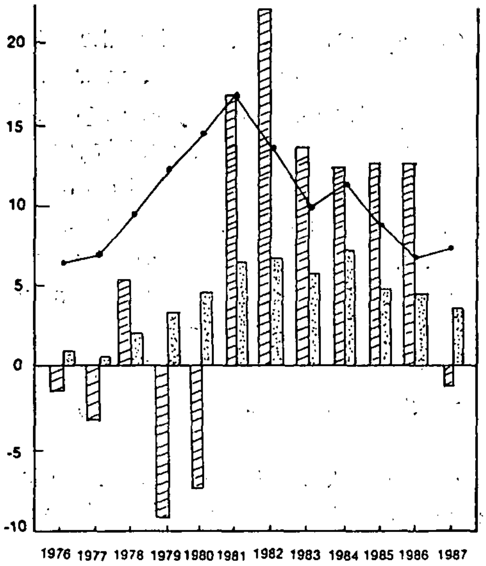
Vehement controversies arose during the age of reformation while the "5% interest" was regarded as on the high side in the catholic church; Luther considered 4 to 6% interest rate-as acceptable. But the interest-based economy finally gained ground following industrial revolution in Europe and international financial system in the West adopted it on the ground that it helps to allocate funds to their most efficient use around the world. The term international financial system covers the institutional arrangements, the rules governing international exchange rates and the mechanism for creating and distributing liquidity. The institutional arrangement in official and private sectors involve a wide range of participating entities (international financial institutions,. governments, commercial and development banks and industrial companies) providing funds for developing countries.

The scale of international capital flows often was larger (in percentage terms) than in the 1970s. Great Britain invested over 5% of its GNP abroad, France and Germany 2-3%.

From the historical perspectives, characteristic for international financial flows were as follows:

- almost all lending came from private sources (stock and bond issues - lending on long terms (up to 99 years) was common.
- Periodic debt servicing difficulties were also common:.(e.g., the Turkish crisis in .1870s, the Argentinian and Brazilian in 1880s and 1890s.)
- After World War I following the Great Depression defaults were widespread, starting with Germany 1932. Argentina was the only country in Latin America to service its debts on the terms contracted in the 1930s.
- After World War II until 1970: Public sources became the major source of external finance; debt servicing difficulties were rare.
- In the 1970s transnational banks were the major suppliers of external financing to developing countries - until the debt crisis of 1982. Bank lending rose from less than 15% (1970; $8 billion) to 37.5% (1981; $52 billion).
- Transnational banks became the major vehicle for recycling financial surpluses in the world economy, because on the supply side, ample resources (i.e. OPEC-states) needed placement and many developing countries became appealing customers due to the commodity price boom. On the demand. side borrowers were encouraged by low interest rates which sometime becomes negative in real term (see figure 1).

Real interest rates increased dramatically (see figure 1). **Fig. 1** **Real Interest Rates and LIBOR***



Real interest rate for. developing countries the United States Six month dollar LIBOR.

Note : The real interest rate is defined as the six month dollar LIBOR, deflated by the change in the export price index for developing countries. The u.s real interest rate is defined as the six-month dollar LIBOR deflated by the u.s. GDP deflator.

Source : World Bank Debt Tables, 1987/88 page XV

This effect brought unxpected interest income to the transnational banks and made credit relationships with developing countries very profitable due to higher spreads:

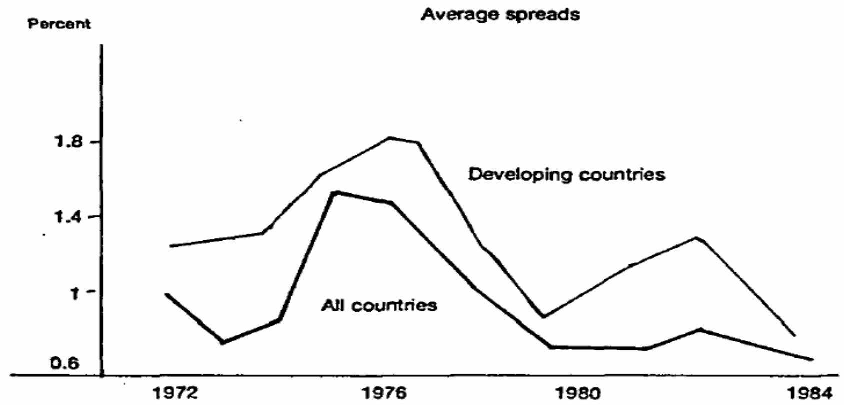
Due to these facts we consider transnational banks (also IDB) as important parts of international financial institutions in the 1970s.

Developing countries in the 1970s became more vulnerable to debt servicing difficulties for three reasons:

1. Loans have far outstripped equity finance,
2. the proportion of debt at floating interest rates arose dramatically (see annex 1), and
3. maturities have shortened considerably.

However, low-income countries could not participate in this process, because they were not considered creditworthy. Their lack of excess to international financial markets has been attributed mainly to their poor economic performance. An acceleration in the pace of innovation, deregulation and structural change in recent years transformed the international financial system in important ways. Innovation improved the efficiency of international financial markets, to cope with greater fluctuation of exchange and interest rates. Also advances in economies of scale achieved in information-technologies, credit assessment, diversification and transaction costs yield efficiencies that reduce costs (in some fields 90%, see BIS 1986, p.4) and risks for borrowers and savers.

Fig. 2



Source : World Bank - WDR 1985, p.11

Now the losses of 15 leading British and US banks in the second quarter 1987 were approximately US$ 11 billion. Doubt credits with some developing countries (e.g., Argentiana, Brazil, Mexico, Philippines) are around 40% written off in US-banks. German banks made even higher provisions against "problem country loans", and the German taxpayer participated with 60% - due to reduced corporate taxes - in this quota.

Table 2

Provisions against Problem Country Loans

Banks, by Nationality	Reserves/exposure (Per cent)	Reserves a
United States		
15 Largest	20-35	18.5
Other	5-25	4.0
Canada	35-40	7.0
Japan b	5	1.5
United Kingdom	25-30	9.0
France Germany & Switzerland	35-70	25.0
Others	n.a.	6.5
Total		71.5

a World Bank estimates
b Twenty-two largest banks

Source: World Debt Tables 1988, p.XXVI ,

Although now real interest rates for developing countries as a group experienced a sharp decline (see figure 1), yet lenders and depositors tried to protect themselves against interest rate fluctuations. Let us now discuss in some details the effects of changes in international financial institutions on Islamic countries.

III
External Debts of Islamic Countries

The external debt of Islamic countries increased during the last few years. Yet the burden of debt on their economies remains far below the countries of Latin America.

Several indebted Islamic countries have introduced debt management strategies to tackle external imbalances. However, the consequences of debts and their impact on debt management strategies is expected to bring:

'1. declining or slower economic growth rate;
2. higher unemployment
3. decreasing investments
4. increasing environmental and health problems(e.g., living conditions)..

The external debt situation differs from one Islamic country to another. Certain Islamic countries are sufficiently wealthy not to borrow in their sovereign capacity (Saudi Arabia[2], Kuwait, UAE, Qatar and Bahrain) preferring their corporate entities to arrange their own financing. Other have low to medium debt profile and can still borrow from the international markets (e.g., Oman, Jordan, Libya, Algeria, Tunisia). Other made fewer approaches to the international syndicated market and concentrated on public financial sources (e.g., Egypt, Syria, Yemen Arab Republic). Five countries (Mauritania, Morocco, Somalia, Egypt and Sudan) are already subject to Paris Club official creditors' rescheduling agreement and three countries (Morocco, Sudan - already hostages to debt in 1979 - and Iraq) have rescheduled their commercial bank debt.

A comparison between Arab debtor countries and all developing countries is given in table 1. Table 1 indicates total external civilian debt (public and publicly guaranteed) of Arab countries[3] increasing from $ 69 billion in 1982 to $ 95 billion in 1986 and is estimated to reach $102 billion in 1987.

While total debt of all developing countries increased by around 43% during the period 1982 - 1987, while in the Arab region it is increased by 47%.

Islamic debt remains a good part in the Islamic world. Arab international banks, governments of Arab donor countries and Arab national and regional development funds and institutions played an active, important role in financing the external requirements of the various Islamic countries. During the 1978 -1986 period, Arab countries received more Euro-lending from Arab banks than any other region (gross total estimate $20 billion). In 1986, Arab banks accounted for around 41% of total syndicated Arab lending, compared to 25% in 1980. Government to government loans have been far larger than loans by development institutions. The volume of co-financing is also growing.

The growing size of Islamic external debt since the early 70s is indicative of the widening gap between the countries' export earnings and their import requirements. While net new lending has contracted, substantial principal repayments were made during 1982-1986.

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2. Saudi Arabia's government has not borrowed long-term money to finance its budget for over 20 years. Now it might borrow externally to finance once the budget deficits (1988 = SR 36 billion, 1987 = SR 53 billion, 1986 = SR 63 billion, 1985 = SR 50 billion).
3. Excluding Iraq, estimate $75 billion - of which around $30 billion comprises long term loans from Arab states.

IV

Debt Indicators and Debt Structures of Islamic Countries -

In assessing the ability of (developing) countries to borrow externally, various indicators may be considered:

1. Solvency indicators reflecting the structural strength and overall stability of the economy (debt/GDP, debt/export earnings),
2. Liquidity indicators - measuring the adequacy of a country's export earnings and its international reserves to meet it current external obligations, principally to pay its imports and debts.

The Islamic countries debt indicators are shown in table 4 and 5. Between 1982 and 1986 the average ratio of debt to current account earnings for Arab countries rose from an acceptable 179% to a critical 363% in 1986.

Due to high share of official and concessionary loan with low-interest, external debt results in a relatively low debt (interest) servicing burden for some Islamic countries like Bangladesh Egypt and Pakistan. However, the interest service ratio for the Middle East region, i.e., Arab/Islamic countries, trippled between 1980 and 1989, more than in other regions, as can be seen in-table 3.

Table 3
Developing Countries: Debt Service Ratios, 1980-89

(In per cent of exports of goods and services)

Of which, Interest Service ratio	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Developing Countries	6.6	8.7	11.0	10.8	11.5	11.9	11.6	9.3	.10.2	11.1
By Region										
Africa	5.8	7.3	9.4	9.9	11.1	12.2	12.3	11.3	12.2	11.1
Asia	4.4	5.2	5.8	5.5	5.8	6.1	5.8	4.8	4.4	4.0
Europe	9.9	12.8	13.0	11.5	11.2	11.5	11.1	10.1	10.7	10.4
Middle East	2.2	2.8	4.0	4:7	5.9	6.4	8.1	6.7	7.3	7.4
Western Hemisphere	'18.3	24.6	32.3	30.4	30.5	30.2	29:2	22.6'	28.8	25.0

Source: IMF: World Economic Outlook 1988, p.1830

The relative burden of external debt to a debtor country depends basically on the terms of borrowing from different sources or creditors. Thus a breakdown of "total debt" into its components according to various sources of loans or categories of creditors is useful. The main sources of external funds available for Islamic countries include:

1. Official creditors comprising loans from both multilateral sources (e.g., World Bank, regional development funds) as well as other multilateral and inter-governmental agencies and bilateral sources (e.g., governments and their agencies, including central banks and autonomous public bodies), and

2. Private creditors which comprises loans from suppliers (export credit or credits from manufacturers) and financial markets (loans from commercial banks and other private financial institutions as well as publicly issued and publicly placed bonds).

The soft nature of Islamic countries debt is reflected in the ratio of total debt service to total external debt, which was for Arab countries around 10 for the 1982 - 1986 period, falling to 9.4 in 1986 (see table 5). For several Islamic countries this ratio is even lower. In 1986 North and South Yemen had ratios of 4.3% and 4.8% respectively. In 1986 Egypt was able to reduce its debt service from 8.5% to 6.8% of total debt by substantial arrears build up and partial rescheduling.

Table 4

Exrernal Debt for The Year 1985

Country	Long& short-term Debt Outstanding Including Undis-bunsed (US$ mn)	Disbursed Only (US$mn)	Interred Payment (US$ mn)	Net Transfers (US$mn)	Total Debt (US$mn)	Diabursed Outstanding As Sol XCS	Diabursed Outstanding As%of GNP	Inferred Payment As%of XCS	Inferred Payment As%of CNP	Total Debt Sent. As%of XCS	Total Debt Sent. As%of CNP	Concessional leons as 10%of publicty guaranteed outstanding debt
Algeria	20.226.9	15.526.0	1.297.3	-1229.9	4.853.6	99.3	24.6	9.4	2.3	33.3	8.3	4.3
Bangladesh.	9.405.7	5.967.8	88.5	366.4	214.3	466.0	39.1	6.9	0.6	16.7	1.4	97.9
Benin	1.119.2	775.7	8.8	15.0	22.4	236.3b	65.0	5.10	0.8	9.25	2.2	44.6
Burkina Faso	912.1	532.3	9.9	28.5	26.7	186.9a	46.4	4.1a	0.9	9.3c	2.5	' 76.6
Cameroon	3.750.3	2.870.7	. 133.1	•305.6	599.9	69.2	25.9	3.3	1.2	8.3	3.1	47.5
Chad	255.0	161.3	2.0	-0.1	8.1	96.1c	26.6b	0 . 1 c	0.0b	2.2c	0.11)	66.6
Comoros	209.1	133.1	1.5	20.9	2.0	630.4	123.3	7.5	1.5	9.6	1.9	93.7
Djiboutti	278.1	145.6	2.2	29.6	3.8	165.4c	42.9c	2.5c	0.6c	4.3c	1.1c	88.5
Egypt	28.206.3	24.342.4	627.0	308.2	2448.9	267.6	65.4	8.5	1.8	33.9	7.1	-71.7
Gabon	1.718.1	1.33.7	51.9	17.0	222.6	30.8c	27.4	27.c	1.6	11.2c	7.0	13.9
Gambia	322.1	.233.6	2.6	13.4	8.1	210.4c	119.7	2.3c	1.7	7.3c	5.4	67.1
Guinea	1.858.6	1.380.3	19.8	31.5	65.8		70.2	-	1.1	-	3.6	70.9
Guinea Bissau	437.7	254.8	1.9	42.2	10.2	1.659.7	162.3	14.8	1.4	77.8	7.6	74.5
Indonesia	51,008.6	35.760.7	1.931.2	-778.8	5.051.1	133.0	33.4	8.3	2.1	20.1	5.0	35.1
Jordan	5.186.1	3.672.9	153.0	-33.8	454.3	131.3	70,9	7.5	4.0	22.1	12.0	50.2
Lebanon	442.0	407.0	11.5	-27.6	54.0	-	-	-	-	-	-	57.4
Malysia	20.222.26	18.083.66	1.460.8	-775.2	4.902.7	77.7	47.8	6.3	3.9	22.3	13.7	9.5
Maldives	109.0	86.2	1.7	-1.6	7.8	57.4	99.2	1.8	3.2	8.6	14.9	72.7
Mali	1.983.6	1.469.2	12.5	67.5	37.9	616.0	117.0	5.8	1.1	3.3	5.8	94.8

Country	Long& short -term Debt Outstanding Including Undis- boned (US$mn)	Disbursed Only (US$mn)	Inferred Payment (US$ mn)	Not Transfers (US$ Inn)	Total Debt (US$mn).	Disbursed Outstand'ng Debt As%of %C$	As%of CNP	Inferred Payment As%of %CS	As%of CNP	Total Debt Service As%of XCS	CNP	Concessional As%of lensl0%of publicly guaranteed outstending debt
Mauritania	2.030.8	1.477.3	27.8	7.5	- 78.4	634.6c	212.2	7:1c	4.3	13.1c	. 12.2	- 66.6
Morocco	17.851.1	14.084.4	489.9	-363.3	1.34.4	350.5	93.4	15.3	4.1	32.3	8.6	38.5
Niger	1.335.5	1.154.5	30.2	8.1	66.9	315.7	51.5	12.0	2.0	26.7	4.4	48.2
Oman	3.301.5	2.367.5	111.9	447.3	255.2	36.4	24.1	2.1	1.4	4.8	3.2	12.1
Pakistan	16.949.7	12.695.3	307.9	-89.1	1.88.3	294.1	31.7	8.4	0.9	29.5	3.2	82.9
Senegal.	3.066.7	2.453.9	44.5	128.3	49.1	' 306.0	.82.3	5.5	1.8	11.7'	'3.7	' 45.1
Sierra Leone	, 651.3	527.4	2.6	25.5	9.9	188.45	29.8	2.9c	0.2	10.8c	0.3	61.3
Somalia	' 1.741.8	1.485.7	17.1	82.3	57.2	1.025.1	66.7a	13.4	0.58	44.8	1.1a	71.6
Sudan	6.827.6	6.331.9	66.7.	-21.7	130.4	610.2	64.2	8.0	0.8	15.6 '	1.6	- 45.0
Syria	4.689.0	3.565.9	95.8	166.9	360.2	112.7	15.7	3.9	0 .5	14.8	'2.1	75.7
Tunisia	7.845.5	5.250.0	240.5	73.7	676.9	163.3	54.5	8.8	3.0	24.9	8.3	42.1
Turkey	31.681.2	26.123.4	1.276.6	-898.3	3.659.2	157.1	33.6	11.0	2.4	- 3.9	6.6	27.4
Uganda	1.571.9	1.030.3	27.0	33.0	106.2	271.8b	20.4c	7.1b	0.5c	28.0b	2.10	69.5
Yemen A.R. .	2.729.5	2.038.5	18.5	120.2	125.7	829.3	49.9	8.2	05	55.8,	3.4	91.2
Yemen P.D.R.	2.586.4	1.531.1 '	18.7	379.6	-113.7	649.8c	132.5	8.6c	1.7	47.9c	10.4	100.0'

XGS = Exports of Goods and Services.
a Refers to 1982 b Refers to 1983 c Refers to 1984 d Excluding short-term
Source : Compilations based on figures in: (1) Country Reports (2) World Bank, World Debt Tables, 1986-87Edition

Table 5
External Debt and Debt Indicators of Various Arab Countries

(US$ Millions)

	Total External Debt		' External Balances						Solvency indicators		Liquidty Indicators		
	End. 1987	End 1986	1987 Trade Balance	Current Account	1986 Trade Balance	Current Account	Total Debt Service 1986	Int'1 Reserves (end87)	Ratio of Total Debt To GDP (1986)	Ratio of Tolal Debt to current Account Earnings (1986)	Debt Service Ratio (1986)	Months of Import Cover (1987)	Liquidity Gap Ratio (1986)
Oman	2.44.5	2.200	NA	NA	6.7	-969	395	- 1220	- 30.9.	7	11.3	6.0	40.4
Algeria	22.190	30.300	1.811	-725	-811	-3125	5.004	' 1.512'	312	222	. 55.6	2.6	55.8
Jordan	4.200	4.134	-1.957	-238	-1.426	-40	540	304	89.6	' 144	18.8	1.8	35.7
Tunisia	7.369	6.527	-957	-358	-935	-618	899	531	72.9	210	. 20	21	36.7
Libya	NA	4.500	-1.260	-890	95	-2.205	746	5.750	21.8	9	15.8	13.2	- 70.5
North Yemen	3.000	2.824	-1.428	-50	-781	-125	213.	- 510	. 113.9 .	403	- 28.8	5.7	55.3 -
Morocco	16.810	15.937	-900	-50	-1.001	-205	2.013	. 223	106.7	306	38.4	0.7	29.4
Egypt'''	43.880	'40.035	-5.453	-2.450	-5.167	-2.770	3.315	' 1.219	73.1	499	39.9	1.8	100.0
Syria	4.600	4.050	-1.000	-650	-800	-300	400	20	18.6	205	20.0	0.1	62.5
South Yemen	- NA	2.059	NA	NA	-101	-191	99	104	180	495	23.9	2.9	76.1
Sudan	10.900	10.600	' -180	' 60	-307	-18	668	14	97.0	1.644	18.6	0.3	111.7

NA = Not available' ' Estimates based on IIF and other sources (1) Includes mdilitary debt estimated at $ 9.3 billion.
Source for Algeria. Egypt, Morocco and Tunisia. Institute of International Finance IIF) Country Reports. 1987.
For South Yemen. Jordan. Syria, and North Yemen. Oman and Libya. Various National and International sources including the world Bank Debt Tables. 1987/88 Edition.

For the Islamic debtor countries as a whole external debt is primarily of a long term nature. In 1986 Arab countries had 82.5% of total external debt as long term, 15.3% short term and 2.2% IMF credit (less than 18 months). This long term debt is primarily public or publicly guaranteed debt, with private non-guaranteed debt practically non-existent.

In terms of creditors most long term debt of Islamic countries is official bilateral credit. While in 1986, 65% of Latin American debt was owed to commercial banks, 63% of Arab external debt was from official sources (76% from bilateral funds and 24% from multilateral agencies). The remaining 37% of long term debt was from private sources[4].

Arab banks had a high concentration of Algerian risk. Algeria had 80% and Oman 84% of their outstanding long term credit owed to commercial banks in 1986.

Since the early 1970s loans from official Arab sources became a major source of funds for several Islamic countries. The main Arab donor countries involved in extending soft term loans on bilateral basis (government to government loans) and/or from national/regional development funds and institutions are Kuwait (the Kuwaiti Fund), Saudi Arabia (the Saudi Fund) and United Arab Emirates (the Abu Dhabi Fund). Iraq was donor in the 70s and early 80s through the Iraqi Fund for External Development. Now Iraq in its current difficult circumstances took advantage of Euroloans supported heavily by Arab banks. According to the Unified Arab Monetary Report published by the Arab Monetary Fund in 1988 total loans extended to Arab debtor countries from official sources reached $37.1 billion during 1980-1985. Saudi Arabia was the largest creditor accounting for an average of around 69% of total, Kuwait paid 20%, UAE 6.3% and Qatar 1.5%. These transfers are close to 50 per cent of the credit extended in the form of aid and grants while the loan portion is of concessionary nature to be repaid over periods ranging between 10 and 20 years with interest rates far below the commercial levels.

Among the Arab countries receiving subsidized loans from various Arab development funds, Jordan was the largest borrower ($1.6 billion by the end of 1986 or 12.5% of total loans extended), Morocco came next (11.4% of total), Tunisia (11 %),South Yemen (9.9%), Algeria (8.4%), Sudan (8.3%) and Syria (6.1%).

4. The indebted oil producing countries differ considerably and resorted primarily to international capital markets, e.g., most of Algeria's debts incurred in the 1970s to finance gas liquefaction and other downstream projects. Debt problems occured by falling energy prices.

Table 6
Geographic Distribution of Disbursements
of Bilateral and Multilateral Arab/OPEC Aid

$ **million**

	Gross				**Net**			
	1983	**1984**	**1985**	**1986**	**1983**	**1984**	**1985**	**1986**
Middle East and North Africa	2474.3	2269.8	2143.4	1740.0	2266.4	2002.2	1868.5	1509.0
of which:								
Syria	924.3	852.7	618.1	778.5	890.5	815.9	850.1	756.6
Jordan	703.6	'661.7	513.4	450.6	686.0	603.8	454.2	407.9
Morocco'	148.8	97.8	483.4	12.1	133.6	75.7	465.4	2.3
Yeman AR	215.0	213.6	168.5	99.9	203.6	189.8	139.0	71.7
Bahrain	225.0	208.4	83.8	109.9	214.8	197.3	70.8	97.4
Oman	76.0	73.4	75.3	65.4	63.5	57.6	60.8	52.2
Other	178.6	162.2	200.9	223.6	74.4	62.1	98.2	120.9
Sub-Saharan Africa	. 933.2	648.4	766.9	687.5	860.9	561.6	661.1	509.2
of which:								
Sudan	732.5	127.4	216.3	280.8	632.6	121.5	215.2	' 207.7
Mauritania	73.7	68.3	77.7	58.5	68.3	64.1	58.4	40.4
Senegal	59.0	62.6	'47.3	49.8	57.0	60.6	' 44.8	44.1
Somalia	62.5	30.1	45.2	7.5	59.7	16.2	38.2	4.6
Mali ...	49.0	13.7	40.0	48.6	45.9	10.1	' 30.9	41.2
Djibouti	13.7	43.3	20.1	37.7	13.4	43.2	19.1	35.8
Kenya	11.4	34.3	24.5	7.5	8.9	31.2	21.9	4.1
Other	291.4	268.7	295.8	197.1	245.1	214.7	232.6	131.3
Asia	410.6	307.2	327.9	440.1	110.0	53.2	61.3	194.3
- of which:								
Bangladesh	1231	' 41.1	30.2	98.4	109.0	25.7	11.5	82.3
China	35.7	49.4	25.1	25.7	35.7	49.4	21.9	22.7
Pakistan	110.1	50.1	21.0	12.3	19.9	-48.0	-80.9	-73.4
India	27.3	52.8	57.5	39.8	-127.7	-40.1	-34.3	-45.3
Other	114.4	113.8	194.1	263.9	-34.5	66.2	143.8	208.0
America, Europe and Ocearnia	77.2	73.8	93.3	92.5	65.2	60.0	66.5	70.9
of which: Turkey	32.7	34.4	43.1	42.4	24.3	30.2	26.6	32.0
Unlocated[a]	894.3	1191.7	386.2	1611.9	894.3	1191.7	386.2	1611.9
Total	**4789.6**	**4490.9**	**3717.7**	**4572.0**	**4187.7**	**3868.6**	**3043.6**	**3895.3**

P = Provisional

a = mainly grants and loans from the Saudi Arabian Finance Ministry

Note : Countries are ranked according to total net disbursements over the period 1983 - 86

Source : OECD P.152.

V

Causes of Islamic Countries External Debts

The causes and development of Islamic countries external debts are very complex, but depend mainly on 3 variables:(1) the policies of Islamic countries, (2) the policies of industrialized countries (fiscal, monetary and trade: e.g., protectionism is of vital concern) and (3) the financial mechanism of capital flows to developing countries, (i.e., risk-sharing, maturities, and volumes).

The following internal factors caused the accumulation of debts:

1. Excessive consumption and rising budget deficits of the past decade accentuated by increasing burden of debt repayment and massive outflow of private capital coupled with drought in some Islamic countries in Africa are predominant causes of Islamic countries debt problems. Also the expansion of imports (i.e., subsidized for for the rapidly increasing population) led to the decline in international reserves and accumulated foreign debts further.

2. In their efforts to carry out ambitious development plans the Islamic countries maintained sizeable trade and budget deficits. The public sectors account for a high portion of total domestic investment in the Islamic world. The rapid growth of public sector investment (i.e., infrastructural projects, new industries, agriculture) was the precursor to debt service problems later on, as too much investment went into projects that often failed to produce ample rates of return[5]. Also the uncoordinated building boom created shortages and bottlenecks, pushing up prices.

3. In some Islamic countries the state owned enterprises (SOE) realized deficits larger than the overall public service sector. The public sector would have generated a fiscal surplus in these countries without the net transfer to the SOEs (World Development Report 1988, p.168 ff). This was caused by poor decisions in investment, pricing, management and overambitious investment programs.

5. GIB 3/88, p.4

Table 7

Average Annual Net Transfers from Government to Non- financial SOES (Source: World Development Report 1988,p.170)

Percentage of GDP	1978-82	1983-85
Egypt	5.2	3.5
Morocco	2.1	1.0
Turkey[(6)]	3.0	1.5

4. The very high expenditures of several Islamic countries for arms (due to military, political and social conflicts in the Islamic world) added considerably to the debt burden.

5. "Large scale capital outflow is also an important cause of the external debt problem in the Arab region. Capital flight is usually associated with overvalue exchange rates, high inflation rate, low or negative real interest rates and in general lack of suitable domestic financial assets at attractive rates. With a sizeable percentage of private financial resources being invested abroad, several Arab countries, resorted to foreign borrowing to supplement domestic savings and finance widening budget deficits.[('

Various external factors contributed to the accumulation of foreign debts of Islamic countries:

1. The collapse of world market prices of exportable commodities (oil, phosphates, etc.). The Islamic countries are a very heterogeneous group, but all have relatively limited production base and are overdependent on a narrow range of exportable goods,' like all other developing countries. The countries which are dependent on a single or narrow range of exports experienced the most difficulties in their external balances: For example, Morocco (40% of export earning coming from phosphates) and Sudan (60% coming from agricultural crops) invested heavily in the expansion on the basis of high world market prices in the late 1970s, but were greatly affected when the prices of these commodities collapsed in the 1980s. "In a larger frame of reference, commodity prices have driven the evolution of the debt problem of a period almost two decades now."[(8)]

6. If in Turkey, including in the public sector deficit such items as the State economic enterprises, the extra-budgetary funds, province and municipal expenditures, the state banks and so forth, this end up with an overall deficit of US$8.6 billion. That is more like 15% of GNP.
7. GIB 3/81988, p.5.
8. OECD, 1987, p.10f.

2. The rising costs of imports from industrialized countries, especially after the US dollar devaluation.[9] For example, total outstanding indebtedness of Turkey rose from $31.2 billion at the end of 1986 to an estimated $38.3 billion at the end of 1987, equivalent to 59% of GNP.

3. Shrinking world markets (e.g., agriculture and energy product) under slow economic growth world wide and rising protectionism increased the external debts even more.

4. The borrowing opportunities from official sources of credit in the industrialized countries have been greatly reduced in the last few years, forcing indebted countries to depend more on commercial sources of funds.

5. For many Islamic countries workers' remittances and official transfers became the largest source of foreign exchange earnings. For the group of Arab debtor countries workers remittances accounted for around 30% of their current account earnings during the 1982-1986 period. The dependency on invisible earnings is particularly important in Islamic countries like Pakistan, Jordan, Sudan, Yemen Arab Republic, Turkey and Morocco, where a great part of their trade deficit is financed by the surplus of invisibles. Invisibles are volatile and extremely vulnerable to external-conditions. Several highly indebted Islamic countries felt the impact of the recession in the Gulf region with substantial workers' remittances since the early 1980s.)

VI

International Financial Institution's Reform and Islamic Countries

The debt crisis is not an isolated phenomenon and cannot be solved by isolated measures. It is only part of a worldwide (economic) development process towards more complex structures. The debt crisis requires a new form of constructive international cooperation from all participants (private and public) in "developing" and "developed" countries.. Important for this new form in the future will be particularly the symmetry of discipline in "developing" and "developed" countries through growing participation of all people. However, a "... satisfactory resolution of the debt problem is likely to take longer than was expected earlier" (IMF-Interim Committee 1988). The Keynes plan at the Bretton Woods conference

9. Most of the recent increase in developing countries debts is due to the valuation effects resulting from the depreciation of the US$, this represents an underlying growth in debt of 4.5% in 1987 and 2.8% in 1987. (OECD 1987, p.49ff).

proposed financial mechanism for sharing the debt burden between deficit and surplus countries. In this context, a "share economy" was proposed theoretically for the factor labor.[10]

Concrete steps for reducing the debt burden/crisis for developing/Islamic countries may include the following:

1. Assuming a larger share of the burden of adjustment by transnational banks due to their former lending and borrowing decisions, i.e., substantial reductions of interest rates.

   Also the leading Arab international banks can play a constructive role in dealing with Islamic world's foreign debt.

2.. In the recent debt crisis and financial system extreme interest rate fluctuations were often damaging poor (Islamic) countries[11]). A financial system based on more equity could adjust more efficiently to (global) economic changes, and extreme - real-interest rates fluctuations would not be burdened alone on the debtor (Islamic) countries. Also many development projects financed by credits never brought sufficient returns to pay the interest for it.

Thus it is important for a partial reducing the extreme fluctuations of (exchange and) interest rates via progress to introduce equity based instruments (i.e. direct- and portfolio-investments) by sharing chances and risks between lenders and borrowers of development projects. The World Bank[12] also demand for progress in equity financing to developing countries, because: 1) equity financing stagnated in the last years, (2) foreign investors bear commercial and exchange rate risks and (3) equity is generally accompanied by management and technology, which can raise the rate of return on development projects. The lack of risk capital in Islamic countries could be reduced by a strategy to support cooperation (e.g., direct investments - with western companies; joint French-German group on this aspect). But equity may cost more than commercial debt - as empirical studies show.

In this context, there is a need for Islamic concepts of financing at the international level as demonstrated in the Islamic literature as well as in this seminar.

3: Expansion of secondary markets, i.e., converting debts intoequity: several indebted developing countries adopted mechanism to transform outstanding

10. Martin Weitzman: The Share Economy, Harvard 1984.
11. Enzyklika Sollicitudo Rei Socialis - 30.12.1987
12 World Development Report 1985, p.125ff.

external debts into equity investments (debts-equity conversions/debt-equity swaps). Thus fixed interest payments are replaced by variable profit outflows and indebted countries can absorb external (interest) shocks easier.

This could be a strategy for e.g. Islamic Development Bank with a potential in Islamic countries. Until now the secondary market for Islamic countries debt is of a very limited nature, accounting for an estimated 2% to 5% 13 of the total world [13] of the total world's debt traded.

Only a limited number of debt swaps deals appeared in the market in the last few years mainly for Turkey, Algeria, Morocco, Tunisia and Egypt.

Very little of the Islamic countries debt is traded because most of it is of an official nature. Besides, most Islamic states have not yet reached the stage of devising debt for equity programmes similar to those of other developing countries. Only Turkey introduced a scheme in 1980, and was the last country to enact legislation before the emergence of the debt crisis.

However, it is difficult to balance - on empirical evidence - the attractions (e.g. increasing investment and production while reducing foreign currency payments obligations) of debt-equity programs against concerns about possible negative implications (e.g. inflationary impacts). Many difficulties are arising from the conversion of debts for public investment (particularly infrastructure projects; e.g. long amortization periods, distribution of profits and legal aspects). Their beneficial economic impacts and contribution to reducing external debts can be over-estimated.

4. Foreign finance can only be a complement to, and no substitute for, domestic efforts. However, Islamic countries are a very heterogeneous group with different financial infrastructure. Some (e.g. Bahrain, Kuwait) show very advanced financial systems. Others lack adequate financial infrastructure due to several reasons (See Gerald Braun/Eckhard Freyer: Islamische Banken-Banken fur die Armen ? E+Z 5/1988). Thus mobilizing additional financial resources - i.e., domestic savings - and increasing the efficiency with which scarce resources are used in developing/Islamic countries is important; i.e., implementing decentralized development processes (like the example of Mit-Ghamr initiated by Dr. El-Naggar). Even the poor in developing countries have an empirically proven ability to save. However, in many developing/Islamic countries disincentives (i.e., negative real interest rates, in Turkey even 70%=1979, see Annex 4) for savings exist. For increasing the efficiency in Islamic countries' financial

13. Arab Countries, See GIB 3/1988, p.4

system structural reform will be needed. First steps are e.g. by increasing competition in. the banking sector, diversify further domestic (and foreign) borrowing markets, instruments and techniques. Several new financial instruments (e.g. Qirad bonds) seem to be appropriate for this purpose (see Gulf International Bank, BSC: Gulf Financial Markets, Bahrain 1988).

5. It is also important to reduce capital flight by having a stable political and economic environment. The end of the wars in Afganisatan, Iraq/Iran can help reducing military expenditures and to eliminate fiscal deficits. For Islamic countries it is important to create an "effective savings" and "investment-milieu". Maintaining positive real interest rates and' realistic foreign exchange policies will also reduce capital flight and provide a substitute for foreign borrowing. The foreign assets held by individuals and financial institutions of many indebted Arab/Islamic countries are estimated to be quite sizeable (GCC-states $150 billion)[14]; perhaps even larger than the countries' respective total out-standing foreign debts.

6. Increasing financial support from official institutions and technical cooperation, particularly with Non-Governmental-Organizations (NGO) from OECD-countries, a need for an increase in the ratios of ODA (Official Development Assistance) to GNP in OECD-countries exists. Industrial countries (IC) grants (financial help) for (DIC) should be in the form of establishing local investment projects in (DIC) rather than in the form of consumable goods. "Teaching a person how to fish is much better than feeding him a fish." An expected increase in oil-prices could also enable Islamic OECD-donor countries to in-crease their even now high (in % /GNP) financial flows to neighbouring Islamic countries to its former higher level (early 1980s) in the longer run. A progress in the Near/Middle East Peace process could enable Islamic countries with further financial resources from these sources urgently needed.

7. Improvements of international financial institutions, i.e., control-instruments (e.g. Bank for International Settlements - BIS, Basle) to adapt the international financial system according to changing (risk-) structures.

Austerity measures necessary to stabilise the debt burden (e.g. adjustments demanded by IMF and transnational banks) may have high political, social, .economic and ecological[15] costs for Islamic countries. This could result in higher unemployment rates, bring to the. surface political tension and undermine in the long run the development process of Islamic countries.

14. GIB, 2/1988, p2.
15. For the links between environment and development (i.e. environmental degradation and poverty) see eg. Bruntland-Report.

8. Development planning for developing Islamic countries must be of land-range nature. Hence, investment in human resources must have the first priority. Empirical evidence demonstrates the social rate of return to education exceeds that of most alternative investments. "An investment into knowledge pays the best interest" (Th. Jefferson). Adequate education concepts and programs are needed, because nearly 80% of all misinvestments are caused by management mistakes. This could be improved. "Development does not start with goods; it starts with people and their education, organization, and discipline." (E.F.Schumacher)

9. Future borrowing by Islamic countries for consumption should be kept to minimum, meanwhile, borrowing for feasible and productive investments should be maximized, and set of careful priorities must be implemented.

10. Industrial countries should ease their import protectionism in favour of DIC's exports.

11. World Development Report (1988) stated that tax reform in some DC's could help simplifying overly complex and costly systems, broaden tax bases, lower tax rates, and improve tax administration, while maintaining or even increasing revenues.

12. Decentralizing decision-making to local governments (in DIC's) could help in increasing the efficiency of public services and the scope for raising revenue.

VII

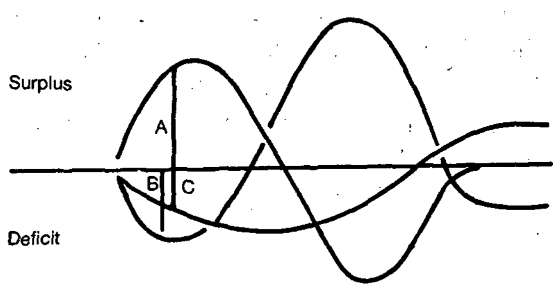
Conclusion - a "Debt Cycle"

As development - in Islamic countries - proceeds, changes in income, rate of saving, capital stock accumulation, and rates of return on investment can be expected to alter the rate and direction of international capital flows. The debt cycle hypothesis, under certain assumptions, means that countries will move through stylized ballance of payments and debt stages - as follows: Stage I (Young debtor), Stage II (Mature debtor), Stage III (Debt reducer), Stage IV (Young creditor), Stage V (Mature creditor):

Figure 3

The balance of Payments

I II III IV V



The debt cycle

Net debts

Net assets

Balance of payments flows and debt stock during the debt cycle

___________Net capital flows (A= B + C)
___________Trade account (B)
___________Net Interest Payments (C)
___________Debt stck

Source: World Development Report 1895, P. 47.

Based on certain assumptions we try to project for Islamic countries as follows:

The short term outlook for the indebted Islamic countries remains bleak. Demand for oil, agriculture products, phosphates and most other of their export commodities will be restricted by global conditions.

In the longer run .more optimistic perspectives are based on the proposed measures (together with implementing the necessary adjustments programs, increasing commodities' export prices and progress in the Near/Middle East Peace process) could help to enlighten of Islamic countries.

Overall ability of Islamic countries' financial institutions to adopt to the rapid economic/financial changes will determine the financial shape of the Islamic world. The author feels convinced that Islamic world should be able to manage its debt problem efficiently.

ANNEX I A

External Financing for Developing Countries, by Type of Flow, 1980 to 1995

(billions of dollasrs)

	Level		Period Exchange(man value)				
			1995			1988-95	
Country group and type of flow	1980	1987	Base	High	1981-87	Base	High
All developing countries							
Defict on goods services, and private transfers	71.2	13.9	62.3	75.3	56.0	37.0	39.4
Net ODA	23.6	27.5	47.6	50.1	24.3	38.3	39.1
Grants	12.1	17.3	21.7	23.2	14.5	17.9	18.5
Concessionalloans	11.5	10.1	25.9	26.9	9.7	20.4	20.6
Direct private investment	10.0	11.3	19.5	21.2	11.8	15.3	16.1
Long -term nonconcessional loans, net	49.4	20.2	17.9	37.9	36.9	6.7	15.4
Official	8.8	9.4	9.4	10.0	10.4	6.3	6.6
Private	40.6	10.8	8.6	27.9	26.5	0.4	8.8
Other capital	-0.3	-5.0	-2.5	-1.2	-10.1	-5.5	-4.8
Highly indebted countries							
Defict on goods, services, and private transfers	23.4	8.3	1.0	3.8	20.0	7.9	8.5
Net ODA	1.6	1.4	5.9	5.3	1.9	4.6	4.0
Grants	0.5	1.4	2.3	2.2	1.0	1.7	1.7
Concessionalloans	1.1	0.0	3.7	3.0	0.9	2.9	2.3
Direct private investment	4.4	2.6	5.9	6.4	4.3	4.5	4.8
Long-term nonconcessional loans, net	27.5	14.4	-11.4	-7.4	19.3	-2.7	-1.0
Offficial	3.6	6.9	1.9	2.0	5.0	1.0	1.0
Private	23.9	7.5	-13.3	-9.4	14.3	-3.8	-2.0
Other capital	0.9	0.9	4.4	5.3	-9.6	2.8	3.3
Sub-Saharan Africa							
Deficit on goods, services, and private transfers	5.5	10.9	12.6	11.8	11.0	11.1	10.6
Net ODA	5.2	6.5	15.3	15.1	5.6	12.2	11.9
Grants	2.7	3.6	7.6	7.8	3.1	6.2	6.3
Concessional loans	2.5	2.9	7.7	7.3	2.5	6.0	5.6
Direct private investment	0.0	1.0	1.7	1.8	0.9	1.3	1.4
Long-term nonconcessional loans, net	5.5	2.3	-3.3	-4.0	3.3	-1.5	-1.6
Official	1.2	0.4	-0.5	-0.5	1.0	-0.7	-0.7
Private	4.3	1.9	-2.9	-3.5	2.2	-0.8	-0.9
Other capital	-1.4	-0.7	-0.1	0.0	-0.8	-0.3	-0.3

Note: All data are based on a sample of nintey developing countries. The deficit on goods, services,. and private transfers not financed by ODA, direct investment, long-term loans, and other capital is covered by foreign exchange reserves.

Source : World Bank, Development Report 1988, p.195.

,ANNEX I B

Net Transfers to Europe, Middle East, and North Africa

millions of US dollars

	Turkey		Egypt		Algeria		Total region	
Item	1988	1984-88	1988	1984-88	1988	1984-88	1988	1984-88
IBRD and IDA commitments	1.063	4.683.1		791.3	391.0	1.535.0	3.358.4	' 16.331.
Gross disbursements	954.6	3.431.4	163.2	1.177'15	'174.9	592.2	2.819.6	11.937.
Repayments	' 415.1 '	1.49.2	124.3	424.8	99.3	281.6	1.671.8	4.720.3
Net disbursements	539.4	2.282.2	39.0	572.7	75.6	310.6	1.147.8 '	7.217.0
Interest and ' Charges	516.7	1.621.5	148.4	528.8	68.7	211.9	1.573.0	5.002.6
Net transfer	22.7	660.7	(109.4)	234.4	6.5	98.6	(425.2)	2.214.3

Note : Disbursements from the IDA Special Fund are included. The countries shown in the table are those (not including Poland which has yet to borrow from the bank) with the greatest amount of public and publicly guaranteed debt outstanding, including undisbursed. The regional totals include ***current*** borrowers only. Detalis may not add to totals because of rounding.

Source : World Bank, Annual Report, 1988 p. t92

ANNEX II A

Total Net Resource Flows to Developing Countries

	Curent $ billion									Per cent of total.		
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1980	1985	1988
I. Official development finance (ODF)	32.7	37.4	45.5	46.5	44.9	42.0	47.6	49.0	54.8	35.5	59.5	65.2
1 . Official development assistance(ODA)	27.4	31.7	. 37.5	37.2	34.1	33.4	34.9	37.1	44.0	29.3	45.1	52.3
A. Bilateral	22.0	25.5	29.8	29.4	26.7	25.9	27.1	28.6	34.5	23.2	34.8	41.1
a) OECD countries	13.1	16.4	18.0	18.2	18.4	18.5	19.8	21.9	26.4	14.0	26.6	31.3
b) OPEC countries	6.7	6.5	8.7	7.5	4.5	3.9	3.7	2.9	3.7	6.8-	3.5	4.4
c) MEA countries	1.6	2.1	2.7	3.2		3.2	3.2	3.6	4.1	2.t	4.4.	.4.9
d) Other countries	0.6	0.5	0.4 '	0.5	0,5	0.3	0.4	0.2	0.3	0.3	0.2	0.4
B. Multilateral	5.4	6.2	7.7	7.8	7.4	7.5	7.8	8.5	9.5	6.1	10.3	11.3
2. Other ODF of which	5.3	5.7	8.0	9.2	10:8	8.6	12.7	11.9	10.8	6.2	14.5	12.9
Multilateral	3.1	4.1 .	4.8	5.7	6.6 .	7.2	8.2	7.9	7.8	3.7	9.6 .	9.3
Bilateral	2.2	1.6	3.2	3.5	4.2	1.4	4.5	4.0	3.0	2.5	4.9	3.6
II. Total exports credits	16.1	12.8	16.9	18.4	14.6	8.3	5.4	2.9	2.0	13.2	3.5	2.4
OECD countries	15.8	12.4	16.0	17.3	13.8	7.7	5.5	2.5				
of wihch short term	2.6	2.0	2.4	2.6	3.0	-0.3	-0.8	t.5	4.0	1.9	t.8	4.8
2. Other countries	0.3	0.4	0.9	1.1	0.8	0.6	0.2	0.4	0.5	0.7	0.5	0.6
III. Privateflows -	56.0	,53.9-	66.0	74.3	58.3	47.4	.33.1	30.4	27.2	51.4	-36.9	32.4
1. Direct investment	11.7	-13.5	11.2	17.1	12.7 .	9.3	11.5	7.5	11.8	8.7	9.1	14.1
2. International bank sector	39.9	35.7	49.0	52.0	37.6	34.1	17.4	13.5	5.0	38.2	16.4	6.0
of which: short-term	17.0	16.0	26.0	22.0	15.0	-13.0	-6.0	-10.0	n.a	20.2	12,2	n.a
3. Total bond lending	0.2	x	1.5	1.4	5.0	1.2	0.6	3.9	3.5	1.2	4.7	4.2

	Curent $ billion									Per cent of total		
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1980	1985	1988
4. Other private	4.2	4.7	4.3	3.8	3.0	2.8	3.6	5.5	6.9	3.3	6.7	8.2
of which: Grants by non governmental organisations	1.6	2.0	2.3	2.0	2.3	2.3	2.6	2.9	3.3	1.8	3.5	3.9
Total resource flows (I + II + III)	104.8	104.1	128.4	139.	117.8	97.7	86.1	82.3	84.0	100.0	100.0	100.0
For information :												
ODA grants	15.7	19.5	32.4	22.1	21.0	12.6	23.5	25.8	31.5			
IMF purchases net	-0.9	0.5	2.6	6.2	6.4	12.5	5.4	0.8	-1.4			
	At 1985 prices and exchange rates											
Total resource flows	118.1	105.7	119.5	134.3	116.2	69.7	87.0	82.3	68.4			
Official development finance	36.5	37.9	42.4	44.9	44.3	41.9	48.0	49.0	44.6			
ODA from all sources	30.5	32.0	35.0	36.0	33.6	33.1	35.3	37.1	35.7			
ODA from DAC Members	(22.5)	(23.0)	25.4	24.7	27.4	27.3	29.0	29.4	29.9-			

a) Including grants by non-governmental organisation (NGO). and estimates of unreported bond lending and swaps of loans for direct investment.
P= Provisional.
Source: OECD, 1987, p.46

ANNEX II B

ODA Net Disbursements by National Arab AID Agencies

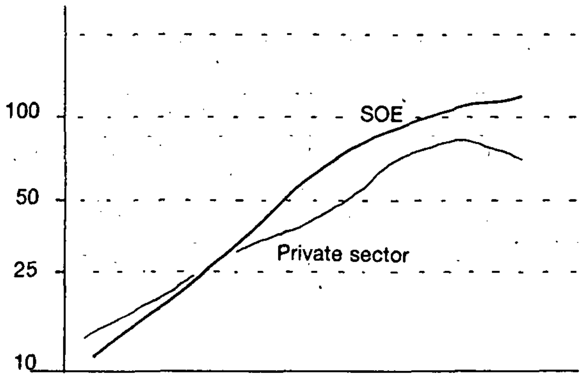
	1981	1982	1983	1894	1985	1986
A. Own operations ($ Million)						
Abu Dhabi Fund	65.7	54.9	46.3	16.6	-5.5	8.4
Kuwait Fund	275.6	309.9	326.6	393.8	305.8	311.6
of which: Bilateral	227.8	256.5	244.1	313.2	222.7	229.4
Saudi Fund	318.5	262.8	244.1	134.6	75.2	166.3
	659.8	627.6	617.0	545.0	375.5	486.3
B. On behalf of their governments ($ million)						
Abu Dhabi Fund	36.8	16.9	10.1	38.0	34.7	41.8
Kuwait Fund	2.8	15.1	9.8	5.6	5.5	10.0
Saudi Fund '	256.6	129.0	40.3	16.0	22.5	23.7
	296.2	161.0	60.2	59:6	62.7	75.5
A + B as % of total national aid						
Abu Dhabi Fund	12.7	17.6	16.2	62.1	41.2	70.0
Kuwait Fund	23.8	28.0	34.0	39.2	40.9	45.0
Saudi Fund	10.4	10.2	8.6	4.7	3.7	5.3
A+ B as % of GNP						
Abu Dhabi Fund	0.33	0.24	0.21	0.21	0.12	0.24
Kuwait Fund	0.87	1.21	1.25	1.50	1.31	1.35
Saudi Fund	0.36	0.25	0.25	0.15	0.11	0.24

Source : OECD - DAC (1987) p.149

ANNEX - III

SOE Contributions to the Growth of External Debt in Developing Countries, 1970 to 1986

Billions of dollars



1970 1974 1978 1982 1986

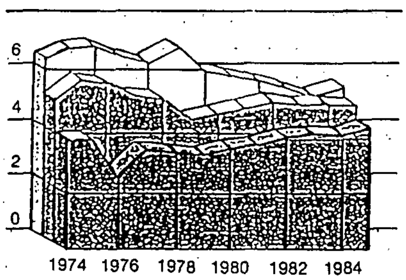
Notes: The Vertical axis is in log scale, Data are from a sample of ninety-nine countries and include only direct SOE and private sector medium and-long term debt.

Source : World Bank,
World Develoment Report 1988 p.171

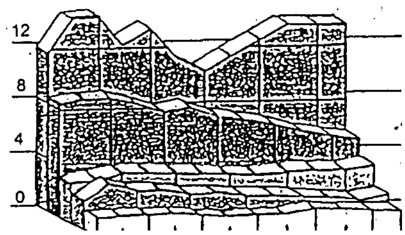
Box figure 5.1 **Military Spending as a Share of GNP, 1974 to 1985**

Industrial countries
Middle-income countries ❑ Low-income countries

Percent By income . 8



Precent by region
16 g



1974 1976 1978 1980 1982 1984
❑ Latin America and caribbean Sub-Saharan Africa ❑ South Asia
East Asia Middle East and North Africa

Source : World Bank,

World Development Report 1988 p.171

Source: United States Government 1986 and 1987.

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Discussion

Horn Holz

I think that this is very interesting and informative paper. I am sure that if the principles of sharing is introduced in the international level through governments participation, it will effect the whole structure and international economic relationship having many political implications.

We reached now a stage where the net flow of capital has changed its direction in that much more money comes from the third world to the first world. Debt service is higher than credits and the official development aid the developing countries get from the first world. Since we are speaking of the role about Islamic Economics in this context of debt crisis it would' support your argument if it is pointed out that the proportion of interest in the debt service had doubled from almost 44 to 80 billion dollars between 1970 and 1987. Despite various suggestions to solve this problem of debt crisis, it is important to seriously consider the issues relating to sharing and participation on which Islamic Economics is based. The moratorium of the debts of the 36 Least Developed Countries, what is' about 26 billion dollar, is really a problem for the Industrialized countries. But the problem is that we would like them to pay and those do not have the capacity to repay do pay, it would aggravate the problem of the masses. It has been suggested that the industrial countries will collect their debt in national currencies and build a National Developmeht Fund within these' countries and to invest them in profit-able project on the basis of equity participation which has a bearing with Islamic economic thinking although it is not mentioned as such. This strategy would certainly help developing the economic bases of the debtor countries. I think we should find ways and means to build the bridge between the new orientation of the economists in the West and development planning of the developing countries. So they have to go in the direction of development oriented programmes for the debt problem. Re-scheduling alone is really no solution.

M.N.Siddiqi

I must congratulate the writer for his somewhat innovative, approaches. into the problem. However, I would like to make a point with regard to extreme rate fluctuation and converting debt into equity for financing infrastructure and public sector projects of debtor countries. It is very clear how the past vast accumulated debt can be converted into equity for financing national development. Again some of the modalities need further clarification.

I do not have enough statistics relating to the exchange rates fluctuation but I know some thing about my own country, India. The rate of exchange between rupee and dollar has been fluctuating for decades. It used to be 8 rupees to one dollar about 15 years from now. It stands at the moment about 15 rupees to one dollar and it has been declining whereas the dollar has supposedly gone down by over 50 per cent in terms of Japanese Yen or German Marks. It does not help me because I have to convert my rupees into dollars. This is the situation for almost all the developing countries like Sudan, Bangladesh, Pakistan. This fact needs to be taken into consideration in calculating the real rates of interest.

E. Freyer

This is a very useful observation. In case of Bangladesh and Pakistan and other developing countries, the exchange rate of dollar has never came down,. yet potential creditor countries may develop a system of control which legalizes the flow of credits to potential debtor countries enabling them to repay the debts by interest in real terms i.e., by exports to the creditor countries in a manner so that transfer of real resources becomes impossible. Again the debt equity swap at a discount to the debtor countries would be secondary solution but I think in some cases, international debt has been converted into investment but there is a limit. So the possibility of writing off the whole debt of developing countries may further be explored.

Horn Holz

The problem of debt crisis as discussed by Dr. Freyer is very complicated and complex indeed. It is not easy to calculate the interest rate in real term. It is difficult to establish a comparable base due to fluctuations of exchange rates resulting from various socio-economic factors. It is perhaps desirable to examine the debt crisis of each country separately because situation varies from country to country and even within a country it varies over a period of time. It is a complicated factor. I think there is no one single solution for the debt problem. A few years ago IMF had the idea to give a solution. Therefore, it can be handled only , in my view, through phase by phase approach and on a country to country basis. This is a very complicated task, indeed.

Prof. Shigar

I think there is a contradiction in the thinking and behaviour of the Western industrialised countries in respect of solving the debt problem. Take the example of Germany after the World War and its deterioration in the balance of payments. The problem was not that Germany could not repay the debt, given the chance to develop its real economy. But the victor did not permit Germany to develop its real economy in a way so that it could repay its debt. What is really needed is the political will. Because while the industrialised countries want the developing country to repay the debt but they do not want to open up their markets or develop necessary adjustment programmes. These hindrances growing protectionism in the industrialized countries are standing in the way for any adjustment programmes. In the case of least developed countries, a part of debt-money can be used for financing "basic need" programmes enabling them to increase their ability to export. Besides, there has been a perceptible decrease of the official development aid from 1973 to 1983, the proportion of the private banks' loan with higher interest rate has been increased from 40 to 60 per cent of the foreign debts during the same period. Therefore, there is a need for increasing level of aid. But real solution to the problem lies- in political will.

Dr. Brown

It was pointed out that the present debt crisis is really a logical outcome of the structure of the financial system. There is a need for structural change. I am doubtful whether cancelling the repayment of the debt is really the solution of the problem: There is a need to identify the real causes of this problem. While the international banks should develop better risk analysis system, governments of developing countries should identify the projects capabling of generating income. It becomes a joint responsibility of creditors and debtors to see that projects selected for financing are really viable and should have bearing with income and employment generation.

E. Freyer

Thank' you Dr. Brown for your valuable comments. While I agree with your observations, it is felt that a case can be made for writing off loans to least developed countries. on a case to case basis. He added that Germany is really pioneer in writing off loans to poor countries. We cannot put the entire responsibility on the creditors. There is a need to review the whole of system of, aid and debt crisis.

M.A.Mannan

First of all, I congratulate Dr. Freyer for presenting a very balanced and a very informative paper devoting exclusively the debt crisis of the Muslim countries. I agree with him that there are very few literatures written by Western scholars regarding Islamic countries' debt crisis. Although the debt crisis of the Islamic countries is less serious compared to African and Latin American debt crisis, yet this problem needs serious attention. It is a complicated problem. It is not easy to calculate the real rate of interest. While debt crisis has its ethical and, moral dimensions, the problem of real transfer of goods and services in the light of debt burden needs further explanation. The solution to this complex problem is not easy, yet creditor countries may evolve necessary adjustment programmes whereby products of developing debtor countries do not face unfair competition and tariff wall of creditors countries. While a case for writing off a portion of loan can be made, it is perhaps desirable to develop a set of conditions or criteria before any loan is written off. That is, the projects intended to increase production of goods and services for the poor masses need a special care. Debt burden of such projects should be examined very carefully. It is desirable to write off loan of such projects. Besides, this seminar has generated a number of good ideas which are worth exploring. For example, debt cycle hypothesis as advanced can further be explored. There is also mention of debt equity swap which needs further analysis.

CHAPTER VIII

ALTERNATIVE STRATEGIES OF INTERNATIONAL FINANCING

Monzer Kahf and Tariqullah Kahn *

The paper reviews current forms of external finance classifying them into Debt Creating (DC) and Non-Debt Creating (NDC) flows. While borrowing is considered to be a major source of DC flows, major components of NDC flows are identified as foreign direct investment and official transfers. It is argued that new forms of international investments such as production sharing, turkey projects, build operate and transfer, offsets, subcontracting, franchising, revenue sharing etc. may be of move interest to developing Islamic countries due to their risk and profit sharing nature and non-interest character.

A review of Islamic financing technique shows that financing techniques based on profit/risk sharing will develop better linkges between servicing external finance and forign exchange earning, would be more efficient in comparison to interest-based financing techniques in terms of their effects on domestic production capacity, equitable distribution of risk and reward, and promotion of investment incentives. The paper also reviews some recent experiences in Islamic financing and conclude that Islamic financing techniques could easily and usefully be applied in international finance. – (Editors)].

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I
Introduction

The general argument for the rationale of external finance is presented in the framework of the two gap model. Since, in the developing countries domestic savings, generally speaking, do not match domestic investment requirements, some sources must be arranged to finance this gap. Even if sufficient funds could be generated from domestic Sources, capital accumulation requires the import of certain essential inputs: Due to various institutional characteristics 'of the developing countries, export earnings often fall short of import requirements. SO the conditions created by the existence of two gaps, i.e., saving -investment and export-import gaps make some form of external capital an imperative of capital accumulation in the capital scare countries.

The objective of this paper is to present the outlines of an alternative international financial strategy consistent with Islamic economic principles. section one present an overview of the existing international financing schemes. Section two briefly discussess the alternative Islamic modes of financing. Section three deals with the desirability of alternative financing schemes for the home and host countries. Problems and prospects of the Islamic financing scheme are discussed in section four. The last section presents conclusions.

II

Composition of Existing International Financing

For the sake of convenience, major sources of external finance can be classified into Debt-Creating (DC) flows, i.e., borrowing, Non-Debt-Creating (NDC) flows and contractual investments. Table I, given in the appendix to this paper provides comparative data on current account deficit, DC and NDC flows to major capital importing countries for the period 1970, 1975 and 1980-86.[1]

Debt Creating-Flows Funds borrowed from bilateral, multilateral or private sources either on the basis of interest liabilities or without it, create debt. This form of international finance has traditionally been a significant source of external capital for the developing countries. But, during the last two decades, commercial banks lending on the basis of London-inter-bank- offering-rates (LIBOR) became the most important source of the debt creating flows.

The intensity of the debt crisis for the OIC member countries during the period 1970-1985, is reflected through the data given in the Table 2 in the appendix.

Three factors are generally held responsible for this situation: relative decrease of the global risk capital in total financial flows, borrowing at floating rates of interest followed by increase in interest rates and relatively quick maturity structure of LIBOR based funds compared to flows from official sources.

Non-Debt-Creating flows Major components of the NDC flows are foreign direct investment (FDI) and official transfers. In this regard, from the data of Table-1, two significant conclusions can be derived:

i) that in absolute terms NDC flows have increased but their significance in total resource flows has declined up to 1982. However, with a drastic decrease in DC flow (1983 upwards) the significance of the NDC flows has increased again.

ii) that with the decline in FDI flows after its peak level of 14 billion US dollars in 1981, official transfers have become the most important source of NDC flows.

Interest in FDI as a NDC form of external finance is renewing.(2) The motivations for undertaking FDI are classified as "resource seeking" (relative abundance of raw materials in the host developing countries), "market seeking" (possibility of selling the entrepreneurial, technological and managerial services associated with FDI in one package) and "efficiency seeking" (exploitation of comparative advantages in any particular field of investment).(3) These three forces may work together or separately.

The advantages of FDI for the host country are generally expressed in terms of its package (of capital, entrepreneurial services and technology content), its directly productive nature and fungibility with other sources of external finance.

However, FDI is known to face a growing problem which may be termed as a phenomenon of "reciprocal fears". The host countries are afraid of foreign control of their resources, retardation of indigenous technological capabilities, and net transfer of the resources from the host to the home countries. From the perspective of investors, the attitudes of governments in the host countries and the socio-economic conditions which determine investment atmosphere involve numerous amount of non-economic risks: Fear of nationalization, social unrest, difficulties in remitting profits, possibilities of undesirable changes in, exchange rate and tax policies. Considering the importance of FDI, a number of guarantees against these risks at national, regional and international level are being provided.

Indirect capital flow in the form of portfolio equities is an important source of financial flow between developed countries but its 'nonexistence in the data of Table-1 shows that, so far, it has been negligible in the developing countries. Non existence of well developed capital markets is the most important reason for this, in addition to other considerations, which direct capital flows also face.

Due to interest of the International Finance Corporation (IFC) and major indebted countries, a potential means for the evolution of capital markets in developing countries may be the scheme of conversion of international debts into equities.

The IFC encourages the conversion process by developing reliable markets for this purpose through converting its own debts with different countries into equities and motivating other banks to follow. Under this scheme, Investment Trusts would be established. Commercial banks would be encouraged to exchange some of their loans for shares in these investment trusts. The loans bought as, such will be. swapped for local, currency equity participation in the borrowing entitles: public or private sector organizations. After merging the equity position into the trust, they would be traded in foreign markets providing an opportunity for the lending banks to sell their shares to non bank financial institutions.(4)

. Contractual forms of investments: These quasi-equity arrangements are based on contractual sharing of risks and returns between the contracting parties; viz., production sharing, turnkey, production-in-hand, build operate and transfer, and risk service contracts, and international leasing, off-sets, buy-backs, subcontracting, franchising, licensing, revenue sharing, joint venture arrangements, etc.(5)

There could be several reasons for the growing significance of these modes in the commercial, technological and financial relations of developing and developed countries. Firstly, for the host countries the greatly needed financial and technological inputs become available without allowing, foreigners undue control of national resources. Secondly, as these arrangements are less vulnerable to non commercial risks, developed countries avail the benefits of FDI with lesser risks. Thus; the considerations of host and home countries are simultaneously fulfilled at lower "reciprocal fear". Thirdly, unprecedented growth in the flow of bank lending during the seventies may have led to an increase in the developing countries' demand for the entrepreneurial and technological services.

The growth of these forms of investments is also likely to confront certain difficulties. Host countries have to meet the initial financial liabilities of the contracts. Depending on the complementarity of demand for these contracts on the - availability of debt financing the general decline in flow of funds can be expected to adversely affect their future growth. Moreover, host institutions can face operational and maintenance problems after taking over the projects. Similarly, certaih difficulties related to performance requirements and contract enforcement may also be expected.

However, in addition to being mutually acceptable to the host and home countries, these investment relations are mostly based on the principle of risk and profit sharing. They are, therefore, production oriented. Proper combination of the different modes may also minimize the non-commercial risks usually associated with international investments.

In view of their risk and profit sharing nature it can be suggested that the so-called new forms of investment may induce the interests of Islamic economists.

In addition, the religious, social and political atmosphere in the Muslim countries may be more receptive to these arrangements as compared to either interest-based DC flows or even traditional FDI. Therefore, in general terms, some forms of contractual arrangements for risk and profit sharing may be considered as a potential basis for the evolution of a viable alternative scheme of international financing.

III

Islamic Modes of Financing

The established principle of the Islamic economic code is that a return to capital can only be earned if it is somehow linked to risk bearing. Knowing that the economic transactions and relations have by their very nature varying degrees of exposure to risk, the Islamic system associates the entitlement to obtain earnings from a property to the right of its ownership. Be it a physical or financial asset, the right of ownership itself exposes the owner to certain risks commonly encountered in real life.[6] Consequently, any form of association of funds with entrepreneurial skills must abide by this principle if it were to be acceptable in Islam.

The immediate implication of this principle is that any form of financing which transforms available physical or monetary assets into a pure liability on the borrower does not entitle the financier to any return. Moreover, any form of contractual relationship, which puts all the risk only on one party, or gives a right to a guaranteed return, proportional or otherwise, to any party regardless of the final result of the operation, is also in conflict with this principle of *Shari'ah.* Obviously, this may pose certain restrictions to some variants of production and rename sharing arrangements. This applies to the initiation of a financing relationship as well as to its extension. or continuation. In other words, whenever, funds are provided on the basis of. lending which is characterized by creating a liability' on the part of the borrower, such financing must be void of any return or any sort of material benefits to the financier in order to comply with the rules of *Shari'ah.*

This' principle restricts *Shari'ah* compatible. modes of profitable financing to those which can fulfil the' test-of ownership. In this regard, Islamically approved modes can be sorted into two broad categories, commercial and financial. Firstly, there are modes based on purchase and sale, i.e. trading, whereby the financier buys certain assets or merchandise and either physically sells them or sells their services. The basis for earning profit or a return in these modes is the ownership of purchased assets or goods. We call this category the commercial modes of finance because modes included in this category are derived from a common commercial practice of purchasing with the intent of selling. Moreover, any condition. which interrupts the full implications of ownership, such as charging the insurance responsibility or the effects of unforeseen circumstances, to any person other than the owner, is not permissible under *Shari'ah.*

It should also be noted that the practice of the commercial modes of financing requires commercial expertise and know-how of markets as well as close follow up of the development of their legal and economic conditions.

Commercial modes of financing include the following:

1. *Murabaha:* It is a sale on the basis of disclosing seller's cost and margin of profit. In the context of Islamic financing, it is practiced as a *Murabaha* sale to the orderer of purchase with deferred payment. .

2. Sale with deferred payment and installment sale. These are also practiced with purchase orderer.

3. Other versions of the sale contract are: purchase with deferred delivery for. the benefit of the recipient of finance *(Bay'-al- Salam),* contracting for the benefit of the recipient of finance *(Bay'-al Istisna).* These two forms of sales are not common in the practice of Islamic banks.

4. Leasing *(Ijarah)* which takes a variety of forms, such as, simple leasing, leasing at a rate which recovers cost and rent, leasing at a declining rate, leasing with a promise to sell at the end of the lease, etc.

5. Partnership *(Musharakah);* which includes simple and diminishing *Musharakah.*

Obviously, the first three modes are based on sale, and can apply to one transaction only, the fifth mode implies collaborating in decision making and management for a series of sales, while the fourth implies a medium or long term relationship, repetitive in nature.

These differences make the *Murabahah* more tuned to a short/medium term financing of imports, raw materials and trade in general, while deferred and installment sales suit short, medium and long term financing.

On the other hand, leasing arrangements and *Musharakah* are tuned to medium and long term investment type of financing, while *Salam and Istisna'* are suitable to financing working capital.

Although the time element in financing is recognized, the profit margin involved in sale/purchase based modes is linked to contractual sale. Consequently, these modes create a commercial indebtedness. A test for distinguishing financial indebtedness from commercial indebtedness is two fold:

1. Commercial indebtedness arises from sales of real goods and/or services. This is not necessarily the case with conventional financial indebtedness.

2. In case of default, commercial indebtedness does not transform into financial one. This means that default does not entitle the creditor to additional earning.

On the other hand, *Musharakah* and *Ijarah* require a process of decision making which is medium and/or long term in nature and they do not, in principle, result in indebtedness, although, *Ijarah* creates indebtedness in the amount of due rent only but not in the amount of investment. While commercial modes maintain one to one correspondence between management and ownership, the second category of modes of financing is based on the separation between management and ownership. The essential mode used in this regard is the *Mudarabah* which is a profit sharing type of partnership in which the financier, while maintaining ownership of funds provided, abstains from taking any managerial-cum-entrepreneurial functions. However, there are other modes of financing in which financed capital takes the form of real assets such as land, trees, equipments, and raw materials.[9]

IV

Potentiality of Islamic Modes in International Financing

As, in Islam, the continuation of ownership with or without management and control is the effective cause of earning a return on supplied funds, the Islamic modes of finance have an obvious tilt towards FDI and nonconventional or quasi-equity forms of international financial flows. The only Islamically acceptable mode of financing left out in the preceding section is-free lending *(Qard Hasan)* which is in fact a form of grant without any return to the lender, except a guaranteed principal. Inspite of its importance and practice in the international arena, this mode of financing is usually given for non-economic motives. It is worth noticing, however,' that the Islamic modes of financing offer a wide, range of financing arrangements from commercial indebtedness to direct investment and control, passing through variant blends of ownership-cum-control and management.

Whether foreign finance is made available in the form of debt, equity, direct investment or quasi equity, it is generally understood that it constitutes future liability in foreign exchange. Therefore, if the expected present benefits of a mode of available external finance are greater than the cost of its future servicing, in general terms, it could be considered useful for the recipient economy. It is argued that by removing the foreign exchange constraint, a capital scarce economy could be pushed towards full capacity operation. However, the relative desirability of the alternative foreign sources of finance can be compared in terms of the following factors:

Linkages of servicing with foreign exchange earnings If the available finance is a future liability in foreign exchange, then a fundamental consideration for its desirability would be the linkage of its servicing with the foreign exchange earning capability of the recipient economy. Generally speaking, the liability of servicing debt finance is independent of foreign exchange earnings of the recipient economy. The country has to pay its debt and interest liabilities even if its foreign exchange earnings have been negative and the country is facing a real balance of payments difficulty. However, the sale based Islamic modes of financing are likely to have less independence and more linkages with foreign exchange earnings than the interest based financing because they represent trade of real commodities or assets which makes them unavailable for pure monetary financing in addition to their susceptibility to being selective and because of the fixation of the amount of indebtedness in case of extending debt maturity.

On the other hand, under *Musharakah* and *Mudarabah* type of financing, the question of profit remittances can only arise' if the concerned project has proved to be profitable. To be profitable, it has also to be efficient. If the project in question turns out to be inefficient and unprofitable, no profit remittances is to be made. Hence, the balance of payment of the host country is not likely to be adversely affected. Therefore, a financing scheme based on profit/risk sharing should be considered superior to fixed-interest-based debt finance.[(10)]

Effects on local financial markets: One of the important disadvantage of international debt financing has been the fact that it has encouraged to neglect, the domestic financial markets.[11] As a result, local financial markets, institutions and instruments have stagnated in the developing countries. Moreover, increasing amounts of capital flight have curtailed the financing capabilities of the domestic institutions. In addition, the system of bank lending takes it for granted that the financial sector has a claim on the real sector even if the latter faces a negative output. Interest becomes due irrespective of the use of funds and/or the ability to pay of the domestic borrowing entities. Thus the expansion of external debt liabilities which is closely related to these claims is mostly independent of the net addition to the productive capacity of the home economy. Consequently, increases in the debt liability of the economy result in producing a destabilization effect on the domestic prices; adversely effecting import management and export expansion prospects.

On the contrary, since the *Shari'ah* does not permit pure monetary transactions, i.e., transactions which are not linked to real goods, services or assets, no significant changes in the money market can be expected to take place independent of the changes in the goods and services market. Since the claims of the financial sector on the real sector are due because of either net income generation in the later; or utility arising from the acquisition of purchased assets, the productive capacity of the economy is expected to be a major determinant of the monetary stock. Thus monetary variables such as the price level would be less vulnerable to destabilizing factors. This by itself would be useful, not only in managing imports and sustaining export competitiveness but also for the development of domestic financial markets. However, the development of interest free capital markets is imperative for the Islamic financial system as it cannot utilize the facilities of the interest based financing instruments. This equally applies to mobilization and allocation of resources.

Effects on efficiency The fundamental advantage of interest free modes of financing is its apportionment of risks between financiers and entrepreneurs.(12) Due to their shares in the risks and rewards of a project, financiers have natural incentive to work for their efficiency. In the international framework, financiers can contribute, e.g., to procurement of technological inputs, project evaluation and monitoring methods and marketing of the products of sponsored projects.

Under a system of interest based modes of financing, the repayment of funds is generally guaranteed by the public authorities. Thus the suppliers of funds do not carry any risk except the risk of default which happens only rarely. Therefore, the criterion which determines the attitude of suppliers of funds is an unrealistic indicator of a country's economic performance: so-called creditworthiness. An economically viable project may well be found in a country which is not creditworthy. Such good projects could not, therefore, be financed under the interest based financing system.[13]

Under commercial borrowing from conventional banks, recipients usually enjoy free hands in spending the funds compared to the alternative Islamic scheme. This may be an 'advantage in theory but a disadvantage in practice because in the existence of pressing consumption needs in many developing countries, it has been politically convenient to postpone investment.

Even if investments are undertaken, there is a conflict between the maturity structure of the short term debt and long term investment.(14) The problems becomes even more serious if such funds are used for the development of infrastructural projects which do not yield any direct. financial return in the short run. Under such circumstances, debt servicing (to maintain creditworthiness) requires generation of funds by other domestic sources, such as, deficit financing which inflates prices, and thus reduces the prospects of export competitiveness and/or additional. taxes which discourage domestic investment and cause a deterioration in the net productive capacity of the economy.

Impact of the Islamic modes of financing on domestic production capacity: Changes in the domestic production capacity have important implications for the external sector of the economy. Therefore, the impact of introduction of the Islamic system of financing on domestic productive capacity needs to be briefly discussed. In this regard, the relevant factors to be considered are : savings and investment.

a) Impact on domestic savings: The impact of interest free financing scheme on domestic savings could be discussed in terms of following two factors:

i) Effects on distribution of risk: In the absence of interest-based risk free assets, would savings increase or decrease ? An argument could be made that the non-availability of risk free assets will discourage savings as future income will become uncertain. The well-known counter argument is that in the presence of uncertain future, rational individuals should be more, not less, careful about their future. Thus, they could be inclined to save more. It could also be expected that higher expected returns on risk sharing investments could upset the discouraging effects of non-existence of risk free assets. As risk bearing financial instruments are inevitable for the success of the Islamic financial system, with appropriate institutional arrangements a diversified investment portfolio of high yielding risk based assets can also be expected to emerge as a substitute to the abolished interest based system .(15) The interest free system will in fact distribute risks and uncertainties across the whole economy thus making better business prospects available.(16)

ii) Implications of the Islamic values for the motivations to save: God in the Holy Qura'n has very strongly condemned extravagance and prodigality (both of which are unfortunately high in the developing countries). On the other hand, earning maximum income from permissible sources is greatly encouraged by a very strong incentive: to attain capability of spending in the way of God, i.e., for the welfare of others. The greater the earnings and the less extravagance, the higher, one can expect, is the capability to spend in the way of God. Therefore, the religious motivation to earn more and restrain consumption can be expected to offer a base for resource mobilization in the developing Muslim countries.(17)

The importance of motivation is generally acknowledged for raising domestic savings. In addition to the above mentioned motivation of a Muslim for saving, two of the fundamental elements of Islamic belief, *Zakah* (which has been thoroughly discussed in the related literature) and *Hajj* depend on the financial position of the believers. *Hajj, i.e.,* the pilgrimage to the Holy places in Makkah, once in his life time, is obligatory on every able Muslim. Each conscious Muslim aspires to perform Hajj and considers this opportunity as a great blessing from God. Therefore, it can be considered as a factor affecting the propensity to save of the individual. In fact, in Malaysia since 1963, on the basis of this religious aspiration, savings are being mobilized by the Tabung Hajji as a saving and *Hajj* financing institution.(18)

In the absence of permissible investment opportunities, there is little incentive in many developing Muslim countries, for many people to save. Therefore, the newly established Islamic financial institutions have attracted substantial savings as reflected by the growth of deposits of the Islamic banks.(19) Thus adoption of Islamic values and emergence of Islamic financial institutions will in fact encourage saving.

b) Effects on domestic investment: There is no doubt that the interest free economy for its efficient operation will greatly depend on the availability of investment opportunities. In an Islamic economy, compared to interest based economy, investment opportunities are expected to be higher because of the following factors.

The demand for investment opportunities is strengthened by two factors: Imposition of *Zakah* discourage the accumulation of idle wealth and forces wealth owners to put their assets into productive channels; elimination of interest leaves only one option for investment, i.e., to be an entrepreneur or to invest in profit and risk sharing activities.

On the supply side also, there are substantial reasons to have more of the entrepreneurial services than less, besides being encouraged by several Qur'anic verses and sayings of the Prophet (Pbuh)(20)

i) *Zakah* based social security system guarantees a minimum level of living for every one, ensuring against any risk of entrepreneurial failure and consequent difficulties of maintaining life. *Zakah* also provides insurance against bad business debt.(21)

ii) In the partnership of *Mudarabah* the entrepreneur only risk his time and takes no financial liability.

iii) Harmonization of the financial and entrepreneurial interest: Interest as a return for the financing is in fact, a fixed cost for the firm. Where, under the Islamic scheme, profit being shared by the financier and the entrepreneur presents a common indicator of the two parties' interests. The more profitable is the firm the higher is the share of the parties. Thus, on one hand, "the marginal product of the firm could be taken up to the point where maximum profits would be obtained",(22) and on the other hand, this establishes a strong link between savers and investors.(23) .,

iv) The role of Central Bank as an investment institution: Because of the prohibition of interest, the central bank can only supply funds to the banking system either free of charge or on the basis of participation in their investment accounts. This is in fact an important role which partially changes the nature of central banks.

V

Problems and Prospects of Islamic Scheme of International Financing

Resource mobilization

During the past few years the development of interest free financial instruments has received considerable attention under the patronage of the Islamic Development Bank (IDB) as several consultation meetings of *Shari'ah* experts, economists and Islamic bankers have been organized.

As a result of these efforts, an Islamic financial market is emerging. In this context, the Islamic Banks portfolio and the IDB Unit Trust Scheme as pioneering attempts are worth mentioning.(24)

The Islamic Banks portfolio has been established by 21 Islamic banks including the IDB with an initial subscribed capital of US $ 65 million (composed of share certificates having a par value of US$ 1000 each). The funds will be used for short term trade financing between the member countries and in case of capital goods between member and non-member countries too. In conformity with the *Shari'ah* principles, a part of the funds will be used in leasing and other financial operations.

The IDB assumes the role of a *Mudarib* and is entitled for 5 per cent of the profits generated by the operations of the portfolio in a fiscal year. Whereas another 5 per cent of the profits will be retained as a backup to the financial state of the portfolio; the rest 90 per cent of the profits will be distributed among the certificate holders.

The certificates of the initial capital are negotiable and transferable only among the Islamic banks whereas subsequent issues not to exceed 10 times of the initial issues, will be open to other institutional investors too. Until such time that the certificates are listed in regular security markets, the *Mudarib is* authorized to periodically fix the prices based on market conditions for the certificates and financial position of the portfolio.

The IDB Unit Trust Scheme when it comes into operation, shall aim to mobilize private resources with the objective to invest in productive channels in the IDB member countries. It will also facilitate unloading of some of the mature investments of IDB and release resources for investment in other projects in the member countries. Different portfolios for different modes of financing are planned to be structured for the purpose of direct and indirect investments.

Resources would be raised by issuing negotiable and transferable certificates of different denominations to be listed in regular stock markets. Until such time, the IDB as Trustee will be ready to buy the certificates, on request, at prices to be determined.

The important feature of these profit and risk sharing certificates is that these are essentially linked to some real assets or properties. In this format, the Leasing Certificates (LCs) are widely considered relevant for the Islamic financial system.[(25)] The important characteristic of the leasing mode is the fact that it separates ownership and use rights of an asset. Furthermore, the ownership and use rights of a project or real asset can also be separated from the financial and administrative interests in a project/asset. As long as this principle applies, a good prospect for the profit and risk based financial instruments can be foreseen.

Muqaradah bond (MBs) is another prospective financial instrument whose development has received substantial attention from the Islamic economic academic circles. First proposed by the Hashemite Kingdom of Jordan, the concept of these bonds was discussed in 1984 during an IRTI Training Seminar on the management of *Awqaf* properties. Recently a special workshop was also held to discuss different dimensions of the proposed bonds. Although, *Muqaradah* bonds have so far not been issued but similar instruments are in operation in Pakistan and Turkey: Participation Term Certificates (PTCs) and Revenue Sharing Bonds (RSBs) respectively. The original idea of *Muqaradah* bonds was to evolve a financial instrument to develop the assets and properties of *Awqaf* The non-profit voluntary sector. PTCs and RSBs are respectively specific to the manufacturing and infrastructural projects.

The common characteristic of these bonds is that all of them are interest free and are being devised as an alternative to the interest based financial instruments and the operation, of these few instruments shows good prospects for the development of a non-interest financial market.

Moral hazard and resource allocation:

Chapra has strongly apprehended that the Islamic financing system will face a dual problem: "(a) moral risk which arises from the *Mudarib* declaring a loss, or a profit lower than the actual, because of lack of honesty and integrity and (b) the business risk. **(26)** The moral problem is the general problem of "moral hazard" known to be common in several agency-principal relationship: a situation in which cost of monitoring information on the proceeds of funds supplied is significant. For an interest free Islamic economy the importance of the problem is claimed to be conspicuous.(27)

In the framework of international flows of risk capital, this problem has been discussed by several scholars.(28) Lachler and Kamp have tested the response of the domestic economy (particularly savings and growth) to different forms of external finance (grants, equity, and debt) by using cross-sectional data for 36 Countries (including 6 OIC members). Their conclusion is that, "... neither form of capital inflow can be judged unambiguously superior to the other, and thus recommended for all countries, independent of social attitudes towards risks." (29) This conclusion is clearly due to the existence of a moral hazard situation.

Although the long-run competition for funds may contribute to the elimination of dishonest entrepreneurs, the significance of appropriate auditing and accounting procedures, modes of investment, improved project related capabilities of the economy, and above all, moral values cannot be neglected.

There is, however, a long list of the complex considerations of international' profit seeking investors. Their range varies from completion of official formalities, sources of local capital, availability of appropriate social, financial, commercial and economic atmosphere, supply of raw materials, labor legislation, to national economic restrictions.[30] A realistic appraisal of these and similar other factors related to host economies can be expected to contribute to minimize the non-commercial risks confronted by foreign investors. An appropriate approach in this regard is perhaps a joint venture type of arrangement particularly between local private investors, national development financing institutions and foreign investors.

Moreover, if one adds to the modes of financing discussed in section II above, a flexible mix of monetary assets, physical capital and technological know-how embodies in skilled labor as offered in *Shari'ah,* through different forms of *Musharakah* especially "industrial" partnership *(Sharikat al Sana')(*[31] and the most common kind of partnership in Islamic jurisprudence known in *Shari'ah* as *Sharikat al Anan*)[32]*,* all put together accommodate a whole variety of modes of international cooperation between monetary assets, technology embodied machinery manufactured and semi-manufactured goods and raw materials, skills and know-how, a variety which may cater to the promotion of such cooperation without any need to resorting to interest based lending.

To supplement such- arrangements the scope of national and multilateral guarantee facilities like Multilateral Investment Guarantee Agency, Inter Arab Investment Guarantee Corporation and the Agreement between OIC member countries on the Protection and Guarantee of Investments has to be increased against various types of non commercial risks.

Financing of infrastructural projects:

It has been argued that "many public projects, which are economically important - like a great number of infrastructural projects, for example, would not be covered by outside financing because they are financially unprofitable".[33]

In this regard two points need clarification: Firstly, the abolition of interest from the economy does not mean that all types of loans will be completely eliminated. In fact interest free loans and grants are expected to play an important role in the economy in addition to loans based on actual services charges. Secondly, the apprehension that infrastructural and social utility projects cannot be financed by the market sources seems to be rather unfounded. Instances are available from the literature as well as practical experiences of developing countries that market sources based on profit and risk sharing finance may be used for the development and maintenance of infrastructural projects. In several developing countries, these projects are financed by means of contracting, subcontracting and revenue sharing, without borrowing on the basis of interest or resorting to domestic deficit finance. The institutional mechanism of national development financing institutions may be geared to link such projects with profit and risk sharing sources of finance.[34] After the elimination of interest bearing debts from the economy, it can be expected that such arrangements will receive more attention and the; linkage of these projects with the market will also improve their efficiency.

Concluding Remarks

This paper has attempted to outline the relevance of the Islamic modes for international financing. It is generally accepted that the current difficulties in international financing system have strong links with the debt financing strategy. Since, Islamic modes of financing present a direct alternative to debt financing, such a discussion may be considered timely.

The Islamic modes of financing are classified as commerce and finance related. Only the commercial modes may generate some form of quasi-debt, but such debts are based on certain real magnitudes: Assets, commodities or services. Since delay in the payment of debt is not supposed to improve the quality or quantity of the debt-base, the amount of debt liability does not increase as a result of the delay. Although lending may serve the purpose of financing, yet it belongs to the non profit sector of the Islamic economy, therefore, it does not entitle for any material claim except the principal lent.

Interest bearing finance in fact separates the risk of ownership from ownership rights and transfers them to the borrower which is prohibited in Islam. Moreover, the inability on the part of the debtor to pay the debt practically functions as a very significant source of income for the interest earner! As a consequence, "May be the private banks are not at all interested in debt repayment".... "Interest rates of 16% or .17% are in fact proud returns.." [35] The payment of these returns are not the result of performance of the economies of borrowers but guarantees by the governments.

Is there a case for a quasi or non-debt creating international financing system? The principles and practice of Islamic modes of finance suggest: Yes. *Musharakah, Mudarabah* and other contractual arrangements of sharing risks and profits can be taken as the basis for resource mobilization, trade and leasing etc. On the other hand, the developing countries shall attract different forms of joint ventures involving national entities, foreign investors and multilateral organizations. .

Table-1
Capital Importing Developing Countries External Financing 1970-86 (in billion US dollars)

	1970	1975	1980	1981	1982	1983	1984	1985	1986
Current account deficit	18.6	46.3	76.3	116.8	107.6	65.0	38.1	41.3	42.2
Non debt creating flows	6.6	13.7	23.6	26.1	25.6	24.6	24.2	30.8	30.1
Official Transfers	3.0	7.6	12.5	13.6	13.0	14.0	14.2	16.7	17.0
Direct Investment	2.7	6.8	9.1	14.2	13.0	10.5	10.3	10.2	9.8
SDR allocations	0.9	-0.7	2.0	-1.6	-0.5	0.2	-0.3	3.8	3.4
Use of reserves	1.5	-2.0	-22.9	0.4	17.5	-9.9	-20.0	-10.7	-14.0
Asset transactions	-2.2	-5.2	12.8	-25.8	-10.0	-9.7	-14.9	-10.9	-1.9
Errors&Omissions	0.1	-7.2	-16.1	-18.9	-25.3	-9.9	-2.2	-5.4	-2.1
Net borrowing	12.7	47.0	104.4	134.9	99.9	69.8	51.1	37.5	31.2
Reserve related	-0.5	2.5	2.5	12.3	25.7	21.4	2.3	0.4	3.2
Use of Fund credit	-0.5	2.1	1.4	6.1	6.7	11.2	4.9	0.3	-2.2
Arrears		-0.1	-0.7	5.6	15.7	12.3	3.2	0.1	5.2
Other	-	0.4	1.8	0.5	3.3	-2.1	-0.8	-	0.1
Long term official	6.0	11.1	24.5	32.6	31.5	31.4	30.9	24.1	30.2
Other borrowing	7.1	33.4	77.5	90.1	42.7	17.0	12.9	13.0	-2.2
Long term	7.1	32.5	42.6	60.7	30.3	33.2	10.3	32.8	7.5
Banks	3.1	20.5	24.8	30.8	18.9	33.9	9.9	61.0	9.9
Others	4.1	12.0	17.8	29.9	11.4	-0.7	0.4	-28.1	-2.4
Short-term	-	0.9	34.9	29.4	12.4	-16.1	2.5	-19.9	-9.3
Total Non-Debt-Creating Flows and Net Borrowing	19.3	60.7	128.0	161.0	125.5	94.4	75.3	68.3	61.3

Source: IMF and Staff estimates, Taken from Lanyi (1987)

Table 2
Debt Services of Selected OIC Member Countries as Percentage of GNP and Exports (1970,1979-1985)

	GNP								EXPORTS							
	1970	1979	1980	1981	1982	1983	1984	1985	1970	1979	1980	1981	1982	1983	1984	1985
Allgeria	0.8	8.6	9.0	9.6	9.4	10.7	9.2	8.3	3.2	25.6	23.9	28.7	27.2	36.3	32.4	33.3
Bangladesh	-	0.9	0.7	0.8	1.0	1.3	1.3	1.4	-	8.4	7.1	6.9	8.3	14.4	14.1	16.7
Cameroon	0.8	2.5	3.6	3.1	4.0	3.4	3.0	3.1	3.2	9.5	-	17.9	17.4	13.9	8.9	8.3
Chad	1.0	3.3	3.1	2.9	0.1	0.1	-	-	3.9	14.4	-	10.5	0.3	0.6	2.2	-
Comoros	-	-	0.5	0.5	0.9	-	-	1.9	-	-	4.8	6.1	3.8	-	-	9.6
Egypt	4.1	5.5	6.9	7.0	6.6	6.0	7.4	7.1	28.7	15.8	18.9	22.7	30.7	34.0	34.2	33.9
Gabon	-	-	12.1	10.0	10.1	7.8	8.5	7.0	-	-	15.1	15.4	13.3	9.4	11.2	-
Gambia	-	-	0.1	2.1	3.4	3.1	4.6	5.5	-	-	-	7.1	-	-	6.6	-

	GNP								EXPORTS							
	1970	1979	1980	1981	1982	1983	1984	1985	1970	1979	1980	1981	1982	1983	1984	1985
Guinea	2.4	5.7	6.6	5.3	4.9	4.0	5.8	3.6	26.7	22.2	24.6	19.4		-		
Guinia B.			4.1	-	1.9	0.8	2.8	7.6		-	30.3	-				77.8
Indonesia	0.9	4.5	2.7	2.4	2.6	3.4	4.3	5.0	6.9	13.4	8.0	8.3	10.9	12.8	14.7	20.1
Jordan	0.7	-3.5	3.7	5.0	4.5	5.0	6.8	12.0	3.6	5.3	5.4	5.7	9.3	11.3	14.8	22.1
.Malaysia	1.7	-2.9	1.4	1.7	2.9	3.5	' 4.9	13.7	3.6	4.7	2.3	3.1	3.7	5.8	7.7	22.3
Maldives			-	1.0	.1.8	--		14.9	. -		-	6.4	8.6	5.5	12.5	8.6
Mali	0.2	0.7	0.8	3.2	0:8	0.6.	1.7	5.8	1.2	8.5	-	15.4	4.8	6.1	6.0.	3.3
Mauritania	2.0	13.6	5.9	7.7	5.8	5.4	6.2	-12.2	3.2	32.4	11.5	16.3	11.8	10.0	13.1	-
Morocco	1.5	5.2	6.7	8.0	9.3	8.3	9.2	8.6	7.7	21.8	28.0	30.1	57.8	36.2	37.6	32.3
Niger	0.6	0.8	2.2	3.8	7.3	5.6	6.1	4.4	4.8	3.6	5.7	19.1	30.4		-	26.7
Oman			3.5'	1.7	1.8	2.1	- 3.0	3.2	-		4.2	1.9	2.2	-3.2	4.6	4.8
Pakistan	1.9	2.3	2.4	1.8	1.6	2.7	2.8	3.2	23.6	12.0	10.9	9.6	. 9.3	21.9-	24.1.	29.5
Senegal	. 0.8	5.0	6.9	3.9	4:2	1 . 9		3.7.-	2.7	13.7	-	23.2	22.2		. , 1	11.7
Somalia	0.3	0.2	2.5	1.3	1.6	2.5	2.0	-	2.1	1.1	3.5	6.1	10.3	13.1	28.8	44.8
; Sudan	1.3	4.5	1.8	1.6	1.1	2.1		1.6	10.7	33.0	17.4	16.8	17.0	17.8	13.6	15.6
Syria	2.1	3.8	4.2	2.6	2.2	2.0'	2.0	2.1	11.0	16.5	15.2	19.3	15.9	14.6	-	14.8
Tunisia	4.5	4.8	4.9	6.3	6.2	7.4	8.5	8.3	18.5	11.8	18.8	21.0	15.4	22.3	24.4	24.9
Turkey	1.3	.1.1	-1.2-	2.0	3.2	-4.7	4.4	6.6	16.3	12.9	11.6	13.3	27.6	29.1--	22.5	30.9
Uganda	0.6	0.3	0.4.	0.9	.0.8	1.4	2.1		3.4	7.4	11.9	17.3	28.0	-	-	30.9
Y.A.R.	0.2	1.2	0.7	1.8 ,	1.5	1.0	1.8	3.4	-	1.8	1.7	4.6	3.8	13.9 ,-	-	55.8
Y.P.D.R.		1.3	1.8	3.8	4.9	4.3	3.0	10.4		2.8	3.3	9.3	-	25.1	49.9	-

Notes : - data not available "relates to exports of goods only"
Source: IDS Annual Reports Various

Notes

1. Lessard and Williamson (1985) have given a comprehensive account for the components of external finance.
2. See e.g., UNCTAD (1983):
3. Lessard and Williamson op.cit.
4. UNCTAD op.cit.
5. Oman (1984) provides a detailed picture of the subject. Proceedings of the Workshop on the Organization and Management of The Pilgrim Management and Fund Board of Malaysia, Islamic Research and Training Institute, Jeddah, 1987
6. This is a known, rule of *Shari'ah* that yield or return is linked with responsibility *(al Kharaj bi-al Daman)* which is a saying of the Prophet (Pbuh).
7. In *Bay'al Salam,* the bank contracts a supplier for future delivery to the Bank's client who pays back to the bank at a future date.

8. In *Bay'al Istisna',* the bank contracts a constructor for a construction to the benefit of the bank's client who passes back to the bank on a future date.

9. The case of equipments and raw materials is only approved in the Hanbali School of jurisprudence. It should be noted that *Sharikat al 'Anan* in the *Hanafi Fiqh* caters for the practical applications of this Hanabilite form of Mudarabah as it is permissible in the 'Anan to be transformed from an ownership partnership *(Sharikat al Milk)* in which shares are paid in physical terms and for a partner to be sleeping and to share profit at a proportion different than that of capital contribution.
   It is also worth noticing that this form of *Mudarabah* provides a convenient instrument for transfer of technology embodied in equipments, finished and semi-finished products, and raw materials. This flexibility makes it suitable for various forms of franchising and production, revenue, and profit sharing relationships.

10. Of course, non payment of profit dues affect the expectations of investors, and therefore, future flow of financing. But it is known that investment returns average out over the years, making the remittance of profits related to payment ability in these forms of financing while it is not so in interest based financing. This point is made by several scholars. See, e.g. Siddiqi (1982).
11. See, Lessard & Williamson op. cit.

12. Risk distribution is obvious in *Musharakah, Mudarabah* and leasing. *Murabahah,* deferred and instalment sales also involve some level of risk distribution as financiers take full responsibility of buying and selling. Moreover, since commercial indebtedness does not increase in the event of change in maturity dates, an added element of risk distribution is featured compared to interest based finance.

13. Chapra (1985).

14. Lanyi (1987).

15. Iqbal and Mirakhor (1987).

16. Zarqa (1987).

17. Khan (1984).

18. Those interested in the organization and functions of the Tabung Hajji could profitably use: Proceedings of the Workshop on the Organization and Manage-

meat of the Pilgrims Management and Fund Board of Malaysia, Islamic Research and Training Institute, Jeddah, 1987.

19. See, Ahmad (1987) and Nienhaus (1988).

20. Many verses encourage walking on the earth and seeking the bounties of God to the extent that Maxim Rodinson claims that in the Qur'an God speaks to the believers in commercial terms of profits and losses. Moreover, the Prophet had always encouraged his Companions to have a trade and/or a craft. He even motivated them to become independent businessmen and • helped them in some cases. See for instance the saying of the wood collector.

21. Kahf (1978).

22. Iqbal and Mirakhor op.cit

23. Kahf op.cit.

24. This review is based on IDB Twelfth Annual Report.

25. LCs were first proposed by al Jarhi (1983).

26. Chapra (12982), p.152.

27. Khan (1985).

28. See for example Lessard and Williamson op.cit and Lachler and Kamp (1987).
29. Ibid, p. 644.

30. See, Reidal (1984).

31. *Sharikat at Sana'i is* a partnership in which partners provide skills.

32. *Sharikat al 'Anan* is very flexible with regard to the degree of control and management. 33. Hemmer (1986), p.14.
33. Hemmer (1986), p-14.

34. Kahf (1986).

35. Hemmer op. cit., p.15.

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Discussion

A Participant

I wish to point out that in the Western countries, leasing is going on very fast. The conventional credits are on the decline. I wish to draw your attention to show what could be some kind of convention between the Western and Eastern countries. In the beginning, the concept of leasing was introduced in the developed countries on fiscal advantage. However, the regulation of economies from time to time makes this fiscal advantage to disappear. Besides that, one wonders to find that government credit is declining too. There is such a perspective in leasing also. We have to point out that it comes from the ownership. The bank keeps the ownership of equipment in lease financing. The bank is responsible and careful in how it finances the projects. The borrower is also more safe and normal because if something happens, finance will not be taken away. An equipment could be considered as a centre for profit. That means that some banks are developing a way of financing in which they are able to keep the centre of. profit under control.

M.A.Mannan

May I remind that yesterday, a point was made in Dr. Minai's paper that leasing is an important operation of the Islamic Development Bank. The Bank is making a successful experiment in this field. Then, it is a common area between the Western and Islamic institutions.

A Participant

I wish to point out that they articulate it in a different way from what we do.

M.A.Mannan

Leasing is not a new concept. It is an age-old concept in the Islamic world as well as in other countries because it is just a principle. The reason for the recent growth of leasing is that leasing costs in the Western countries are tax deductible. I do not know whether in Islamic countries, there is any provision making leasing costs tax deductible. This limits the operation of leasing in the Islamic countries until they bring the legal system which allows for tax deduction of leasing costs.

A Lady Participant

I do not quite see why *Musharakah* would be grouped with commercial loan. Actually, I wish to know whether *Musharakah* and management of its ownership can be separated while capital must-belong to all of the participants. Not all of them will have to be managing the project any way. So, in that case, this would turn to *Mudarabah* mode, due to the fact also that many problems associated with *Mudarabah* are very similar to *Musharakah* case. So I wonder what this grouping shows? .

The second question relates to the distribution of risk in *Mudarabah* mode of finance. I wonder what kinds of agents there would be to make *Mudarabah* operational? The authors have suggested in their paper that domestic savings are expected to improve because of Islamic values. I do not see the reasons for improved domestic savings.

Another issue relates to *Mudarabah.* I would like to know the provisions and institutions of the *Mudarabah* model the authors have in mind. A am familiar with the *Mudarabah* Ordinance of Pakistan in which a company would collect capital from the public in the form of *Mudarabah* certificates. Then, the *Mudarabah* company could invest this money in National Investment Trust (NIT) or Investment Corporation of Pakistan (ICP). The ICP would, in turn, invest its capital in some productive project. In case of profit, there is no problem as profits are distributed to all persons holding *Mudarabah* certificates. In case whatsoever loss occurs, the loss remains with the first certificate holders only. I do not see how Participation Term Certificate. (PTC) could be fit in this scheme.

My last point is related to financing of infrastructure project. It is well known that commercial banks are not usually interested in financing infrastructure projects which do not yield any direct profit. What criteria and what allocation mechanism would be used for financing of these projects?

Prof. Shigar

I want to raise the question of the official allocation of capital gain and state my view that the authors have passed over slightly the problem of the information costs and what is called no risk.

A Participant

In practice, the Islamic countries as indebted countries have not made any effort to introduce any aspect of Islamic banking in their international relations. We notice that Pakistan has a foreign debt of about 12 billion dollars and Sudan has a debt of about 8 billion dollars. Like any other country, these countries also pay interest on their debts. They did not try to change anything in the creditor-debtor relationship. I wonder whether the Islamic Development Bank could take any initiative in this connection.

Monzer Kahf

I hope I will be able to answer some of the questions. I am sure that I will not be able to give satisfactory answers to all of the questions which have been raised, particularly because the experiment of Islamic finance is still new. Many issues have not yet settled and the Muslim economists are themselves looking for appropriate answers and solutions.

I think we may not find much difficulty with the statement that interest rate based allocated money is not capital. The difference between money and capital is obvious and clear. A more important point, which Muslim writers in this area have been' emphasizing, is that expected social rate of return could serve as a suitable, even better criterion than the rate of interest, for allocation of resources.

A point was raised yesterday that the Jordan Islamic Bank selected the profitable projects to finance and did not accept the losing one. This is only natural to do so. In fact, the Islamic banks select more projects over less profitable within the set of profitable projects. This kind of practice, at a micro level, in an Islamic bank, or at a macro revel, in those societies which have already switched over to non-interest based system, is based upon a measurement of expected rate of return. Different projects are evaluated according to their expected rate of return. Thus, whether socially or individually, we can think of certain criterion for resource allocation which is more flexible and more realistic in the sense that it reflects the past' performance of the project on investment.

The concept *of Mudarabah* may be exactly the same thing like a sleeping partner. The Islamic code of business defining different categories of partnership did not have the concept of sleeping partner except in the form of a partner that does not take action and who is the contributor of funds in *a Mudarabah.* However, this form is not restricted only to the case where the entrepreneur does not provide any fund. So, it could be that an entrepreneur has some funds and at the same time he is allowed a percentage to give refund as fiscal bonus. This is the case of Islamic banks with the depositors. This is the form of *Mudarabah* in the traditional sense of *Mudarabah* from the Islamic point of view, that came into existence centuries, ago. It is in fact, *Mudarabah* from the point of view of the provider of funds, but not full *Mudarabah* from the point of view of the entrepreneur who could also put his own funds along with other funds.

There is some discussion on why Islamic banks did not succeed in promoting *Mudarabah.* When funds are provided on the basis of traditional concept of

Mudarabah, two requirements have to be fulfilled. First condition is that provider of the capital does not interfere with the management of funds. Secondly, the funds which are to be provided should be in the ownership of the provider of the capital, so that he can bear the whole loss, if there is a loss. May be this is the reason why traditional form of *Mudarabah* has not been a popular mode of financing with the Islamic banks.

Let us now consider the relationship between ownership and entitlement to earnings. This relationship is applicable to funds, investments and earnings. However, profits going to the entrepreneur under *a Mudarabah* agreement, in its traditional form, the entrepreneur does not provide any fund at all. But the provider of capital and the entrepreneur both can get a share in the profits on whatever they have agreed on. The word profit in Islamic jurisprudence is used in a special sense i.e., it refers to all yield or return from any asset. It appears to me that Islamic *Shari'ah is* very strict in maintaining that there is no entitlement to profit without the ownership of the assets. This principle also becomes the basis of financing.

Mudarabah does require full and continued ownership. Without ownership, one is neither entitled for return nor refund. That is why, in our paper financial form of credit has been compared with the commercial form, i.e., the *Mudarabah.* If funds provided by the fund owner have been transferred into equipments, assets, etc. the element of ownership is still there. The relationship between the entrepreneur and the owner of funds dues not get transformed to any different relationship. In the Western tradition, financing is a debt on the person who is being financed. This is not the case in *Mudarabah.* In the Western form of financing, there is no element of ownership. There is only a debtor-creditor relationship and that is all. In *Mudarabah;* there is a continuance of ownership which justifies the taking risk of any loss. That is why in Islamic jurisprudence, it is held unanimously that loss is to be borne by the provider of funds. The entrepreneur does not carry any part of the loss except for those of which he may be the owner. Thus, ownership is the only justification, from the Islamic point of view for extracting 'profit from the use of those funds which have been invested in *Mudarabah.*

The important difference between this form of financing and *Musharakah is* that one owns something in *Musharakah* and he can dispose it off whenever he wants. A partner in *Musharakah is* a decision-maker. He may also give his right of decision making to someone else and may revoke this whenever he wants. In the case of a company based upon the principle of *Musharakah,* this can be done by calling a general meeting of the shareholders. Main difference between the Islamic financial credit i.e., *Mudarabah* and direct ownership and investment is that of control. In *Mudarabah,* owner and provider of funds has no control which is monopolized by the entrepreneur. Definitely, it is permissible to impose certain conditions on the entrepreneur, in *a Mudarabah* contract, with respect to field, kind of activity, selection of sector, commodity, even geographic location. However, the control exercised by the owner is confined to keep an eye on the entrepreneur that any one of the imposed condition is not violated. He does not participate in the actual decision making of selling, buying, and investing, etc.

Now, let us consider why *Musharakah* is classified as commercial. In our definition, commercial credit is concerned with ownership, buying and selling, either on spot or with deferred payment. The difference between the sale revenue and cost is profit which is taken as lump sump. Profit is not justified on the basis of time. It is justified on the basis of ownership, which also involves the risk of loss *Murabahah* may be confined to one transaction of sale and purchase, but in *Musharakah,* buying and selling may be repeated again and again. Therefore, it is termed commercial. The fund, in a *Musharakah* operation, are not handed over to anybody else. They are used by the owner. *Musharakah* by definition is a kind of relationship which aims at making profit and implies productivity. We need a surplus or profit in *a Musharakah* contract which is to be divided among the partners.

In case of international investment, there is a feeling in all developing countries and it will remain that we do not want our domestic economy to be controlled by direct equity owned by the foreigners. It reminds us of the past fifty years when every thing was colonized. We do not want to go back to the same era. The solution is to have international investment based on the concepts of leasing and installment sale instead of loans on the basis of interest. The financing of infrastructure can also be made on this basis without being involved in the interest.

Regarding the Islamic concept of leasing, it was mentioned in the paper that leasing does not create a debt in the amount of rent. So far the rent that is due, it does create debt. There is an important distinction between what is known in the West as "financial leasing" and leasing that is compatible with the *Shari'ah.* The leasing contract in *Shari'ah is* defined in a way that it always relates the payment to the services. The payment of rent is not binding on the leasee without the services unless it is by his choice.

On the interest-free loans, it could be said that in Islam it is a form of grant. The Islamic jurisprudence recognizes that money is useful. The amount given as loan is as useful to the lender as it is to the borrower in the sense that he could have used it for alternative purposes: The interest-free loan has to be paid back. It is binding. It is a kind of grant because the lender is granting its use and benefits to the borrower which is not discouraged from the Islamic point of view.

The point of tax privileges in leasing needs the removal of a little misunderstanding. Tax privileges in the productive sectors are common in almost all countries. For example, a car is leased for business purposes. The expense is tax deductible in most countries. However, in certain-cases, an individual is not allowed to deduct leasing cost from the tax while interest paid by the individual is tax deductible. Perhaps a time will come when both will be treated in a similar manner.

On saving and relationship of the forms of financing with saving, there was an underlying assumption in the paper that people like to preserve their wealth. They do not want that their wealth should decline. With this assumption, I think, it is obvious that presence of *Zakah is* a reduction in the wealth. Hence, alternative ways of increasing the, wealth should be found, otherwise it would decline. This assumption is based on observed human behaviour and it was also mentioned by the Prophet (Pbuh) on more than one instances. -

Now let us consider the point that why Muslim governments did not take action in the international arena to adopt and implement the Islamic economic principles instead of submitting to the will of the international market in accepting interest transactions ? Islamic banking is still new in the area. Even the first experiment of Islamic banking did not last more than a few years and died because of external factors shortly after it started. However, the Islamic Development Bank was established on the basis of Islamic economic principles. The experience did not get sufficient momentum yet to reach the international arena so that it could be adopted by the governments in the Muslim countries. The establishment of the Islamic Development Bank (IDB) was certainly a courageous step in this direction. It will be recalled that agreement to establish the IDB was signed in 1974 in a meeting of the Finance Ministers of the Islamic countries in Jeddah, Saudi Arabia. The IDB practices the Islamic financing techniques and also makes an attempt to promote them.

M.A. Mannan

The most important point in this paper is that Islam provides a variety of mode of financing, including some of those in which the West already has sufficient experience. For example, one could list leasing and equity financing as those financing techniques in which the West has more experience. Perhaps the West can provide better management in managing these types of activities than the Islamic countries. We can see now how different mechanism could be available for solving debt crisis.

About infrastructure financing through *Musharakah* it is possible to handle some public utility projects, such as construction of a road or a bridge. We are aware that there is a provision for the imposition of toll tax. Therefore it is possible to finance part of the infrastructural project which can be organized through *Musharakah.* Of course, in addition to this, government can also impose taxes on public. There are different ways where public sector projects can be financed. The Islamic Development Bank is also providing loans free of interest for supporting infrastructural projects like roads, bridges, dams, airports, etc. Therefore, it is not necessary that everything has to be on commercial lines.

The Islamic Development Bank is not merely concerned with loans, equity and foreign trade financing, it has also major operations in instrumental advances. It has accumulated experience in this area and in fact, the Islamic Development Bank is deeply involved in studying the Western experience as to how it can be best utilized.

CHAPTER IX

THE CONTRIBUTION OF INTERGOVERNMENTAL INSTITUTIONS TO DEVELOPMENT IN THE SOUTH ESPECIALLY IN THE ISLAMIC COUNTRIES

(A CRITICAL APPRAISAL)

A. Ghani Ghaussy*

(Since 1970s a number of intergovernmental institutions have emerged in the developing and Islamic countries whose main purpose is to promote social and economic development in the member countries. Theoretical basis for the establishment of these multilateral intergovernmental institutions is provided by the theory of collective 'self reliance'. Making the developing countries in general, and Islamic and Arab countries in particular, a rame of reference, the paper reviews the emergence of multinational financial institutions, development banks, development finance institutions, financial intermediaries, multilateral government and semi-governmental institutions in different sectors of the economy such as industry, trade, agriculture, and transport. A critical review of multinational cooperation and integration schemes in the countries has been made. Certain impediments and discrepancies are also identified which, in the opinion of the author hinder efficient integration of Islamic countries. It is recommended that self-reliance strategy must take cognizance of individual, social and political factors necessary for socioeconomic advancement. - (Editors)]

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I

Intergovernmental Institutions in the Framework of Self-reliance Strategy

Since late 1960s and early 1970s, developing countries have recognized the need to create multilateral intergovernmental organizations to promote their economic and social development. With the founding of United Nations Confernce on Trade and Development (UNCTAD) in 1964 and the formation of Group of 77, the institutional framework for a joint action of developing countries was set.

The demand of the developing countries to establish a "New International Economic Order" (NIEO), which was first initiated by the Conference of the Group of Nonaligned Developing Countries in Lusaka (1970) and later underlined in the conferences of Georgetown (1972), Algier (1973), Dakar (1975), Columba (1976), and Havana (1979), led to the action programs of the developing countries. The economic aspects of these "action programs" were discussed in the "World Trade Conference" of New Delhi (1968), Chile (1972), Nairobi (1976), Belgrade (1983) and Geneva (1987). In each of these conferences, the developing countries' desire to establish a New International Economic Order (NIEO) and to reach a certain degree of economic independence and accelerated economic growth was stressed. The result was the creation of institutions at regional and subregional levels, integration schemes, multilateral production and marketing ventures, south-south trade agreements, preferential trade relations, cooperation in different sec-tors of the economy, etc

For the economic cooperation among Islamic countries specifically, two documents should be mentioned: 1. The General Agreement for Economic, Technical and Commercial Cooperation among Member States of the Islamic Conference (1977) and the Plan of Action to Strengthen Economic Cooperation among Member States (1981). Both documents classify different measures to promote economic cooperation among member countries in different sectors as well as technical cooperation."

The theoretical base of these economic attitudes and actions of the developing countries was the theory of "collective self-reliance", which had been influenced by the neo-Marxian theories of imperialism(2), by the Dependence-theory(3) developed in Latin America, and by the auto-centric development theories in general.(4) The core of these theories was the developing nations' exploitation by colonialism, the destruction of their production structures by capitalist ventures, and their degradation to a mere "market" for industrial production of the Western capitalist countries. Therefore, the originators of these theories called the developing economies to dissociate from the Western capitalist economies and to rely upon themselves collectively, since they themselves had a better knowledge of their own needs, resources,abilities and adequate measures. Furthermore, they called for more solidarity and collaboration among the developing nations.

The economic implications of these theories are, from a realistic point of view, rather impractical, but nevertheless very interesting.[(5)]

During the 19170's different institutions motivated by the spirit of the "Self-Reliance" theories were established in the developing countries. Some countries oriented their whole economic policy according to this doctrine (Tanzania). However, the results have been poor, because the existence of international economic interdependence, was ignored.

Generally, throughout world history, the most prosperous countries have been those with more international ties and more commercial, technological and economic cooperations. As P.T. Bauer states, "external market contacts expand people's choices and opportunities, provide outlets for their products and serve as sources of supply for the satisfaction of their wants. They also serve as channels for human and material resources, skills and capital. And when the contacts are with more advanced societies, they serve as vehicles of new ideas, methods, crops and wants".[(6)] New trends in the extraordinary development and accelerated economic growth of the "Newly Industrialized Economies" prove that openness and international economic cooperation, not only among the developing countries themselves but also with the industrialized economies, have certainly led to a much better way of economic advancement.

However, the role of the institutions which were created in different sectors of the developing countries - inspired by the self-reliance strategies - should not be neglected. They contributed considerably to their countries' economic development as a supplement to other national and international measures. The first reason for this development is that a "collective self-reliance strategy" opens the way for economic cooperation, which has been very much neglected among countries with similar development patterns, similar interests and a strong development potential. The chances for industrialization through enlargement of the markets, through "economies of scale" that enable the developing countries to be more competitive in the world market, increased. Secondly, the growing tendency to various types of protectionism, especially through "non tariff barriers", that have increasingly emerged in the industrialized economies since the 70's, forced the developing countries to adopt collective self-reliance strategy.

II
Intergovernmental Institutions in the Islamic World

There is a wide 'range of multilateral intergovernmental institutions in the developing countries created in the last 10 to 15 years. The multilateral intergovernmental institutions can be classified either under their regional, subregional and interregional aspects,. or according to their sectoral field of activities. From the point of view of economic development, however, their classification according to fields of activities is more meaningful.

A. THE SECTORAL ASPECTS OF MULTILATERAL INTERGOVERNMENTAL INSTITUTIONS

The sectoral classification of multilateral governmental institutions in the Islamic world can be divided into two groups:

- Multilateral financial .institutions, financial intermediaries, banks and financial funds.

- Multilateral institutions in other_ sectors of the economy such as agriculture, . industry and trade, energy, mineral and water resources, education and training.

The degree of intergovernmental cooperation in the above mentioned sectors widely varies between a tighter form of joint ventures and loose financial participation. Furthermore, it is determined by the kind of operation and the targets set for the operation of such multinational institutions. While, for example, some organization types, like joint ventures, provide a more direct and efficient way of production, distribution and control, other types of multilateral organizations lack any efficient operation and control.

Let us review the four groups of sectoral multilateral governmental institutions already mentioned in a little more detail.

1. Multilateral Financial Institutions, Financial Intermediaries, Banks and Financial Funds

In the Islamic world, the following institutions belong to this category: Islamic Development Bank (IDB), founded in Jeddah in 1975; Arab Bank for Economic Development in Africa (ABEDA), founded in 1975 in Khartoum; Arab Fund for

Economic & Social Development (AFESD), founded in 1968 in Kuwait; Islamic Solidarity Fund (ISF), founded in 1974 in Jeddah[7]; Arab Monetary Fund (AMF), founded in 1977 in Abu Dhabi; OPEC-Fund for International Development, founded in 1976 in Vienna.[8]

While the first three institutions mentioned are multilateral joint ventures, the other Funds mentioned have to be classified as bilateral and multilateral agencies that promote economic development in the Islamic World, especially in the Arab countries.[9]

Development banks, financial institutions and development funds can play a significant role for the economic development of the Islamic countries. Generally speaking, they all channel resources to different production and distribution sectors of the related economies in which the private and commercial oriented creditors are usually unwilling to invest. They provide loans at low interest rates enabling the investors to produce goods and services at a low capital cost. They also mobilize additional resources for commercial markets at home and abroad that could not have been achieved otherwise.

The *development banks* as multilateral intergovernmental institutions combine the following essentials for a sound investment policy:

- Acquisition of investment projects in different sectors with a detailed feasibility, study and evaluation of the project. This is possible, because development banks are usually better equipped with the technical know-how and have experienced technical personnel. They are able to follow a detailed appraisal of the projects and are effective instruments to ensure that the financial means invested yield a proper profit. They are specialized in certain economic activities in industrial as well as in agricultural sectors. Knowing the special needs of these sectors, the development banks are the most suitable financial organizations for the development process, performing loan analysis, taking under special consideration economic and technical feasibility. While generally the development banks charge low interest rates, the Islamic Development Bank (IDB) finances projects in the. Islamic countries without interest. Its purpose is to promote economic and social progress in the member states and Muslim communities in accordance with the principles of the *Shari'ah.*

- Financing of projects not only by providing direct credits to the projects at comparatively reasonable rates or by participation of the bank in the project, but also by attracting additional private or governmental financial resources at preferable credit conditions.

- Control of the projects during the investment period and after it is completion: The development banks have worked out a special "follow-up" method, which enables them to overcome the difficulties of the project completion in time, resolving the project's problems and guaranteeing its greater success.

- Assisting in the promotion of foreign trade among member countries. Apart from the short and middle term financing, the development banks, especially the IDB has also long-term financing schemes.

Apart from these functions, the development banks perform other regular banking services necessary for the success of the projects, namely finding out ways of refinancing the projects in cases of temporary capital scarcity, reducing foreign exchange risks, etc.(10) Moreover, the multilateral development banks usually keep a strict political neutrality. This nonpolitical attitude makes them invulnerable to the different ideologies and political movements of their host countries.

The multinational financial intermediaries - other than development banks - play a similar role in' the development of the South, especially of the Islamic countries. There have been a number of financial intermediaries such as these which have been institutionalized in the developing countries within the last 10 to 15 years. They play a significant role in the development of domestic financial markets, in capital and foreign exchange mobilization, and contribute considerably to overcome short-term domestic capital shortages. A review of such institutions in the Gulf countries shows to what extent such institutions are capable of solving short-term balance of payments problems. There is a great potential for further expansion of these institutions in the developing countries of the Islamic, world, since they direct additional short-and middle-term financial resources to promote development, while the development banks only concentrate on. long-term investment projects.

The bilateral and multilateral funds are slightly different from multilateral development banks. and development financial institutions in their development and resource transfers. Generally, they don't operate as joint ventures, but contribute substantial financial aid to the developing countries. Quantitatively, their resource transfers to the Islamic world were far greater than the aid of the multilateral' development and financial institutions, and the banks together. For example, the. net disbursement of the OPEC Funds to the developing. countries in 1980 amounted to well over $ 9 billion. (11)However, with the decline of oil prices in the world market on the one hand, and with the decision of the OPEC-countries to limit their production on the other hand (which resulted to major cuts in the oil revenue of these countries), the OPEC aid has continued to decline.(12) Due to the war between Iraq and Iran, the Arab members of the OPEC have channeled their aid to Iraq.(13) This has led to additional cuts of financial aid to other developing Islamic countries.(14) The classified transfer of resources from OPEC and OAPEC to different developing countries during the last 5 to 6 years proves this trend. The total development aid of OPEC declined, for example, from $ 9.6 billion in 1980 which was 1.84% of the total GNP of the member states, to $ 3.3 billion in 1987 reaching 0.64% of the total GNP of the member countries only.(15) Iran and Iraq have turned from donor countries to recipient countries among the OPEC-states, Iran since 1979, Iraq since 1983.16)

2. Multilateral Government or Semi-governmental Institutions in other Sectors of the Economy

As illustrated above, the bulk of multilateral government or semi-government organizations in the Islamic world operates in the financial sector of the economy. However, there are ample possibilities for other sectoral cooperations among the developing countries as a whole and especially among the Islamic countries. The different structures of the economies of the Islamic states - rich but scarcely populated countries (Saudi Arabia, Libya, Kuwait) as opposed to poor but densely populated countries (Egypt, Syria, Turkey, Pakistan, Bangladesh, etc.) - necessitate their closer cooperation in different sectors of the economy in order to overcome shortages of labour, capital and the narrowness of the markets.

In agricultural sector there has been little direct cooperation. The trade of agricultural products and food among developing naticns as well as among Islamic countries has been comparatively negligible. Agricultural products and food are not only imported from and exported to the industrialized economies but they are also channeled through firms and agencies of industrialized countries. On the other hand, there have been intensive efforts to finance the agricultural sector through multinational development finance institutions, development banks, and development funds. For example, in 1976 the share of agricultural credits of the Asian Development Bank to the total credits of this bank exceeded 41%.(17)

In this context the special cooperation of oil-exporting countries with a limited food base on one hand and the cooperation of other developing and Islamic countries who have vast potentials for food and other agricultural productions on the other hand should be emphasized. The OPEC funds, especially the Arab Authority for Agricultural Investment and Development (founded in 1976 in Khartoum), the Arab Fund for Economic and Social Development, and the Arab

Bank for Development of Africa have financed, to a considerable extent, the development of the agricultural sector in non-arab countries (Pakistan), as well as in Arab and African states (Sudan, Egypt).

In the industrial field, there are no major cooperation efforts among the developing and Islamic countries despite their comparatively larger diversity of industrial structure. Here again, industrial projects are financed through development banks and special funds. These institutions help to finance infrastructural projects also, such as large power plants and refinery projects, which in turn supply the user industries with their products. But apart from the Islamic Cement Association (founded in Ankara) and a few other projects which were initiated by the Regional Cooperation for Development (RCD)[18], there are no major multinational intergovernmental institutions operating in the industrial field.

In the field of <u>transportation</u> <u>and</u> <u>communication,</u> no major multinational institutions have been created in the Islamic countries. These sectors are promoted by the development banks, development finance. institutions or other funds, either directly or in the framework of infrastructural development. However, there are a few multinational establishments in these sectors, e.g. the Islamic Shipowner Association, Jeddah, .and the Islamic Telecommunication Union in Karachi.

In the field of <u>energy,</u> <u>mineral and water</u> <u>resources,</u> the intensity of multilateral intergovernmental cooperation differed among developing countries as well as among Islamic countries. Developing countries, especially the Islamic countries of the Middle East, are very rich in energy resources like oil and natural gas. The Middle, Eastern countries as a group have some 60% of the world oil reserves. There is no need to explain that OPEC and OAPEC as multinational institutions served a semi-monopolistic function until the beginning of the 1980s. The range of activities of these institutions covered exploration, production, . financing, marketing, trade agreements, etc. of oil products. As previously mentioned, these institutions organized different funds for the regional and sectoral development of the developing countries as .a group, especially for the development of the Islamic countries. The OPEC started its financial aid in 1971 with the establishment of the Arab Fund of Economic and Social Development. Until now, there have been 8 different development funds which were created, either directly by the OPEC or cofinanced by it. The OPEC funds finance the development projects without charging interest. They charge a service fee of only 1 %.

The importance of OPEC as a source of development finance could be derived from the quantitative disbursements 'of their development loans. According to figures give by the OECD from 1975 to 1985, development aid was granted totalling some US $ 69.9 billion, out of which some 89.1 % was contributed by the four countries of the Gulf, Saudi Arabia, Kuwait, United Arab Emirates and Qatar.(19)

Although there are numerous possibilities for cooperation in developing water resources among developing nations, little has been done in this field. Joint projects have taken place, exploiting the water resources in the Islamic countries in West Africa (Senegal, Mali, Mauritania, Niger and Nigeria), and also in the Middle East '(Turkey and Syria) where the water resources of the Euphrates river have been utilized. Co-operation between Pakistan and India concerning the Indus river basin is another example. However, there are no specific multilateral intergovernmental institutions for the development of such projects. The water resource projects mentioned have been financed by bilateral and/or multilateral development funds.

The cooperation in the field of minerals among Islamic countries is not promising, due to the fact that none of these countries have a sufficient volume of production that could control the markets. Therefore, no multilateral institutions have been created. Participation of some African Islamic countries in a few raw material and commodity agreements, and simple information-sharing are the only means of cooperation in these fields.

In the field of trade, Islamic countries are cooperating with other developing countries to outline joint policies to reduce tariff and non-tariff barriers and to extend the global system of trade preferences within the GATT. However, discrimination among developing and Islamic countries is very common, thus, trade among these countries is made very difficult. Efforts to diminish this situation among the Islamic countries are taken at regional levels that will be discussed in the next section. It should be mentioned here, that two institutions have been created to promote trade among the Islamic nations: The Islamic Center for Development of Trade (Casablanca), and the Islamic Chamber of Commerce, Industry and Commodity Exchange (Karachi). The latter one, however, concentrates its activities mostly within Pakistan and the Gulf countries.

B. MULTINATIONAL COOPERATION AND INTEGRATION SCHEMES

The second group of multilateral intergovernmental institutions aims at a closer economic, social and political integration of the Islamic countries within a region or subregion. This type of institutions could be classified as:

1. Multinational Conferences, Committees and Councils.

2. Integration Schemes at Different Political and Economic Levels.

Generally speaking, both groups demonstrate a loose form of cooperation, although developing countries as well as Islamic nations usually emphasize their desire for closer economic, political and social ties at regional and interregional levels. In the case of Islamic countries, such desires are derived from the nature of the Islamic region.

1. Multinational Conferences, Committees and Councils

.The following organizations belong to the first group of above mentioned institutions within the Islamic countries: Organization of the Islamic Conference (OIC), founded in 1969 (with its sub-conferences and committees such as Islamic Commission for Economic, Cultural and Social Affairs, Standing Committee for Commercial and Economic Cooperation, etc.). All Islamic countries are members of these institutions. The membership of Afghanistan was suspended after the Soviet invasion in 1980. Nearly all organizations and multilateral institutions that were established by Islamic countries and discussed in the first section of this paper are also independent members of the OIC-System.[20]

The League of Arab States, (founded in 1945) whose aim is to economically an politically unify the Arab world, and the Gulf Cooperation Council (founded in 1981), are other examples of loose political and economic cooperation at regional and subregional levels.

Apart from the goals of political and social integration, all these institutions intend to promote the economic integration and cooperation of their member states. In order to achieve these goals, they have established integration schemes that structurally change the process of 'economic development of their member states. Because of the gravity of this' problem, the second group of 'the above mentioned institutional arrangements, namely integration schemes as key elements of economic development policy of the Islamic countries, should be discussed in more detail.

2. Integration Schemes at Different Political and Economic Level

The efforts to achieve economic development and to accelerate its growth, has led to different economic integration schemes in Islamic countries. The first example is the creation of Arab Economic Unity (EAU) in 1962 by 12 Arab countries.

Within the framework of this institution two other organization were created in the year 1964: The Council of Arab .Economic Unity (CAEU) and the Arab

Common Market (ACM). The same goal, that of economic integration was pursued in 1964 with the establishment of the Economic Cooperation among Maghreb countries, Morocco, Algeria, Mauretania and Tunisia. In a rather different form but with the same economic goals, the Regional Cooperation for Development (RCD) was established in the year 1964 by the non-Arab countries of Turkey, Iran and Pakistan.

It is well known that economic integration means the merger of different national economies into one larger regional unit. This could be achieved first by the classical type of integration namely by the Customs Unions (CU) and the Free Trade Associations (FTA). Both cases imply the abolition of custom duties and quota systems among integrated member economies. While the Customs Unions introduce new joint custom tariffs against "third countries", the Free Trade Associations permit the member states to put new customs on third countries' products independently. Secondly, full integration could be reached by the creation of Common Markets and Economic Communities. These very intensive types of economic integration however, lead, through joint trade and currency policies to a joint economic policy of the member countries.

The economic effects of integration are "trade creation effects" and "trade diversion effects",[21] both leading to accelerated growth and more prosperity among member countries, because integration enforces more competition among member states, introduces the "economies of scale", leads to high efficiency and innovations because of competition and, last but not least, optimizes the allocation of economic resources.

Although developing countries as well as Islamic countries express in their conferences their desire to achieve full economic integration and cooperation22 at different levels and therefore - as mentioned before - create institutional arrangements for economic integration, they are far from the realization of traditional integration concepts. The Arab Common Market (ACM), for example, has documented in its agreement the three essentials for a common market: (1) free movement of goods and services, (2) free transaction of capital, and (3) free movement of labour. None of these objective have been achieved. In fact, due to protectionistic trade policies of the member countries, inter-Arab trade shows a declining trend. The same discriminatory policies hinder the free transaction of capital and free movement of labour. However, not only the ACM faces many obstacles towards its integration efforts. But nearly all the other integration schemes in Islamic countries as well as in other developing nations are confronted with barriers resulting from restrictive actions of their governments that opt out of their respective commitments documented in their agreements respectively.

The reason for these barriers are manifold. The primary reason is the lack of economic and political homogeneity among the developing and Islamic countries that desire regional integration. A closer look at the present economic situation of the developing countries shows that in many cases even their national markets are not integrated. Thus, the intergovernmental institutions created to develop and implement concepts of integration are generally overtaxed. The economic requirements and conditions of the developing countries desiring integration stipulate that instead of realizing the traditional concepts of integration now practiced in the' industrial economies, it is preferable for them to find new practical and flexible solutions to manage their trade and industrial relations. For example, exploring the possibilities of preferential trade agreements and the creation of suitable institutions in the field of industrial cooperation (such as joint ventures in selected industrial sectors and of joint financial institutions) may be a structurally better means of achieving closer cooperation, possibly resulting in a higher degree of integration.

III

Conclusion

The review of intergovernmental institutions in developing countries, especially in the Islamic world, shows that since the 1970s a large number of institutions have been created, working in different sectors of the economy. These institutions are not restricted to regional or interregional integration schemes. They operate at various sectoral levels in different organizational forms. The range of their operation varies from a mere strictly managed type of joint venture to a loose financial participation and collaboration in the fields of trade arrangements, sectoral production, marketing, and of information and communication.

From the point of view of operational effectiveness, target-oriented and corn paratively well-managed joint venture undertakings usually perform better in the fields of production and marketing. Such joint ventures could operate on a private basis as well as on intergovernmental participation. However, comparing joint ventures mobilized by intergovernmental capital with those undertakings organized by private capital, the latter show much better economic performance; due to much greater freedom of activity and decision making.[(23)] A comparison of such privately owned institutions in the South-East Asian countries with the intergovernmentally financed joint ventures in developing countries, especially Islamic countries clearly shows how much greater the economic efficiency of the first group of organizations is in comparison to the second group.

There are many reasons for the fact that joint ventures are generally more effective instruments of economic performance. *For* example, they not only make capital transfers possible but also initiate the transfer of new technologies, especially in cases in which capital is transferred from a more advanced country to a developing country; these joint ventures cause not only import-substitution effects in the first stage, but also enable the capital and technology importing countries to launch an export drive in a later stage. This so called "spillover-effect" leads to a greater production growth and employment, and promotes integration of national and regional economies.[(24)] Furthermore, joint ventures produce "social benefits" as a result of indirect investment effects, promote "learning effects", etc.[(25)]

There are, however, some negative effects of joint ventures, especially of private joint ventures. Conflicts in the sphere of management and personnel, in planning, in investment and in distribution, marketing etc. should be mentioned. Nevertheless, these negative aspects of multinational joint ventures do not outweigh their positive economic effects.

The chances to attract investment of individual and private multinational institutions in developing countries are rather small. Individual private capital will not be invested in a developing country or in joint participation with the institutions of the host country unless there is proof that the invested capital will yield sufficient profit. If we consider the development projects whose profitability is uncertain and whose investment risks are comparatively high, the only possibility that re-mains for a developing country to import capital is the bilateral governmental aid and the multilateral government contributions. They would then participate in projects or finance them by bilateral or multilateral development funds. Therefore, multilateral development banks, development finance institutions, financial intermediaries and other multilateral intergovernmental institutions could perform - as previously stated - pioneer achievements, especially in infrastructural networks of the developing countries. They might also attract additional financial sources from foreign countries or from international financial markets. The operation of the multilateral financial institutions show that they have contributed to finance the economic development of developing countries as well as those of Islamic countries.

However, there are also a few problems relating to operations of the multilateral governmental institutions. It is difficult, e.g., to mobilize sufficient governmental capital for such a multilateral institution. Even if the capital is mobilized, the decision of who is to assume what liability-sharing among the different parties remains another problem. Experiences with existing multilateral development banks, development finance institutions and regional banks (operating globally) prove that these institutions create their own dynamics in influencing developing countries in some way or another. This is also true for multinational intergovernmental development funds. However, these funds have the advantage of financing the development projects at lower costs (IDA-conditions) and of promoting the development plans of the recipient countries by financing long-term infrastructural projects.

Compared to multilateral intergovernmental institutions working in the financial sector, the efforts of the developing countries as well as of the Islamic countries to integrate their economies have not been very promising until now. With the exception of regional integration successes in the ASEAN-countries, other regional integration schemes (especially in the Islamic countries) have not shown significant promise. The reasons for the failure of the-intergovernmental institutions created to promote regional integration are as follows: -

1. Differences in the political and economic attitudes and motivations of the related countries. The differences in the economic and political ideologies among Arab countries or in the three RCD countries (Turkey, Iran, Pakistan) are examples.

   Lack of homogeneity and diversity of the economic structures of the countries to be integrated.

3. Disparity of. economic interest between the countries. The disparities lead to different economic measures in different countries causing a large gap between desired integration goals and actual economic growth processes: .

4. Nationalistic attitudes and the predominance of national interests lead to a very low propensity towards integration, i.e. in the proportion of acceptance of national sacrifices caused by integration to integration benefits.

5. Historically set structures in the pattern of international trade. Changes in these structures cannot be undertaken within a short period and with economic and political declaration. The only way to change these patterns is to provide sound economic benefits for the general population.

6. Disregard for the living standards of the masses by setting up the regional joint projects. For example, very often such projects - which are mainly unproductive and predominantly financed by the governments or by multilateral intergovernmental institutions - do not consider the market conditions of the developing-countries.' They ignore the real needs and requirements of the people.

7. Divergencies of a whole range of economic policies between the countries. As a result, economic measures actually undertaken to reach the policy goals

set by the policy makers eventually lead to deepening of the existing divergencies.

In as much as such discrepancies exist in the develo- ping and in the Islamic countries, efficient integration cannot occur, despite the existing potential for regional economic integration. Thus, the multinational intergovern- mental institutions set up in the Islamic countries to exploit economic potential cannot utilize the major compo- nents of economic development. These are the individual, social and political factors which are necessary for the progress of socio-economic achievement. If the Self- reliance Strategy does not take into account these socio-economic factors in the developing and Islamic countries, and if it is used merely as a slogan and a means to reach political goals, the establishment of intergovernmental institutions may lead to poor results and frustra- tions hampering the national development of the developing countries as well as their international relations.

Notes

1. See for Detail, ROIC: General Agreement on Economic, Technical and Commercial Co-operation among Member States of Islamic Conference. Resolution of the 8th Islamic Conference of Foreign Ministers held in Tripoli, 1977. OIC: The Plan of Action to Strengthen Economic Cooperation among Member States. Resolution No. 1/3 of the Third Islamic Summit Conference, held in Taif, 1981.

2. See for example, P. Baran: The Political Economic of Growth, New York, 19957; J. Galltung: Eine strukturelle Theories des Imperialismus, in: D. Senghaas: Imperialismus und strukturelle Gewalt, Frankfurt, 1972, p. 39 if.

3. Diaz-Alejandro, S.F.: Delinking North and South: Unshackled or Unhinged, in: A. Fishlow et. al. (eds.): Rich and Poor Nations in the World Economy, New York, 1980, p. 85 - 162.

4. See D. Senghaas: Weltwirtschaftsordnung und Entwicklungspolitik. Pladoyer fur Dissoziatin, Frankfurt, 1977; S. Amin: Zur Theorie der Akkumulation und Entwicklung in der gegenwartigen Weltgesellschaft, in: d. Senghaas (ed.) Peripherer Kapitalismus - Analyse uber Abhangigkeit und Unterentwicklung, Frankfurt, 1974, p. 71 if.

5. For a detailed discussion see K.M. Khan and V. Matthies: Collective Self Reliance: Programm und Perspektiven der Dritten Welt, Munchen, 1976; A.

Lemper: Collective Self Reliance - A Development Strategy of Promise? in: Intereconomics, Vol.5/6 (1977), p. 115ff.

6. P.T. Bauer: , Collective Self-Reliance. as Development Strategy, in: Intereconomics, No.5/6 (1977), p. 121.

. 7.. This institution was founded after the Second Summit in Lahore.

8. The Kuwait and Abu Dhabi Funds for Arab Economic Development, the Saudi Fund for Development and the Iraqi Fund for External Development should not be considered here because they operate as national development aid agencies of the respective countries.

9. It should be noted that the International Association of Islamic Banks (IAIB) is a multinational association of different Islamic Banks that operate at national levels. The IAIB is not a bank nor a financial institution or financial intermediary itself.

10. For detail of such operations see W. Diamond: Development Banks, Baltimore 1968 and H.G. Geis: Die entwicklungspolitische Wirksamkeit von Entwicklungsbanken, Bd. 1, Berlin, 19172, p. 77 ff.

11. The development assistance from OAPEC reached 1980 $ 9.5 billions. See World Bank: World Development Report, 1987,' p.243.

12. Ibid.

13. See World Economic Survey 1983, New York, p. 12.

14. See UN: Supplements to World Economic Survey 1983, New York 1983, p.12.

15. However, comparing to the contributions of development aids of the OECD and COMECON countries the OPEC development aid has been more considerable. In the period 1973 - 1987,the development aid of the OPEC reached 1.6% of the cumulative total GNP of the member states while those of the OECD and' the COMECON were 0.35% and 0.19% respectively. See I.H.: Saudi-Arabien als Finanzier in der Dritten Welt. In: FAZ, January 2, 1987.

16. See World Bank: World Development Report, 1c.p. 243.

17. See Handbuch fur Internationale Zusammenarbeit, 243. Lieferung Sept. 1987, p.1.

18. The RCD has approved a total of 50 projects out of which 18 projects were operating. See: Handbuch fur Internationale Zusammenarbeit, 150. Lieferung, October 1987, p.1. The organisation has now changed its name to "Economic Cooperation Organization" (ECO).

19. Calculated by the author. For the yearly disbursement of financial aid see World Bank: World Economics Report, 1.c. Annex table 21, p. 267.

20. For a selection of the independent members of the OIC-System see V. Nienhaus: Economic Cooperation and Integration Among Islamic Countries: International Framework and Economic Problems, IRTI, Jeddah, 1986, p. 60 if.

21. "Trade creation" means shift of trade within the integrated region due to better competition of the low cost member countries. "Trade diversion" de-scribes shift of trade from nonmember countries to member countries of an integrated region.

22. See, for example: The documents of the conference of non-Aligned countries in Lusaka (1970) and in Algier (1973), the report of the UNCTAD-export group on economic cooperation among developing countries presented to the Geneva-conference 1975, the action program on economic cooperation of the 5th conference of Non-Aligned countries in Colombo (1976),report of the conference of the Group of 77 on economic cooperation among developing countries in Mexico City (1976), the documents of the UNCTAD-conferences in Nairobi (1976), in Manila (1979), in Belgrade (1983) and in Geneva (1987).

23. For this performance see W.G. Friedmann and J.P. Beguin: Joint International Business Ventures in Developing Countries, Case Studies Analysis of Recent Trends, New York - London 1971.

24. For such effects of private investment in developing countries,see G.L. Reuber: Private Foreign Investment and Development, Frankfurt 1973.

25. As to these effects, see the fundamental article of K.J. Arrow: "The Economic Implications of Learning by Doing" in: The Review of Economic Studies, Vol. 29 (1962), p. 8 if.

26. The crisis in qualitative experience of various cooperations among developing countries has been described by C. Vaitsos: "Crisis in Regional Economic Cooperation (Integration) Among Developing Countries. A Survey", in: World Development, Vol. VI (1978), p. 719 if.

CHAPTER X

ISLAMIC FINANCIAL INSTITUTIONS AND THEIR CONTRIBUTION TO TRADE AND DEVELOPMENT

Ziauddin Ahmad*

(The continuous increase in the number of Islamic banks, their impressive record in deposit mobilization, the smooth transition from an interest based to interest free banking system in Pakistan and Iran have show that an Islamic alternative to conventional banking is fully viable. However, the Islamic finance movement is still in its infancy. Till such time that Islamic banking becomes the dominant system of banking in the Islamic countries, conventional banking and Islamic banking, both will have a role to play in the economic growth of those countries.

Islamic banks have used their funds largely in financing local and foreign trade. Because of the high degree of dependence of most Islamic countries on foreign trade, Islamic banks serve an essential need of these countries by making foreign trade financing available. Foreign trade financing has the potential of assisting the process of development even more if it helps in promoting specialization in production of goods in line with the comparative advantage of different countries in various fields of production. However, Islamic banks need to go for direct financing of agriculture and industry in order to accelerate the process of economic growth in the Islamic countries. (Editors)].

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I
Introduction

Policies designed to foster the growth of a wide network of financial institutions form an integral part of development strategy in all countries. Recent literature has given a lot of attention to the relationship between financial development - or "financial deepening" - and economic growth. There is enough empirical evidence to show that financial development and economic growth are positively related to each other. A number of writings have also stressed that the ability of an economy to draw resources to their most efficient uses, depends, in a crucial way, on the efficiency of its financial system. In the absence of banks and other financial institutions, households tend to hold a good part of their saving either in the form of idle money balances or invest it in socially less desirable avenues of investment. The existence of financial intermediaries reduces the demand to hold money and enables the utilization of the community's savings in more productive channels. Investment and growth are also encouraged by virtue of the lengthened maturity structure of financing made possible by the process of financial intermediation.

While the importance of financial institutions in promoting growth is well recognized, the actual stage of financial development differs widely from country to country and region to region. The industrialized countries of the West have highly developed and sophisticated financial intermediaries Compared to developed countries, the growth of financial institutions in the developing countries has been much slower and uneven. Till the end of the Second World War, a large number of developing countries were under colonial domination. The colonial powers were not interested in an over all and integrated development of the countries they ruled. The economies of these countries therefore, developed a dualistic structure in which the foreign trade sector, dominated by expatriates, was well developed while the rest of the economy remained primitive and extremely backward. The agricultural sector remained characterized by a large subsistence sector while there was hardly any industrial development. Only the raw material producing potential or these countries was developed by the colonial powers. Furthermore, these raw materials were largely exported to developed countries. On the other hand, consumer goods requirements were satisfied mostly by imports from highly industrialized countries. The economies of a large number of developing countries thus became typical export-import economies. The financing requirements connected with export-import business were met by the branches of foreign banks established in these countries. These banks, located mostly in port towns, confined their business to financing of foreign trade and did not evince interest in financing other economic activities. Nor was there any move to set up specialized financial institutions to promote the growth of agriculture and industry. These countries, therefore, did not experience any "financial deepening" in the colonial period and had a very rudimentary financial sector.

With the attainment of independence by a large number of less developed countries after the Second World War, measures were taken to develop the financial system. Countries which had no central bank established such a bank. The statutes of the newly established central banks generally gave them a mandate to promote. economic development, often including special responsibilities for developing financial institutions and domestic money and capital markets. They adopted a number of measures to foster the growth of the financial structure such as institution of training programmes to meet the deficiency of trained banking personnel, preferential treatment to local banks in the matter of branch expansion and even direct participation in the share capital of new institutions, be they commercial banks, specialized financial institutions or equity participation funds. The growth of the institutional framework of banking and finance, under the care and guidance of the central bank, has played a vital role in quickening the pace of development in a number of developing countries in the post Second World War period. In many cases, Governments have also been actively engaged in the establishment and promotion of various types of financial institutions.

II

Conventional Banking and Islamic Banking

The process of financial intermediation can basically take only two forms. It can either be based. on a creditor-debtor relationship or it can be founded on some form of partnership between the providers and users of capital. The system of financial intermediation that currently dominates the world scene is of the former type. It can be termed as conventional banking. During the last quarter of a century, however, a number of banks and financial institutions have been established, mostly in Muslim countries, which work on a participatory basis. This has come to be known as Islamic banking.

Conventional banking uses the interest rate mechanism to perform its task of financial intermediation. It mobilizes the savings of the community by offering a specified return on the sums of money that are entrusted to it in the form of saving and time deposits. The financial resources at the command of the conventional banks are lent to the users of funds who are obligated to pay a pre-specified charge by way of interest on the amount borrowed. Conventional banks in many countries are not allowed to take a stake in the equity of any business concern or engage in direct trading. Even in countries where banks are not specifically prohibited from engaging in equity financing, the conventional banks generally prefer a creditor-debtor relationship in the conduct of their operations.

Islamic banking represents a radically different form of financial intermediation. Because of the strict prohibition of interest-based transactions in Islam, Islamic banks can neither offer a pre-determined return on the saving and time deposits nor can they provide interest bearing loans to any party. They, therefore, conduct their operations on a participatory basis. Like the conventional banks, Islamic banks also accept both demand and time deposits. Demand deposits are fully repayable on demand and do not get any return. Holders of fixed term deposits are given a share in the profits earned by the bank according to a profit sharing ratio made known in advance. Islamic banks employ the funds mobilized by them in a variety of ways. The following are some of the more important modes of financing and investment adopted by them:

A. MUDARABAH

A contract in which all' the capital is provided by the Islamic bank while the business is managed by the other party. Profit is shared in pre-agreed ratios, and loss, if any, unless caused by negligence or violation of the terms of the contract, is borne by the provider of capital.

B. MUSHARAKAH

A cooperative agreement under which the Islamic bank provides funds which mingle with the funds of the business enterprise and others. All providers of capital are entitled to participate' in management but not necessarily required to do so. Profit is distributed among the partners in pre-agreed ratios while 'loss is -borne by each partner strictly in proportion to respective capital contribution.

Musharakah financing is somewhat akin to equity financing of the Western financial-system. Islamic banks can freely invest in the variable dividend common stock of business concerns. They -can , also participate in the underwriting of shares provided it does not involve any element of interest. For example, the "firm commitment" technique of underwriting is regarded as a permissible mode of Islamic financing. in Pakistan while the "stand by" technique is regarded as incompatible with *Shari'ah.*

C. MURABAHAH

A contract in which a client wishing to purchase equipment or goods requests the Islamic bank to purchase the items and sell them to him at cost plus a declared profit.

D. BAY'MUAJJAL

A trade deal in which the seller allows the buyer to pay the price of commodity at a future date in lump sum or instalments. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

E. BAY'SALAM

A trade deal in which the buyer pays the agreed price of a commodity in advance and the commodity is delivered to the buyer at a specified future date.

F. IJARAH

An arrangement under which the Islamic bank leases an equipment, building or other facility to a client against an agreed rental.

G. IJARA-WA-IQTINA'

A contract under which the Islamic bank finances equipment, building or other facility for the client against an agreed rental, together with an undertaking from the client to make additional payments in an account which will eventually permit the client to purchase the equipment, building or facility.

H. QARD OR QARD HASAN

Qard is a loan transaction in which the client undertakes to repay the principal at a stipulated future time but on which no interest is charged. Levy of a modest service charge on such a loan is permissible but it has to be based on actual cost of administering such a loan. *Qard Hasan is* a benevolent type of loan without any service charge and repayment schedule suited to the economic circumstances of the borrower.

Apart from the above mentioned differences in the operating procedures of conventional and Islamic banks, there is another point of distinction between them. Conventional banks work in a secular framework and are not subject to any religious commandments. Islamic banks, on the other hand, have to work within the normative framework of Islam. They cannot provide financial resources for types of activity which are prohibited in Islam even though such activities may be "productive" in the common economic sense of the term. In the conduct of their operations, they have also to be mindful of the socio-economic objectives of Islam which are eradication of poverty, equitable distribution of income and wealth and sufficient opportunities for gainful employment.

III

Banking in The: Muslim World

It is a fact of life that notwithstanding the strict prohibition of interest-based transactions in Islam, banking in large parts of the Muslim world also is conducted on the basis of interest. Prohibition of interest is enjoined by the verses in the Holy Qur'an in strongest terms and those who do not desist from this practice are warned of "war from Allah and His Messenger" (2:279). A number of authentic sayings of the Holy Prophet (Peace be upon him) elaborate on .the Quranic injunctions prohibiting interest. Interest is disallowed in Islam because it is a socially unjust practice. If interest is charged on loans taken for meeting the basic consumption requirements, it amounts to taking advantage of a man's inferior economic position and is therefore morally reprehensible and prohibited. Charging of interest on loans taken for productive purposes is also prohibited because it is not an equitable form of transaction. When money is invested in a productive undertaking, the quantum of profits that may accrue is not known beforehand . and there is also possibility of a loss. Charging of a fixed and pre-determined rate of interest on loans for productive purposes cannot therefore be morally justified. Islam, however, does not prohibit return on capital if the provider of capital funds is prepared to share the risk of productive enterprise with the entrepreneur. It is for this reason that profit/loss sharing is considered the real alternative to interest in an Islamic economy.

In the early history of Islam, the injunction relating to prohibition of interest was strictly observed but with the decadence of moral values and spread of Western influence, financial practices based on interest penetrated the Muslim societies as well. The Muslims mind, however, has always remained uneasy with involvement in interest-based practices. As pointed out by an eminent Islamic economist, "Muslim society never legitimised interest: throughout the thirteen centuries of its history prior to domination by imperialist powers, it managed its economy and carried on domestic and international trade without the institution of 'interest.... Introduction of interest-based banking by colonial regimes. in the Muslim countries during the nineteenth century failed to involve the bulk of the community until the legal framework made it almost impossisble for any business to thrive without such involvement."(1)

It is this uneasy feeling about involvement in interest based transactions that has given rise to Islamic finance movement in the past two decades or so. As already mentioned, the interest-based system had become solidly entrenched in the Muslim countries in the period of colonial domination. With the attainment of freedom from foreign yoke and resurgence of Islam, there is a widespread yearning in Muslim countries to reorder their economic life in the light of injunctions of Islam. Elimination of interest, which is prohibited in Islam, is one of the big challenges facing the Muslim world in this context.

The Islamic finance movement is an attempt to measure up to this challenge. It owes its genesis and progress both to the enterprise and efforts on the part of Islamically motivated individuals and groups as well as to the initiative and encouragement of Governments of Muslim countries. The earliest experiment of Islamic banking took place in Egypt in the early sixties of this century with the establishment of Myt Gamr saving Bank. Though the venture was a great success in terms of the large clientele, it went almost entirely unnoticed in the outside world on account of being localised in nature and having a restricted domain of operations. It was actually in the seventies that the Islamic banking movement gathered real momentum. According to a recent study[(2)], there are about 40 Islamic banks presently operating in different parts of the world including some non-Muslim countries. The response of Muslim masses to the establishment of these institutions has been highly enthusiastic. According to one estimate, the Islamic banks in different countries now hold deposits of over 10 billion U.S.dollars.[(3)]

While the vast majority of Islamic banks have been established under private initiative and work in an environment which is dominated by interest-based banks, Governments of Pakistan and Iran have undertaken to replace interest-based banking by banking without interest on an economy wide basis. The process of this transformation has been largely completed in both the countries in as far as domestic banking transactions are concerned.[(4)]

The collective will of the Muslim people throughout the world to move away from the interest-based banking system to a system without interest is also epitomised in the establishment of the Islamic Development Bank with its headquarters in Jeddah, Saudi Arabia in 1975. It is an inter-governmental multi-lateral development financing institution whose mandate is to foster economic development and social progress in member countries and Muslim communities, individually as well as jointly, in accordance with Islamic *Shari'ah'.*

The continuous increase in the number of Islamic banks, their impressive record in terms of mobilization of deposits and the smooth transition from an interest-based banking system to an interest free banking system on an economy wide basis in Pakistan and Iran have more than adequately proved that there is an Islamic alternative to conventional banking which is fully viable. However, the Islamic finance movement is still in its infancy. Islamic banking has made a place for itself in the world of finance but it will require vigorous efforts both on the part of the Governments and the Muslim people to make it the dominant system in their countries. Till that time, conventional banking and Islamic banking both will have a role to play in promoting the economic growth of these countries.

IV

Contribution of Conventional Banking and Development Finance Institutions to Promotion of Trade and Development in the Muslim World.

Till the second half of the nineteenth century there were hardly any bank in the Muslim world. Conventional banking made its appearance in the Muslim countries around that time when banks incorporated in foreign countries move in to finance trade and commerce of these countries. There were practically no national banks, much less full fledged national banking systems, till the Muslim countries gained their independence mostly after the Second World War. The subsequent period has witnessed all round, acceleration in banking activity though the pace of banking development has differed from country to country and from time to time in the same country. '

The manner in which the banks deploy the funds mobilized by them have far reaching effects on the working of an economy. The allocation of these funds amongst competing uses has important distributional effects because such funds given command over real resources, and the sectors and persons who receive such funds are placed in a more advantageous position to improve their financial status vis-a-vis others who are unable to obtain similar access to bank assistance. Till the attainment of independence by Muslim countries when foreign banks dominated the scene, the foreign trade and commerce sector was the major recipient of bank assistance to the almost complete neglect of agriculture and industry. Large areas of these countries had no modern banking facilities. After attaining independence, it was soon realised that reliance on foreign banks alone would not enable these countries to tackle the problem of poverty and under-development. Policies were therefore initiated to promote the growth of a national banking system which has had the effect of significantly accelerating the pace of development.

A number of countries in the Muslim world, specially in the Middle East, nationalised the then existing banks to get rid of foreign domination over the banking system'. Thus banks were nationalised in Egypt in 1961, followed by Syria, Iraq, Algeria, South Yemen, Libya and Sudan in subsequent years. In most other countries, foreign banks were not nationalised but a rigorous effort was made to develop national banking systems. In Saudi Arabia, under a process initiated in 1975 and completed in 1980, foreign banks were obliged to accept sixty per cent Saudi ownership.

The Middle Eastern region has witnessed an unusually fast growth of conventional banking following the formation of OPEC and the quadruplicating of crude oil prices in 1974 which resulted in a correspondingly increased need for financial intermediation. The steep increase in the earnings of oil producing countries in the Middle East flooded .the banks with funds which were far in excess of local absorptive capacity of these countries. On the other hand, the sizable increase in the balance of payments deficits of a number of non-OPEC countries gave rise to the phenomenon of "recycling". Most of this recycling took place through the conventional commercial banks. At first major portion of recycling business was done by the Western. and multi-national banks. Gradually, however, there was a sharp increase in the number of banks and bank branches which shared in this business. Some Euro-Arab joint venture banks existed in the Middle Eastern region even before 1974 but there was a rapid expansion in their activities in the mid seventies. Arab commercial banks set up a number of subsidiaries and branches in foreign countries to find profitable outlets for surplus funds and played an increasingly important role in the recycling process.

As the Arab banks. internationalized their networks, they succeeded in considerably enhancing their share in the financing of foreign trade of the Middle Eastern region which had increased manifold following the steep rise in oil prices in 1974. The Arab banks also successfully penetrated the Euro-bond market. Lately they have also shown interest in financing developmental activity in the developing countries.

The conventional commercial banks everywhere are generally averse to long term financing of agricultural and industrial projects. In most countries, therefore, specialised financial institutions have been set up to finance the medium and long term requirements of agriculture and industry. Such institutions are found in most of the countries of the Muslim world also. Many of these institutions have been set up only in the last decade but some of them are twenty to thirty years old. They have taken many forms like state investment corporations, private investment houses, development banks of mixed ownership and parastal corporations. These institutions have played an important role in promoting agricultural and industrial development in the developing countries.

In recent years the OPEC countries have made a significant contribution, both individually as well as jointly, to the economic development of a number of developing countries through bilateral assistance as well as finance provided through specialised development assistance agencies. The latter include Kuwait Fund for Economic and Social Development, Abu Dhabi Fund for Arab Economic Development, Arab Bank for Economic Development in Africa and Saudi Fund for Development. All the OPEC countries have combinedly set up an OPEC Special Fund for providing assistance to the developing countries. The main emphasis in their financing operations has been on supporting projects involving basic infrastructure, such as transport and communications network, or utilities such as electricity, water and sewerage. Substantial sums have also been provided for financing industrial projects in a number of countries.

V

Islamic Banks and Financial Institutions and Their ' Contribution to Trade and Development'

The Islamic financial institutions currently operating in various parts of the world include Islamic commercial banks, Islamic investment companies, Islamic national and international holding companies and Islamic development finance institutions. Besides, there are Islamic insurance companies. The central banks of Pakistan and Iran, where country-wide Islamization of banking has taken place, can be termed as Islamic central banks.

The Islamic commercial banks are performing all general banking functions without involving interest. They handle current accounts, saving accounts and investment accounts. Financing is done in a variety of ways to cater to the needs of trade, industry, agriculture and services. *Murabaha* and *Bay Muajjal* are the most widely practised techniques at present for meeting short term financing requirements of trade, industry. and agriculture. Medium term and long term financial requirements are met by using , the techniques of *Mudarabah, Musharakah, Ijarah,* and *Ijarah wa Iqtina':* The Islamic commercial banks also perform international banking services for foreign exchange transactions; purchase and sale of currencies, purchase and sale of internationally traded commodities, transfer of funds, export financing,. letters of credit and letters of guarantee; etc. They also undertake miscellaneous services which include safe deposit facilities, management of private investment portfolios and trustee functions.

The Islamic investment holding companies have either a national or an international mandate and have been fairly active in promoting the growth of various types of Islamic financing institutions., The Dar al-Maal Al-Islami (DMI) deserves special mention in this connection. It is an international holding company and has played a dynamic role in promoting Islamic financial institutions in various parts of the Muslim world.

The Islamic investment companies and Islamic development finance institutions provide medium and long term finance for the development of industry, agriculture and other sectors. Among the Islamic development finance institutions, the pride of place belongs to the Islamic Development Bank which has its headquarters at Jeddah, Saudi Arabia.

Leaving apart Pakistan and Iran, where the domestic banking operations are being carried out without interest on economy wide basis, there are now 57 Islamic banking and financial institutions in the rest of the world, out of which 8 institutions are operating at an international level. A list of these institutions is given in Annex I.

The available data show that Islamic banks have succeeded in mobilizing large amount of funds. The performance of Islamic banks in the mobilization of deposits has been particularly remarkable in Sudan. Sudan has six Islamic banks. The oldest Islamic bank in Sudan is not even nine years old, and the others are less than five years old. However, figures for 1984 showed that deposits of these six Islamic banks accounted for 23% of the total deposits of the banking system. A detailed study of the working of Islamic banks in different countries conducted in the Islamic Research and Training Institute of the Islamic Development Bank (called IRTI study hereinafter) (8) shows that deposits in almost all Islamic banks have been growing at a rapid pace. The growth in deposits was the fastest, in the initial years of the establishment of these banks after which there has been some slowing down in the rate of growth of deposits. Data given in the aforesaid study also show that in the beginning when an Islamic bank is established, there is pre-dominance of current accounts. As the bank grows older, the ratio of saving and investment accounts in the total number of accounts goes up progressively. This shows the increasing confidence of people in Islamic banking. In Pakistan and Iran also, where Islamization of banking has taken place on an economy-wide basis, the deposits of the banking system have continued to increase at a fast pace.

Detailed studies of the working of Islamic banks have shown that the funds mobilized by them have been used largely for the financing of local and foreign trade. From the data given in the IRTI study, for example, it appears that in the case of some banks, trade financing constitutes upto 90 per cent of total financing. It is significant that even in the case of the Islamic Development Bank, foreign trade financing dominates the overall operations. According to the latest available figures, the total financing approved by the Islamic Development Bank since its inception amounted to $ 6.21 billion of which foreign trade financing accounted for $ 4.39 billion or 71 per cent of the total.. .

An important reason for the dominance of foreign trade financing in the operations of a number of Islamic banks is the high degree of dependence of most Muslim countries on foreign trade Many of these countries are still typically export-import economies. Even in the case of countries where foreign trade does not loom so large, availability of foreign exchange is a crucial determinant of the level of economic activity. Many Muslim countries are in need of large imports of food items and most of them are heavily dependent on imports of capital goods for development purposes. Foreign trade financing by the banks thus serves an essential need of these countries.

Foreign trade financing has the potential of assisting the process of development even more if it helps in promoting specialization in the production of goods in line with the comparative advantage of different countries in various fields of production. The Foreign Trade Financing Facility of the Islamic Development Bank focuses on this aspect, and promotes mutual trade among Islamic countries by enabling 'countries with shortage of foreign exchange to procure developmental imports from other Muslim countries. Unlike the conventional banks which provide financing for foreign trade on the basis of interest, the Islamic banks, including the Islamic Development Bank, actually purchase goods needed by their clients and resell these goods to them at a higher price and accept repayment of the amount due in instalments. Foreign trade financing operations of the Islamic Development Bank started in '1977 and within a period of ten years, the total approvals for these operations reached $ 4.39 billion for 294 operations in 29 member countries. Repayment is normally made within 9 to 18 months except in the case of capital goods imported from Muslim countries when the period of repayment extends to 30 months.

Plans are under way to involve the Islamic Development Bank more effectively in the field of trade promotion and economic cooperation among member countries through the introduction of a Longer-term Trade Financing Scheme. The Board of Governors .of the Bank approved the broad details of this scheme . in March 1986. The objective of the scheme will be to increase trade among member countries in non-traditional items [10] with emphasis on exports. The scheme will provide partial funding for periods ranging from 18 months to 5 years and may associate other Islamic financial institutions in its operations:

For promoting foreign trade among member countries, the Islamic Development Bank has under consideration the establishment of a special portfolio for financing trade, the resources for which will be contributed both by the Islamic

Development Bank and other Islamic banks. The current thinking is to establish the trade portfolio in the form of a Fund within the Islamic Development Bank with the portfolio having its own autonomy. Resources for the portfolio are expected to accrue from the issuance of Certificates which will be negotiable and tradeable among Islamic banks. At a later stage, it may be feasible to raise additional resources by inviting subscriptions to these Certificates from the general public in the member countries.

Though trade financing is an important field of activity for all banks, it is necessary in the developing countries to induct banks in the direct financing of agriculture and industry also to accelerate the process of economic growth. Left to themselves, commercial banks generally avoid direct financing of agriculture and industry. Sufficient data are not available on the sectoral distribution of financing in as far the operations of Islamic banks are concerned. The IRTI study, however, gives a certain amount of information about the sectoral pattern of financing of a few Islamic banks. According to this study, Islamic banks so far have not provided much finance for agriculture and small scale industry. Data relating to the term structure of finance show that, like conventional banks, Islamic banks also deploy the bulk of their funds in short term financing of six months or less or medium term finance of one year or less. These data show that Islamic banks so far have not involved themselves in longer term financing of agriculture and industry to any significant extent: However, time series data which are avail-able for some Islamic banks show that as a bank grows in the age and experience, it tends to bring about a shift in the pattern of its financing operations. In the case of Sudanese Islamic banks, for example, 25 per cent of the total financing in 1984 went to medium and long term operations.(11) Faisal Islamic bank of Egypt shows a similar trend. In the case of Jordan Islamic bank, the finance provided to manufacturing sector has shown a consistently rising trend.

Islamic banks operating internationally are involved in financing agricultural and industrial projects in larger measure. Among such institutions, the Islamic Development Bank, established in 1975, is the most important source of development finance to Muslim countries using Islamic financing techniques. Besides providing interest free loans for infra-structure projects, for which it charges a certain amount to cover its administrative expenses, the Bank provides finance to member countries on the basis of equity participation. It also engages in leasing operations. The Bank has completed its eleven years of operation and has, since its inception, approved a total financing of about $6.21 billion in various forms. Out of this amount, project financing accounted for $ 1.61 billion which was given for 224 projects located in various member countries. The major share of project financing has gone to industry, including mining activities. The share of agriculture in total project financing has also been showing a significant rise in recent years.

VI

Islamic Banks and Enhanced Economic Cooperation among Muslim Countries

Liberation of a large number of Muslim countries from foreign domination and contemporary Islamic resurgence have given rise to a keen desire among the Muslim peoples for closer cooperation in all spheres of activity. The Muslim world has a vast potential for varying forms of economic cooperation and collaboration. The resource endowment of the Muslim countries is fairly varied which affords vast scope of economic cooperation in mutually beneficial ways. The Muslim countries, taken together, lack neither capital, nor manpower, nor land nor other natural resources for achieving a much faster rate of growth for the entire Muslim world. On an individual level, however, different countries face different constraints to faster growth. Some countries have abundant capital re-sources but shortage of manpower. Small size of the domestic market due to small population is a constraint to faster growth in certain countries while lack of sufficient capital is the most serious obstacle to achieving higher rate of growth in other countries. The small size of the land area and agronomic conditions stand in the way of faster development of agriculture in certain countries. On the other hand, certain countries possess large areas of arable land which can be developed and put to greater productive use. The wide gap in per capita income levels and differences in the absorptive capacity of different countries for employment of capital in productive sectors affords the possibility of intercountry movement of capital to mutual advantage. Manpower needs of countries with small population can 'be' met by those having larger population. The constraint ,of smallness of domestic market is capable of being relaxed through trade integration measures like establishment of free trade areas, custom unions and common markets. Once sufficient progress has been made in these areas of cooperation, movement can take place in the direction of a unified. monetary system through measures of monetary integration.

In the above perspective, it is clear that there is a big potential for increase in the welfare of all Muslim countries through increased factor mobility and increased exchange of. goods: The world experience has shown that, notwithstanding the obvious advantages of closer economic integration, the process of actual economic integration is usually very slow. The Muslim countries themselves are members of several regional groupings and integration schemes but most of them have yet to show substantive achievements. A number of studies in recent years have identified the obstacles that stand in the way of closer economic integration among Muslim countries.[12] These are: (a) lack of strong sense of urgency on the part of policy-makers to move swiftly in the direction of economic integration, (b) uncertainties about the costs and benefits of various schemes of economic integration, (c) wide disparity in the levels of development and per capita incomes of the Muslim countries, (d) inadequate means of communications among the Muslim countries which cover a wide geographic area and (e) insufficient mobility of capital due to lack of sufficiently attractive investment climate in capital deficit countries. It is clear that it will be necessary to take measures on a broad front to remove these obstacles to speedier economic integration of the Muslim world.

It seems that the Islamic banks and Islamic system of finance can play an important role in overcoming some of the obstacles that stand in the way of greater economic integration of the Muslim world. They can be of significant help, for example, in reducing the disparity in the level of development and per capita income among the Muslim countries and thus create more favourable conditions for greater economic integration. Islamic banks can help expand availability of risk capital which can be expected to lead to higher investment and higher growth. In their financial operations, Islamic banks do not go by the collateral a borrower can offer but look to the entrepreneurial abilities of persons who wish to obtain finance from them. This can help in broad-basing the process of development.

The Islamic system of finance, applied to the financing of foreign exchange cost of productive enterprises, can be expected to ease substantially the balance of payment problems of the less developed Muslim countries and thus aid the process of development. In this approach, Islamic banks can become the key intermediary for diminishing the burden of foreign debt and improving the capacity of the Muslim countries to cope with external shocks, thus protecting the development effort from undue disruptions caused by exogenous factors.

The Islamic Development Bank has already played an important role in the growth and development of the Muslim countries and in fostering closer economic cooperation among its member countries. It is the policy of the Bank to give special treatment to its least developed member countries. A major part of the Bank's concessional financing is directed towards the least developed member countries. The foreign trade financing operations of the Bank have been of help in alleviating the balance of payment problems of the less developed Muslim countries. They have also fostered promotion of trade among its member countries as special preference is given to member countries as sources of supply of various commodities.

To enlarge the flow of development finance to less developed Muslim countries, it would be helpful to set up another institution to work on a multi-lateral basis which may not depend on governments of the Muslim countries for deriving its capital resources but mobilise funds from the private sector on the basis of Islamic financing techniques. Its initial capital may, however, be subscribed by the governments of member countries of OIC to give it a good start and confidence. It can be called Islamic Finance Corporation. It may be mentioned that a number of other regional groups of developing countries have already established such institutions which of course have interest-based transactions also. The most recent example is the setting up of ASEAN Finance Corporation which commenced business in 1981 and is playing an important part in the integration efforts of the countries belonging to the ASEAN regional groupings.

The economic integration of the Muslim world could be further speeded up if a part of the foreign exchange reserves of Muslim countries presently invested in the money and capital markets of the Western countries could be diverted to investment in capital deficit less developed Muslim countries. The preference for investment in Western money and capital markets seems to be motivated by the desire to avoid risk. However, even these investments are not risk free. In fact, they are exposed to both commercial and political risks. Commercial risks emanate from exchange rate fluctuations which have been quite wide and frequent in recent years as also the unpredictable inflation rates. The political risks include possible expropriation and freezing of funds. The political will for diverting a part of such resources to capital deficient less developed Muslim countries could be strengthened by improvement in the investment climate of these countries. This could be done by liberalising their foreign exchange and trade regimes and by structural changes to improve their growth performance. The process could be aided by making the Agreement for Promotion,. Protection and Guarantee of Investments among the OIC Member States operational as early as possible. This Agreement was adopted in 1981 and will come into force after ratification by at least ten OIC members where only six states have ratified it so far. This Agreement can be considered as a first step towards a freer intra-group movement of capital which is so basic for promoting greater economic integration among the Muslim countries,

Another meaningful cooperation among the Muslim countries can, be in the field of equity participation in joint ventures. Some cooperative agreements of this type are already in operation. For instance, Pakistan has benefited by this type of cooperation from Iran, Kuwait, Libya, Saudi Arabia and U.A.E. in projects like textiles, petroleum and oil refinery. Such cooperative arrangements need to be expanded for the greater economic integration of the Muslim world.

To foster collective self-reliance within the Muslim world for meeting temporary balance of payment problems and for easing the adjustment problems of deficit countries, it would be helpful to expand the membership of the Arab Monetary Fund to include all the Muslim countries. A Fund comprising all Muslim countries would gain in strength and size of economic operations without any detriment to the interest of the present members of the Fund. Besides, to give it an Islamic character and to maximise its utility to member countries, its operations should be re-modelled to eliminate interest and to use Islamic financing techniques.

VII

Islamic Banks and Achievement of Islamic Socio-Economic Objectives

The chief aim of Islamic banking is to provide an "Islamic" alternative to the conventional interest-based banking. There has been a good deal of discussion in recent literature on whether Islamization of banking means only abstinence from interest or something more. Most writers on the subject are in agreement that to deserve the name, Islamic banking should fulfil the following two basic criteria:

(1) It should be conducted without transgressing any religious commandments.
(2) It should help in achieving the Islamic socio- economic objectives.

The monetary and banking system of a country does not operate in an ideological vacuum. It is an integral part of its parent ideology. Its operating procedures have to be fashioned in accordance with the requirements of a particular ideology. Judged in this perspective, the task of the replacement of conventional banking by Islamic banking does not consist of a mere mechanical replacement of interest by non-interest modes of financing. These modes of financing have to be chosen keeping in view the religious prescriptions as .well as the ideological orientation of an Islamic society. Further, the financing activities of Islamic banks have to be directed towards achieving the Islamic socio-economic objectives. These objectives briefly are promotion of a pattern of growth best suited for eradication of poverty, equitable distribution of income and wealth and sufficient opportunities for gainful employment.

Studies of the working of conventional interest-based banks have shown that their operating procedures result in the monopolization of the bulk of their credit facilities by the already affluent sections of the population and big business enterprises. This is on account of what is known as the "collateral syndrome". Because of the commitment to pay pre-determined rate of interest to depositors, conventional banks are most concerned about. the safe return of the amount lent to the borrowers along with the stipulated interest. This leads them to confine their lending to the already established big business houses and such other parties as are in a position to pledge sufficient security. If they find that such avenues of lending are not sufficient to absorb all their invertible resources, they prefer to invest in Government securities with a guaranteed return. This exaggerated security orientation does not allow the flow of bank resources to a large number of potential entrepreneurs who can add to gross national product by their productive endeavour but do not possess sufficient security to pledge with banks to satisfy their criteria of creditworthiness. Such operating procedures result in over-abundant supply of credit to well established parties and its denial to a large segment of population, thus accentuating inequalaities of income and wealth. Islamic banks are expected to follow a radically different policy because of the, great emphasis that Islam places on an equitable distribution of income and wealth.

Islamic banks can play an important role in reducing, inequalities of income and wealth by augmenting opportunities for gainful employment through the use of the technique of *Mudarabah.* There is no dearth of persons in Muslim societies who can make good use of capital but they are unable to obtain funds from conventional banks. Since Islamic banks operate in a profit-and-loss sharing framework, they should be looking to the profitability of the venture under a *Mudarabah* or *Musharakah* arrangement rather than the present financial position of the party to whom they provide the funds. Their financing may be on a short, medium or long term basis depending on the nature of the project. Though *Mudarabah* and *Musharakah* are the ideal substitutes for interest in the Islamic system of finance, Islamic banks may adopt other financing techniques also permitted in Islam, depending on circumstances, but the financing should go to as large a number of persons as possible belonging to low income groups. Islamic banks of course cannot be expected to limit their financing to any one particular class of society and have to work on the basis of a diversified portfolio. It is their moral responsibility, however, to ensure that all sections of society who can make productive and effective use of bank finance, have access to them and receive their due share in the financial assistance provided by them.

. Detailed information is not available with regard to the operations of Islamic banks in different countries to assess. whether they have significantly helped in achieving the Islamic egalitarian objectives. The Annual Reports of some of the Islamic banks do mention that social considerations are given due importance in planning their operations, but it is worth nothing that, the charters of many Islamic banks make specific mention of Islamic socio-economic objectives being the guiding force of their activities. This gives cause for hope that as the new system develops and matures, it will truly reflect the moral values of Islam and demonstrate in practice what banking should mean in the Islamic context.

Notes

1. Muhammad Nejatullah Siddiqi, Issues in Islamic Banking, Leicester, The Islamic Foundation, 1983, p.9.

2. See Ausaf Ahmad, Development and Problems of Islamic Banks, Islamic Research and Training Institute of Islamic Development Bank, Jeddah, 1987.

3. See Rami Khauri, "The Spread of Banking for Believers" Euromoney, May 1987, p.145.

4. For a fairly comprehensive account of replacement of interest-based banking by banking without interest in Pakistan and Iran, see Zubair Iqbal and Abbas Mirakhor, Islamic Banking occasional paper No. 49, International Monetary Fund, Washington, DC, 1987.

5. For a good account of the Activities of Arab banks and quantitative dimensions of their lending operations for various purposes, see Traute Wohiers-Schart, Arab and Islamic Banks: New Business Partners for Developing Countries, Paris, OECD, 1983.

6. See UNIDO, Financial Resources for Industrial Projects in Developing Countries, Vienna, 1983.

7. For details, see Rodney Wilson, Banking and Finance in the Arab Middle East, Hong Kong, Macmillan Publishers, 1983, pp.145-169.

8. Ausaf Ahmad, Development and Problems of Islamic Banks, op.cit

9. Islamic Development Bank: Eleventh Annual Report, Jeddah, Saudi Arabia, p.59

10. Non-traditional items are defined to include all commodities representing, on an annual average, not more than 20 per cent of the FOB value of a country's exports during the preceding three year period.

11. See Albagkir Y. Mudawi, "Islamic Medium and Long Term Finance", Arabia, August 1986, p.56

12. See, for example, A:K.Satirogluy,The' Theory of Economic Integration and Its Relevance to OIC Member Countries, aIslamic Research and Training Institute of Islamic Development Bank, Jeddah, 1987.

ANNEX I

List of Islamic Financial Institutions

Country		Name of the Institution
Bahamas	1.	Dar-Al-Maal Al-Islami, Nassau.
	2.	Masraf Faisal Islamic Bank & Trust Bahamas Ltd.
Bahrain	1.	Albaraka Islamic Investment Bank, Manama
	2.	Masraf Faisal Al-Islami of Bahrain
	3.	Bahrain Islamic Bank, Manama
	4.	Bahrain Islamic Investment Co., Manama
	5.	Islamic Investment Company of the Gulf.
Bangladesh	1.	Islamic Bank of Bangladesh Ltd., Dhaka
Denmark	1.	Islamic Bank International of Denmark, Copenhagen.
Egypt	1.	Bank Misr (Islamic Branches), Cairo
	2.	Faisal Islamic Bank of Egypt, Cairo
	3.	Islamic International Bank for Investment and Development, Cairo
	4.	Nasser Social Bank, Cairo
	5.	Arab Investment Sank (Islamic Banking Operations), Cairo
	6.	General Investment Co., Cairo
	7.	Islamic Investment & Development Co., Cairo
Guinea	1.	Masraf Faisal Al-Islami of Guinea, Conakry
	2.	Islamic Investment Co. of Guinea, Conakry
Jordan	1.	Islamic Investment House Co.Ltd., Amman
	2.	Jordan Finance House, Amman
	3.	Jordan Islamic Bank for Finance and Investment, Amman.
Kibris	1.	Faisal Islamic Bank of Kibris, Lefkosa
Kuwait	1.	Kuwait Finance House, Safat

Country		Name of the Institution
	2.	Al-Tukhaim International Exchange Company, Safat.
Liechtenstein	1.	Arinco Arab Investment Co., Vaduz
	2.	IBS Finance S.A., Vaduz
Luxembourg	1.	Islamic Banking System International Holding SA.
Malaysia	1	Bank Islam Malaysia, Kuala Lumpur
Niger	1	Faisal Islamic Bank of Niger, Niamey
Philippines	1.	Amanah Bank, Zamboanga
Qatar	1.	Islamic Exchange & Investment Co., Doha
	2.	Qatar Islamic Bank
Saudi Arabia	1	Al-Baraka Investment and Development Company, Jeddah
	2	Al-Rajhi Company for Currency ' and Exchange, Riyadh
	3.	Al-Rajhi Islamic Investment Banking Company, Jeddah.
	4.	Islamic Development Bank, Jeddah
	5.	Islamic Investment Company, Jeddah
Senegal	1.	Faisal Islamic Bank of Senegal, Dakar Islamic Investment Company of Senegal, Dakar.
Sudan	1.	Tadamon Islamic Bank, Khartoum
	2.	Bank Al-Barakah Sudani, Khartoum
	3.	Faisal Islamic Bank of Sudan, Khartoum
	4.'	Sudan Islamic Bank, Khartoum
	5.	Islamic Investment Co. of Sudan, Khartoum
	6.	Islamic Cooperative Development Bank, Khartoum
	7	Islaamic Bank of Western Sudan, Khartoum
Switzerland	1.	Dar-al-Maal Al-Islami, Geneva

Thailand	1.	Arabian-Thai Investment Co. Ltd., Bangkok
Tunisia	1.	Bait Ettemouil Saudi Tunsi, Tunis
Turkey	1.	Al-Baraka Turkish Finance House, Istanbul
	2.	Faisal Finance Institution, Istanbul
U.A.E.	1.	Dubai Islamic Bank, Dubai
	2.	Islamic Investment Co. Ltd., Sharjah
U.K.	1.	Al-Barakah International Ltd., London
	2.	Al-Barakah Investment Co. Ltd.,. London
	3.	Al-Rajhi Company for Islamic Investment Ltd., London
	4.	Islamic Finance House, London.

ANNEX II

Recommendations of the Seminar on International Economic Relations from Islamic Prespectives

(Held between 28 Aug. and 1st Sept. 1988 at Tubingen, West Germany)

1. Recognizing the importance of Islamic Economics, Banking and Finance,German and Muslim economists and social scientists participating in this seminar felt the need for further work in the form of independent and joint research both at individual and institutional level, covering various issues discussed in the seminar (e.g. Islamic alternatives in trade financing and debt management, tied aid, access to credit facilities to Least Developed Countries, etc.).

2. In view of the growing significance of Islamic economic studies and institutions in Islamic countries and communities as well as German/Muslim cross-cultural relations, this seminar emphasizes the need for institutionalizing the study of Islamic Economics by establishing a chair of Islamic Economics at German universities and introducing Islamic economic courses in their department of economics. In this context, this seminar expresses the need for collecting, translating and disseminating relevant scientific materials and contributions in Islamic Economics in Germany through collaboration between the Islamic Development Bank/Islamic Research and Training Institute and Institute for Scientific Cooperation in Tubingen.

3. This seminar felt the need for closer interaction between Islamic and German financing institutions to exchange ideas and operational experiences to their mutual benefits.

4. This seminar emphasizes the need for financing rural development in Muslim countries through Islamically approved modes and appropriate channels.

5. This seminar appreciates the interest of the German scholars to form a study group on Islamic Economics, Banking and Finance to further the development of this discipline.

6. Finally, while appreciating the efforts of the Institute for Scientific Cooperation/ Institute for Foreign Cultural Relations and Islamic Research and Training Institute/Islamic Development Bank in organizing this seminar, the participants call on these institutions to follow up on the implementation of recommendations of this seminar as well as the publications of its proceedings as soon as possible.

The seminar participants expressed their deepest appreciation for the warm hospitality and cooperation accorded to them during their stay in Tübingen by the host institutions.

ANNEX III

Programme of The Seminar

(Sunday, 28th August 1988)

20.00 Welcome dinner for the distinguished speakers of the seminar given by the Institute for Scientific Co-operation and the Institute for Foreign Cultural Relations.

Monday, 29th August 1988

9.15 Opening by the Organizers. Welcome addresses by the President of the University of Tubingen, the Ministry of Science and Arts of the State of Baden-Wurttemberg, the Representative of the Foreign Office of the Federal Republic of Germany and the Director of the Islamic Research and Training Institute.

11.00 Beginning of working sessions
Topic Area I: Islamic View on International Economics:
1. Prof. Dr. Najatullah Siddiqi, King Abdulaziz University,Jeddah:
"Principles of International Economic Relations in Islam".

12.30 -

14.00 Prayer and lunch break

14.00 2. Dr. Ernst-Jurgen Horn, Institute for World Economy, Kiel:
"Normative Premises in the Theory of, International Economics"

15.30 -

16.00 Prayer and coffee break

16.00 Topic Area II: International and Intra-Isalmic Countries Trade and Finance
1. Prof. Dr. Khurshid Ahmad, Institute of Policy Studies, Islamabad:
"The `New International Economic Order (NIEO)' in an Islamic Perspecitve"

19.30 Reception and dinner hosted by Dr. Michael Rehs, Secretary General of the Institute for Foreign Cultural Relations.

Tuesday, 30th August 1988

9.00	2. Prof. Dr. Volker Nienhaus, University of Bochum: "Problems and Potentials of South-South Trade with Special Refrence to the Islamic Countries".
12.30 - 14.00	Prayer and lunch break
14.00	3. Prof Dr. Ahmed El-Naggar, International Federation of Islamic Banks, Cairo: "International Islamic Banking in an Interest-based World Financial System: A Theoretical Model".
15.30 - 16.00	Prayer and coffee break
16.00	4. Dr. S.A. Meenai, Stockport/Islamabad: "International Development Banking in an Islamic Framework: Lessons of Islamic Development Bank Experience"
19.30	Reception and dinner hosted by Prof. Dr. Jurgen H. Hohnholz, Director of the Institute for Scientific Co-operation.

Wednesday, 31 August 1988

9.00	5. Dr. Eckhard Freyer, University of Bonn: "The Debt Crisis: International Financial Institutions and Islamic Countries" 6. Dr. Monzer Kahf and Tariqullah Khan, Islamic Research and Training Institute, Jeddah: "Alternative Strategies of International Financing ".
12.30 - 14.00	Prayer and lunch break
14.00	Topic Area III: International Financing of Development 1. Prof. Dr. Ghani Ghaussy, University of the Federal Armed Forces, Hamburg: "The Contribution of Intergovernmental Institutions to Development in the South Especially in the Islamic A Critical Appraisal".

15.00 -

15.30 Prayer and Coffee break

16.00 2. Dr. Ziauddin Ahmad, International Islamic University, Islamabad: Islamic Financial Institutions and their Contribution to Trade and Development"

19.30 Dinner

Thursday, 1st September 1988

9.00 -

12.30 Concluding programme; recommendations for future co-operation

12.30 -

14.00 Prayer and' lunch break

End of seminar

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