

**AAOIFI – World Bank Annual Conference
on Islamic Banking and Finance**



**Manama, Kingdom of Bahrain
3-4 December 2012**

**Islamic finance in overall
economic systems**

Mahmoud Sami NABI
Senior Economist
IRTI – Islamic Development Bank

Outline

- What is an Islamic economic model?
- What are key lessons for Islamic finance from the economic and financial crisis?
- Can Islamic finance be applied in monetary and fiscal policies to manage economic growth?

What is an Islamic economic model ?

Emergence of the Islamic Economics as a discipline

- Islamic economics formally took off in 1976 with the 1st International Conference on Islamic Economics.
- In the follow-up to the 1st Conference, two seminars on fiscal and monetary policies were held in Makkah and Islamabad.
- Themes of the *Makkah* Seminar (1978) and Islamabad (1981): Monetary policy, fiscal policies, central banking operations, Fiscal analysis of *Zakah*, Distributive justice, Institutional framework for monetary policy.

Conceptual studies

- Umar Chapra (1985) “Towards a Just Monetary System”
- Ahmed Ziauddin (1989) “Public Finance in Islam”.

Analytical works : effects of fiscal and/or monetary policies in the context of macroeconomic models.

- Muhammad Mukhtar Mutwally (1981) “Macroeconomic Models of Islamic Doctrines”
- Mohsin Khan (1986) “Islamic Interest-Free Banking – A Theoretical Analysis Mohsin Khan and Abbas Mirakhor (1987), “The Financial System and Monetary Policy in an Islamic Economy”

“The Future of Islamic Economics”

- Workshop organized by the IEI of KAU (November 2012):
- M. Aslam Haneef: “Preliminary Thoughts on Diagnosing Some Methodological Issues in Developing Islamic Economics”
- M. Fahim Khan: “Theorizing Islamic Economics: Search for our Framework for Islamic Economic Analysis”
- Mabid Al-Jarhi: “Gaps in the Theory and Practice of Islamic Economics”

Islamic Economic Model

The framework in which the policies are to be conceived in order to achieve the socio-economic goals that Islam emphasises:

- Economic well-being with full employment and optimum rate of economic growth
- Socio-economic justice and equitable distribution of income and wealth.

(Chapra, 1983, Monetary Policy in an Islamic Economy)

(U. Chapra, 1983, Monetary Policy in an Islamic Economy)

“..Muslim jurists have unanimously held the view that welfare of the people and relief of their hardships is the basic objective of the Shari’a.

This view would, in the economic field, necessitate economic well-being through satisfaction of all basic human needs, removal of all major sources of hardship and discomfort, and improvement in the quality of life, morally as well as materially..”

U. Chapra (1983, p2) “Monetary Policy in an Islamic Economy”

“.. The goals of socio-economic justice and equitable distribution of income and wealth are an integral part of the moral philosophy of Islam and are based on its unflinching commitment to human brotherhood.”

Z. Hasan (2010, p16) “Scarcity, self-interest, and maximization from Islamic angle”


*“.. Shari’ah encourages people to acquire and enjoy all good things in life in gratitude of Divine benevolence. However, they are instructed to **observe moderation in consumption and avoid waste...***

Pursuit of self-interest demands that one should be conscious of the interest of others and should avoid hurting them. The requirement invokes mutual respect and **calls for cooperation - not conflict** - for promoting the interest of each other.”

What are key lessons for Islamic finance from the economic and financial crisis?

Islamic Banks

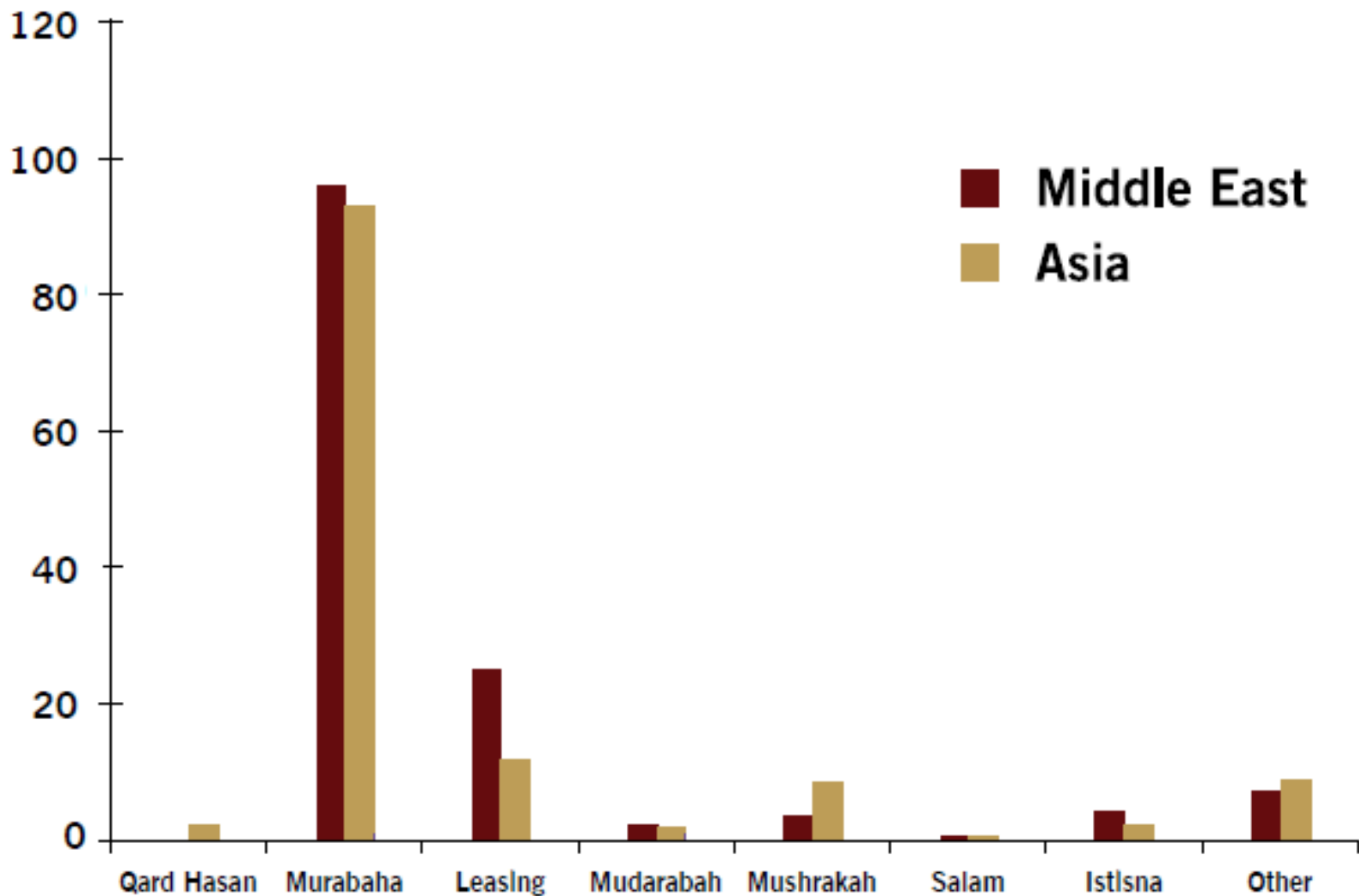
- Continuous increase of the Islamic banks' assets: 826 US\$ billions in 2010 - 1,130 US\$ billions in 2012 (Ernst & Young, 2011) with growth rate of 21% in 2011 (Oakley, 2011).
- In many countries the banking system is becoming dual with the simultaneous presence of conventional and Islamic banks (IBs' assets: 14% in the MENA region, 26% in GCC 17.3% in Malaysia.)
- Increasing interest of researchers in comparing the behavior and performance of the two types of banks in general and during the recent financial crisis.



Shamshad Akhtar Ex-Vice-president of the World Bank for MENA in his speech during the “Symposium on Islamic Finance in Roma: Developments in MENA region”, Bank Italia, Rome, Italy, November, 11th, 2009.

“...Although IBs have illustrated a degree of resilience and stability, they have been impacted by the crisis because of their higher exposure to real estate and their limited reliance on risk sharing or equity based transactions...”

Islamic Modes of Finance for Islamic Banks (billion US\$) – 2010 (Based on data for 66 Islamic Banks)



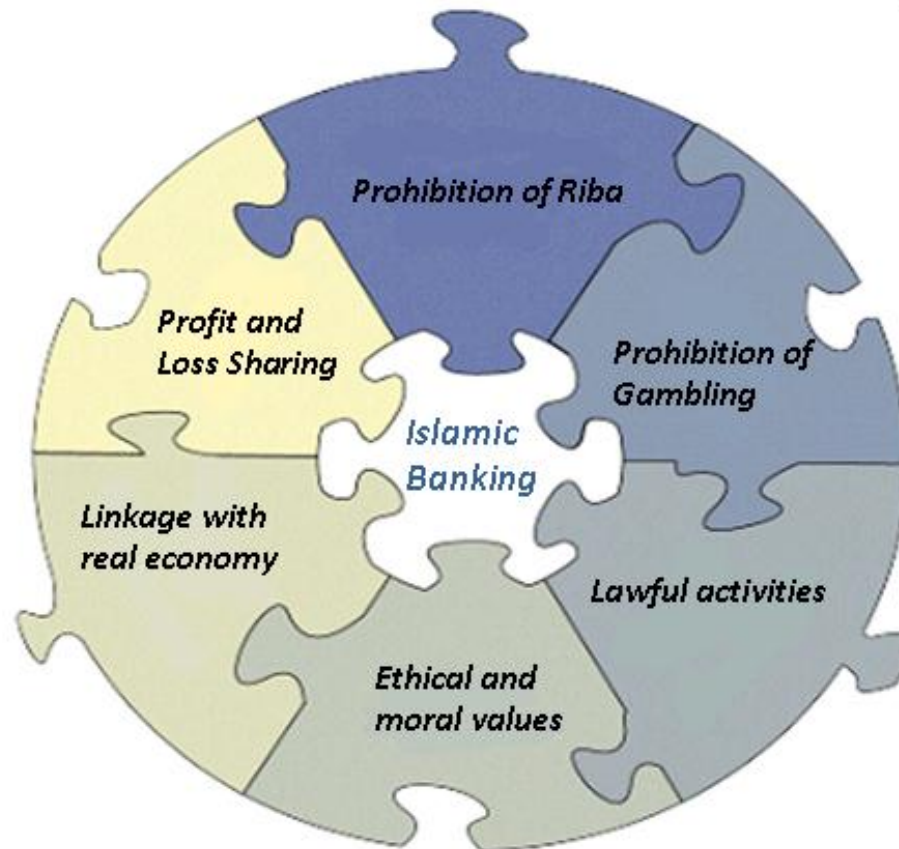
Source: Islamic Banking and Finance Information System (IBFIS) - IRTI

Deviation of Islamic Banks' practices from their initially designed business model

- Siddiqui (2008): IBs all over the world rely more on debt like financing on their assets side rather than PLS based financing instrument.
- The empirical studies revealed that the current practices of IBs deviate from their theoretical model.
- Zainol and Kassim (2010) and Cevik and Charap (2011): CB deposit rates Granger cause returns on PLS accounts in Malaysia and Turkey.
- Chong and Liu (2009): the retail Islamic deposit rates mimic the behavior of conventional interest rates (in Malaysia)
- Beck et al (2010) carried an empirical investigation on a broad cross-country sample and reached the same conclusion since they identified few significant differences in business orientation, efficiency, asset quality between conventional and retail Islamic banks.

Theoretically IBs should be more resilient to the financial crisis

- Definition of Bank soundness: bank's capacity to be solvent and remain so under difficult economic conditions by means of their capital and reserve accounts (Lindgren et al, 1996)



Relatively better resilience of IBs to the recent crisis

- Hasan and Dridi (2010) and Bourkhis and Nabi (2011): IBs were more profitable than CBs before the recent global financial crisis but became less profitable in 2009 when the crisis's passed-through to the real economy.
- Beck et al (2010): confirmed the relatively better performance of IBs during the recent crisis.
- The presence of IBs has not generated positive externalities on the stability of CBs (Cihak et Hesse, 2010; Bourkhis et Nabi, 2011).

Can Islamic finance be applied in
monetary and fiscal policies to manage
economic growth?

- Demirgüç-Kunt and Levine (2009, p.2): « The financial system influences who can start a business and who cannot, who can pay for education and who cannot, who can attempt to realize one's economic aspirations and who cannot. Thus, finance can shape the gap between the rich and the poor and the degree to which that gap persists across generations.»
- Clarke et al. (2003) argues that policy makers should know whether “finance” can be used as an instrument to affect income inequality.

- In recent decades the income inequality in many developed countries has widen.
- In OECD countries the inequality of incomes has increased since mid-1980s such that the income of the richest 10% of people was nearly nine times that of the poorest 10% in 2005 (OECD, 2008).
- As mentioned by OECD (2008) this situation could degenerate in social unrest fueled by the confining of the political power by a few wealthy citizens

- Observing the recent widening of income inequality in many countries we might conclude that the influence of policy makers on “finance” through taxation and monetary policy is ineffective.

Looking for an alternative in Islamic Economics ?

- U. Chapra (1985): “Towards a Just Monetary System”: economic growth isn’t by itself of prime importance if not accompanied by the reduction of inequalities, full employment and broad-based economic well-being.

- U. Chapra (1985, p217) : “Towards a Just Monetary System”: “high or low interest rates are the result of restrictive or liberal monetary policies adopted in the larger national interest. There is no reason why the entrepreneur or the financier should be the only one to suffer or benefit from such policies. Why shouldn’t the gains or the losses be equitably distributed between them?”

- In order to achieve what he called equitable distribution of gains and loss between the entrepreneur and the financier, he suggested considering a profit-and-loss sharing mechanism which guarantees the convergence of the two parties’ interest while interacting with the economic conditions as the interest rate do.

Islamic Financial System

- Islamic banks
- Shari'a compliant funds
- Shari'a compliant Equity Market
- *Sukuk* Market
- Islamic insurance (Taqaful)

Financial and the real sectors closely integrated: Financial follows run parallel to real flows (as in *murabahah, salam and ijarah financing*) or tied to real economic activity (as in partnership based financing).

Fiscal Policy in an Islamic Economic Model

Faridi, F.R. (1983) “A Theory of Fiscal Policy in an Islamic State”:

- Islamic economy would be a three-sector economy consisting of traditional private and public sectors as well as a voluntary sector.
- Goals for the fiscal policy:
 - ✓ Justice and equity
 - ✓ Provision of socioeconomic needs of the community or socioeconomic welfare
 - ✓ Enhancement of the community’s economic resources or economic growth
 - ✓ Improvement in the cultural milieu of the society

Faridi, F.R. (1983) “A Theory of Fiscal Policy in an Islamic State”:

- Role of the government: traditional allocation, stabilization and distribution roles.
- Zakah and voluntary charity would provide anchors for distributive purposes.

Monetary Policy in an Islamic Economic Model

U. Chapra (1983) “Monetary Policy in an Islamic Economy”

- Economic well-being with full employment and optimum rate of economic growth
- Socio-economic justice and equitable distribution of income and wealth.
- Stability in the value of money

Sayyid Tahir (2006) “Public Policies (Fiscal and Monetary) from an Islamic Perspective”:

- Inflation is not being a major concern in the Islamic setup [financial flows being tied to (or, running parallel to) the real flows].
- Central bank: focus on solvency of the financial system through prudential regulations, reserve requirements and open market operations.
- Fresh money may be injected into the system through Shari’a permitted fiscal deficits or through injecting liquidity into the system on partnership basis.



Thank you

msnabi@isdb.org
msaminabi@gmail.com