ally) serve as a basis for greater economic and political integration. In the current free-for-all, there is an additional, and contradictory, force at play: Islamic countries are repositioning themselves in the global economy, creating capital markets and responding to the demands of global financial regulation;[55] in the process, they are often in competition with one another.[56]

As for the convergence between Islamic and conventional finance, it is highlighted by five recent phenomena. First, a growing number of conventional banks are opening Islamic subsidiaries and/or 'Islamic windows', offering their customers a choice between Islamic and conventional products. Following a well-established trend, the Arab Banking Corporation, one of the largest Middle Eastern banks (which was founded jointly by Kuwait, Libya and the United Arab Emirates in 1980), announced in late 1997 the creation of an Islamic unit. Virtually every conventional bank in the Middle East and the Islamic world offers at the very least some Islamic investment options.

Second, financial institutions from outside the Islamic world are now creating Islamic subsidiaries or offering Islamic products. Financial firms that aspire to become global brands – Citicorp, Merrill Lynch – have long-standing ties with Persian Gulf states, but have recently felt the need to tap Islamic middle classes. Citicorp's establishment of an Islamic subsidiary in Bahrain in 1996 has been closely watched within the international financial community. Kleinwort Benson, ANZ Grindlays, Goldman Sachs and ABN Amro are among those Western firms active in Islamic finance.

Third, many Islamic institutions are aiming their increasingly sophisticated and diverse products at non-Muslims. Financial institutions are creating products not only on the basis of their being Islamically acceptable, but also on the basis of their being intrinsically attractive to buyers of conventional products. In the words of Majed Al-Refai, chief executive of the Bahrain-based First Islamic Investment Bank: 'Our aim is to create credit-rated medium-to-long term investment tools which are comparable with existing conventional products, so that financial advisors can advise their clients to invest with us on the basis of returns, rather than because they are Islamic.'[57]

Fourth, a growing number of Islamic banks have been established outside the Islamic world, in order to cater to local Islamic communities. Since the 1980s, such institutions have been created in Europe, the United States and Australia. Today, Islamic banks exist in virtually all parts of the world. In 1997, Russia announced the creation of its first Islamic bank. Badr Bank (with 51 per cent of the shares belonging to Russian citizens but with most of the $20 million start-up capital coming from Iran, Saudi Arabia, Kuwait, Qatar, the Sudan and Egypt) said it would initially invest up to $60 million in various long-term projects in the arms industry, space technology, shipbuilding and industrial ecology. Its investments would

include a major project in the Baikal-Amur railway region, an economically depressed area of eastern Siberia with very high unemployment. Another stated goal was to invest in infrastructure projects to boost trade links between Russia and the Middle East and Southeast Asia.[58] And in 1998, the autonomous region of Ningxia announced it was about to establish China's first joint-venture Islamic bank, in association with an unnamed Saudi Arabian bank.[59]

Fifth, much of the new ijtihad on Islamic finance is conducted in cooperation between conventional and Islamic institutions, often outside the Islamic world. Perhaps the most ambitious research on Islamic finance is now conducted at Harvard University. A number of programmes have been established in the last few years under the aegis of the Center for Middle Eastern Studies (CMES), in cooperation with the Harvard Law School and Harvard Business School, and with financing from such institutions as the National Commercial Bank, the Islamic Development Bank, Wellington Management and Goldman Sachs. In December 1995, the Harvard Islamic Finance Information Program (HIFIP) was started with financing from the Islamic Investment Company of the Gulf, Bahrain (IICG), a member of the Dar Al-Maal Al-Islami group. It is 'committed to the collection, analysis and dissemination of information on the Islamic financial sector' and aims to 'promote research and development in the field of Islamic finance, sponsor research projects which investigate new trends, strategies, and methods in Islamic finance' with 'particular emphasis given to studies which investigate how existing financing methods available in conventional finance can be applied to Islamic finance and vice versa'.[60]

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5

ISLAMIC FINANCE AND THE GLOBAL POLITICAL ECONOMY

What is the significance of Islamic banking from the standpoint of international politics and economics? Superficially, the creation of the first Islamic banks could be seen, especially in the context of the oil crisis and the calls for a New International Economic Order, as a challenge to the Western banking system. Just as superficially, as we saw, it is common to say that Islam – and one would assume its economic manifestations – is incompatible with the New World Order that has emerged with the end of the cold war.[1]

This chapter attempts to place the development of Islamic banking in its broader international political and economic context, showing that, paradoxically, the first aggiornamento was firmly embedded within the Western banking system of the era, and that, even more strikingly, the new global economy which has emerged with the end of the cold war has allowed Islamic banking to thrive.

5.1 The Political and Economic Context of the First Aggiornamento

Modern Islamic banking would probably not exist were it not for two political–economic developments: pan-Islamism, and the increase in oil prices. At the centre of both was Saudi Arabia's King Faisal. It is thus appropriate that the leading network of Islamic banks be named after him, even though the Faisal Bank is still not allowed to operate as a commercial bank in Saudi Arabia.

5.1.1 Pan-Islamism

For all the talk throughout Islamic history about the 'umma' (the Islamic nation, or the community of believers), pan-Islamism as a modern political movement did not begin in earnest until the 1960s at the time of the 'Arab cold war'.[2] Egypt's President Gamal Abdel Nasser was then a champion of the Third World's struggle against Western colonialism. His brand of nationalism, secularism and socialism was embraced by other newly

independent Islamic states such as Algeria and Indonesia. The relations between Egypt and Saudi Arabia had their ups and downs, but for most of the 1960s, the two countries were at odds. Saudi Arabia was a conservative Islamic monarchy with strong ties to the West. It served as a sanctuary for many of the Muslim Brothers leaders who suffered from the repression of Nasser's regime. Egypt reciprocated by offering asylum to insubordinate members of the Saudi royal family. The Yemeni civil war (1962–7), during which both countries fought on opposing sides, became the focal point of the 'Arab cold war'.

King Faisal sought to trump Nasser's pan-Arabism by sponsoring a pan-Islamic movement, the Muslim World League, and used the pilgrimages to Mecca to forge ties with Islamic leaders, both inside and outside the Arab world. To oppose Nasser's message of Arab and Third World solidarity, he proclaimed the doctrine of Islamic solidarity.[3] In addition, he extended substantial amounts of aid to non-Arab Islamic countries in Asia and Africa, and embarked on a series of high-profile visits to Islamic capitals. Upon one such visit to the Shah of Iran in December 1965, the Saudi king was accused by the Egyptian press of using Islam 'as an instrument to combat Arab unity'.[4]

A number of events set the stage for an Islamic renewal, thus enhancing Faisal's position. The most dramatic was the six-day war of June 1967. Significantly, in his first speech following the crushing Arab defeat, a humbled Nasser made a specific reference to religion.[5] In the soul-searching that followed, many of the principles that had governed Egypt's policy were called into question. It became common to say that the Arabs were punished for straying from the path of true Islam.[6] Egypt embarked on a more moderate course and Saudi Arabia's stature within the Islamic world grew. Then in 1969, a deranged Australian set fire to the Al-Aqsa mosque in Israeli-occupied Jerusalem. In the aftermath, King Faisal, by then the unquestioned leader of the nascent pan-Islamic movement, called for an Islamic summit in Rabat, Morocco, at which it was agreed to form a permanent Islamic organization. The Organization of the Islamic Conference (OIC) was born in 1970, the same year Nasser died. And unlike the June 1967 war, which was fought in the name of Arab nationalism, the October 1973 (known as the Ramadan war in Arab countries and as the Yom Kippur war in Israel) was full of religious symbolism. It was, for example, code-named 'Badr' – the name of Mohammed's first decisive victory over the Meccans.

By the mid-1970s, pan-Islamism had become a powerful movement, helped in no small part by the newfound wealth of Saudi Arabia. In such countries as Turkey and Pakistan, which until then had limited ties to the Arab world, Islamic solidarity became an important foreign policy theme 'as the Muslim oil-producing states of the Middle East become important markets (especially for manpower) and important sources of economic

aid'.[7] The rapprochement between Pakistan and Persian Gulf states was especially significant since, as we saw, it was in Pakistan that the bulk of the early research on Islamic banking had been conducted. Throughout the 1970s, '[w]hile Saudi Arabia and other Gulf states provided the cash, Pakistan has provided much of the manpower, and much of the zeal, for the network of supranational 'Islamic' institutions that has developed ... under the umbrella of the Organization of the Islamic Conference.'[8] Interestingly, it all occurred during the rule of Zulficar Ali Bhutto – to whom the labels of 'secular' and 'socialist' are usually affixed – who made numerous trips to oil-producing countries, emphasized the theme of Islamic brotherhood in his speeches, and hosted the Islamic summit conference in Lahore, during which the idea of the creation of an Islamic bank was adopted. (That summit was also the occasion of the reconciliation between Pakistan and the newly created Bangladesh, following an appeal in the name of Islam by Egyptian President Anwar Sadat.)[9]

5.1.2 The Petrodollar Windfall

Although Nasser's policies following the 1967 war were marked by relative moderation and pragmatism, it was under his successor Anwar Sadat that Egypt, timidly at first and then increasingly boldly, embarked on a new course: an Egypt-first stance that meant the abandonment of Nasser's 'meddling' in other countries' affairs; distancing from the Soviet Union (Soviet advisers were expelled in 1972, but the Soviet Union nonetheless supported Egypt during the 1973 war); and de-Nasserization policy at home, primarily the abandonment of socialism and embarking, especially after 1974, in a policy of 'infitah' (open door).

All those policies were welcomed by Saudi Arabia, and the two countries entered into an era of close cooperation. King Faisal granted generous financial assistance to Egypt, recognized Egypt's military role as the main confrontation state vis-à-vis Israel, and coordinated his oil policy with President Sadat. Cooperation on military and oil matters was crucial since the embargo and oil price increases of 1973–4 were closely linked to the Arab–Israeli war of October 1973.

By the early seventies, the balance of power between oil producers and consumers and between governments and oil companies had shifted. Because of uninterrupted economic growth and the increased reliance on oil – at the expense of other energy sources – worldwide demand was very strong. Oil producers realized that with high inflation and a falling dollar, their oil receipts were steadily dwindling. (In real terms, the price of oil, which had remained stagnant for decades, was going down.) At the same time, oil-producing countries had become more assertive and better equipped to negotiate with oil companies: they now had nationals who had studied petroleum engineering, law or business administration in Europe

and the United States; they had also accumulated enough financial reserves to enable them to survive a showdown with oil companies. In the period between 1970 and 1973, they were thus able to obtain better terms: greater control over oil policy, higher prices, greater share of receipts, and even gradual nationalization, which increasingly transformed the role of foreign oil companies from all-powerful intermediaries and owners or part-owners of oil resources, to mere service providers, hired at the discretion of governments, to explore for, extract, refine and sell the oil.[10]

So, just as King Faisal was kept apprised of war preparations, Anwar Sadat was strongly pressing him to use the 'oil weapon' – that is, to create a linkage between the price, indeed the availability, of oil, and the Arab–Israeli conflict.[11] A conjunction of political and economic factors led to the oil embargo in October 1973 against countries supporting Israel (including the United States), and the quadrupling of the price of oil between October and December of that year. In what is commonly considered one of the most massive transfer of wealth in modern times, the mid-seventies were dominated by talk of a New International Economic Order (NIEO), more specifically of new relations between North and South and of Southern and particularly Islamic solidarity. In that context, Islamic banking went from a vague, somewhat utopian, idea to reality.

5.1.3 Relations with the US and the West

In 1975 Hans Morgenthau, then the leading American theorist of international relations, said:

> The control of oil, the lifeblood of an advanced industrial state, by potentates who have no other instrument of power and who are accountable to nobody, morally, politically, or legally, is in itself a perversity. It is a perversity in the sense that it defies all rational principles by which the affairs of state and the affairs of humanity ought to be regulated to put into a few irresponsible hands power over life and death of a whole civilization.[12]

The tone of Morgenthau's statement, and others by similarly learned people – let alone those of lesser learned ones – suggests an unwarranted attempt to somehow cripple if not destroy 'the free world' and its economy.

The great paradox of the developments presented in the previous pages is that the main players involved – Anwar Sadat, King Faisal, the Shah of Iran – happened to be the strongest supporters of the United States and the West, and were all keen on having their national economies firmly embedded within the US-centred international economic framework. Sadat and Faisal felt that the 'oil weapon' was a means to break a political deadlock and achieve a more equitable distribution of wealth between North and South. On the extent of the increase of oil prices, Saudi Arabia

was decidedly a dove. Indeed, one of the lesser-known facts about what is generically considered an 'Arab' price hike was that, at the fateful December 1973 meeting of the Organization of Petroleum Exporting Countries (OPEC) in Tehran, the two main hawks were Iran and Venezuela – both non-Arab countries and both at the time squarely within the US 'sphere of influence'.[13] The hawks saw no contradiction there, insofar as they considered the new prices consistent with the rules and logic of the free market. Perhaps a bit disingenuously, the Shah of Iran frequently reiterated his concern that the West was too dependent on oil, and that only significantly higher prices would lead to less waste and to a more resolute search for alternative sources of energy. Saudi Arabia had good reasons to lead the doves. It was sparsely populated and did not need all the additional income. Also, having the largest oil reserves in the world, it was worried that too steep a rise would encourage the development of alternative sources of energy which in time might altogether supplant oil. Perhaps most importantly, Saudi Arabia, along with other Gulf states, was also heavily invested in international markets and was economically and militarily dependent on the United States. Crippling the US and the world economy would be self-defeating. When in the following years the Shah of Iran pushed for further price increases, Saudi Arabia refused to comply, for a time creating a two-tiered price system within OPEC.[14]

Overall, the relations between Saudi Arabia and the United States had been very close, although they were marred by differences over the US's staunch support for Israel. The strong bilateral ties were reinforced by the official visits of Faisal to Washington in 1966 and 1971, as well as by Nixon's visit to Riyadh in July 1974 at the height of the Watergate scandal and shortly before his resignation. In the context of the cold war, and despite the events of 1973, Saudi Arabia was firmly in the American camp. In the words of George Lenczowski:

> The two countries had a long history of mutual cooperation based on common concerns and complementary interests. Both were anticommunist and opposed to radical revolutionary movements anywhere in the world; both looked for stability and security in the Arabian Peninsula and the Persian Gulf; and both were interested that Saudi petroleum should flow uninterruptedly to the consumers in the industrialized democracies for the mutual benefit of the buyers and the sellers. The fact that a purely American company, Aramco was the sole operator of oil fields on Saudi territory added to the closeness of this relationship.[15]

Edward Mortimer observed that, for King Faisal, as for his successors, 'the interests of Islam are in the last resort identified with those of the "free world" – which Faisal saw as the Christian world, ruled by "people of the book" – against those of atheistic communism'.[16]

So despite policy differences over Israel and an oil policy which provided, among other things, for a gradual nationalization of Aramco, cooperation between the two countries actually increased, especially in military and financial matters. Since 1974, the Saudis have significantly increased their purchases of American weapons and have chosen to invest a significant part of their newfound wealth in US Treasury Bonds, while maintaining most of their deposits in American banks.[17]

It is thus not surprising that despite the heated rhetoric, US leaders such as Secretary of State Henry Kissinger considered the oil crisis to be a benign development that would further the geopolitical position of the United States.[18] His view was that, in relative terms, the US was less dependent on oil than Europe and Japan, and that most of the oil windfall would find its way back into the United States in the form of military and civilian contracts or Treasury Bonds purchases. From a geopolitical perspective, the Shah of Iran, the leading hawk on oil prices, was designated as the regional 'policeman' and granted 'blank cheque' privileges in his shopping sprees: Iran, then considered to be a rock of stability in a highly unstable area, became the only country allowed to purchase, on a cash basis, any weapons it wanted. In 1978–9 the second 'oil shock' occurred, triggered by riots and strikes in Iranian oil fields, and later by the Iranian revolution. Fearing a domino effect in the region, President Jimmy Carter formulated in January 1980 what became known as the Carter Doctrine:

> Let our position be absolutely clear. An attempt by any outside force to gain control of the Persian Gulf region will be regarded as an assault on the vital interests of the United States of America, and such an assault will be repelled by any means necessary, including military force.[19]

The alliance between the United States and Saudi Arabia and other Persian Gulf states was consolidated as these countries became more dependent than ever on American protection.[20]

5.2 Islamic Finance in the Global Economy

By the mid-1980s, the circumstances that had given rise to Islamic banking had subsided. More specifically, oil revenues had fallen to such an extent that most Islamic countries were experiencing serious fiscal and balance of payment problems. In Saudi Arabia, for example, oil revenues declined from a high of $120 billion in 1981 to $17 billion in 1985.[21] In most countries, the economic downturn had dramatic political and economic consequences: budget cuts, tax increases, cancellation of contracts, sharp drops in labour remittances, etc. Yet Islamic banking kept growing.

This section considers the trends that help explain the recent growth of Islamic finance: the emergence of a global economy which limits the

options of national governments and is characterized by new norms and a new ideology; the transformation of the financial sector, whereby the lines between commercial banking on the one hand, and investment banking as well as other financial activities on the other, are increasingly blurred; the rise of Islamism, which has put pressure on governments throughout the Muslim world to allow for religiously inspired financial products and institutions; and the very preoccupations – ethical, political, economic and social – resulting from the excesses of globalization and the search for correctives.

5.2.1 The Global Economy and its Ideology

The 1970s were characterized by the emergence of a regional economy within an international system still dominated by the confrontation between the United States and the Soviet Union. The petrodollar windfall had reconfigured economic relations within the Islamic world. A sharp increase in trade, aid, and labour remittances transformed the economies of the Muslim world. The poorer countries could also count on financial aid from one of the superpowers, and sometimes from both. In the wake of the Camp David accord, Egypt became the second largest recipient of US aid (after Israel), while countries such as Syria or Iraq received significant aid from the Soviet Union. In the wake of the oil bonanza, the abundant deposits in international banks were often 'recycled' into loans to governments, which in those years of statism played a central role in economic development.

Throughout the 1980s, both the regional economy and the cold war system slowly disintegrated. The debt crisis (starting in August of 1982) led banks to reconsider their commitment to sovereign lending.[22] With the accession to power of Mikhail Gorbachev in 1985, East–West relations were transformed. The fall of the Berlin War in November 1989 and the disintegration of the Soviet Union in December 1991 marked the end of the cold war. Within the Islamic world, the Gulf War marked the end of the regional economy.[23]

The changes leading to a New World Order were accompanied by an ideological shift. Traditional views on development had already been under sharp attack.[24] Since 1979, the World Bank had changed its focus from financing individual projects to transforming entire economies. With the Philippines as its first guinea pig, it set out to transform economic (and hence political) 'structures' in exchange for aid.[25] And since the debt crisis which spread from Mexico to much of the developing world, the International Monetary Fund (IMF) had become a sort of 'global bankruptcy judge', disbursing funds only on condition that countries adopt 'structural adjustment' policies.[26] Both in the cases of IMF and World Bank plans, the typical package included addressing macro-economic imbalances and

implementing sound fiscal and monetary policies, reforming the public sector, modernizing the supervisory and legal infrastructure, liberalizing financial markets, eliminating subsidies, promoting the free flow of capital and investment, etc. It should therefore come as no surprise that some have called such 'structural adjustment programs' the equivalent of 'a foreign-controlled coup in slow motion'.[27]

The new paradigm was strengthened by the collapse of Communism in Eastern Europe and the implosion of the Soviet Union, which were interpreted as the victory, in the battle of ideas, of capitalism and the market economy over socialism and central planning.[28] Old dogmas regarding the respective roles of states and markets were turned on their head: government leaders were now seen as neither able nor willing to promote the public good; state controls could only encourage inefficiency, stifle entrepreneurship and delay reform. What came to be known as the 'Washington consensus' was shared by the US and other industrialized countries and by international organizations. The state, once seen as the provider of solutions, was now perceived as the major obstacle to development. All attempts at central planning, and even milder forms of industrial policy, were doomed. State-led policies, protectionism and import-substitution had to be replaced by privatization, deregulation, and an export orientation. Foreign 'experts', some of whom – for example, Harvard's Jeffrey Sachs – achieved celebrity status, advised governments, often with disastrous results, on the reform process and the transition to free-market economies.[29]

Reform was the sine qua non of obtaining access to international financing and to global markets. In order to obtain financial help from international organizations, or to be allowed to join the World Trade Organization (WTO), governments had to embrace – perhaps, more accurately, claim to embrace – the new ideology of reform. Governments also came under the surveillance of markets. Embracing the new ideology was more a matter of necessity than choice. With the drying-up of external aid and the virtual end to sovereign loans by banks, the only option governments had was to borrow on the international markets. An added incentive for reform was related to a new phenomenon – the grading of countries and their debt by rating agencies. Throughout the 1990s, Moody's and Standard and Poor's awarded ratings to emerging markets, based in large part on an evaluation of how well the reforms demanded by 'the markets' and their proxies were implemented. The cost of a bad rating is very high: punishing interest rates, perhaps even the outright inability to tap international markets.[30] At a time when private and public borrowers are fiercely competing across the globe to attract capital, in what John Maynard Keynes used to refer to as a 'beauty contest', poorly rated countries are likely to be shunned.

In short, the after-effects of the debt crisis and the end of the cold war,

along with the impacts of deregulation and technological change, have recast the choices available to national governments. Unless they prefer autarky, countries are forced to conform to the dictates of the global economy. Most Islamic countries are heavily indebted and increasingly dependent on the outside world for financing, and the political and economic clout of bankers and other financiers is on the rise.[31] In order to raise funds in the international markets, or to obtain aid from the International Monetary Fund or the World Bank, governments must adopt policies that conform to the new international orthodoxy (economic austerity, liberalization of trade and capital flows, privatization, deregulation and dismantling of the public sector).[32] Even so-called 'rogue states' such as Iran or the Sudan, lest they be financially starved, have to deal with the IMF and the World Bank and thus comply with demands related to economic policy.

The tidal wave of liberalism was somewhat late in reaching the Islamic world, but it is now clearly there.[33] The 'alliance' between Islamists and liberals is justified by the existence of a common target: the all-powerful (and secular) state. Two areas of convergence between the Islamist critique of statism and the Washington consensus should be emphasized. First is the Islamic commitment to private property, free enterprise and to the importance of contracts, as opposed to state-led economic policy and the arbitrary decisions that go along with a strong state bureaucracy. In many countries, Islam has become the tool of entrepreneurs seeking to get around restrictive regulation, and an instrumental factor in privatization and deregulation – and the best excuse to disengage the state from the economy. Insofar as financial liberalization is 'the process of reducing government control over the allocation of credit',[34] Islamic bankers were bound to make common cause with economic liberals. Second is the parallel between the 'privatization of welfare' (through reliance on zakat and other religiously based redistribution schemes) advocated by Islamists, and the downsizing of the state that is central to the new ideological consensus. Private virtue thus meets efficiency: by helping the poor, the wealthy become better human beings; and the voluntary provision of charity reduces the need for public welfare organizations that are usually costlier to run.

This is not a new phenomenon. In medieval Muslim society, the Shariah was often used as a shield for private property against arbitrary confiscation.[35] Today the merchant classes are using the Koranic emphasis on private property rights, and Islam's positive view of commerce and profits, to pursue policies of privatization and deregulation. Even Islamic Republics have on occasion openly embraced neo-liberalism. Thus, in Sudan between 1992 and the end of 1993, Economics Minister Abdul Rahim Hamdi – a disciple of Milton Friedman and incidentally a former Islamic banker in London – did not hesitate to implement the harshest free-

market remedies dictated by the International Monetary Fund. He said he was committed to transforming the heretofore statist economy 'according to free-market rules, because this is how an Islamic economy should function'.[36]

5.2.2 The Transformation of Banking and Finance

For most of the past decades, the world of finance was neatly divided between commercial banking on one side and investment banking and other forms of finance on the other. In the United States, the 1933 Glass-Steagall Act, for example, prevented the two types of institutions from encroaching on each other's territory. Typically, commercial banks were regulated like utilities. They benefited from government-sanctioned oligopolies, as products, rates, and geographic expansion were tightly regulated, and deposits were up to a certain level covered by insurance. The main source of profit for commercial banks came from interest income (the difference between interest earned on loans and interest paid on deposits). Since the 1970s, the nature of banking has started to change, and virtually every country has embarked on a wholesale overhaul of its banking system.[37] 'What is going on now is a revolution in the way finance is organized', wrote Adrian Hamilton, 'a revolution in the structure of banks and financial institutions and a revolution in the speed and manner in which money flows around the world'.[38] This revolution was made possible by the impact of technology on financial services. According to Peter Dicken, 'information is both the process and the product of financial services. Their raw materials are information: about markets, risks, exchange rates, returns on investment, creditworthiness. Their products are also information: the result of adding value to these informational inputs'.[39]

Five major trends capture change in international finance. First is the impact of the new dominant ideology on financial policy. In contrast with the previous belief that strict government controls were necessary, a new ideology stressing the importance of free markets asserted itself in the mid-seventies in the United States and soon became the new worldwide orthodoxy. Since the US decision to deregulate commissions on securities transactions on 1 May 1975, and then to phase out interest-rate controls and credit restrictions in landmark pieces of legislation enacted in 1980 and 1982, an irreversible process of deregulation has been underway. European countries followed suit, most dramatically with the British Big Bang of 1986, and later with the creation of a single European financial market. Alone among industrialized countries, Japan engaged – at least until its 1997 announcement of a phased-in 'Big Bang' – in a reluctant, incremental and tightly controlled process of deregulation.[40] As for emerging markets, most underwent during the 1980s a conversion to free-market economics. As we saw earlier, the liberal ideology spread to most of the world and a huge

privatization effort has since been underway.[41] Latecomers had a tendency to embrace the new ideology with a vengeance.

Second is the globalization of finance brought about by technological change and the opening of national markets to foreign competition. Richard O'Brien has written about the 'end of geography', whereby 'financial market regulators no longer hold full sway over their regulatory territory',[42] and firms recast their strategy based on a global marketplace. With the lifting of restrictions on capital movements, financial markets are increasingly interconnected. While interest rates are still far from achieving full convergence,[43] they are now increasingly sensitive to market forces and global capital movements.[44] In addition, governments now find themselves under the constant surveillance of 'the markets' via such proxies as rating agencies, securities analysts and the like.[45] Not since the glory days of the gold standard (1870–1914) have countries been so subjected to the whims of international capital. It is estimated that $1.25 trillion change hands every day in the foreign exchange markets. In an era of quicksilver capital, foreign investors have the power to enter and exit a market as they please, and little can be done by governments to stem the flow of short-term and often speculative funds.[46]

Third is the changing dynamics of competition. Deregulation and liberalization have intensified competitive pressures and blurred the lines within the financial sector. The cosy world of national oligopolies started fading with the erosion of the near-monopoly of banks on the intermediation process (the conversion of savings into loans). Banks were squeezed on both sides of their balance sheets. On the asset side, they lost the core business of lending to large (and even not-so-large) corporations, to commercial paper and junk bonds. Indeed, major corporations discovered that commercial paper was a much cheaper source of short-term working capital – as well as a higher yielding short-term investment for their own excess cash.[47] The amount of commercial paper outstanding increased fourfold in the 1970s to $124 billion, and then quadrupled again in the 1980s to $570 billion as of December 1990. By contrast, all money centre banks' commercial and industrial loans at that time were only $322 billion.[48] Banks also lost high-margin borrowers when second-tier corporations started issuing junk bonds mostly under the aegis of ill-fated Drexel Burnham Lambert.[49] On the liability side, depositors left banks in droves for higher yields in mutual funds, money market funds, or even stocks and bonds.[50] All these developments put tremendous pressure on banks' margins. Having lost their core businesses, indeed their franchise, they had to venture, initially without much success, into new territories, for which they were singularly – whether because of their inherently conservative culture, or regulatory strictures to which they were still subjected – ill-prepared.[51]

With the commercial banks in competition with securities firms, insurance companies, mutual funds, pension funds, hedge funds, etc.,

investors faced a growing range of choice. Increasingly, loans and other financial assets were securitized, that is, converted into tradable securities that can be bought and sold on the market. Fierce competition brought forth industry consolidation. Unable to compete, a growing number of firms fell by the wayside as a few players grew bigger, typically evolving into conglomerates combining banking, securities, and insurance activities in a single group.[52] Most countries have been moving towards a German-style universal banking model, where a financial institution can be at once a commercial bank, an investment bank, and a shareholder in industry.

In the United States, while Glass-Steagall is still on the books – although there have been, since 1991, annual Congressional attempts to abolish formally the 1933 legislation – barriers separating various types of finance have been slowly but surely disappearing. Commercial banks have acquired other types of financial institutions, and have reinvented themselves. Among the first to move away from traditional commercial banking were J. P. Morgan and Bankers Trust, the latter redefining itself as a 'risk manager' and creating a variety of new 'derivatives' designed to fulfil a variety of commercial and investment needs.[53] Similarly, John Reed, the chairman of Citicorp – usually considered to be the most innovative commercial bank – redefined money as 'information on the move'. Leading banking experts even argued that '[t]he commercial bank – the institution that accepts deposits payable on demand and originates loans – has outlived its usefulness and is in terminal decline'.[54] Such experts as consulting firm McKinsey's Lowell Bryan suggested that in the future all loans could be securitized. As a result banks would no longer be necessary, and could be 'broken up'.[55] To be sure, banks have not disappeared, but their share of the broad financial sector has steadily dwindled. For decades, commercial banks had somewhere in the order of magnitude of 70 per cent of the financial assets of the United States. The share has now fallen to about 30 per cent.[56]

By the same token, innovation in products and risk management techniques have taken centre stage. Deregulation and technological change allowed the creation of a wide array of financial products. Hence the explosion of derivatives – products such as swaps, options and futures whose value is derived from an underlying asset. 'Financial engineers' are now in a position to create an infinite variety of new financial products through a process of slicing and splicing. For example, the interest and principal components of a bond can be split and sold separately, or they can be combined with other instruments and packaged as a single product. Initially devised as hedging devices, many such products have in fact amplified the risk exposure of their users. With the proliferation of derivatives, risk management and control are now at the core of financial strategies. Increasingly, risk management is global, cutting across products, countries and legal entities.[57]

Fourth is the new relation between finance and economics. Until recently, finance was a reflection of the underlying real economy. Increasingly, the relationship has been reversed. Economics now seems driven by finance.[58] In many respects, there is even a disconnection between finance and the underlying economic reality, posing new risks to the economy and new challenges to governments who now ponder John Maynard Keynes's famous statement: 'Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation'.[59]

Fifth is the new power of central banks. Once relegated to a purely technical role and typically confined to being an appendage of the Ministry of Finance, central banking has become a locus of economic, and indeed political, power. The prototype of the new central banker is Paul Volcker, who chaired the Federal Reserve Bank between 1979 and 1987, and whose anti-inflation policy became legendary.[60] As price stability came to define the new orthodoxy of economic policy, the central banks were bound to became the guardians of the dogma. The underlying rationale was that vote-seeking politicians were spendthrift by nature, and that only 'independent' experts could insulate monetary policy from political pressures. So despite occasional criticisms of the growing power of unelected technocrats, a number of countries have moved to grant independence to their central bankers, considerably increasing their power in the process.[61] Between 1989 and 1998, more than 25 countries have upgraded the legal independence of their central banks.[62]

Based on all the above, we can see how the new world of finance has facilitated the growth of Islamic finance. Where interest income was once the cornerstone of banking, its relative importance has steadily declined in recent years. As a result of competitive pressures and thinning margins, most financial institutions have increasingly been relying on fee and commission, rather than on interest, income. For traditional banking operations – deposit-taking and lending – banks have discovered that tacking on fees was as inconspicuous as it was lucrative. But more significantly, banks are now engaged in financial operations – such as the creation and sales of derivatives and other new products – that do not directly involve interest. The downgrading of interest has allowed banks to sidestep – to some extent – the most controversial aspect of banking and move beyond inconclusive debates about riba.

Another striking development is the convergence between the profit-and-loss sharing logic of traditional Islamic finance and many modern financing techniques. Indeed, modern finance has seen a sharp increase in risk-sharing arrangements, along the lines of the merchant banking or the venture capital model, where the financier is no longer a lender but a partner.[63] And the financial innovation made possible by deregulation allowed the creation of specially tailored Islamic products. A few years ago,

financial institutions could only sell a narrow range of financial products. Now there are far fewer constraints on the products that 'financial engineers' can devise. In the wide array of available derivatives or mutual funds, there is a product for every need, religious or otherwise.[64]

5.2.3 The Rise of Islamism

The Islamic revivalism phenomenon has challenged most of the assumptions of Western liberal secularism and development theory. In an influential study of the Middle East published in 1958, Daniel Lerner pronounced the 'passing of traditional society'.[65] An entire generation of scholars of the Middle East and the Islamic world viewed the march of secularization and Westernization as inexorable. As we have seen, political Islam had launched its comeback at least from 1967. From the early seventies, even pro-Western, secular leaders such as Anwar Sadat in Egypt or Zulficar Ali Bhutto in Pakistan had actively courted Islamic leaders and made increased use of religious symbols in politics. But it took the Iranian revolution of 1978–9 for the scholarly community outside the Islamic world to take notice. Still, with the first rumblings against the Shah, most 'experts', ignoring the happenings in the holy city of Qom and concentrating instead on the 'viable alternatives' for Iran's future – the military, the Communists, secular nationalists – considered an Islamic revolution to be a logical impossibility. When the Ayatollah Khomeini rose to prominence during his brief exile in France, few imagined that he would be anything more than a figurehead or a unifying but politically inconsequential symbol.[66] Predictably, the Iranian revolution brought about a pendulum swing in outside perceptions of Islam. Once ignored, Islam became a ubiquitous and monolithic threat.[67]

The brand of Islam best known outside the Islamic world is revolutionary or radical, and usually anti-Western. Since the Iranian revolution, a number of developments have highlighted the political dimension of Islam. Only a few months after an Islamic republic had been proclaimed in Iran, the Grand Mosque in Mecca was seized by religious extremists. In 1981, Anwar Sadat was assassinated by an Islamist organization which argued that it was its religious duty to do so since, in its view, jihad was the sixth pillar of Islam.[68] In Syria, increased activity of the Muslim Brothers resulted in the Hama massacres of 1982.[69] Throughout the mid-eighties, 'Islamic terrorism' took centre stage. A number of terrorist incidents, inside and outside the Muslim world, were traced to Islamic extremists or to one of the other 'rogue states' (at various times, the list included Iran, Iraq, Libya, Syria and the Sudan). The long-drawn hostage crisis in Lebanon, where Westerners were kidnapped by Hezbollah, a Shia party of Iranian obedience, was a daily reminder of the dangers of Islamic 'fundamentalism'. During the Gulf War of 1991, although most Islamic governments

were part of the US-led coalition, Islamic public opinion seemed deeply divided. The presence of foreign troops in Saudi Arabia, the birthplace of Islam, was especially controversial. Later that year in Algeria, the Algerian Islamic Salvation Front (FIS) was poised to sweep the Algerian parliament in the first open elections in the history of the country, when the electoral process was cut short, touching off a bloody civil war. Throughout the Islamic world, Islamic parties and organizations had burst upon the political scene. Some were part of the existing institutional and electoral system, others operated outside of it. Even secular Turkey had a year-long experience with an Islamist prime minister.

Religious sentiment though ran deeper and went beyond politics, although private and religious manifestations of Islam seldom make headlines. In reality, throughout the Muslim world there had been increased manifestations of religious sentiment that were quite diverse – ranging from demands for an Islamicization of political life to a rise in 'pietism' – and different from the Iranian model. Thus, while Hamas, the Hezbollah or the Taliban are household words, few people outside the Islamic world have ever heard of the Jamaat Tabligh which, in terms of numbers and impact, far outstrips fundamentalist organizations. According to Yahya Sadowski:

> In part precisely because it is so apolitical, governments from Tunisia to Pakistan have not only tolerated but encouraged Tabligh's spread. After putting down strong roots in India, it grew rapidly across Pakistan, Afghanistan, Bangladesh, and Sri Lanka into Southeast Asia. It is one of the three movements that led the Islamic revival in Malaysia and plays an important role in Indonesia as well. It is highly popular among Muslim minorities in the West, including America, England, and France. It has a firm foothold in parts of the Middle East as well, though it has not yet spread as widely there as in other parts of the Muslim world.[70]

Such aspects of the Islamic revival are reflected in increased emphasis upon religious observance (mosque attendance, fasting), religious programming on television, as well as dynamic daawa (missionary) movements aimed at converting non-Muslims and bringing Muslims to deepen their religious knowledge and commitment. Islam is also playing a large role in civil society. It has penetrated deeply within associations, ranging from trade unions to civic organizations to student groups, and is now part of the mainstream of society.[71]

Many reasons for such reawakening have been suggested: the vacuum left by secular ideologies, socialism in particular, which were discredited both politically and economically, as well as the moral outrage at the extent of oppression and corruption; the attempts by certain groups, especially among the lower classes and those traditionally under-represented in

government, to secure a place for themselves in the political arena; and the identity crisis and the search for roots in a world dominated by commercialism and materialism, and in settings where rapid demographic growth combined with poverty and unemployment to produce a sense of hopelessness. All those factors were intensified by economic problems and political demands. The decline in oil prices led to significant job cutbacks in oil-producing countries, falling remittances and the return home of migrant workers to dire economic conditions. Most governments, strapped for cash, embarked on austerity policies, which had the dual consequences of increasing discontent and providing Islamic movements with the opportunity to fill a vacuum. Schools and hospitals, along with a host of welfare services, were increasingly run by Islamist groups. Islam had also become, if not the language of protest, at the very least a means by which opposition could be expressed with minimal government interference.[72] Insofar as the phenomenon is multifaceted, every one of those explanations is to some degree plausible. Taken together, they explain why different groups and social classes found reasons to embrace – or return to – Islam.

Beyond the diversity of Islams (pietist or political, modernist or revivalist, quietist or activist, moderate or radical, conservative or revolutionary, pro-Western or anti-Western), there has been virtually everywhere some demand for enhancing the role of religion in political and economic life. A diverse group of countries – including secularly oriented ones such as Egypt and Yemen – have responded by upgrading the role of the Shariah in the Constitution. A standard, if usually vague, demand by Islamist groups everywhere is to Islamicize the financial system, or at the very least to allow for Islamic financial products. So typically, as banking laws are being overhauled, some provision is made to permit, if not promote, some form of Islamic finance. It is also common both for countries exposed to Islamic challenges and for newly formed or newly independent Muslim countries to announce financial Islamicization. Soon after the 1991 Gulf War, one of the first decisions of the returning Kuwaiti government was to form a committee to study changes to the constitution in order to make the Shariah 'the sole source of legislation' (rather than simply 'a main source'). A key provision was to propose an Islamic banking legislation (at the time, the Kuwait Finance House was the sole Islamic bank in the country).[73] And in the Philippines, barely six weeks after the government had signed the 1996 peace agreement with the Islamic rebels, five Islamic banks had requested permission to establish branches in the southern part of the country where a majority of the five million Muslims live.[74] Similarly, soon after Chechnya proclaimed its independence from the Russian Federation, one of the first announcements by the president of the breakaway republic was that the financial system would be Islamicized.[75]

In sum, at a time of Islamic reawakening, the toleration, if not the

promotion, of Islamic finance is for most governments a low-cost, low-risk (insofar as the details of legislation are left for experts to work out) proposition.

5.2.4 The Concern with Ethics

Morality and ethics have always been the Achilles' heel of the market economy. Just as free-market ideas and policies triumph, there is a renewed interest in ethical matters. So there is no real contradiction: the greater the triumph of the free market, the more vocal the challenge to the 'entrenched utilitarian, rationalistic, individualistic, neo-classical paradigm which is applied not merely to the economy but also, increasingly to the full array of social relations, from crion to family'.[76]

Until recently, the imperfections and the excesses of the market were addressed by law and public policy. In the US financial system the rigour of the marketplace was mitigated by strict regulation and by legislation such as the Community Reinvestment Act, the Fair Housing Act or the Equal Credit Opportunity Act.[77] Such laws required, among other things, financial institutions to go beyond considerations of profit maximization to achieve other societal goals and ensure the provision of credit to under-served neighbourhoods and groups. In recent years, many of these strictures have been relaxed. The trend towards deregulation (since 1980) has been accompanied by a search for non-legislative and non-regulatory correctives, ranging from moral suasion to the promotion of personal ethical behaviour.[78]

Examples of the renewed interest in the ethical dimension of business and finance in an era of unfettered capitalism are numerous.[79] Ethics is now a fixture of business school curricula. Companies play up their philanthropic effort and their 'social responsibility'. 'Socially responsible' funds are booming.[80] Individualism or materialism have come under attack, and ideas about 'communitarianism', 'civic virtues', 'meaning', 'corporate citizenship' and 'stakeholding'[81] have been widely promoted, by intellectuals and also by political figures, including Bill Clinton and Tony Blair. The underlying theme is that rights cannot exist in the absence of corresponding obligations, and that aggressive individualism is not a sustainable basis for any society. Individuals are called on to give their time and effort to their communities. Corporations are called on to acknowledge a wider range of responsibilities than the maximization of shareholder value.[82]

In 1997, the Philadelphia 'Summit for the Future of America' was a major media event: under the chairmanship of General Colin Powell, and in the presence of Bill Clinton and former presidents Bush, Carter and Ford, the summit emphasized the importance of volunteering, civic virtue, and community involvement as necessary to the proper functioning of a

free-market economy.[83] In such a context, religion can be an essential part of the 'matrix of culture and the institutional structures that provide a context for personal behavior'.[84] As illustrated by the slogan 'doing well by doing good', ethical behaviour can be compatible with a market economy. In the quest for a free-enterprise system that is circumscribed by moral norms and codes, religion, and Islam in particular – a religion that holds a positive view of economic activities while providing for a strict ethical framework – can play a central role.

5.3 Embeddedness, Convergence and Fusion

This chapter and the previous one have sought to show that, the rhetoric and certain analyses notwithstanding, Islamic finance is firmly embedded within the international political and economic order. The world of banking and finance is by nature status quo oriented. It craves stability and abhors uncertainty. In every new market they have penetrated, Islamic banks have typically established links with the local power structure, have operated within the political, economic and regulatory framework, and have worked within established oligopolies.[85] At the international level, the major Islamic banking groups, rather than trying to establish a global Islamic network that would rival the global banking system, are keen on remaining embedded within that system. Indeed, in its transnational operations, Islamic banking operates more out of London, Geneva or the Bahamas, than it does out of Jeddah, Karachi or Cairo. As for the Islamic Development Bank (IBD), its statutes provide for coordination and collaboration with the International Monetary Fund (IMF) and other international organizations.[86]

In the 1970s, and as summarized by Anwar Sadat, there was a 'commonality of interests between the Islamic states and the West: oil in exchange for technology and the common interest against the Soviet threat'.[87] Ideologically, both liberalism and economic Islam were driven by their common opposition to socialism and economic *dirigisme*.[88] With the elimination of the Soviet threat, a New World Order has emerged, and with the exception of a few 'rogue' states which remained at the fringes of that system,[89] most countries involved in the second aggiornamento were active participants in, and in some cases major beneficiaries of, the new system.[90] The seminal event of the New World Order was the 1991 Gulf War, and most Islamic states were part of the US-led coalition.

Geopolitical factors were reinforced by economic and business considerations. After the oil shocks of the 1970s, the 'recycling' of petrodollars was undertaken by Western, and primarily American, banks. More generally, many countries involved in Islamic finance – especially those in the Persian Gulf – belong in the 'coupon-clipper' category and have a stake in the stability of international markets, in which they are

heavily invested.[91] Paradoxically, the paucity of acceptable Islamic products has also led Islamic banks to be heavily invested in foreign currencies and to have a large percentage of their deposits abroad.[92]

The international banking system was also instrumental in the very creation of Islamic banks. The fledgling Islamic banks, lacking experience and resources, had little choice but to rely on the expertise of their international counterparts. And as Islamic banks gained experience, the world of finance was undergoing major transformations. So rather than being phased out, the cooperation with Western banks – in the form of joint ventures, management agreements, technical cooperation and correspondent banking – was stepped up, leading to increased convergence and fusion between conventional and Islamic finance.

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6

COUNTRY DIFFERENCES

In the 70-odd countries that allow them, there are infinite variations in the importance, status and characteristics of Islamic financial institutions. Their role in national economies range from essential to insignificant. Their 'special character' may or may not be recognized. In some countries they are strongly encouraged by the authorities; in others they are barely tolerated. One of the themes running through this book is the diversity of Islamic finance. Even those countries that fully Islamicized their financial systems – Pakistan, Iran, the Sudan – did so under different religious, political, economic and cultural circumstances. In most cases, Islamicization did not occur in a carefully thought-out application of Islamic principles and jurisprudence, but in an ad hoc manner and as a result of situational factors.

This chapter discusses the experience of countries that have undergone full Islamicization of their financial systems. It also examines the case of Malaysia, a country that has promoted Islamic finance alongside conventional banking, and looks at Islamic offshore banking, with a special focus on Bahrain.

6.1 Pioneers of Full Islamicization: Pakistan, Iran and the Sudan

6.1.1 Pakistan

The Pakistani experiment in Islamic banking is nothing short of contradictory. As early as the 1950s, Pakistani economists had pioneered the study of Islamic banking. And Pakistan was the first country to embark, in 1979, on a programme of full Islamicization of its economy and financial system. The Pakistani government went farther than most Islamic governments in recreating the concepts, language and institutions of early Islam. This commitment has been constantly reaffirmed since, with countless measures designed to achieve that goal. Indeed, Islamic banking is on the platform of every major political party, and for any politician, not endorsing it amounts to political suicide.[1] Yet almost 20 years after the

Islamicization had begun, a leading Pakistani economist could state: 'I don't think in the next few years [Islamicization] is going to happen. The roots of the British banking system are very strong.'[2]

The Pakistani case, pioneering as it is, is testament to the fact that situational factors can thwart the best intentions of governments. Turmoil, poverty and indebtedness have imposed sharp constraints on policy options. The British legacy had also created commercial habits and a financial culture that could not be undone by reform. In addition to being interest-bearing, the heavy foreign debt – some $32 billion in 1998 – meant that the IMF and other foreign creditors had a say in how the economy was managed.[3]

Pakistan is a young country. Even the idea of a separate state for Indian Muslims is relatively recent. For decades, there had been a common Hindu–Muslim independence movement sparked by anti-British sentiment. But in 1930, Muhammad Iqbal (1875–1935), the poet and major figure of Islamic reform, started calling for a Muslim homeland. And since 1940, Muhammad Ali Jinnah (1876–1948), the thoroughly Westernized leader of Indian Muslims, and his Muslim League Party championed the cause of Muslim nationalism. In 1947, the British departed, India was partitioned, and the independent state of Pakistan was born. Pakistan thus constituted both a rejection of a multiconfessional, secular India and an attempt to recreate an Islamic order after a long period of Western colonial rule. The country's name was both an acronym of some of the regions that were carved out of India to create the new state, and a word in Urdu, Pakistan's principal language, that meant 'land of the pure'. The founding fathers were secular, Westernized people who were nonetheless intent on creating an Islamic state.

The task was complicated by the huge problems facing the new state: the population transfers and civil strife that followed the partition, the consistently troubled relations with India with whom Pakistan fought three wars, etc. In addition, there was still a well-entrenched British influence and a lack of consensus about the kind of Islam that should be adopted. For not only does Pakistan have a substantial Shia community (accounting for 20 per cent of the population), but even the Sunni majority (75 per cent) is divided among three major sects and dozens of amorphous groups, making a consensus on the interpretation of Islam nearly impossible.

Still, all the successive leaders of the country have reaffirmed the Islamic character of Pakistan, and their desire to harness Islam to the goals of economic growth and modernization. In 1949, the Constituent Assembly defined Pakistan as a state where 'the Muslims shall be enabled to order their lives in the individual and collective spheres in accord with the teachings and requirements of Islam as set out in the Holy Quran and the Sunna'. It declared that 'sovereignty over the entire universe belongs to God Almighty alone' and that therefore authority would be exercised by

the people of Pakistan only 'within the limits prescribed by Him'. The new country was an 'Islamic Republic', that would build itself a capital city called Islamabad.

At times, leaders felt stifled by traditional religious interpretations. Thus Mohammed Ayub Khan, who came to power in 1958, set out to 'liberate the spirit of religion from the cobwebs of superstition and stagnation which surround it and move forward under the forces of modern science and knowledge'. He once stated: 'The miracle of Islam was that it destroyed idolatry, and the tragedy of Muslims has been that they rendered religion into the form of an idol'.[4]

Throughout the 1970s, Pakistan drew closer to the Islamic world, and particularly to Saudi Arabia.[5] Interestingly, most of these developments occurred under the rule of Prime Minister Zulficar Ali Bhutto, whose name is usually associated with socialism and secularism, but who nonetheless made increasing use of Islamic language and symbolism. The country received significant amounts of aid – in addition to growing labour remittances – from oil-producing countries, and became one of the most active members of the OIC (Organization of the Islamic Conference). In 1977, the military, led by Zia ul-Haq, seized power with the support of Jamaat-i Islami, the country's best-organized and strongest religious party. In a televised address to the nation on the day of the coup, the new leader, who remained in power until his death in 1988 in a mysterious plane crash, praised the 'spirit of Islam' that had inspired the opposition to the Bhutto regime, concluding: 'It proves that Pakistan, which was created in the name of Islam, will continue to survive only if it sticks to Islam. That is why I consider the introduction of an Islamic system as an essential prerequisite for the country'.[6]

In 1979, Zia appointed a 12-member committee of 'scholars, jurists, ulema, and prominent persons from other walks of life' to formulate recommendations for the structure of an Islamic government system.[7] The recommendations included the creation of a new Islamic economic order, the substitution of traditional Islamic laws and punishments for inherited Western codes, and the creation of a pure Islamic form of government designed to serve as a model for other Muslim states.

The first phase of economic reform (1979–85) had three significant components. The zakat (almsgiving) – a 2.5 per cent percent per annum levy on savings accounts, various kinds of bank deposits, unit trusts, government securities, corporate shares and debentures, annuities, life insurance and other comparable assets – would be distributed through an elaborate voluntary system of zakat committees at federal, state, and village levels. They in turn would channel the money collected to benefit the 'mustahaqueen' (the deserving), or those living below the poverty line. The ushr (literally, tithe) would be imposed at a rate of five per cent on all agricultural produce above a certain level. The hope at the time was that it

would raise enough revenue to allow abolition of income tax and to reduce the corporate tax, thereby releasing pent-up entrepreneurial energies to the benefit of the country's economic development. The third component was the partial Islamicization of the banking system through the introduction of private-and-loss sharing (PLS) accounts. In theory, it meant that deposits would be invested by lending institutions in a productive business. If the investment turned out to be profitable, then the depositor would share in the proceeds. If it posted a loss, he would receive no return, although the original deposit would not be affected.

Such measures did not go without political controversy. The introduction of zakat caused an outcry among Pakistan's Shia minority, who objected to its being collected and distributed through the state, as opposed to through their own ulemas. Following riots in Islamabad, the government gave ground, allowing Shia groups to collect and distribute the zakat on their own. Overall, there was scepticism that the new Islamic taxes would truly alleviate poverty, or that the creation of profit-and-loss sharing windows, opened in all 7,000 branches of domestic banks, would create a qualitatively different banking system (a 'profit and loss sharing project' instead of a fixed-predetermined interest), or that it would draw the amounts hoarded by pious (or suspicious) peasants into the banking system.

Pakistan was also the first country to revive the old Islamic institution of hisbah, the office that supervised markets, provided municipal services and settled petty disputes. But in its new incarnation, the office had the much more limited role of protecting ordinary citizens against administrative wrongs.[8]

In December 1984, the Pakistani government called on all five nationalized Pakistani banks and 17 foreign banks operating in the country to submit proposals of more 'godly and brotherly' ways to generate profits. In the second phase of Islamicization, which was implemented through a series of measures imposed between January and July of 1985, interest was outlawed. In reality however, huge loopholes remained, and the successive governments, despite their official commitment to interest-free banking, proved quite pragmatic in their actions. Foreign currency deposits, foreign loans and government debt continued to function on the basis of interest. Overall, the Pakistani authorities took care to ensure that the new modes of financing did not upset the basic functioning and structure of the banking system. As a result, the exceptions proved more significant than the rule: the (interest-bearing) government debt was four times larger than the private sector's debt,[9] and about 80 per cent of domestic deposits were denominated in foreign currencies, which allow interest payments, and the rest in rupees, which do not.[10]

The government has thus been caught between two sets of conflicting forces. On the one hand, religious groups as well as a large domestic constituency had been calling for Islamicization. On the other hand, however,

Pakistan carries a long tradition of conventional, interest-based banking, and has been under pressure by the IMF and other foreign creditors to privatize its banking sector and liberalize its economy. The alliance between the military, which was committed to a policy of neo-liberalism, and the main religious party had been fraught with ambiguity. In the words of one scholar:

> Aside from abstract notions about the shape and working of the ideal Islamic state, the party had little to offer in the way of suggestions for managing its machinery. Its notions about the working of Islamic dicta in economic and political operations provided Zia with no coherent plan of action. Just as the Jama'at became disappointed with the politics of Zia's regime, so the general became disillusioned with the practical relevance of the Jama'at's ideas.[11]

In 1992, the country's Federal Shariah Court ruled that interest paid or charged by banks and other financial institutions was un-Islamic. The government was given a few months to amend its financial laws accordingly, otherwise the existing laws would 'cease to have effect'. (The government appealed the decision.)[12] Still, the government maintained its theoretical commitment to the elimination of riba. In January 1998, it decided 'in principle' to eliminate riba from the economic system of the country.[13] These conflicting pressures occurred at a time when a third of the four public banks' assets were non-performing and 30 per cent of their branches were unprofitable. Most Pakistani banks were also seriously overstaffed: by some estimates, they had twice as many employees as they needed.[14]

One of the useful lessons of the Pakistani experiment concerns the ways banks, businesses and individuals responded to Islamic finance. Profit-and-loss sharing was mostly shunned by banks, where 90 per cent of transactions consisted of mark-up schemes.[15] The new system also gave rise to questions of 'Islamic moral hazard', with many Pakistani businessmen taking advantage of the new laws to reduce their outstanding debts.[16] More generally, risk aversion and preference for the short term accounted for the behaviour and demands of bankers, businessmen and depositors.[17]

A recent appeal to reduce the country's debt has illustrated the persistent preference for fixed, pre-determined remuneration of capital. In a country where only 1 per cent of the population pays income taxes, meeting foreign debt payments had been a chronic problem. In 1997, in an attempt to make interest payments on its $30 billion foreign debt, Prime Minister Nawaz Sharif established a National Debt Retirement Scheme which gave Pakistanis three ways to participate: simply giving money to the government; lending it with zero interest; or, depositing it in an account earning from 7.5 per cent to 9 per cent 'profit'. The plan was launched amidst much hoopla. Newspapers were filled with ads from companies boasting of their contributions, and Nawaz Sharif himself contributed

$250,000. Yet the result – which was short of the $2 billion expected – showed that over 75 per cent of the money had gone into the interest-bearing accounts, which meant that the government had merely traded one kind of loan for another.[18]

All the preceding explains why most analysts have concluded that the experiment failed to live up to its billing. One Islamic banking specialist criticized the belief 'that the simple statement by a Muslim government that its banking system is Islamic suffices to make it so'.[19] Others have argued that the changes introduced in Pakistani banking 'were nominal, not substantial', that the process of Islamicization 'had lost its sense of direction' or that it 'was put in reverse gear'.[20]

6.1.2 Iran

There were two distinct phases in the history of revolutionary Iran. In the early years (1979–88), three factors were decisive: first, the desire to achieve economic independence and mark a radical break with the Shah's economic policies; second, the need to resolve the ideological struggle between conflicting strands – conservative/free market on one side and populist/socialist on the other – of the coalition that brought about the revolution; and third, the need to consolidate the revolution at a time of war against Iraq. In recent years (roughly since 1989) the challenges have been different, and the economic debates centred around new issues: reconstruction and its financing, oil production and sales, and the integration of the country within the global economy. During both periods, banking issues were rather secondary, and seldom rose to the level of 'high politics'.

At the time of the Islamic revolution, it was inevitable, given Iran's history, that economic nationalism would take centre stage. Since the late nineteenth century, foreigners (initially the British and to a lesser extent the Russians, and later the Americans) had been perceived as having exploited the country to their own benefit (the tobacco and later the oil concessions being among the most visible examples) and of having exerted undue influence on Iranian politics. The circumstances of the removal of Mossadegh and the role played by the US Central Intelligence Agency (CIA) in the return of the Shah in 1953 still loomed large in the Iranian psyche. The close military and economic ties between the Shah and the United States during the years of the oil boom were a major factor in the revolution. The hostage crisis (November 1979–January 1981) and the subsequent freezing of $10 billion in Iranian assets in the US fed anti-West attitudes.

Another peculiar feature of the Iranian situation was the strong leftist leanings of one segment of the revolutionary coalition. The Communist Party (Tudeh) was a long-time opponent of the Shah, and a myriad groups

(most significantly the Mujahedeen-e Khalq) embraced left-leaning, sometimes Marxist, ideologies. One of the main actors of the revolution was Abul-Hasan Bani-Sadr, a French-educated economist, who was an aide to Khomeini in his exile and later became the first elected president of the Islamic republic (1980–81). Although associated during his short presidency with the moderate camp, his writings had a distinct Marxist flavour. Shortly before the revolution, he had written an analysis of the 'economics of towhid' (Eqtesad-e Towhidi), which fused the theological concept of towhid (the oneness of God) with a populist political–economic interpretation. Except of course for its religious component, the analysis rejoined the 'final Communist' stage predicted by some Marxist historians.[21] This was bound to provoke a clash with advocates of an Islamic Third Way, among clerics influenced by the writings of Mohammed Baqer as-Sadr,[22] and with the advocates of a more conventional 'laissez-faire' or market economy, who were primarily Western-trained economists supported by economically conservative segments of the coalition – primarily the high clergy and the Bazaar.[23] Yet given the circumstances of the revolution, it was clear that anything marking a break with the policies of the Shah's regime would prevail.

The early assertion of economic nationalism took many forms. The vast holdings of the Shah and his entourage were confiscated and taken over by Islamic foundations. Banks were nationalized. In the new Constitution, Article 77 provided that all international treaties, conventions, contracts and agreements had to be approved by the Majlis (Parliament), and Article 81 stated that 'granting of concessions to foreigners for the establishment of companies or organizations in the commercial, industrial, agricultural, mining and service fields' was strictly forbidden.[24] A reinforcing factor was the Iran–Iraq war (1980–8), which justified the centralization of economic decision-making and led to the consolidation of statist, command-economy-style allocation mechanisms: price controls, rationing of goods, quantitative regulation of imports, etc.[25]

Two contentious economic issues took centre stage and dominated the first decade of the revolution: the nationalization of foreign trade and the issue of land reform. The Revolutionary Council which was captured early on by the radical clergy introduced in April 1980 a land reform bill, designed to transfer ownership of 'temporary cultivation agricultural land' (land seized by peasants and by revolutionary organizations in the immediate aftermath of the revolution) from the owners to the cultivators actually working the land.[26] It took over six years for the majlis to approve the bill, in a controversial and contested vote. The resolution of the issue was complicated by the power structure of Iranian politics. The parliament was dominated by populists, but its decisions could be overridden by the Council of Guardians (a body of senior Islamic jurists and experts on Islamic law), who firmly believed in private property. Conflicts between the

two bodies were typically arbitrated by the Ayatollah Khomeini in his capacity as supreme ruler. The policies were all the more inconsistent and contradictory in that Khomeini's decisions tended to go back and forth between populism and liberalism.[27]

By the end of the first decade following the revolution, the Iran–Iraq war had ended (1988) and the Ayatollah Khomeini had died (1989). A number of constitutional and institutional changes occurred, transforming power relations. For example, the velayet-e Faqih position, tailor-made for Khomeini, was weakened. Ending Iran's isolation, rebuilding the infrastructure and resuming oil exports were the new priorities. The power struggle was now between the 'ideologues' who sought to preserve the orientations of the early years of the revolution, and the 'pragmatists' who sought to loosen the grip of the government and improve ties with the outside world, the US in particular.

On economic matters, the pragmatists scored a few points at a time when foreign loans and foreign investment (especially in the oil sector) were sorely needed. Article 81 which stated that all forms of foreign loans, investment and participation were forbidden was reinterpreted by the Council of Guardians to mean that 'contracts where one party is a ministry or a government agency or company and the other party is a private foreign company, are not considered international contracts and are not subject to article 77 of the constitution'.[28] Another aspect of Iran's opening to the outside world was related to the implosion of the Soviet Union. A number of ethnic groups in newly independent states of Central Asia had ethnic, linguistic or historical ties to Persia, and Iran saw all the religious, political and economic advantages that closer ties with these countries or some of their ethnic groups could bring, at a time when Russia, the United States, Turkey and Saudi Arabia were all seeking to consolidate their own positions in the region.

Financial policy reflected the broader evolution of Iranian politics. Soon after the revolution, the banking industry had been nationalized and consolidated through a vast movement of mergers. The 1983 Usury-Free Banking Act phased out over a three-year period interest-based practices. But bank policy was strictly dirigiste. The amounts of credit and foreign exchange available to banks were rationed by the main regulatory authorities, the Central Bank, as well as the Supreme Council of Banks (a body whose members include the governor of the Central Bank as well as other government officials). And since interest rates were eliminated, the profit rate became the main policy instrument: a ceiling on profit rates was imposed. But as was the case in other countries that had Islamicized their banking systems, interest-based finance was not completely eliminated. Overseas banking operations for example continued to operate on the basis of interest,[29] and, as the next paragraphs show, informal and semi-informal interest-based finance has thrived.

One of the lessons of the Iranian experiment is that certain religiously motivated reforms can give rise to even worse religious transgressions. Riba may have been eliminated in theory, but a much higher interest rate has appeared in disguised form in informal markets. The world of Iranian finance has become more speculative than it has ever been before. Fraud is rampant and seldom sanctioned. And one of the more curious elements of the official banking system is the proliferation of lotteries and randomly offered gifts (thus raising religious issues related to maysir and gharar) as a means of encouraging savings accounts.

More specifically, the tight regulatory framework was conducive to the growth of the informal sector. Some 1,300 Islamic credit funds have become essentially 'usury stores'. Under the aegis of the Bazaar, they were federated into an 'Organization of the Islamic economy', offering annual 'profit participation' rates in the 25 to 50 per cent range.[30]

The powerful foundations, which now possess the Shah's assets, function outside of any substantive governmental control. By one account, 'the ability of the Central Bank of Iran to tax the Bonyad-e Mostazafan (Foundation of the Oppressed), or to monitor its foreign-currency flows – let alone audit its activities – is close to nil'.[31] An unregulated financial market, administered by Bazaaris, has filled the gaps opened by official banking restrictions. Abuses have been common, and a number of financial scandals have been discovered.[32] The most massive fraud occurred between 1992 and 1996. Some $4 billion disappeared and the primary suspect was Morteza Rafiqdoust, younger brother of the head of the Bonyad foundation.[33]

In the 1990s, the government moved towards greater financial liberalization. Many controls were loosened, especially in relation to foreign exchange.[34] The Supreme Council of Banks, which had previously set a uniform profit rate for all banks, now allowed banks a broader margin of profit and allowed them to increase their 'fees' and the various forms of remuneration of deposits.[35] Another significant development was the establishment of 'special economic zones' in the southeastern, northern and northeastern parts of the country. Free-trade zones were set up on the islands of Kish and Qeshm, and in Chabahar in the Persian Gulf. Iran expected to attract $5 billion in foreign investment. As of early 1998, 14 foreign banks, including banks from the United States and Switzerland, have expressed interest in establishing banking subsidiaries in those free-trade zones.[36]

6.1.3 The Sudan

The largest in Africa, this country of 35 million inhabitants has in the past two decades been buffeted by political turmoil, famine and civil war. When it became independent in 1956 (it had previously been ruled as an Anglo-Egyptian condominium), the Sudan was deeply divided geographically,

religiously and politically. Straddling the Arab world and Africa, the country had a significant (estimated anywhere between 30 and 40 per cent) minority of Christians and animists, living mostly in the south. In its institutions and legal system, the British influence was pervasive. Culturally and to a large extent politically, Egypt exerted a dominant influence. Both the Communist Party and the Muslim Brothers were well entrenched.

When they seized power in 1969, Jaafar al-Nimeiri and his 'Free Officers' appeared to follow the model of the 1952 Egyptian revolution. Nimeiri looked up to Nasser and seemed poised to emulate his populist and socialist model of government. An attempted coup by the Communists in 1971 led to significant changes. Increasingly, and in a striking parallel with the evolution of neighbouring Egypt, Nimeiri turned against his leftist allies, became an ally of the United States and Saudi Arabia, and sought to improve relations with Islamist groups. Over the years, the once secular Nimeiri became increasingly religious. Some have claimed that his newfound religious zeal was genuine, and had started after he narrowly escaped death in an assassination attempt. Others have argued it was a tactical move designed to consolidate his hold on power. Regardless of the causes, his displays of piety were innumerable. He led prayers in mosques, and he seemed intent on Islamicizing all aspects of Sudanese life. The constitution of 1973 stated that 'Islamic law and custom shall be the main sources of legislation'. As part of this policy, Nimeiri appointed a committee for the 'Revision of Sudanese laws to bring them in conformity with Islamic teaching'.

In 1978 Nimeiri signed the National Reconciliation Pact, which enabled the Islamic opposition to return to public life. Islamic political parties were able to compete successfully for parliamentary seats in national elections. The Muslim Brothers became closely associated with the new government. Hassan al-Turabi, the Sorbonne-educated leader of the Brotherhood and former dean of the University of Khartoum Law School, was appointed to the post of Attorney General in 1979. Since that time, Turabi seems to have built his power base, eventually becoming the dominant figure of Sudanese politics, in part thanks to his involvement in the Faisal Islamic Bank of Sudan, which had been created in the late seventies, simultaneously with the Faisal Islamic Bank of Egypt.[37] Both countries had then extended significant exemptions and privileges to the Saudi-financed institution.[38]

The process of Islamicization culminated with the proclamation, on 8 September 1983, of an 'Islamic revolution' that would impact Sudanese politics, law, and society. These 'September laws' caught everyone by surprise. Sadiq al-Mahdi, a former prime minister and the Oxford-educated great-grandson of the Sudanese Mahdi (the Islamic revivalist reformer who had driven out the British and established an Islamic state in the Sudan in the 1880s), dismissed Nimeiri's 'Islamic' September laws as opportunism, arguing that the imposition of Islamic law was premature and unjust, since

such laws required first the creation of a more socially just society.[39] The most dramatic and controversial aspect of the legislation was the imposition of hudud (punishments such as dismemberment and death by stoning). Even Turabi, who was then in charge of revising the Sudanese laws to ensure their conformity with the Shariah, was surprised by the legislation and found the penal code too harsh, though he later embraced it.[40]

In the following months, new guidelines were enacted for banking and taxation. In December 1983, the entire banking system, including foreign banks, was Islamicized, and interest was outlawed. By one account, 'Nimeiri timed this to outflank the traditional religious and political leaders and cultivate the allegiance of the Muslim Brothers, the only political group still supporting him.'[41] The Zakat Tax Act of 1984 replaced much of the state's taxation system with Islam's alms tax: the government was empowered to levy, collect and distribute what had been a voluntary alms tithe. Other Islamic banks were created, mostly specialized by region and by sector. The specifics of Islamic banking legislation were inconsistent, since the process of Islamicization was erratic, and in a poor, isolated and heavily indebted country, careful ijtihad on banking matters was far from being a high priority.

In early 1985, a year and a half after the September laws, Nimeiri turned against the Muslim Brothers, accusing them of plotting to overthrow him, and arrested more than 200 of their leaders, including Turabi. But it was not long before he himself was overthrown. It happened in April 1985, while Nimeiri was on a visit to the United States. Elections were held in 1986, and a new government led by Sadiq al-Mahdi came to power. It suspended the application of Islamic law, and restored the criminal court system based on civil codes inspired by the British–Indian tradition. Another coup led by a coalition of military leaders and Islamists took place in June 1989. Hassan al-Bashir was the leader of the coup, but effective power was exercised by Hassan al-Turabi, now Speaker of Parliament. Once the voice of moderate Islam, Turabi grew more radical. He established close ties with Iran, leading some to speculate about the emergence of a Khartoum–Tehran axis. In 1991, the Shariah was reintroduced in all the northern provinces, where they would apply to Muslims and non-Muslims alike.

The ups and downs of Islamicization can be explained by the chaotic situation of the country, the presence of non-Muslims (who objected to the application of the Shariah and had been in rebellion against the government since the early eighties), the divided nature of Sudanese Islam (with a strong sufi tradition at odds with the more politicized and sometimes radical Islam of the National Islamic Front) and by outside influences (of Egypt, Libya, Saudi Arabia, the United States, the International Monetary Fund and the World Bank) – all against a backdrop of economic disintegration.

The same erratic patterns prevailed in the country's relations with the West. For most of his years in power, Nimeiri enjoyed close relations with the United States. But the government's violations of human rights during the civil war resulted in suspension of US aid. In 1985, during a visit to the Sudan, then-Vice President George Bush reportedly obtained four conditions in exchange for the resumption of aid: discontinuation of the hudud, dismissal of Islamic activists from the government, halting contacts with Libya and acceptance of reforms demanded by the IMF.[42] In the 1990s, the Sudan was added to the list of countries supporting terrorism, and was subjected to a US bombing in 1998 (on the grounds that the Sudanese regime had ties to Usama bin Laden).

The relations with the IMF were also marked by a familiar cycle: suspension of aid, promises of reform followed by partial reform, resumption of aid, unrest followed by a halt in the application of IMF policies, suspension of aid. In 1990, the IMF took the unusual step of declaring the Sudan non-cooperative because of its non-payment of arrearages to the Fund. In 1992, the IMF threatened to expel the Sudan from the Fund. In response, the government administered shock therapy to the economy, devaluing the Sudanese pound, lifting price controls, and ending government subsidies, including those destined to the poorest regions of the country. The main architect of the policies, Economics Minister Abdul Rahim Hamdi, formerly an Islamic banker, justified the policies by saying: 'The population accepts these hardships, because it supports Islam and us'.[43]

6.2 The Special Case of Malaysia

Two features set Malaysia apart from other countries discussed in this chapter: first, the creation of an Islamic banking system functioning alongside the conventional one; and second, the harnessing of Islam to the goal of economic growth through the embrace of high technology and finance.

Malaysia, a multicultural country of 20 million people, with 30 ethnic groups and subgroups in 13 states, has three distinct ethnic/religious communities: 61 per cent of the population are bumiputras, 30 per cent are Chinese and 9 per cent are Indian. Most Malays are Sunni Muslims, although there is also a small Shia minority. For generations, the Malaysian economy had been controlled by minority communities (Chinese and to a lesser extent Indians). Except for a small Westernized elite, the Malays, or bumiputras, literally 'sons of the land', kept to their villages and were excluded from business life. At the time of the Malaysian independence in 1957, a deal was struck whereby in exchange for citizenship for the Indians and Chinese, the bumiputras were given political supremacy. Malay became the official language, and Islam the state religion. Ever since, politics and economics have been largely structured along religious and racial lines.

Following riots in 1969, the government adopted in 1970 a New

Economic Policy (NEP) which provided a host of preferential policies for bumiputras: quotas in universities, housing, government jobs, government contracts, etc. This massive 'affirmative action' program was designed to increase the Malay share of corporate wealth from 2.4 per cent in 1970 to about 30 per cent in 1990.

By 1990, when the government undertook a review of the NEP, significant progress had occurred, although it fell short of the 30 per cent objective. According to government statistics, the country's accomplishments were many: the percentage of the population living under the poverty line dropped to around 8 per cent in 1995 from 60 per cent in 1970; literacy rates exceeded 85 per cent and life expectancy became comparable to that of developed countries. The share of wealth of the bumiputras had increased to 20 per cent and the country had achieved a remarkable economic transformation. The main architect of the transformation of Malaysia from agricultural backwater to Asian 'tiger' was Mahathir Mohammed, a physician who became Prime Minister in 1982. In addition to persevering in the giant 'affirmative action' programme designed to benefit the Malays, his grand ambition was to turn Malaysia into a rich country by the year 2020. Throughout his rule, there was no shortage of grandiose projects, such as the Multimedia Super Corridor outside the capital of Kuala Lumpur, where the twin towers of the world's tallest building symbolize the country's ambitions.[44] Until the 1997 Asian economic crisis, Malaysia was a 'model' economy, with a thriving middle class and growth rates approaching double digits.

Islam was to be a key part of the government's ambitions. In that respect, the Malaysian brand of Islam does not fit typical Western perceptions and stereotypes. It is fused with other influences (nationalism, capitalism, 'Asian values') producing a unique ideology of development.[45] Rather than being an obstacle to change, religion was to be an engine of growth and modernization and a tool to promote financial innovation. An Islamic financial system that could offer a growing array of sophisticated financial services was part and parcel of the effort to turn Kuala Lumpur into a leading regional, if not international, financial centre.[46]

The role of religion in Malaysia is a study in paradox: the system of government is secular, yet Islam is ever-present; the constitution recognizes the primary position of Islam, but it also guarantees freedom of worship for other religious groups. The dominant political party is wholly Malay and therefore Muslim. The justice system consists of civilian courts which are administered centrally, and separate Islamic courts answerable to local state authorities. The Malaysian brand of Islam is pragmatic and tolerant, yet strict traditionalists are a political force. The northeastern state of Kelantan, for example, is controlled by the Parti Islam Se Malaysia, an opposition party whose ideology is traditional if not reactionary. On a number of occasions, Shia militants were imprisoned on the grounds that

their teachings could divide society and trigger violence between sects. By most standards, the brand of Islam promoted by the government is a modernist one, although some of the most prominent political figures (such as one-time Deputy Prime Minister Anwar Ibrahim) were at one time considered 'fundamentalists'.[47]

Malaysia is a nation in a hurry, and on numerous occasions, Mahathir has shown impatience with ulemas arguing over the fine points of religion rather than putting religion at the service of developmental goals. He accused them of being dilatory, inconsistent, or too harsh.

According to Mahathir: 'Only when Islam is interpreted so as to be relevant in a world which is different from what it was 1,400 years ago can Islam be regarded as a religion for all ages'. More specifically, he objected to those who wanted to interpret the Koran too literally. For him, the tolerant, forgiving spirit of religion should be the starting point.[48] Or in the words of his one-time heir apparent (later disgraced), Anwar Ibrahim, 'In implementing Islamic principles in banking and finance, we must address substantive issues rather than be always preoccupied with terminology and semantics.'[49] A recurring theme in speeches and publications was that hard work was a form of 'jihad'.[50]

The ulemas were challenged to a new 'ijtihad': rather than be content with the imitation of existing models, they were asked to adopt a more innovative approach, exploring the wide array of Shariah concepts that had not even been tested. They were also encouraged to look at the state-of-the-art in global finance, and create corresponding Islamic products.[51] The only products to be excluded were those that went explicitly against Islamic beliefs.

A number of Islamic research centres and universities engaged in a vast effort to legitimate modern finance, and in particular to create an 'Islamic capital market' that would use specially designed interest-free bonds and other securities. The International Islamic University opened a management school. The Malaysian Institute of Islamic Understanding (IKIM) held seminars on all aspects of religion and finance. The message was that industrialization and productivity were fully compatible with piety, and that welfare in this world was fully compatible with salvation in the next.

In order to avoid bickering among rival schools of Islamic thought, Mahathir established in 1997 a National Syariyah (Shariah) Board designed to harmonize financial practices and review the compatibility of new financial products with religion. In a statement, Bank Negara Malaysia (BNM), the country's central bank, said that it would be 'the sole authoritative body to advise BNM on Syariyah issues pertaining to Islamic banking and takaful (insurance) operations'.[52] The Board was also to play a key role in establishing Malaysia's credibility as a hub for Islamic products.

The contrast with other countries is clear. Malaysia has not sought full Islamicization but has implemented a parallel system, with Islamic banks

operating alongside conventional ones. It was a two-pronged policy designed to promote Islamic finance, and to turn Kuala Lumpur both into an international Islamic finance centre and a key conventional regional finance centre that would compete with Hong Kong or Singapore. In addition, Labuan would become an International Offshore Financial Center with a focus on Islamic products. Importantly, Islamic banking was not limited to providing special or exceptional treatment to certain banks in order to placate or co-opt certain groups. Rather it was a principal tool in the country's developmental policy, and was designed to form the vanguard of financial modernization. A number of privileges, for example greater flexibility with respect to their liquid asset holdings, were given to Islamic banks.[53]

Islamic finance cannot be separated from Malaysia's New Economic Policy (NEP), from the promotion of Kuala Lumpur as a financial centre and from the effort to enhance the role of bumiputras in the economy. The first experiment in Islamic finance can be traced back to the Muslim Pilgrims Savings Corporation, which was set up in 1963 to help people save for performing haj. In 1969, it evolved into the Pilgrims Management and Fund Board, or the Tabung Haji as it is now popularly known. In 1983, Parliament passed the Islamic Banking Act, which created Bank Islam Malaysia Berhad (BIMB), a full-fledged commercial bank, controlled by the government and in which the Tabung Haji had a 12.5 per cent participation. The bank's memorandum of association stated that 'all businesses of the company will be transacted in accordance with Islamic principles, rules and practices'. The bank has been at the forefront of financial innovation. In 1985, it set up Syarikat Takaful Malaysia, which it touted as the world's first Islamic insurance company. (In reality, other Islamic insurance companies have claimed precedence.)[54] In 1990, it issued Islamic corporate bonds. The bank also introduced Islamic Acceptance Bills and an Islamic export credit refinancing facility. In 1993 Malaysia took a further pioneering step when it introduced its dual banking system. Conventional banks were allowed to offer Islamic banking services. A bank could thus have under the same roof two windows, one for conventional banking operations, the other for interest-free transactions.[55] Throughout the 1990s, the government was also very active in encouraging the creation of Islamic products ranging from insurance to bonds, introducing a secondary market for banking products, and promoting an Islamic capital market in Kuala Lumpur whose products and practices mirrored conventional capital markets. In January 1994, the Islamic Interbank Money Market (IIMM) was introduced. Islamic unit trusts (IUT), Islamic debt securities (IDS), and Islamic commercial paper were created alongside an Islamic interbank and cheque-clearing system. The introduction of indices and benchmarks – such as the RHB Islamic Index, which tracks the performance of listed companies that do not contravene Islamic principles or

the minimum benchmark for Mudaraba interbank investments, by which a bank obtains an investment from another on a trustee profit-sharing basis – were other steps taken to promote credible capital markets, which Malaysia has in recent years perceived as being its primary competitive advantage in relation to other Islamic financial centres.[56]

Malaysia encouraged its Islamic bankers to try to become global leaders by offering home mortgages and a wide array of financial services to consumers. It was the first country to introduce Islamic mortgage bonds. Since 1994, mudaraba bonds can be used to purchase housing loans from Bank Islam Malaysia Berhad (BIMB). The bonds are based on the profit-sharing principle, with the profits generated shared according to an agreed ratio.[57] One institution, Arab-Malaysian Bank, engaged in an aggressive marketing of the country's first Islamic credit card – an interest-free Visa card on which users can charge an amount equal to their deposits in the bank for a fee that is a percentage of their annual spending. The bank said it would reject payments for night clubs, massage parlours and other religiously forbidden activities.[58] Another singular characteristic of the Malaysian system is that Islamic products were geared to Muslims as well as to non-Muslims. Muslims would have the opportunity to invest according to their religious beliefs, while non-Muslims, especially the Chinese minority which controls most of the country's wealth, would have an extension of choice in money-management.[59]

Constant financial innovation was justified by the need to remain ahead of the pack. Financial products are easy to imitate, and Malaysian leaders felt that other Islamic financial centres were closing in on them.[60] But conservative scholars, mostly outside Malaysia, considered that it was going too fast, and that in its rush to grow, Malaysian finance was cutting too many corners. One of the most controversial issues was that of the dual-window strategy. Even in the definition of acceptable products, Malaysia was considered too lax.[61] For example, call warrants were deemed acceptable so long as the underlying shares were halal.[62] In other words, complex new financial instruments were given the benefit of the doubt.

Significantly, in addition to catering to non-Muslims, many Islamic institutions were also managed by non-Muslims. And among the pioneers of Islamic finance were foreign institutions such as United Kingdom-based Standard Chartered Bank. In mid-1997, at the time of the Asian financial crisis, Malaysia had 25 commercial banks, 22 finance companies and five merchant banks that offered Islamic banking services. But Islamic assets still represented only 2 per cent of total financial assets. For the year 2000, the Central Bank anticipated that the share would reach 5 per cent.[63] It is unclear how the economic crisis of 1997–8 will affect Islamic finance. The banking sector is in need of rescuing. Particularly exposed is Bank Bumiputra Malaysia, which is 100 per cent state-owned and has already been rescued twice in the last two decades.[64] Once the darling of the

international financial community, Malaysia's reputation has been tarnished since the crisis. The NEP has come to epitomize 'crony capitalism' – the systematic preference given to bumiputra companies at the expense of Chinese ones. A number of political and economic decisions – such as the arrest of his deputy Anwar Ibrahim and the imposition of capital controls – have further isolated Mahathir, casting doubt on the future of Kuala Lumpur as an international banking centre.

6.3 Offshore Islamic Centres: The Case of Bahrain

At the outset, a distinction should be established between those offshore banking centres such as the Bahamas, that are welcoming of any and all foreign banking institutions, and those financial centres within Islamic countries that aim to compete regionally by playing the Islamic banking card. In Malaysia, the Labuan offshore centre has been created to play such a role. In the Persian Gulf, the United Arab Emirates (in particular Dubai and Abu Dhabi) have stepped up their involvement in Islamic finance. Qatar under its new, modernizing, ruler has attempted to step out of its financial isolation by promoting a policy of greater integration in the regional economy and by authorizing the establishment of an offshore banking centre. But it is Bahrain that is today by far the leader in offshore Islamic banking.

Bahrain is the smallest country of the Gulf Cooperation Council, the first where oil was discovered (in 1932) and the first about to run out of oil. As part of its policy of diversification away from oil, the country rulers have been focusing on financial services. Since its establishment in 1973, the Bahrain Monetary Agency (the successor of the Bahrain Currency Board) has been promoting the country as an international financial centre. It has been encouraging major international financial institutions to use Bahrain as their regional base, by touting a number of competitive advantages: a strategic geographic location, a tax-free environment, a skilled workforce, a pragmatic economic policy, a clearly defined legal and administrative framework, a well developed infrastructure, state-of-the-art telecommunications, a convertible currency, a liberal trade regime, and the absence of restrictions on foreign exchange.

Among Bahrain's selling points to the international financial community are its financial focus and the quality of its regulatory system. Bahrain was one of the first countries outside the G10 to impose the Basle capital ratios, and Bahraini banks have maintained an average capital asset ratio in excess of 10 per cent, above the mandatory eight per cent ratio. In 1997, best practice guidelines were issued, modelled after the United Kingdom. All Bahraini banks are expected to comply with the International Accounting Standards (IAS). Locally incorporated banks are required to publish their financial statements on a quarterly basis. The Bahrain Stock

Exchange (BSE), currently capitalized at over $7 billion, is one of the most dynamic in the region, and is heavily weighted (about 75 per cent) towards financial stocks. It is open to cross-border listing of regional and international stocks, bonds, and mutual funds and financial derivatives. It has cross-listing accords with Kuwait, Oman and Jordan. Foreign investors are allowed to buy shares in five listed stocks (ABC, Bahrain International Bank, Investcorp, Bahrain Middle East Bank, and Trans Arab Investment Banks). Also, more than 370 mutual funds are authorized to market their products in and from Bahrain. As of August 1998, Bahrain had 19 onshore banks, 32 investment banks and 48 offshore banking units (OBU) (with assets of $72 billion).[65] The two largest OBUs are the Arab Banking Corp and Gulf International Bank, accounting for 48 per cent of the market. They provide financing and trade-related services to regional oil and major industrial and commercial companies, but they are prohibited from conducting onshore business.

Bahrain intends to become the primary offshore centre for Islamic banking. It already has the highest concentration of offshore Islamic financial institutions. In 1996, Citibank, soon followed by other Western banks, opened a wholly owned Islamic bank. In 1998, Saleh Kamel, head of the Al-Baraka group, one of the two major transnational Islamic banking groups, established an offshore banking unit in Bahrain to bring together his group's diverse global banking interests.[66]

The Bahrain Monetary Authority (BMA) has Shariah advisers to help with the auditing of the banks, and a new regulatory system is being worked out to take into account the special characteristics of Islamic financial products. The BMA is also developing short-term financial instruments that would provide liquidity for Islamic banks.[67]

The main weaknesses of Bahrain are its political instability and its reliance on oil money and on large wholesale deposits. Although the Shia make up a slight majority of Bahrain's 500,000 citizens, the ruling Al Khalifa family is Sunni. Parliament was dissolved over two decades ago. Since December 1994, Bahrain, which is home to the American Fifth Fleet, has been wracked by a wave of political violence that has included car bombs and political assassinations. In addition, OBUs are heavily dependent on wholesale interbank deposits from financial institutions outside the island, and capital is likely to flee – as it did at the time of the Gulf war – whenever regional tensions rise.

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7

FINANCIAL PRODUCTS AND INSTRUMENTS

Most Islamic financial institutions engage in a variety of financial operations. Besides their range of equity, trade financing and lending operations, Islamic banks worldwide also offer a wide array of wholesale and retail products including loans, partnership investments, foreign exchange transactions, fund transfers, letters of credit, securities safe-keeping, investment management and advice, and other conventional banking services. Many are also active in derivatives, fund management and insurance. On the liability side, Islamic banks offer a variety of options for depositors. Current accounts are operated on the principles of al-wadia (safekeeping) and are not remunerated. The purpose is to offer depositors safe custody for precautionary and transaction purposes.[1] Depositors are provided with cheque-books and can withdraw their funds at any time without any restrictions or conditions. No fees are normally charged. Savings accounts usually involve higher balances and a longer time commitment. While few banks promise a fixed interest, most offer some kind of remuneration, usually left to the discretion of the institution, depending on its profitability. Investment or profit-and-loss sharing (PLS) deposits linked to bank mudaraba investments are in theory though not in practice the principal instruments offered to depositors. Banks typically offer a variety of accounts – PLS Deposit Accounts, PLS Special Notice Deposit Accounts, PLS Term Deposit Accounts – with different maturities and withdrawal conditions, and often offer separate account options for the general public and for institutional investors.

Yet in the classical Islamic tradition, the only acceptable loan was the ‘qard hasan’ (literally, ‘good loan’) or interest-free loan, and the only common form of deposit was ‘al-wadia’ (safekeeping). Islamic bankers have been able to devise new products and instruments by updating or combining contracts that go back to classical Islam, by creating products that pose no religious objections, or by invoking custom (urf), overriding necessity (darura) or the general interest (maslaha) to justify the creation of somewhat controversial instruments.

Given the blurred boundaries of Islamic finance and the religious controversies surrounding financial instruments, a typology is useful. This

chapter classifies financial products on the basis of the issues they raise – primarily religious and financial, but also strategic, regulatory, economic, and political – in the context of the global economy.

7.1 Murabaha and Other Mark-up Schemes

'Mark-up' transactions account for 80 to 95 per cent of all investments by Islamic financial institutions.[2] The best-known mark-up instrument is the murabaha, a cost-plus contract in which a client wishing to purchase equipment or goods requests the financial provider to purchase the items and sell them to him at cost plus a declared profit. It is thus a financing-cum-sale transaction: the bank purchases the required goods directly and sells them on the basis of a fixed mark-up profit, agreeing to defer the receipt of the value of the goods (although the goods can be delivered immediately).

There are a number of variations on the basic idea of murabaha. Under bay muajjal (credit sale, or sale on a deferred-payment basis), delivery of goods is made immediately; the price agreed upon, which includes the cost plus a margin of profit to cover administrative costs, is paid by the purchaser at a given date in the future. Similarly, bay salam (advance payment or forward buying) is the sale of goods to be delivered to the purchaser at a future date, which must be determined at the time of the contract. Not widely used yet, it has great potential in certain areas, such as agricultural products. Istisna (commissioned manufacture), an agreement for processed goods and commodities, allows cash payment in advance and future delivery, or a future payment and future delivery. The lender thus has the flexibility to pre-sell to his clients for future delivery on a cash-on-delivery basis and then negotiate the purchase.[3] There are infinite variations on the basic idea of tacking on some form of remuneration, in the form of a profit mark-up, or service or management fees.

In the early years of modern Islamic banking, mark-up transactions were regarded as temporary modes of finance, used for reasons of ease and convenience and generating income while banks devised authentic risk-sharing instruments. What happened instead was that, rather than disappearing, their importance grew over time and today they account for the overwhelming majority of Islamic transactions.

There are two main criticisms of mark-up schemes. One is that, by being low-risk and short-term, they do not fulfil the mission of Islamic banking – to share risk with the borrower. The risk incurred by the bank is usually minimal, and the profit margin is determined in advance. Indeed, the purchased assets serve as a guarantee, and the bank may also require the client to offer a collateral. The combination of predetermined fixed profit and collateral ensures that the risk taken by the bank is negligible. The other criticism is that mark-up schemes mimic conventional banking but

disguise the interest through semantic games and other 'hiyal' (ruses). Indeed, from an economic – though not from a legal or regulatory – standpoint, many such transactions are comparable to interest-rate transactions: if a borrowing firm needs $100 million to buy machinery, it could borrow money at eight per cent a year to purchase it, or it could have the bank buy the machinery on its behalf, and pay the bank $108 million a year later.

The core religious question boils down to the nature of the bank's remuneration. If it is a 'lending fee' then it is akin to interest. If on the other hand it is a remuneration for the service provided, or for the risk incurred, it is acceptable. Since the deal involves two sales transactions (one involving buying or commissioning the goods from the manufacturer, the other involving selling the goods to the 'borrower'), the main difference from a conventional banking loan is that there is a period during which the financial institution owns the goods. During that time the bank bears the risk that the goods will be damaged or destroyed, or that the seller may go bankrupt, or otherwise reject the goods as unsatisfactory. Commonly however, the bank will cover itself against such possibilities, the period of ownership will be more symbolic than real (since the duration can theoretically be of just one second), and the profit of the bank will correspond roughly to the prevailing rate of interest for the period involved.

Especially problematic have been the 'synthetic' murabaha transactions involving trade financing, and widely used in London. Frank Vogel writes:

> These transactions involve, for the most part, trade financing deals between Islamic investors and well-known multinationals seeking lowest-cost working capital loans. Although these multi-billion-dollar contracts have been popular for many years, many doubt the banks truly assume possession, even constructively, of inventory, a key condition of a religiously acceptable murabaha. Without possession, these arrangements are condemned as nothing more than short-term conventional loans with a predetermined interest rate incorporated in the price at which the borrower repurchases the inventory.[4]

As a result of criticisms by Islamic scholars, a growing number of financial institutions have vowed to start phasing out certain types of murabaha transaction.[5] Others have attempted to change their pricing strategies so that the mark-up would be in proportion to the magnitude of the service rendered as opposed to the sum involved and to prevailing interest-rate benchmarks.

7.2 Leasing

Ijara or leasing is probably the fastest growing activity of Islamic financial institutions. The principle is well known and virtually identical to conventional leasing: the bank leases an asset to a third party in exchange

for a specified rent.[6] The amounts of payments are known in advance and the asset remains the property of the lessor. Only in a few respects do Islamic contracts differ. A variation on the basic principle is ijara wa iktina, a lease-purchase agreement whereby at the expiration of the lease, the lessee becomes the owner of the asset.

From the standpoint of classical Islamic fiqh, ijara is understood as the sale of usufruct (manfaa) and, as such, its rules closely follow those of ordinary sales. In order to avoid the elements of riba and gharar, there are a few (minor) differences between ijara and conventional leasing. The law views some benefits and burdens of the property as belonging naturally and unchangeably to the lessee, others to the lessor. For example, the law provides that the duty to repair the goods always fall on the lessor since the repair benefits him as the owner. Also, the usufruct is not something existent and tangible, but a stream of use extending into the future, which is risky and unstable. Islamic law thus gives broad scope to the lessee to cancel the lease if the usufruct proves less valuable than expected.[7] Finally, the price at which the asset may be sold to the lessee at the expiration of the contract cannot be predetermined.[8]

A number of reasons account for the rapid growth of leasing: it is an acceptable instrument in the eyes of most scholars; it is an efficient means of financial intermediation; by financing assets, it is a useful tool in the promotion of economic development; because it is a well-established instrument that lends itself to standardized mechanisms and procedures, and because of its similarity to conventional leasing, it is a flexible mode of financing that lends itself to securitization and secondary trading and to collaboration with conventional institutions.

Although initially directed primarily at businesses, ijara is increasingly used in retail finance, primarily for home mortgages, cars and household needs.

7.3 Profit-and-loss Sharing

The basic principle of profit-and-loss sharing is that instead of lending money at a fixed rate of return, the banker forms a partnership with the borrower, sharing in a venture's profits and losses. The partnership can be of one or two types: mudaraba (commenda partnership or finance trusteeship) and musharaka (longer-term equity-like arrangements). In both cases, the bank receives a contractual share of the profits generated by business ventures.

The principle is at the core of the Islamic banking philosophy. It is at once the most 'authentic' form of Islamic finance since it replicates transactions that were common in the early days of Islam,[9] the one that is most consistent with the value system and the moral economy of Islam, and the most 'modern' one. Indeed, venture capital and merchant banking –