



An Introduction to Islamic Moral Economy and Reflecting on the Resilience of Islamic Finance Against the Financial Crisis

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Why is Essentialisation of Islamic Moral Economy Beyond Islamic Finance Necessary?

- During the initial days of the recent financial crisis, a number of commentators talked about 'greed' and the 'irresponsible attitude' of the financial sector as being an important source of the problem.
- This opened up a new discussion on the importance of moral in economic and financial life.
- As part of the Islamic moral economy, Islamic finance provides a constructivist response for this.
- This lecture aims at providing an overview of the Islamic moral economy and reflect on the resilience of Islamic finance against the current financial crisis.



Islamic Moral Economy: Emergence of Framework Paradigm

- In the opinion of the founding fathers, the failure of economic development in 1960s and 1970s was attributed to capitalist economic development strategies, which ignored the importance of human being and its well-being.
- Their objective was, therefore, to develop an economic system understanding, which could develop a human-centric development strategy.
- The Islamic Moral Economy paradigm aimed at the creation of the Islamic system of economics with its distinct values, norm, rules and institutions with a politically oriented systemic understanding.



Islamic Moral Economy: Emergence

- For Islamic Moral Economy ontological and epistemological sources is the *Qur'an* and *hadith*, which determine the framework of the economic value system, the operational dimension of the economy and also the behavioural norms of the individual Muslims.
- The axioms and foundational principles of Islamic Moral Economy define the framework for economic activity to take place within intra-and intergenerational social justice, which reveal themselves in the methodological framework of the Islamic economic system.
- Therefore, it is based on a constructivist philosophy to oppose the global dominance of capitalism, which has in reality failed in the economic development process.



Islamic Moral Economy: Values and Economics

Since economics and finance are value-loaded, as at the most abstract level, our values are derived from our worldview.

Hence, this provides rationale for a distinct economic system. Since factors affecting worldviews differ, different worldviews exist leading to different 'systems' for different peoples:

- Foundations, operational principles, goals;
- Theories also differ;
- Islamic world view based on the Qur'an;

Islamic Moral Economy, hence, aims at creating a new system.



Defining Islamic Moral Economy

Islamic moral economy:

- part of religion, Islam;
- deals with production, consumption and distribution activities of human beings according to Islamic worldview;
- making economic and financial choices according to Islam;
- describes, analyses, prescribes.



Defining Islamic Moral Economy

- Islamic Moral Economy, thus, is an “approach to, and process of, interpreting and solving the economic problems of human beings based on the values, norms, laws and institutions found in, and derived from the sources of Islam”.
- Islamic banking and finance is the institutional aspect of Islamic Moral Economy, as to finance the economic activity in an Islamic framework, there is a need to have institutions using instruments according to rules and regulations, which are all bound by the Shari’ah.



Foundational Axioms-Philosophical Foundations

The leading Islamic economists and moralists have developed an axiomatic approach to the conceptual foundations of Islamic Moral Economy by treating Islamic ethos as an ideal through which economic and social policies dealing with every aspect of human life, including economic life, are assessed.

In this approach Islam is seen as a system of ethics.

The philosophical and conceptual foundations of this system are as follows:



Foundational Axioms-Philosophical Foundations

(i) Vertical Equality/Tawhid (God's unity and sovereignty).

The Islamic worldview is based on *tawhid* (the Oneness of God), *risalah* (God's prophets as the source of Divine Guidance), *akhirah* (life-after death, that is the continuity of life beyond death and a system of accountability based on Divine Law).

This axiom indicates the vertical dimension of the ethical system. It provides for freedom of action whereby each individual is viewed as an integral part of the whole.



Foundational Axioms-Philosophical Foundations

(ii) Horizontal Equity/'Al-'adl wa'l-ihsan (Equilibrium and Beneficence - Socio-Economic Justice)

Individuals are expected to establish justice (*'adl*) and promote beneficence (*ihsan*), resulting in attaining high levels of good life (*hayat al-tayyebah*), both individual and collective.

This axiom provides for the horizontal dimension of equity in terms of:

- Need fulfilment;
- Respectable source of living;
- Equitable distribution of income and wealth;
- Growth and stability.



Foundational Axioms-Philosophical Foundations

(iii) Free Will/*Ikhtiyar*

Although individual freedom is guided by broad guidelines, and individuals may travel their own paths, careful intellection is required “to interpret-reinterpret that freedom within specific societal contexts, and to suit the needs of changing times”.

(iv) Responsibility/*Fard*

This axiom states that although ‘responsibility’ is voluntary, individuals and society need to conserve for the public good. Hence, there is a social aspect of every asset owned or managed by private or public entities.



Foundational Axioms-Philosophical Foundations

(v) Divine Arrangements for Perfection/*Rububiyyah* (Divine arrangements for nourishment, sustenance and directing things towards their perfection)

This is the fundamental law of the universe, which throws lights on the divine model for the useful development of resources and their mutual support and sharing. It is in the context of these divine arrangements that human efforts take place.

(vi) Growth with Purification/*Tazkiyah*

The mission of all the prophets of God was to perform the *tazkiyah* of individual in all his/her relationships with God, with other fellow individuals, with the natural environment and with society and the state. Hence, growing in harmony.



Foundational Axioms-Philosophical Foundations

(vii) Vicegerency/*Khilafah* and human accountability before God (Individual's role as God's vicegerent on earth)

This defines human being's status and role, specifying the responsibilities of individual and community as the repository of this *khilafah*. From this follows the unique Islamic concept of individual's trusteeship, moral, political and economic, and the principles of social organisation.

Thus, the implications of *Khilafah* are:

- Universal solidarity;
- Resources are trust from God;
- Ethical attitudes in economics and financing attitudes
- Human freedom.



Foundational Axioms-Philosophical Foundations

(vii) *Objectives of the Shariah/Maqasid-al Shariah*

The objective of the *Shar'iah* are in the words of al-Ghazali (d. 505 AD) is interpreted as 'human well-being' which is expressed in the words of Ghazali (d. 505 AD).

"The obligation of the *Shari'ah* is to provide the well-being of all humankind, which lies in safeguarding their faith, their human self (*nafs*), their intellect (*'aql*), their progeny (*nasl*) and their wealth (*mal*).



Foundational Axioms-Philosophical Foundations

Consequently,

“The universal ethical system, based on these axioms, is believed to produce policies aimed at enhancing motivation to seek knowledge and work, enhance productivity, and enhance transparency in government. They should also importantly enhance intra-and intergenerational equity” (Naqvi, 1994).



The Operational and Institutional Features of Islamic Economic System

1. Self-interest is a natural motivating force in all human life. But self-interest has to be linked to the overall concept of good and justice.

2. Private property and private enterprise are affirmed as inalienable rights and a natural mode for economic activity.

But the very concept and function of property is transformed by the provision of moral and legal filters, and instilling in people’s minds and hearts the notion that all in its forms -physical and human, machine power and brain power- property is a trust (*amanah*), and as such, property rights are subject to moral limits and used as a means of fulfilling ethical objectives - the *Maqaasid al-Shari’ah* (the objective of the Islamic way).



The Operational and Institutional Features of Islamic Economic System

3. Economic efforts take place through the process of cooperation and competition.

- The market mechanism is the natural corollary of private property, freedom of enterprise and motivation for profit and reward.
- Trade, the promotion of production and the exchange of goods and services, the pursuit of genuine profit, protection of the market mechanism, and a legal framework for the fulfilment of contracts, are pillars of the Islamic economic system.
- Effort, innovation, creativity, division of labour, technology and skills development have been emphasised by all major Muslim thinkers along with cooperation, compassion, justice, charity and solidarity.



The Operational and Institutional Features of Islamic Economic System

4. The market mechanism is a fundamental pillar of the Islamic economic scheme. But Islam demands actions by extra-market institutions to ensure that the market does not degenerate into wild capitalism, and that self-interest and the profit-motive do not create a situation that is socially disruptive and in violation of norms of justice and fair play.

- A moral filter at the level of personal motivation and the importance of family for the initial system of social security and solidarity;
- Government should be able to provide regulative framework;
- A network of voluntary organisations (*waqf* system), third sector; charity is transformed by making part of it a legal obligation;
- Concern about the problem of waste, over-utilization and the excessive exploitation of non-renewable natural resources and the ecological and environmental aspects of moral activity (*Amanah and haq*);
- Consequently, distributive justice and social security have become structured elements of the Islamic economic system and not merely voluntary supplements.
- The prohibition of certain sources of income is a particularly distinctive element of the Islamic economic system, such as *riba* (usury/interest), gambling, speculation, fraud, exploitation and extortion. Islam lays down an elaborate code of business ethics to ensure honesty, transparency and equity in business and financial dealings.



The Operational and Institutional Features of Islamic Economic System

Consequently;

Islamic moral economy, on the one hand, aims to guarantee individual liberty, freedom of choice, private property and enterprise, the profit motive and possibilities of unlimited effort and reward.

On the other hand, it seeks to provide effective moral filters at different levels of life and activity and established institutions in the voluntary sector, as well as through state apparatus to ensure economic development and social justice in the society..



The Operational and Institutional Features of Islamic Economic System

Ibn Khaldun's (15th century)'s framework provides a summary of the interdisciplinary dynamic model for Islamic socio-economic system:

- “The strength of the sovereign (*al-mulk*) does not become consumed except by implementation of the *Shari'ah*;
- The *Shari'ah* cannot be implemented except by a sovereign (*al-mulk*);
- The sovereign cannot gain strength except through the people (*al-rijal*);
- The people cannot be sustained except by wealth (*al-mal*);
- Wealth cannot be acquired except through development (*al-'imarah*);
- Development cannot be attained except through justice (*al-'adl*);
- Justice is the criterion (*al-mizan*) by which God will evaluate humanbeings; and
- The sovereign is charged with the responsibility of actualising justice”.

(Chapra, 2000: 147-8)



Methodology of Islamic Moral Economy

The methodological postulates of Islamic Moral Economy can be summarised as follows:

- *Sociotropic individual*, not only individualism but social concern is a prerequisite;
- Behavioural postulates: socially concerned God-conscious individuals who
 - (a) in seeking their interests concern with the social good,
 - (b) conducting economic activity in a rational way in accordance with the Islamic constraints regarding social environment and hereafter; and
 - (c) in trying to maximise his/her utility seek to maximise social welfare as well by taking into account the hereafter as well.



Methodology of Islamic Moral Economy

• *Market exchange* is the main feature of economic operation of the Islamic system; however, this system is filtered through an Islamic process to produce a socially concerned environmentally friendly system. In this process, socialist and welfare state oriented frameworks are avoided not to curb incentives in the economy.

Hence, *two dimensional utility function* (present and the hereafter), which leads to *homolamicus*, or as Arif (1989: 92-94) names 'Tab'ay' (obedient) human-being. "To be a Muslim is a necessary but not a sufficient condition to be a *Tab'ay*" (Arif, 1989: 91). As to be qualified as a *tab'ay*, one needs to operationalise Islamic principles in every aspects of her/his life.



Mechanisms and Instruments of Islamic Moral Economy System

Islamic economic and financial activities are shaped by there kinds of measures:

- Positive Measures (zakah, hisbah);
- Voluntary measures (sadaqha, awqaf);
- Prohibitive measures (riba);

Islamic Institutions and Instruments:

- Elimination of *riba*;
- Islamic financial system;
- *Hisbah* for market regulation system
- *Zakah*;
- *Takaful*;
- *Awqaf* system



Principles of Islamic Finance

- *Prohibition of interest* or usury (*riba*);
- An important consequence of the prohibition of interest is the *prohibition of fixed return* as provided by interest;
- By prohibiting *riba* or interest, Islamic moral economy aims at productive economic activity or *asset based financing* over debt-based system; which requires that all financial activities must be referred as tangible assets;
- Money does not have any inherent value in itself; and therefore credit cannot be created.
- The principle of *profit and loss sharing* (PLS) is the essential axis around which economic and business activity takes places. This implies that risks are shared, and hence *risks sharing* is another important feature of IBF.
- An important feature as the consequence of profit-and-loss sharing principle is the *participatory financing*. The *shuratic (consultative) method of governing* the business is, thus, a natural outcome of this process, which is expected to lead democratic process in the society.
- In essentialising productive economic and business activity, uncertainty (*gharar*), speculation and gambling is also prohibited again with the same rationale of emphasising asset based productive economic activity.



Assigned Values of Islamic Finance

- Community banking: Serving communities, not markets;
- Responsible Finance, as it builds systematic checks on financial providers; and restrains consumer indebtedness; ethical investment, and CSR Initiatives;
- Alternative Paradigm in terms of stability from linking financial services to the productive, real economy; and also it provides moral compass for capitalism;
- Fulfils Aspirations in the sense it widens ownership base of society, and offers 'success with authenticity'.



Reflecting on Financial Crisis

The causes of the current crisis can be traced to three levels:

- Regulatory failures;
- Operational failures
- Products related failures



Financial Crisis

Regulatory Failures

- Financial Institutions operated in a deregulated environment
 - Fed—Emphasis on self-regulation
 - Resistance to control OTC derivatives market
 - Basel II—Market based risk assessment and capital requirements



Financial Crisis

Operational Failures

- Lack Risk Management Practices
 - High Leverage (low capitalization)
 - Transferring risk—Excessive risk taking
 - Creating newer risks (not well understood)
 - Under-pricing of risks
 - Ethics and morality
 - Greed
 - Rating Agencies role



Financial Crisis

Product related failures:

- Innovations:
 - Securitization and sale of debt
 - Creation of complex and opaque financial instruments (derivatives)
 - Hedging (risk transfer)
 - Speculation
- Changed financial structure
 - Sources of funds of banks moved from depositors to capital markets (securitization)
 - A complex network of inter-relationships
 - Created systemic risks not well-understood



Financial Crisis and the Resilience of Islamic Finance

Islamic finance principles to moderate financial crisis:

- **Ethics** related to financial activities
 - Prohibitions (fraud, hoarding, exploitation of need, gambling, etc.)
 - Obligations & Recommended (charity, honesty, interest-free loans, risk sharing, etc.)
- **Laws** governing economic/financial activities
 - Principle of **permissibility**: All transactions are permitted except what is explicitly prohibited by Islamic law
 - Prohibitions are *riba* and *gharar*



Financial Crisis and the Resilience of Islamic Finance

Islamic financial principles for real economy rather than financialisation:

- Using risk-sharing instruments—more monitoring
- Prohibition of selling of debt
- Prohibition on derivatives
- Prohibition on short-selling—limiting betting on downside risks.



Financial Crisis and the Resilience of Islamic Finance

Islamic financial sector has performed relatively better under the crisis

- ‘While conventional banks worldwide are nursing losses of more than \$400 billion from the credit crisis, Islamic banks are virtually unscathed ’ (IHT, August 19, 2008)
- ‘In a dire year for mutual funds, the Amana Trust Income Fund, the main Muslim investment fund, has trumped those from all other faiths in the US by losing only 25.8% of its value for the year - half the average 44% loss for the US stock funds’ (FT, Dec. 26, 2008)
- ‘Non-Muslims turn to Islamic Bank as a safe option’ (Birmingham Post, Oct. 3, 2008)
- ‘Shares of most Islamic Banks in GCC markets record spectacular rise’ (Arab News May 14, 2009)



Financial Crisis and the Resilience of Islamic Finance

- In a financial world dominated by Islamic principles, the crisis would not have taken place the way it did; it would have been moderated.
- For full impact, Islamic moral economy system should prevail; otherwise in dual banking system, Islamic finance will be impacted by the business cycle prevailing in the economy, example: Dubai and *sukuk* default in Dubai.
- Despite the developments in the nature of Islamic finance beyond moral economy, it is still based on the fundamental ethical basis of Islam and benefits from the moral values of Islam in its construct.
- Considering that an important aspect of the current financial crisis is 'moral and ethical deficit', Islamic finance has the potential to fill that deficit.



From Utopia to Reality: Lessons for Islamic Finance

- The realism of the Islamic moral economy's constructivist method is tested with the developments which have taken place in Islamic finance, which has given up the value system as identified by Islamic Moral Economy and hence it has been criticised by Islamic economists for its social failure for economic development.
- Islamic finance, hence, in its deviation from the norms and axioms of Islamic Moral Economy followed a **realistic attitude based on positivism rather than normativeness**; and hence has given up the utopia imposed on or assigned to itself by Islamic Moral Economy.



From Utopia to Reality: Lessons for Islamic Finance

- In this alternative understanding, Islamic finance and banking, was assigned an important role: economic development with the objective of human well-being and social justice.
- The initial experience of Islamic finance and banking in Egypt and Malaysia had such objectives, as they were socially oriented institutions.
- In particular since the 1990s, while the operations of Islamic finance and the nature of Islamic modes of financing have expanded, the lives of individuals have not been touched upon by this enormous growth.



From Utopia to Reality: Lessons for Islamic Finance

- The close scrutiny of Islamic financing indicates that the social dimension is limited with their *zakah* and other charitable activities, which does not imply any systematic economic development and social justice programme aiming at capacity building.
- Also poor CSR scores, as there is no proactive dynamic understanding of social responsibility is the prevailing attitudes amongst the IBFI.
- Considering also that Islamic Moral Economy aims at economic development this can only be achieved with long-term financing. However, evidence shows that “Islamic banks rarely offer long-term financing to entrepreneurs seeking capital”.



From Utopia to Reality: Lessons for Islamic Finance

- Taking into account that Islamic Moral Economy aims that Islamic finance should be equity financing towards a particular value-added creating economic activity, the change in the directions of Islamic finance is rather meaningful. **From PLS and participatory financing to efficiency and profit maximisation (*murabahah* centred financial transactions); namely from asset based financing to debt-based financing (see also *tawarruq*).**
- In addition, developmentalist financing with the objective of economic growth necessitates financing sectors such as agriculture, industry, and manufacturing. However, “the majority of Islamic banks’ financial transactions at least initially were directed away from agriculture and industry and toward retail or trade financing”.
- In relation to social lending, it is at an negligible level in IBFs.



Redirecting Islamic Finance

- There is a need to go beyond the legal interpretations and reading of the text; as value and objective oriented approach would help to overcome the growing tension between the performance of Islamic finance and the utopia of Islamic Moral Economy.
- And hence the importance of educational and research activities in the field, which should be able to direct the developments in Islamic banking and finance, rather than allowing the industry to follow ‘rule of the thumb’ in its development.



For socially and environmentally responsible value oriented just economic and financial system, which can enable individuals to function and which can aim at well-beings of individuals...

Utopias should exist so that realities can be constructed and engineered..

Thank you...