The Challenge of Islamic Finance

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THE REAL CHALLENGE OF ISLAMIC FINANCE

From its humble beginnings in the 1990s, Islamic finance has become a trillion US dollar industry. The market consensus is that Islamic finance has a bright future due to favourable demographics and rising incomes in the Muslim community. Moreover, despite voices sceptical of an accommodation between Islamic and global finance, leading global banks are buying Islamic bonds and forming subsidiaries specially to conduct Islamic finance business. Special laws have been passed in non-Muslim financial centres, - London, Singapore and Hong Kong - to facilitate the operation of Islamic banks and associated financial institutions.

How should these developments be viewed from the perspective of the dominant Western financial system and mainstream economic analysis? Does the latter suggest that Islamic finance constitutes a viable alternative financial system? Asking this question is in itself significant, since it was not so long ago that Islamic finance was not taken seriously by leading financial circles. It was superficially dubbed as a zero interest rate system which would lead to inadequate and inefficient resource mobilisation and utilisation. Ironically, mainstream central bankers today routinely use Zero Interest Rate Policies (ZIRP) when pursuing massive quantitative easing.

There are two central precepts of Islamic finance: (a) the absolute prohibition on charging interest on financial transactions; and (b) high moral standards of lenders and borrowers. Interestingly from the perspective of economic theory, the best rationale for a zero interest rate system is provided by Keynes in The General Theory:

Provisions against usury are amongst the most ancient economic practices of which we have record… In a world, therefore, which no one reckoned to be safe, it was almost inevitable that the rate of interest, unless it was curbed by every instrument at the disposal of society, would rise too high to permit of an adequate inducement to invest … .

Keynes suggested that only a very low or zero interest rate policy could ensure continuous full employment and distributional equity. Keynes's endorsement of such a policy does not necessarily make it right, but his analysis does suggest it to be a serious proposition. Importantly, although under Islamic Finance interest is prohibited, profits are not; the latter are derived from various arrangements that

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combine finance and enterprise. In essence, this is a profit and risk-sharing system which is based entirely on equity finance. This contrasts with the current dominant system based on interest-bearing debt, where risks are theoretically transferred to debt holders, but in practice are socialized during a crisis. Other things being equal, most economists will agree that debt finance leads to greater instability than equity finance.

It follows from the second major tenet of Islamic finance, namely its strong ethical foundations, that if people adhered strictly to the requirements of Islamic ethics there would be fewer moral hazard problems in Islamic banking. Moral hazard exists in all systems where the state ultimately absorbs the risks of private citizens. Whether any particular system is efficient in avoiding moral hazard is a matter of practice, rather than of theory. Many would agree that historically Christianity has been a moral force in the rise of Western capitalism. Secular capitalism, however, has seen a recent erosion of values whereby the financial sector hasput its own interests above those of the rest of society. Thus, if ethical values in Islamic finance can further deter the avoidance of moral hazard and the abuse of fiduciary duties of financial intermediation, then Islamic finance could prove to be a serious alternative to the current predominant models of derivative finance. It should be noted that, in addition to conventional regulatory oversight, Islamic finance has an ethical Shariáh oversight over its activities.

The basic tenets of Islamic finance force us to re-think the ethical basis of modern monetary systems, which have evolved into a global reserve currency system founded on fiat money. In the past, gold has been the anchor of monetary stability and financial discipline, even if it has been deflationary. The test of any financial system depends ultimately on whether it will be more efficient, more ethical and more stable. At present there is no Islamic global reserve currency and no lender of last resort. However, the Islamic world is the custodian of huge natural resources that back its trading and financial activities. As the Islamic world grows in stature and influence, Islamic finance will form a formidable competitor to the current financial system. The world would have much to gain from these two financial systems if they were to compete with each other fairly and constructively to meet people's varying needs for different types of finance.

Andrew Sheng and Ajit Singh, March 17 2012

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