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Hasan, Zubair

International Center for Education in Islamic Finance, KL

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Islamic finance, growth, and stability

Professor Emeritus Dr. Zubair Hasan, INCEIF

Abstract

Economists regard the financial and the real sectors of an economy as complementary; the two sides of the same coin. Islamic finance conceives of these sectors differently, albeit not independent of each other. Islamic approach is distinct in that it shuns interest, speculation and indeterminacy. At the same time, it is not independent because Islam allows a time value for money, and maintains of asset liquidity plus system stability as its guiding business principles. The discussion n the subject is scanty. This paper seeks to fill the gap. A diversion briefly discusses debt versus equity as sources for financing growth bringing in technology.

Key words: Islam; finance; Stability, Profit sharing; Debt; Equity; Technology

JEL Codes: J 10; J11

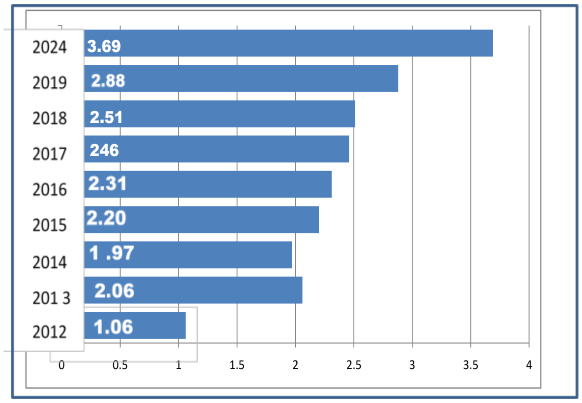
Introduction

To define something is difficult, more in academics. A consensual definition of even economics is still missing; we have to live with a welter of definition. And a working definition is yet needed as a border is needed to identify a city. Growth without financial stability is rudderless. The isea of financial stability is systemic, unquantifiable. For our purpose here it broadly means Financial stability can broadly be defined as a condition in which the financial system can facilitate real economic activities run smoothly and is capable of unraveling financial imbalances arising from shocks. It must be managed by a single independent authority. The central banks are tasked with the job across countries for over half a century.

Since the 1980s, many countries around the world have enjoyed the gains of rapid financial services growth the financial liberalization ushered in. But, they have also experienced periods of dramatic slowdown in economic growth, due to heavy economic expenses arising from financial instability or financial crises. Thus, many countries have started placing emphasis on financial stability in policy implementation. Attention paid to financial stability is growing, as new factors to generate financial instability are fast emerging.

Islamic financial expansion

Islamic finance has grown rapidly, even though it is still a small share of the global financial market. The Islamic banking segment has increased its penetration in many International Monetary Fund (IMF) member countries. It has become systemically important in Asia and the Middle East, while the global issuance of Sukuk - the Islamic equivalent of bonds - is expanding with remarkable international reach of issuers and investors. This trend is expected to continue, driven, in particular, by strong economic growth in countries with different stakeholders interested in Islamic Finance. Figure 1 depicts the growth of Islamic financial assets **U.S. dollars**. The projected value of total asset for Islamic finance markets will amount to 3.69 trillion U.S. dollars by 2024. Islamic finance has grown rapidly, Islamic finance currently encompasses banking, leasing, Sukuk (securities) and equity markets, investment funds, insurance or Takaful and micro-finance, but the banking and Sukuk represent about 90% of total financial assets.



In 2019, the total assets value of global Islamic finance markets amounted to **about 2.88 trillion** though it is still a small share of the global financial market. The Islamic banking segment has increased its penetration in many International Monetary Fund (IMF) member countries. It has become systemically important in Asia and the Middle East, while the global issuance of Sukuk - the Islamic equivalent of bonds – is expanding with remarkable international reach of issuers and investors. This trend is expected to continue, driven, in particular, by strong economic growth in countries with different stakeholders interested in Islamic Finance.

Apart from the known prohibitions – interest, speculation, indeterminacy and other non-permissions, a major departure of Islamic finance from the mainstream is its insistence that every financing act must have a real economy counterpart. Piero Sraffa, the Nobel lariat for his - *Production of Commodities by Means of Commodities* – was indeed echoing from the Islamic scripture: Allah brings out the living from the dead and the dead from the living (55:27). Egg comes from the hen, and hen from the egg. Depending on the time and place, all of these economic activities (production, distribution, and consumption) could be achieved through bartering commodities including work for commodities, no money is required.

In modern economies money makes it possible for people, organizations, and governments to borrow money, loan money, or invest it in other people, organizations, governments, or financial products like mutual funds.

However, money is not an unmixed blessing. As human activities become more specialized and move farther away from the direct exchange for a tangible product to consume or own, the economy becomes increasingly impersonal and removed from the actual, physical activities of production, distribution, and consumption, which are the basis of the economy. Islamic finance is averse to such non-personalization and distancing.

People in general; feel comfortable with direct economic activities: getting paid in cash for hard work, or buying something that they like to bring home to use or consume. They get pleasure in having it, they can touch it, and they understand it at a tangible level. In contrast, when the activities get further into financial investments or economic policy, the matter can be hard to follow; it looks like something out of our reach. More complex activities, such as investing in the stock and bond markets, are layered on top of basic, direct economic activities. Their complexity becomes overwhelming. One way to sort through all of it is to make a distinction between the real economy and the financial economy even as the distinction is a matter of degree.

In most basic terms, the real economy is concerned with the production and sale of physical goods and services with direct, close-contact lending. On the other hand, the financial economy is concerned with selling and buying on the financial markets, such as stocks, bonds, mutual funds, or more complicated instruments like mortgage-backed securities and collateralized debt obligations. A stage comes when mountains of credit grow; money just begets money. The backward linkage to real economic activities becomes dubious and distant as virtually lost. The Islamic avoidance of interest, speculation, and indeterminacy sock the distance: Finance does not lose sight of the real.

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The stability Issue

Financial stability refers to the minimizing of fluctuations in the supply of and demand for money needed for running the real economy turmoil free as trade cycles were considered a monetary phenomenon. This view gained currency after the Great Depression of the 1930s with the publication of the Keynes *General Theory*. It was contended that in the public interest monetary control must be under a single authority. A crop of central banks emerged around the world, more after 1935, to meet the call. However, the recurrence of financial crises their ferocity continues unabated, such id the "human exuberance", as Stieglitz a former World Bank chairman put it.

- **Real economy:** Operating in a duel financial system, the Islamic financial institutions are not immune of cat A 2015 paper of Belouafi et al covers a considerable number of studies that are conducted before and after the global financial crisis for review of the literature on Islamic finance[1] and emphasize the importance of *measuring* its stability but stay short of suggesting how this can be done. Perhaps, one can take a periodic, say seven years, moving average of the cycles and fit an appropriate trend to the series for analysis? The authors rightly maintain that attempting "to clearly define what financial stability is, one has to look into its driving forces"; when the system loses it, it functions in a way that adversely affects the economic condition **Stability**: By being close to the purchase and the borrower, these lenders can have a much better understanding of the benefits and risks of making a loan. With greater understanding of the product, the borrower, and the place where it's happening, they can make loans that work better for the borrower and for the credit union. All of this helps to maintain stability, which is essential to keeping the promise to the membership that credit unions are a safe, secure, and trustworthy place to do your banking.

- **Local Recirculation**: When deposits are lent out into the community for a home, car, or their business, the money goes back into the local economy and enables greater vitality in their shared community. Each time a person makes a payment on their loan, the money can go right back out for another person's needs. The more the money cycles through the ching the cold though the claim that due to their being complaint of the Shari'ah and IFSB norms the turmoil impact is lesser, may have substance.

- **Sustaining and Improving Lives**: focusing on the real economy is one powerful way values-based credit unions and banks can do that. When a loan helps a young family to buy

[1] The authors say: "the available literature suggests that these discussions (on stability}can be traced back to the early 1980s. However, most, if not all pre-crisis studies, were theoretically; conducted on an 'abstract model'. They assumed IFS to be based predominantly on equity and participatory modes of financing. The eruption of the crisis has triggered empirical inquiries. These have tried to capture the practical reality of these institutions. This research aims to provide an account of the main findings and conclusions of the literature.

and move into their first home, that improves quality of their life. When access to credit helps people get that vehicle to get to work and play, that improves the quality of their life. When a business loan helps a company to grow and hire local talent that improves the quality of life.

The Financial Stability Reports the IMF issues periodically provide an assessment of the global financial system and markets, and addresses emerging market financing in a global context. It focuses on current market conditions, highlighting systemic issues that could pose a risk to financial stability and sustained market access by emerging market borrowers. The Report draws out the financial ramifications of economic imbalances highlighted by the IMF's World Economic Outlook. It contains, as special features, analytical chapters or essays on structural or systemic issues relevant financial stability. Extraordinary policy measures have eased financial conditions and supported the economy, helping to contain financial stability risks. They keep alerting if there is a pressing need to act to avoid vulnerabilities sans unduly tightening of financial conditions. For instance the 2022 report warns that actions taken during the pandemic may have unintended consequences such as stretched valuations and the rising financial vulnerabilities.

Islamic finance insists that the parties to a financial contract must share its consequences - gains and losses – as per agreement. This leads to a diffusion of risks and contributes to the overall stability of the system.

Reflecting the importance of Islamic finance for many of its members, the IMF has had a long-standing interest in its implications for macroeconomic and financial stability, and played a key role in the establishment of the Islamic Financial Services Board (IFSB). The IMF has also engaged its members on the implications of Islamic finance, in the context of its policy advice and capacity development efforts, notably in the areas of regulation and supervision of Islamic banks, and development of domestic Sukuk markets.

Islamic restrictions improve financial management and curtail risks in financing the real economy activities. Stability of the financial system – mainstream and Islamic – is a prerequisite to keep real economy free of turmoil or reduce their rigor. For that banks and other credit institutions that lead with values choose to place their assets in the real economy for Here are three main reasons.

Debt verses equity

Output growth can be financed through selling bonds or equity shares in the market. Islamic finance permits both as time is allowed a share in price; thus sukuk bonds have emerged as the leading instrument of Islamic finance. The debt or equity issue in finance arises in three cases: a firm, an industry or a country. A business firm would compare the cost of the alternatives. Long-run considerations and ownership structure – private, public or mixed – would have significance. A country can raise finance internal revenue sources or/and extended external borrowing plus joint ventures as the China Pakistan Economic Corridor, currently worth 60 billion dollars external investment spread over a decade. Borrowing from international financial institutions like the IDB, IMF or the World Bank are other important sources. The scope and the space of this paper is limited to allow a discussion on all three cases

An important issue is how to finance output expansion, using debt or equity or a mix of them? The issue arises in the case of individual firms, domestic industries, even countries. Industrial financial requirement is bulky and long-term. It may have public-private sector issues. Countries may need additional resources to bridge fiscal deficits. to speed up economic growth, or tie up balance of payments difficulties compounded by currency depreciation and rising inflation. Inflows of foreign investments may be encouraged through appropriate incentive; loans from the IMF and the World Bank can be sought, though help usually comes with conditions distasteful to the seeker. This paper has no scope or space to discuss the imponderables involved. Thus, we .take up the case of a firm, for a firm is to economics what an atom is to physics.

Typical for a firm with a long-run perspective is an issue related to technology for increasing output. It has surplus reserves funds that it can transfer to capital account to increase output, technology remaining unchanged. Or, it can borrow from investors to install improved technology or it can use a mix of the alternatives. Figure 2 using a production function framework explains the issue. Here, each of the two curves T_1 and T_2 show levels of technology the higher one giving more output for the same equity capital and the given labor input. Movement along any of the curves informs us how returns to capital in physical terms would change depending on the scale of operations. A movement from P_1 to P_3 or from P_2 to P_4 would keep us on the same curve with a given technology. We should better stay on either of the two for consistent results. We can increase output from Q_1 to Q^* using debt financing for technological improvement. Such debt can be expected to create means for its own repayment. Alternatively, the firm can increase equity from K_1 to K_2 without a change in technology. However, for a jump to Q_2 a mix of both debt and equity would be needed.

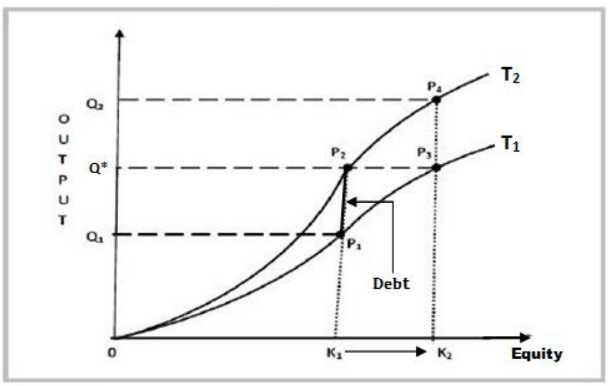

Figure 2: Output expansion & Technology

- Growth of Islamic finance has been fast but lacks variety and balance; of sukuk dominance is overwhelming;
- Juristic restrictions have kept the system stable and less prone to shock exposures.
- A functional framework with fixed technology is more appropriate and logical to study the equity-debt issue. I have used the framework in a section of a full paper on the subject and the results of the model are insightful. I shall be surer of my position if I could get confirmation about the adequacy of the production function employed.

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