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FINANCE AND DEVELOPMENT IN ISLAM: A HISTORICAL PERSPECTIVE

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FINANCE AND DEVELOPMENT IN ISLAM: A HISTORICAL PERSPECTIVE

I. INTRODUCTION

Islamic finance is generally considered as a new discipline, which by implication, makes its impact on economic development also a new phenomenon not yet fully understood. This way of thinking leaves us with a huge unanswered question: if Islamic finance is, indeed, a relatively new discipline, how have Muslims managed their financial affairs from the time of the Prophet until the present? Alternatively, do those who argue that Islamic finance is a new discipline seriously imply that Muslims of the earlier centuries did not have any idea about finance?

Nothing could be further from the truth. Indeed, Islamic finance is as old as Islam itself and constituted an inseparable part of an entire economic system. This was basically an ethical, commercial, pre-industrial capitalist system, which antedated western capitalism by a millennium. Between the tenth and the fourteenth centuries, the west borrowed many of the principles and institutions of Islamic capitalism.[1] Medieval Europe even practiced a stringent prohibition of the rate of interest. But then between the sixteenth and the eighteenth centuries, first with the "Reformation" and then the "Enlightenment", the prohibition was relaxed, and equally important, the ethical constraints were compromised. In the process, the original ethical capitalist was replaced by the rational *homo-economicus* who was an invention of the positivist mind. Devoid of all ethical and religious concerns enshrined in holy texts, a new set of laws governing the behaviour of the *homo-economicus* had to be invented. As Abbas Mirakhor has argued, ever since Adam Smith's *The Wealth of Nations,* the western economic theory has been bussy trying to do just this.[2]

By contrast, Muslims not being burdened by a highly centralized church and its ruthless Inquisition, never felt the need to discard the basic teachings of

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[1] Cizakca, *Comparative Evolution,* chs. 1and 2; Cizakca, "Cross-cultural Borrowing".

[2] Mirakhor, *Islam and Development,* pp. 21-25.

their religion.[3] Consequently, their economic reasoning have always been shaped by the classical sources of Islam. We are now at a position to discuss the basic characteristics of Islamic economics and finance, the outcome of this reasoning.

II. BASIC CHARACTERISTICS OF AN ISLAMIC ECONOMY AND FINANCE

Islamic finance and economic development obey certain rules and principles, which originate in the basic teachings of Islam. The best known of these principles is, of course, the prohibition of interest. The immediate consequence of the prohibition is the problem of combining the factors of production. Put differently, if;

$Q=f(K, L, N, E,\ldots.)$

is a simple production function, where

Q is production,

K is capital,

L is labour,

N is natural resources and

E is entrepreneurship,

then combining these factors becomes a *conditio sine qua non* for production. Indeed, unless a way is found to combine these factors, each owned by different persons, no production can take place.

In conventional economies, the capitalist is compensated for the use of his capital with interest and the entrepreneur with profit. In an Islamic economy, however, since interest is prohibited, the system of rewards becomes more complicated: the capitalist cannot be rewarded with the rate of interest anymore and the capitalist's capital cannot be transferred to the entrepreneur through conventional ways. The problem is solved by rewarding the capitalist also with profit. Put differently, the capitalist and the entrepreneur begin sharing the

[3] Baigent and Leigh, *The Inquisition, passim.*

profits. But there is a further complication, since profits are generated by taking risks, this means that risks are also shared. Since some risks inevitably lead to losses, this means that losses too must be shared.

Thus, when the capitalist is rewarded not by interest but by profits, the capitalist and the entrepreneur end up sharing not only the profits, but also risks and losses as well. As a result, the economy changes its character and what we may call, a "share economy" emerges. We can therefore say with confidence that sharing of risks, profits and losses is the most essential trait of an Islamic economy.

Another very important principle of Islamic economy concerns profits. Unlike the conventional economy where profit maximization, pure and simple, prevails, in an Islamic economy constrained maximization is the rule. A Muslim businessman tries to maximize his profits subject to ethical considerations imposed by his religion. Thus, providing profits are generated through *helal,* legitimate means, there is no upper limit imposed on them. It has been argued that Islam first equips a Muslim with ethical principles and then leaves him free to compete.[4]

There are only a few taxes mentioned in the Qur'an leading some Islamic economists wonder how additional taxes can be imposed. But this is missing the point. The message of the Qur'an should be obvious: in an Islamic economy taxes should be few and the tax burden should be light. With government revenue thus limited, assuming balanced budget, expenditures too must be limited. Since national defence constitutes the most important and inelastic government expenditure, which cannot be compromised, this means that bulk of the tax revenue must be earmarked for defence leaving other important social services such as health and education inadequately funded. Ottoman budgets from the sixteenth century demonstrate that this was indeed the case.[5]

The resulting gap in the provision of services was filled by the waqf system. Known as charitable or philanthropic foundations in the west, waqfs were voluntary endowments provided by high net-worth individuals in order to finance, organize and maintain in perpetuity the most important services needed by the society. That this was not just in theory but found widespread

[4] Zaim, "Ekonomik Hayatta", p. 103.

[5] Barkan, "Bütçe Cetveli", 1953-54.

application in the Islamic world is attested by the magnificent architectural monuments all over the Islamic world from the shores of the Atlantic to the ends of the Indian Ocean. But architecture represents just the tip of the iceberg. The predominant role waqfs played in Muslims' lives has been explained by Yediyildiz, who argued that

"a person could be born in a house belonging to a waqf, sleep in a cradle provided by that waqf, be educated in the school of the waqf and read the books provided by it, become a teacher in the waqf's school, earn a waqf financed salary and at his death be placed in a waqf provided coffin for burial in a waqf cemetery."[6]

III. IMPLEMENTATION

The reader may wonder at this point *whether and how* the theoretical model of an Islamic economy presented above very briefly has ever been actually implemented. If we first view the question: "whether", this is not a new question at all. Western historians of Islamic economic/social history have long debated whether the principles mentioned above were purely theoretical and were confined to law books. It was another western historian Abraham Udovitch who brought the debate to a conclusion. Referring particularly to the interest prohibition, Udovitch was able to demonstrate that by and large the prohibition was observed in real life.[7]

This brings us to the question, "how?". How, indeed, was the prohibition observed and, by implication, how were the different factors of production combined? The simple answer is; through the institutions. It was indeed through various institutions that the classical principles of an Islamic economy were applied in real life. To give just a few examples; sharing profits, risks and losses between the capitalist and the entrepreneur was made possible by the institution of business partnerships. Indeed, it was through these partnerships that the capital owned by the capitalist could be transferred to the entrepreneur. Thus sharing risks, profits and losses replaced the rate of interest. Moreover, despite modest government revenue, waqfs made provision of important services to the society possible. There were serious efforts to maximize government revenue throughout centuries by continuous

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[6] In Babacan quoting Yediyildiz, "Islamic Philanthropic Institutions".

[7] Udovitch, *Partnership and Profit,* ch. 1. Also see; Goitein, *Mediterranean,* passim.

reforms of public finance institutions, but these primarily aimed at financing the ever rising military expenditure, leaving the primarily waqf financed services more or less untouched.[8]

All of this brings us to the next vital question, which constitutes the essence of the present volume: *Islamic Finance and Economic Development.* Namely, have the classical principles of Islamic finance and economy, together with the institutions which applied these principles, ever led to economic development? Do we have any historical evidence of sustained and significant economic development in the Islamic world? We will now turn our attention to these questions.

IV. HISTORICAL EVIDENCE

For obvious reasons, we cannot resort to the types of data, such as the GNP or income per capita, used by modern economists. Instead we have to rely on indirect evidence. Notwithstanding this, there is powerful historical evidence that from the early eighth century onwards, Muslims acquired a core position from where they were able to link the two most important economic zones of the world; the Mediterranean and the Indian Ocean. Andre Wink has argued that establishing an Islamic superstructure on "the rich urbanite substratum of late antiquity and by fusing the formerly rival Byzantine and Sasanid commercial circuits and forcing links between the two zones, the Islamic Caliphate from the eighth to the eleventh century achieved an unquestioned economic supremacy in the world".[9] Muslim impact and economic might did not remain limited to the two seas, vast swathes of not only Northern India but even Europe were incorporated into the Islamic world-economy. Historians now even speak of the "economic Islamization of early medieval Europe".[10]

Substantial evidence has been found in Arab navigation manuals that circumnavigation of Africa, from East to West, was first achieved by

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[8] Çizakça, *Comparative Evolution,* ch. 5.

[9] Wink, *Al-Hind*, p. 10.

[10] *İbid.*, p. 36.

Muslims. Thus the European "discovery" of the Cape of Good Hope was simply the discovery of the already discovered![11]

Post-Roman Europe, utterly destroyed by the *Völkerwanderung,* was drastically de-monetized and desperately needed Islamic coinage.[12] Trade was the only way coins could be obtained. Not being able to produce the goods which Muslims needed, Europeans began to sell furs and even themselves! It was not accidental that the Vikings became important in this period – they were the master slave traders and flourished by kidnapping, enslaving and then selling their fellow Europeans to the Muslims. Muslims paid for these with their coins. Fifty-four finds of Islamic coins have been discovered all over the Carolingian empire as well as even in distant Scandinavia – the land of the Vikings. McCormick provides us with solid and immutable evidence about the monetary might of the Muslims.[13] It is thanks to these coins that post-Roman Europe was able to re-monetize its economy.

These successes were achieved by applying the principles of Islamic capitalism enshrined in the Qur'an and the prophetic traditions, *Sunna,* with the help of specially designed, Shari'ah based institutions. Consider, for instance, money itself, the most fundamental building block of any economy. How come, indeed, Muslim coins were found all over medieval Europe and from where came this monetary power? For this we need to look into the way Muslims monetized their commerce. Put differently, we need to understand how Muslims were catapulted from the age of barter to the age of money.

Indeed, in the absence of money, barter is the only other known method of commerce. Yet, barter necessitates a double coincidence of wants. That is to say, what merchant A wants to exchange, should be needed by merchant B and what B wants to exchange should be needed by A. Moreover, it is also necessary that both of these individuals should personally come together in a market. By contrast, in monetized trade A can sell his merchandise to third persons and with

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[11] Abu-Lughod, *Before European Hegemony,* p. 19, 209. If despite their knowledge about circumnavigation of Africa, Muslims did not use this route, this was because they had better and shorter routes through the Red Sea and the Gulf at their disposal.

[12] *Völkerwanderung* refers to the "barbarian" attacks on the late Roman and post-Roman settlements and cities. It was one of these attacks in the year 476 AD which led to the conquest of Rome and brought the western empire to an end. The attacks and the resulting mass migrations lasted for at least two centuries.

[13] McCormick, *Origins*, p. 344-354.

the money he receives he can travel to another market and there purchase B's goods in exactly the amount he wishes. Furthermore, since it is possible to send money over long distances, he does not even have to travel himself and can have the transaction completed by correspondence. The commercial advantage of trading with money over barter is thus obvious. Finally, since it is nearly impossible to measure the exact value of the goods exchanged in barter, any such transaction may involve an element of unjustified enrichment. It is probably based upon such concerns that Prophet Muhammad discouraged barter while encouraging monetized trade.

This policy is revealed in two *ahadith,* Prophetic statements, one clear and the other subtle. First the former, narrated in Malik's *Muwatta*:

"Someone brought some excellent dates to the Messenger of God as a gift. The Prophet asked 'are all dates of Khaybar like this?' The man said, 'No, Messenger of God! We take a *sa'* of this kind for two *sa's* or two *sa'*s for three'. Upon this, the Messenger of God said: 'Do not do that. Sell the assorted ones for dirhams and then buy the good ones with the dirhams".

In this *hadith,* the Prophet clearly disapproves of barter and orders Muslims to resort to trade instead.[14] In the next *hadith,* narrated by al-Bukhari and Muslim on the authority of Ubadah ibn al Samit, the Prophet takes a dramatic step further and declares barter a form of *riba*, i.e., interest, and condemns it.[15]

"Gold for gold, equivalent for equivalent; silver for silver, equivalent for equivalent; dates for dates, equivalent for equivalent; salt for salt, equivalent for equivalent; barley for barley, equivalent for equivalent and whoever exceeds or asks for excess, he practiced *al-riba.* Sell gold for silver as you wish if it is hand to hand (prompt delivery), and sell barley for dates as you wish if it is hand to hand."[16]

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[14] Ibn Ashur, *Maqasid,* pp. 288-9.

[15] Malik, Book 31 (Business Transactions), *hadith* 31.12.21; see also, Muslim, Book 10 (Book of Transactions), *hadith* 3861.

[16] Al-Qusi, *Riba Islamic Law and Interest*, p. 144.

The wisdom behind this *hadith* is not easy to understand. Actually, even today, more than 1400 years after it had been actually stated, some important scholars admit they do not really understand it.[17] The reason they do not understand it is because they consider the *hadith* from a legal perspective and ignore the historical circumstances in which it had been stated. With this *hadith,* the Prophet clearly makes barter almost impossible and encourages monetized trade. This is because, if the merchants wish to barter like objects, say, dates for dates, they are ordered to do so exactly equivalent for equivalent with total disregard to quality differences, actually a near impossibility. Indeed, they are told that when doing this particular case of bartering if one of them does not obey the rule "equivalent for equivalent" and asks for his higher quality dates a higher amount of the lower quality dates from the other party, he would be committing *riba.* In short, merchants who wish to barter like-objects are not allowed to take quality differences into consideration and are restricted severely to barter only exactly "equivalent for equivalent". While with this particular *hadith,* the Prophet does not prohibit the barter of like objects outright but makes it entirely unpractical and almost meaningless, with the previous one, he teaches the merchants how to trade like-objects by utilising a medium of exchange, i.e., dirhams or coins.

Bartering objects of the same genre, say, silver for gold, is less strict: it is permitted subject to prompt delivery. It has been argued that the wisdom behind this insistence on prompt delivery is the possible change in the relative values of the goods in question if deferred payment is allowed. Since this would lead to an unjustified enrichment for one of the parties, prompt delivery condition is imposed.[18] While this is certainly possible, I would argue that the real wisdom must be sought in the entirety of the *hadith.* What the Prophet has done here is to apply a hierarchy of restrictions with the purpose of gradually but surely leading merchants from barter to monetized trade. Indeed, while the barter of

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[17] Consider the following interview conducted with Sheikh Esam M. Ishaq, a Board member of the *Discover Islam Centre* in Bahrain and *Shari'ah* advisor to several Islamic financial institutions. "If I am going to exchange with you one bushell of a certain quality of rice with a bushell of lesser quality of rice, and if this is consensual and based on spot, people ask 'Why is this forbidden?". I can try to extrapolate a reason but this will be purely deductive. Outwardly, I can't give you a single reason or explanation but I know that it is there explicitly in the theological text". Parker, "*Shari'ah* Advisories", pp.160-61.

[18] Al-Qusi, *Riba, Islamic Law and Interest,* p. 149.

like-objects (gold for gold) is most severely restricted, the barter of objects of the same genre (silver for gold, or, barley for wheat) is permitted subject to prompt delivery and finally the exchange (sale) of precious metals with commodities, say, gold for wheat, is not even mentioned in the *hadith* implying that it is entirely unrestricted. To sum up, by progressively relaxing the restrictions, the Prophet has catapulted Islamic community from the age of barter to the age of monetized exchange.[19]

This progress from barter to monetized trade must have been the *conditio sine qua non* for the establishment of an intercontinental trade system from the Atlantic to the Pacific, which Muslims soon after the birth of Islam, came to dominate. If the gradual elimination of barter and its replacement by monetized trade was the *conditio sine qua non* for the establishment of an intercontinental trade network, the *conditio sine qua non* for the monetization of trade must have been the very existence of money. Indeed, the transition from barter to monetized trade could not possibly have materialised without a massive increase in the supply of money.

In a bimetallic system, which dominated the world trade in this era, an increase in the supply of money was only possible with a corresponding increase in the supply of silver and gold. Under normal circumstances, a drastic increase in the supply of these precious metals is not possible. But during the seventh-eighth centuries circumstances were by no means normal. For, this was the period when Islam expanded at the expense of the two great empires of the period: the Byzantine and the Sasanid. What dramatically changed the world economic history with the conquest of the Byzantine and Sasanid territories was the capture of massive amounts of hoarded gold and silver in the Byzantine churches and Sasanid temples.[20] The gold and silver treasures hoarded by these institutions were melt down and then minted. Aggregate money supply

[19] That the Prophet has condemned unequal barter exchange, encouraging instead monetized trade, has been acknowledged by Iqbal and Lewis as well. See; *Islamic Perspective on Governance,* p. 83.

[20] Actually, substantial amounts of treasury had became available very early on. When Hayber was captured only seven years after the *Hejrah*, massive booty became available. When Bahreyn began to send regular revenue the next year, some 80 000 dirhems became available per annum. Kallek, *Devlet ve Piyasa,* pp. 82-3. So, the advance into the Byzantine and Sasanid territories must have compounded an already favorable conjuncture.

increased in this way and a new economic system based upon monetised trade and dominated by the Muslims could thus become a reality.[21]

A closer look at the radical increase in the money supply reveals that this has been achieved in two steps. First, the coins of the conquered Byzantine and Sasanid territories continued to be the legal tender in the Islamic empire. Since Byzantine coins were gold and Sasanid ones silver based, this meant a *de facto* bimetallic system. The tolerance towards these earlier coins meant that the now much enlarged economy of the Islamic community experienced minimum disruption. Second, when it was decided to mint new Islamic coins, the precious metal content of these was kept deliberately lower than the earlier coins. Apparently, it was understood that the bad money would drive away the good money and in this way Islamic coins came to replace the earlier Byzantine and Sasanid coins. That bad money replaces the good money and the latter comes to be hoarded and taken out of circulation is, of course, known as the Gresham's Law and Muslims apparently had understood the principle behind it almost a millennium before Gresham.[22]

To sum up, Muslim coinage not only replaced the earlier imperial coins but also spread rapidly and dominated the economies of Europe, the Middle East as well as India.[23] Van Der Wee, an eminent Belgian economic historian, also confirms that re-monetization of Europe after the *Völkerwanderung* and the re-

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[21] Wink, *Al-Hind*, p. 34.

[22] Orman, *Iktisat,* p. 28.

[23] On Islamic coins dominating European economies during the ninth century see; McCormick, *Origins of the European Economy*, pp. 332, 334-5, 340, 344. On their spread to India see; Wink, *Al-Hind,* pp. 30-34.

birth of the European banking system owe much to the flow of Muslim coinage to Europe.[24]

International trade, however, would not have been possible without a sophisticated maritime law. A well-known French historian Daniel Panzac, has shown that this institution was also provided by Muslims. This originally Islamic law of maritime trade was transferred to Europe through various compilations.

The three most important compilations were made during the eleventh-twelfth centuries. These were the Maritime Laws of Rhodes, Oleron and the *Consolato del Mare.* It is now definitively established that the first one, previously considered to be a derivative of the Roman-Byzantine digests, was in fact based on *Al-Mudawwana al-Kubra* by Sahnun Ibn Sa'id al Tanukhi (d. 854). It was commented upon by Ibn Rushd (Averroes d. 1117) and drafted in Sicily or South Italy, both Muslim territories during the ninth-eleventh centuries. The second was authored by the Court of the Crusader Kingdom of Jerusalem in order to harmonise trade relations between the occidental and oriental Christians as well as Muslims. This compilation was brought to Europe partly by Eleanor of Aquitaine and partly by her son Richard the Lionheart. The contents of the Oleron compilation are identical to the Muslim laws of the ninth-tenth centuries. Finally, the *Consolato del Mare* was written in Spain. The document originates in the Muslim Middle Eastern texts of the eighth-ninth centuries and was later brought to Andalusia. It was translated during the reign of King Alphonse in thirteenth century Castille as part of the great works of translation from Arabic.[25]

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[24] Van Der Wee, *A History of European Banking*, p. 74.

[25] Panzac, "Le Contrat d'Affrément maritime en Mediterranée", pp. 351-358.

One of the most important components of the maritime laws transferred to Europe, was the law of partnerships, or more specifically, the Islamic *mudaraba.* This particular partnership, so essential for financing an entrepreneur, was learnt by Italian merchants doing business in the Middle East. It then became a custom among them and as such was incorporated into the various compilations just mentioned, which facilitated the diffusion of *mudaraba* to Europe, where it came to be known as *commenda.* It is generally agreed that *commenda* was the most important business partnership of medieval Europe and that it played a crucial role in triggering the "commercial revolution".[26]

An equally important institution that was borrowed by the medieval Europeans from the Muslims was the waqf. As it is well known, waqf establishes, finances and maintains, often for centuries, the most essential services any civilized society needs. Foremost among them are the institutions of learning and health, in short, institutions which enhance human capital. We have now definitive evidence that once borrowed, waqf played an enormously important role in the borrowing civilization. To give a highly dramatic example, one of the earliest colleges of Oxford (Merton College) was established in the form of an Islamic *madrasa* and its endowment deed was practically identical to an Islamic waqf deed.[27]

International trade soon necessitated a whole spectrum of new financial instruments. Indeed, invention of other business instruments facilitating monetary transactions did not have to wait very long. Bills of exchange, letters of credit (*suftaja*), promissory notes, ordinary check, and double entry book keeping were all known to the Muslims. Historians are in general agreement that medieval Europe simply borrowed these instruments from the Muslims and

[26] On the debate about the origins of the *commenda* and its vast importance, see; Cizakca, *Comparative Evolution, passim.*

[27] Cizakca, *Philanthropic Foundations,* chapter 1.

could not improve upon them![28] Without these financial instruments long distance trade would simply have been impossible.

Economic/financial principles enshrined in the classical sources undoubtedly point to a capitalist system. This was Islamic, ethical capitalism, which preceded that of the West by a millennium.[29] It is now well established that all the legal and institutional pre-requisites for financing and administering capitalist production and exchange were in place in the Islamic world long before the Europeans started using them.[30]

It appears that these institutions were highly efficient. The fact that they were borrowed by the west shows that they must have operated at lower transaction costs.[31] This is because, the direction of institutional borrowing between two civilizations is from the low cost one to the higher cost one. Put differently, the civilization with the high cost institutions ends up borrowing the lower cost institutions of the other.[32] All of this has been confirmed by the French historian Sayous long ago:

> "The Muslims had, during the 10th-11th centuries incontestably more perfect commercial methods than those of the Europeans'…The Christians of Europe could not improve upon them"[33]

Application of the economic/financial principles enshrined in the Qur'an and the *Sunna* by efficient institutions, accompanied by the conquest of vast areas of the formerly Byzantine and Sasanid empires, created massive wealth. The economic integration of new territories was achieved by merchants, particularly the so-

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[28] Braudel, *Civilization and Capitalism I,* p. 472; Sayous, *Le Commerce des Europeens*, pp. 132-133; Wink, *Al-Hind,* p. 12.

[29] For more on this, see: Çizakça, *Islamic Capitalism and Finance,* ch. 2.

[30] Abu-Lughod, *Before European Hegemony,* p. 224; Udovitch, *Partnership and Profit,* p. 261. Çizakça, *Comparative Evolution, passim.*

[31] For evidence of western borrowing of Islamic economic/financial institutions in the period 8th-13th centuries see; Udovitch,"At the Origins of the Western Commenda"; Çizakça, *Comparative Evolution,* ch. 2; Çizakça, *Philanthropic Foundations,* pp. 8-13.

[32] Çizakça, "Cross-cultural Borrowing", *passim.*

[33] Sayous, *Le Commerce des Europeens,* pp. 132-33.

called *Karimi* merchants, who connected the Indian Ocean to the Mediterranean via Yemen. Karimis were already observed in Fatimid times and their fabuluous wealth is well known.[34]

Wealth, on the other hand, made massive investments through the waqf system in education and research possible. The *magnum opus* of Fuat Sezgin provides a detailed and most impressive account of the scientific advances achieved by Muslims in this period.[35]

Finally, the relentless attacks by Crusaders from the West and Mongols from the East, attest strongly to the relative wealth of the Islamic world. After all, these attacks basically aimed at plunder and it is the wealthy, who attracts plunderers.

V: STAGNATION AND DECLINE

A cursory look at the Islamic world today would suffice to indicate how far this region has declined from its original glory described above. There is an ongoing debate on the causes of decline of the Islamic world. Most recently, Timur Kuran's arguments have become very popular. Although he has made quite convincing arguments, the initial enthusiasm with which the scholarly community welcomed his views is now waning.[36] This is because, while he has boldly accused Islamic jurisprudence with weak evidence, more refined arguments have been made[37], which were supported by solid archival research.[38] Moreover, his theoretical arguments have also been criticized.[39]

In a nut shell, new research has suggested that rather than the alleged rigidity of Islamic jurisprudence, the culprit for the decline of the Islamic world

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[34] Ashtor, "The Karimi", *passim.* Also see; Labib, *Handelsgeschichte* and Abu-Lughod, *Before the European Hegemony,* pp.227-229.

[35] Sezgin, *Wissenschaft und Technik, passim.*

[36] Boogert, "Legal Reflections", 2009.

[37] Çizakça and Kenanoğlu, "Jurisprudential Shift", *passim;* Cizakca, "Long-Term", *passim.*

[38] Boogert, *op.cit.*

[39] Zaman, review article published in *Islamic Studies*; Çizakça, http://eh.net/bookreviews/library, posted: 2011-06-30; Çizakça, *Review of Middle East Studies,* vol. 45, no. 1, 2011.

should be sought in a variety of factors. Of these, the increasing centralization and militarization of the region which occurred in response to the massive pincer attacks by the crusaders and the Mongols, appears to have been the most important. The degree to which this militarization occurred and led to the rise of a garrison state has been indirectly quantified by Maya Shatzmiller, who showed that from the 8^{th}-11^{th} centuries to the 12^{th}-15^{th}, the military/bureaucratic occupations in the Islamic world increased by 200 percent.[40]

Moreover, since the pincer actions never ceased (Mongols, though temporarily defeated in 1258, were still attacking in 1394 and the Crusaders in 1403), the centralization/militarization must have intensified in the long run. Indeed, the decline of the famous Karimi merchants in the fifteenth century is attributed to the ever increasing demands for funds of the central Mamluk government.[41] The Mamluk government played an important role in transforming the very structure of the spice trade from the traditional competitive one to increasing government monopolization. Thus, competitive markets and entrepreneurship were steadily choked by the ever increasing taxes, price fixing and monopolies transforming classical Islamic capitalism into something new.[42] Monopolization of the spice trade reached to a zenith in the period 1429-34 and brought the Karimi era to a decisive end. After establishing a government monopoly over the pepper trade in 1429, Sultan Barsbay prohibited the Venetian merchants from disembarking in the Alexandria harbor. Finally, in 1434 Barsbay forbade all contacts between the Venetians and the Karimis and then completely cornered the pepper market, later expanding his monopoly to other items.[43]

Although this transformation of Egypt and Syria into a garrison state allowed these states to regain and then preserve their territorial independence, it did so at the cost of gradually weakening the classical Islamic capitalism and replacing it with the ever increasing state control of the economy.

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[40] Shatzmiller, *Labour*, p. 258. Shatzmiller has actually confirmed the earlier observation of Abu-Lughod, p. 147.

[41] Ashtor, "The Karimi Merchants", p. 53.

[42] Abu-Lughod, *Before the European Hegemony,* pp. 228-229.

[43] Abu-Lughod, *ibid.*, p. 246, fn. 22.

Evidence pertaining to the evolution of the Egyptian sugar industry supports this argument. Whereas during the thirteenth and the early fourteenth centuries this industry was able to satisfy both the prodigious local demand and exported large quantities to Europe and was described as "capitalistic" in the sense that big trusts were systematically pushing aside the smaller enterprises, the capitalists themselves appear to have been eventually pushed aside by the Mamluk officials. Penetration of the Mamluks into this industry proved to be disastrous for the Egyptian economy in the long run: not only these officials paid lower taxes than the capitalist plantation owners, they could also mobilize peasants through the *corvée* (forced labor). Eventually, during the fourteenth and particularly the fifteenth century, they even began to force merchants to buy their own and the sultan's sugar at inflated prices and took full advantage of their oligopsony powers to purchase the products of civilian producers at depressed prices. Such market distortions and property rights violations undoubtedly caused the technological stagnation observed in the Egyptian sugar industry during the fifteenth century precisely when the European sugar refining techniques began to improve substantially.[44]

These developments were by no means specific to Mamluk Egypt. They were observed in varying degrees in other Islamic empires as well and culminated in the emergence of the so-called Ottoman proto-quasi socialism.[45] Thus, it can be argued that the constant warfare and the instinct for survival transformed the once capitalistic Islamic economies into proto-quasi socialism.[46] This argument has been supported by research conducted in the Ottoman archives, which has revealed wide-spread, consistent and long lasting price and profit controls, property rights limitations, even confiscations – all socialist traits.[47] Latest on-going research by Mehmet Genç in the

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[44] Abu-Lughod, *ibid.*, pp. 232-233, 236.

[45] "Proto" because, the socialism practiced first by the medieval Islamic states and then the Ottoman empire antedated Marxist socialism by centuries; "quasi" because, it was not based upon the Marxist principles and class conflict but, on the contrary, aimed at creating harmony between all citizens, thus following the Qur'anic notion of "ummatan wasatan", a society of the middle, but doing so, went to the other extreme and choked the private enterprise.

[46] For a full treatment of the concept of "proto-quasi socialism", see; Çizakça, "The Ottoman Government", forthcoming.

[47] Genç, *Devlet ve Ekonomi,* passim. Pamuk is more cautious and argues that Ottoman interventionism was selective rather than comprehensive. See his, "Ottoman Interventionism".

Ottoman archives has also revealed powerful government monopolies and a detailed explanation of their *modus operandi,* lending further support to this argument.[48]

VI. RELEVANCE FOR TODAY, WHAT NEEDS TO BE DONE?

If the above conclusion about the proto-quasi socialism and its long lasting impact on the Islamic world is correct, then it should be possible to come up with a policy recommendation. Muslims inhibited for centuries by "proto-quasi socialism", should re-discover their own ethical capitalism with all its principles and institutions enshrined in the classical sources of Islam. The new Islamic economics should focus primarily on the re-discovery of the classical economic principles and their implementation through institutions. Put differently, rather than mimicking the west where very special circumstances had prevailed and the need was felt to discover new laws of economics, Islamic economists should focus instead on the re-discovery of the major financial/economic principles and institutions of their own past and their adaptation to current needs.[49]

Actually, this process has already started! The first building block, *Tabung Haji,* was laid down by Ungku Aziz, a member of the royal family of Johor and then an economist at the University of Malaya. He submitted a memorandum to the Malaysian Parliament in 1959, which aimed at financing and organizing the modern pilgrimage. Ungku Aziz was able to transform the process of preparation for the pilgrimage into a powerful financial institution. Initially, the total number of depositors was recorded at 1,281, which increased to more than five million in 2009. The original depositors had paid in RM 46,610 which increased to RM 897,068,886 in 2008.[50] In recognition of the enormous services he has rendered to Malaysia, the Royal Professor Ungku Aziz was offered the highest honorific title "Tun" by three different Prime Ministers as well as the prestigious *Royal Award for Islamic Finance* but declined to accept all as a matter of principle. There is no doubt that the *Tabung Haji* will be emulated by the rest of the Islamic world.

Still another success story occurred in the field of banking. This pertains to the classical *mudaraba* partnership and its successful modernization. As it is well-

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[48] Genç, "Yed-i Vahid", forthcoming.

[49] Mirakhor and Zaidi, *Islam and Development,* forthcoming.

[50] For a detailed account of *Tabung Haji see;* Cizakca, *Islamic Capitalism,* ch. 12.

known, the *mudaraba* partnership is a true profit and loss sharing partnership originally practiced by the Prophet. The problem with this partnership, however, was that it was practiced in history usually by a *rab al-mal* and a *mudarib,*i.e., only two partners. This meant that the capital entrusted to the agent remained quite limited. A mechanism by which the savings of thousands of people could be entrusted to a powerful agent did not exist in the early history of Islam.

The crucial step for this purpose was taken by Dr. Ahmad al-Naggar in the year 1963. This was the establishment of the first ever Islamic bank in Mit Ghamr in Egypt. This bank was envisaged as a multiple *mudaraba* with hundreds of depositors/investors entrusting their hard earned savings to it acting as the *mudarib,* agent. Today, Islamic banks are flourishing all over the Islamic world, even in non-Muslim countries, collecting the savings of hundreds of thousands Muslims and non-Muslims and channelling them for profitable projects. We can argue with confidence that Islamic banks have transformed Muslim countries from being non-bank societies to banking societies. This modernization of a classical Islamic partnership is not an achievement to be underestimated.

But at this context it is important to remember that one of the most important goals of Dr. Al-Naggar, enhancement of entrepreneurship through these banks, has not materialized. Had Dr. al-Naggar's original plan of applying the *mudaraba* not only at the liability side but also at the asset side been followed, the goal would have been fulfilled and Islamic banks would have been able to create thousands of entrepreneurs.[51] But as it is well-known, the asset side of Islamic banks is dominated by *murabaha* sales, not the most useful instrument to enhance entrepreneurship. Islamic banks preferred to utilize the *murabaha* primarily because they were worried about their committments to pay back their depositors. Because *Mudaraba* is a long term and risky instrument, there were serious concerns about the mismatch of funds. *Murabaha,* by contrast, provided fixed returns that could be paid back to the depositors easily.

All of this indicates that, as far as encouraging entrepreneurship is concerned, the task is not yet completed. Scholars are now actively searching for other historical instruments that can be modernized so as to provide both fix returns to the depositors and at the same time also enhance entrepreneurship through

[51] *Mudaraba* protects the entrepreneur by shifting all the pecuniary loss to the capitalist. It is therefore truly a profit/loss sharing contract. The agent loses only his time and effort. Its closest western equivalent is venture capital, which triggered in the United States the Information Technology Revolution.

equity finance. In short, there is an urgent need for the development of hybrid instruments.

One of these is *esham,* originally utilized by the Ottoman Caliphate back in 1775 to borrow large *Shari'ah* based funds from the public in order to pay a huge war indemnity to the Russians.[52] A research team at INCEIF, *the Global University of Islamic Finance* at Kuala Lumpur, has identified *esham* as a multiple, unlimited mandate *mudaraba,* which also yielded fixed returns.[53] Thus, the battle to develop *Shari'ah* based profit and loss sharing funds not only enhancing entrepreneurship but also yielding fixed returns to the investors has now reached a new plateau. The INCEIF team is convinced that *esham* can be used for government borrowing. Some team members are also of the opinion that it can be used by the central banks of Islamic countries for open market operations as well as for small and medium enterprise financing.

A close look at *sukuk,* on the other hand, has revealed that this instrument also represents the modernization of not one but two historical instruments, cash waqfs and, once again, *esham*. To what extent the financial engineers who designed the *sukuk,* were aware of these historical instruments is not yet clear – at least one engineer has claimed that he was. Be that as it may, the *sale-lease back-repurchase* method so often used in most *sukuk al-ijara* was originally utilized in the Ottoman cash waqfs. The special purpose vehicle, the crucial part of any *sukuk,* itself, is but a simple cash waqf. As for securitization, that is the idea of dividing a revenue stream into equal parts to be sold to the public, this was first used in 1775 as explained above. In short, *sukuk,* which is currently the most popular instrument of borrowing, whether sovereign or private, is also a highly successful example of financial engineering using historical instruments.

Still another successful modernization occurred in the field of insurance leading to *Takaful.* This involved the modernization of the age old *al-aqilah,* a tribal custom among the Arabs going back even to the pre-Islamic era.[54]

In short, the revival of historical financial instruments to enhance contemporary Islamic finance is well on its way. This is taking place either by an economist

[52] On the details of *esham,* based upon Mehmet Genc, see; Çizakça, *Islamic Capitalism,* pp. 71-74; 165, 178, 180.

[53] Cizakca, Staff paper, p.1

[54] Cizakca, *Islamic Capitalism,* pp. 195-196.

redesigning an ancient tradition (*Tabung* Haji and the Mit Ghamr Bank), or financial engineers, not aware of historical instruments, re-discovering them without realizing their origins (*sukuk*), or more deliberately and systematically, by economic/financial historians informing financial engineers and *Shari'ah* scholars about certain historical instruments and reviving them together in a joint effort (*esham*). The latter is the method used by INCEIF.

VIII. CONCLUSION

Islamic economics is unique in the sense that while one sub-branch of it, finance, has developed by leaps and bounds, the discipline itself has by and large stagnated. This lop-sided development of the field, has led us to expect Islamic finance almost singlehandedly to lead to economic development. But no financial system, no matter how perfect, can generate economic growth without the rest of the economy following and the rest of the economy cannot follow the financial sector unless certain pre-conditions are satisfied.

These pre-conditions are, in a nut-shell, the rule of law, the democratic package, the basic freedoms and the avoidance of sectarian violence. A detailed analysis of these concepts and their compatibility with the *Shari`ah*, however, would be well beyond the confines of this article.[55]

[55] See on this, Cizakca, *Islamic Capitalism,* part V.

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