

**Moral Values and Financial Markets:  
Islamic Finance and the Financial Crisis,**

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**Islamic Economic System as an “Embedded” System:  
Economic Analysis of *Fiqh al-Muamalat* and its  
Macroeconomic Implication to the Current Financial Crisis**

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# 1. Introduction

- This presentation:
  - Clarify the distinctive features of the Islamic Economic System (IES) and the commonalities between the IES and Modern Capitalism (MC)
  - Try to provide the fundamental framework for understanding...
    - Relationship between IES and the economic fluctuations
    - Impact of the current financial crisis on the existing Islamic Finance


## 2. Literature Review

- Two types of Literature:
  - IES is ‘a sort of the sharing system.’
  - Islamic finance is an ‘asset-backed.’
- There is some truth in the way each type of literature describes...
  - Each opinion is determined by only focusing on one aspect of the financial instruments in Islamic finance
  - Not comprehensive picture of IES as whole system

## 3. Methodology (1)

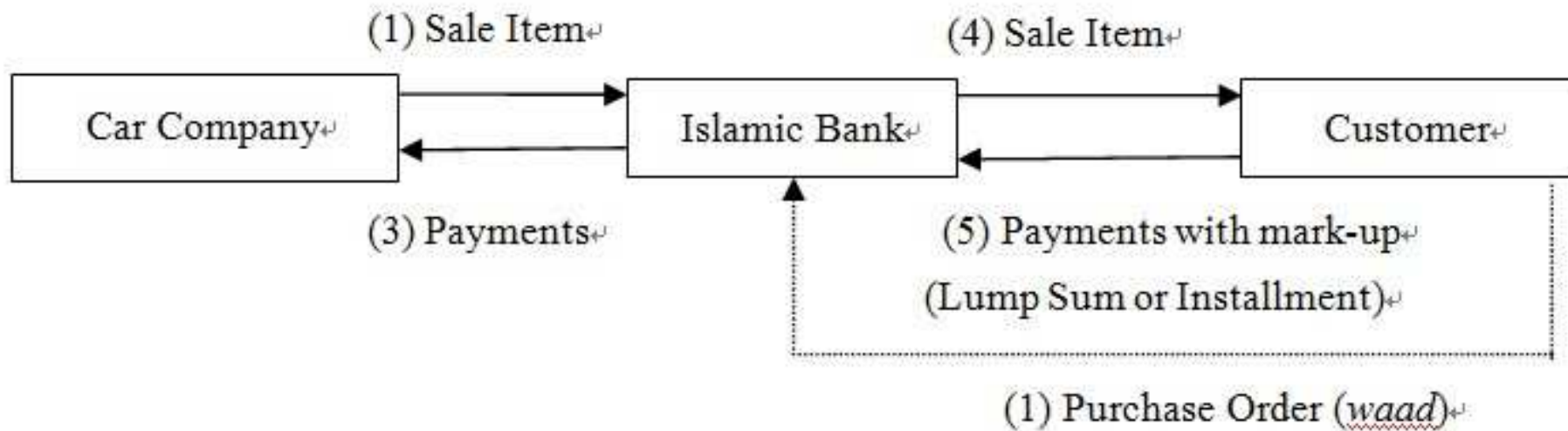
- Methodology
  - Pick up several discussions on the legitimacy of Islamic financial products
  - Review the legal resolutions (*Fatawa*) issued by *Sharia* scholars
  - Two Case Studies
    1. *Murabaha*
    2. *Tawarruq*

## 3. Methodology (2)

- Questions:
    - How *Sharia* scholars differentiate between Islamic finance and modern capitalistic finance (conventional finance)?
    - What is the logic behind their approval or disapproval of Islamic financial products?
- 
- Distinctive features of IES

## 4. Case 1: *Murabaha* (1)

- Basic Scheme of *Murabaha*
  - The most popular product of asset side



## 4. Case 1: *Murabaha* (2)

- Controversy over *Murabaha*
  - Is “mark-up” similar to “interest” prohibited in Islam as *Riba*?
  - Critique by Ziauddin Ahmad [Ahmad 1985]
    - There is genuine concern among Islamic scholars that if interest is largely substituted by devices like ‘mark-up’ it would represent a change just in name rather than in substance, and the new system would not be rid of the iniquitous nature of the interest-

## 4. Case 1: *Murabaha* (3)

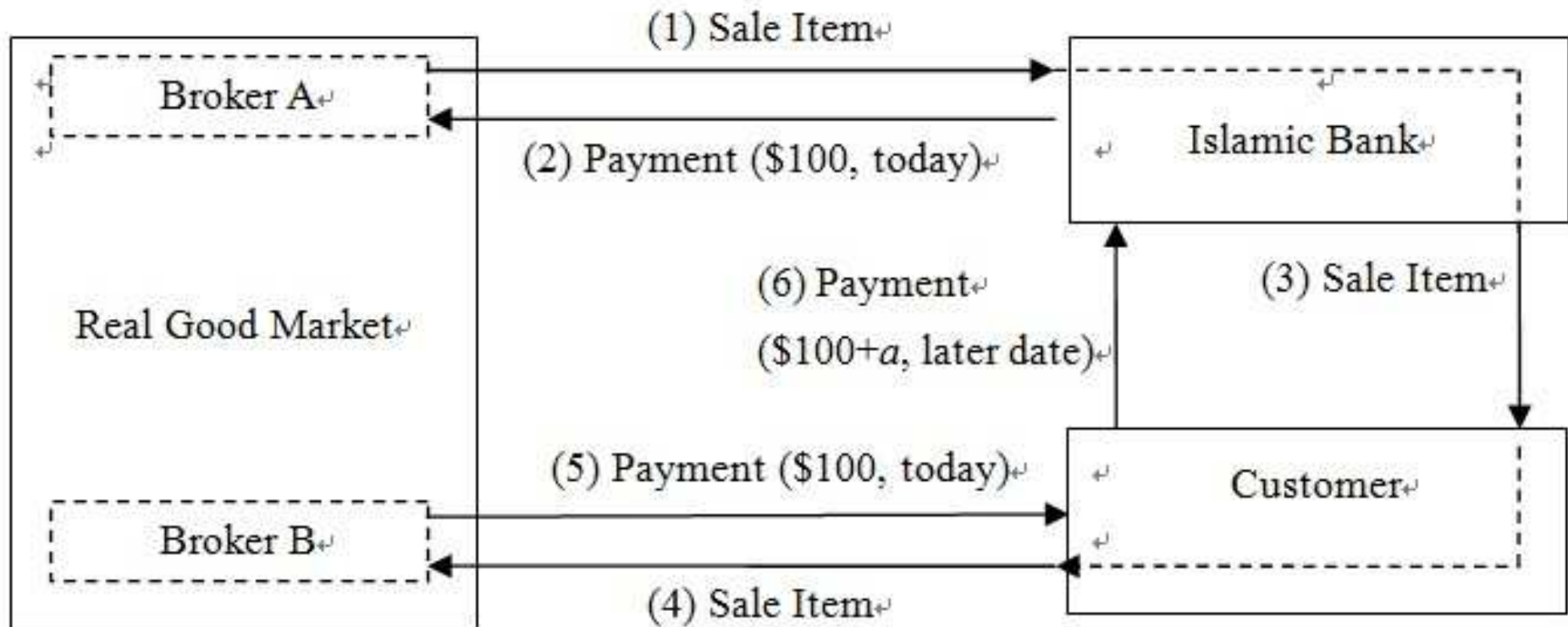
- Resolution by *Sharia* Scholars
  - *Fatwa* of the first Al-Baraka Seminar in 1983 [ABS 1983]
  - Q: Some people cast doubt on the legitimacy of *Murabaha* contracts because this form of contract seems to include some elements of *Riba*.

## 4. Case 1: *Murabaha* (4)

- Resolution by *Sharia* Scholars (contd.)
  - *Fatwa* of the first Al-Baraka Seminar in 1983 [ABS 1983]
  - A: In *Murabaha* ... is conducted in the form of exchange ... real goods for money. The specific feature of *Murabaha*, as compared to *Riba*-based loans, is that even if the mark-up amount is predetermined the seller's profit will be influenced by the market price of the relevant real good. Therefore, any profits in *Murabaha* are expressed as a function of supply and demand in the real goods market rather than the monetary market.

## 5. Case 2: *Tawarruq* (1)

- Basic Scheme of *Tawarruq*
  - Alternative method of securing liquidities



## 5. Case 2: *Tawarruq* (2)

- Controversy over *Tawarruq*
  - Is it allowed to stipulate the transactions of (5) and (6), which relate to the reselling of goods in the *Tawarruq* contract itself?
  - Is *Tawarruq* a fictitious method of avoiding interest-based loans?
    - Real purpose of *Tawarruq*: transactions of real goods or acquisition of liquidities?

## 5. Case 2: *Tawarruq* (3)

- Revision of Resolutions by the Fiqh Academy in the Muslim World League [MFI 1999; 2004] & in the OIC
  - Original Resolution in 1998 (MWL)
    - *Tawarruq* is approved
  - Revised Resolution in 2004 (MWL)
    - Two types of *Tawarruq*
    - *Tawarruq Haqiqi*: approved
    - *Tawarruq* practiced in Islamic finance (*Tawarruq Munazzam* [al-Suwaylem 2005]): disapproved
  - New Resolution in 2009 (OIC)

## 5. Case 2: *Tawarruq* (4)

- Critique against *Tawarruq Munazzam* in the Revised Resolution (2004, MWL)
  - Against the possibility of overlooking the actual transfers of real goods
  - Against fictitious forms of interest-based loans
  - Against the involvement of the Islamic bank in resale transactions [(5) and (6)]

## 5. Case 2: *Tawarruq* (5)

- The latest resolution by OIC (2009)
  - The contemporary definition on organized *tawarruq* is: when a person (*Mustawriq*) buys merchandise from a local or international market on deferred price basis. The financier arranges the sale agreement either himself or through his agent (*Tawki*).
  - Reinforcing the second MWT resolution by defining *Tawarruq Munazzam* more clearly
  - Even the involvement of the agent of Islamic bank becomes to be

## 6. Distinctive Feature of IES (1)

- Economic Implications of Both Cases (A)

- Actual transfers of real goods are required as an essential condition of *Murabaha*.
- The actual transfers of real goods are not overlooked in *Tawarruq*
- *Murabaha* and *Tawarruq* are legitimized not because of the “loan” but because of the “buying and selling of goods.”

## 6. Distinctive Feature of IES (2)

- Economic Implications of Both Cases (B)

- Any profits from *Murabaha* are expressed as a function of supply and demand in the real goods market.
- The source of legitimacy of mark-up in *Murabaha* is considered as opportunity costs of the real goods. [Misri 1976; Shihata 1987].
  - Source of prohibition of interest in conventional

## 6. Distinctive Feature of IES (3)

- Economic Implications of Both Cases (B) (Contd.)

- Involvement of Islamic banks in resale transactions[(5) and (6)] is prohibited in *Tawarruq*.



- Scheme of *Murabaha* and *Tawarruq* must bear the market risk of the relevant real good.

## 6. Distinctive Feature of IES (4)

- What is the distinctive feature IES from the analysis of logic for legitimating Islamic finance?
  - Strong link with the real domain of the economy
  - Market mechanism in the real domain affects the performance of the monetary domain.
- Distinguishing Feature of IES
  - “**Embedded**” (Karl Polanyi) system of the monetary domain of the economy into the real domain.

## 7. Commonality between IES and MC (1)

- Economic Fluctuation and Islamic Finance
  - Considering the response of Islamic finance to the impacts of economic fluctuation
  - Are there specific devices for mitigating economic shocks?

## 7. Commonality between IES and MC (2)

- Case 1: Price Fluctuation Caused by Monetary Factors (e.g., Inflation)
  - Islamic finance allows price indexation in *Ijara* (lease contracts) [AAOIFI 2007; ABS 1990; Usmani 2005] and *Qard Hasan* (interest-free loan) [Kahf 2007].



- IES equips devices for mitigating economic shocks from the monetary domain.

## 7. Commonality between IES and MC (3)

- Case 2: Price Fluctuation Caused by Real Factors (e.g., supply-demand imbalance)
  - Islamic finance does not allow price indexation in case of price fluctuation caused by real factors.
  - Any profits from Islamic financial products must bear the market risk of the relevant real goods.
  - Empirical evidence [Tag El-Din 2004; Hasebe 2004]
- IES does not equip devices for mitigating economic shocks from the real domain.

## 7. Commonality between IES and MC (4)

- Economic Fluctuation and IES
  - No specific devices for mitigating economic shocks in the real domain of the economy
- Commonality between IES and MC
  - Common theoretical platform as far as the real domain of the economy is considered.
  - E.g. Similarity between partnership finance in Islamic finance and equity finance in modern capitalist finance

## 8. Implication to the Economic Fluctuations (1)

- Try to providing the theoretical framework for understanding...
  - Relationship between IES and the economic fluctuations
  - Impact of the current financial crisis on the existing Islamic finance
    - “IES and Islamic finance” is robust & stable compared with “MC and conventional finance”?

## 8. Implication to the Economic Fluctuations (2)

- Existing literatures on the impact of the current financial crisis on Islamic finance
  - ...the Islamic financial industry has been able to weather this first wave of the global financial crisis, demonstrating its robustness as a stable form of financial intermediation. The resilience of the Islamic financial institutions during this crisis epitomises the intrinsic strengths embedded in Islamic finance that are underpinned by forces of the Shariah principles. (Speech by Dr Zeti Akhtar Aziz)

## 8. Implication to the Economic Fluctuations (3)

- What does the notion of “Embeddedness” imply?
  - Instability of IES arising from the monetary causes alone does not tend to occur as long as the linkage between Islamic financial products and the real domain of the economy exists.
  - In the case of the economic crisis caused by real sectors, IES does not possess any autonomous mechanisms to prevent it.

## 8. Implication to the Economic Fluctuations (4)

- **Important theoretical points:**
  - The financial system in IES itself does not have probability to be a starting point of the economic crisis.
  - The instability of IES is necessarily accompanied by the depression caused by the other sectors (real sectors or conventional financial sectors).

## 8. Implication to the Economic Fluctuations (5)

- Implication to understand the impact of the current financial crisis on the existing Islamic finance
  - We need keep in mind that the existing Islamic finance (e-IF) exists with conventional finance together!

## 8. Implication to the Economic Fluctuations (6)

- Two paths for the impact from the economic fluctuations on e-IF
  - Direct impact from conventional finance to e-IF, which is not “negative” rather “positive”
  - Indirect negative impact from conventional finance via depreciation of the real domain of the economy caused by the financial crisis.

## 8. Implication to the Economic Fluctuations (7)

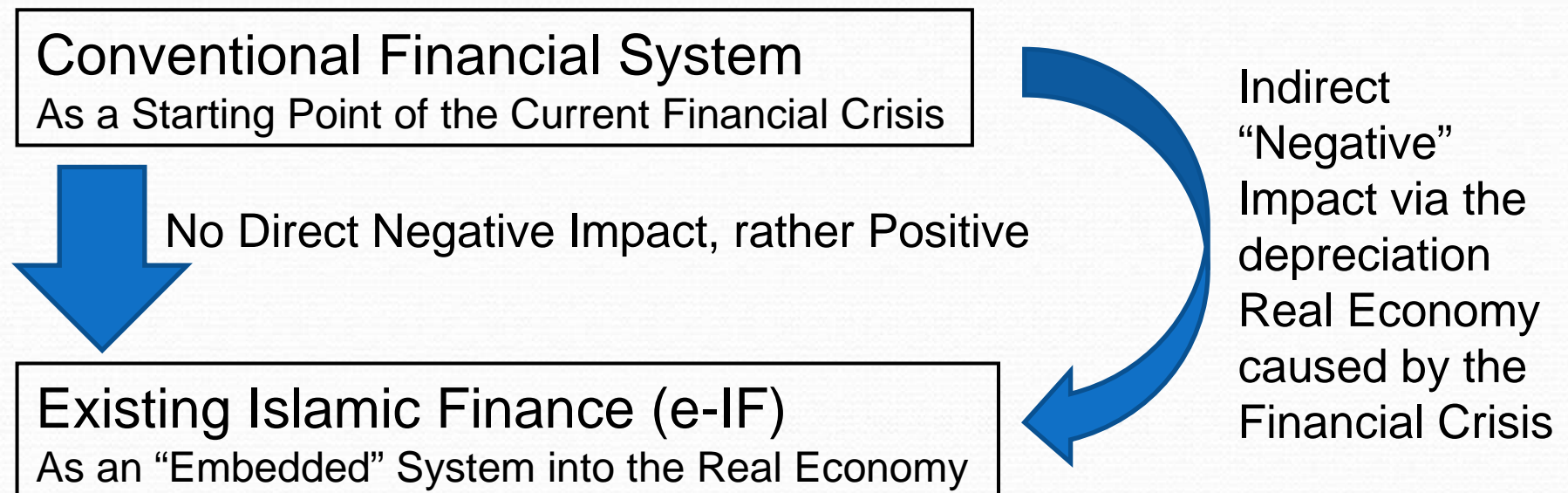
Conventional Financial System  
As a Starting Point of the Current Financial Crisis



No Direct Negative Impact, rather Positive

Existing Islamic Finance (e-IF)  
As an “Embedded” System into the Real Economy

## 8. Implication to the Economic Fluctuations (8)



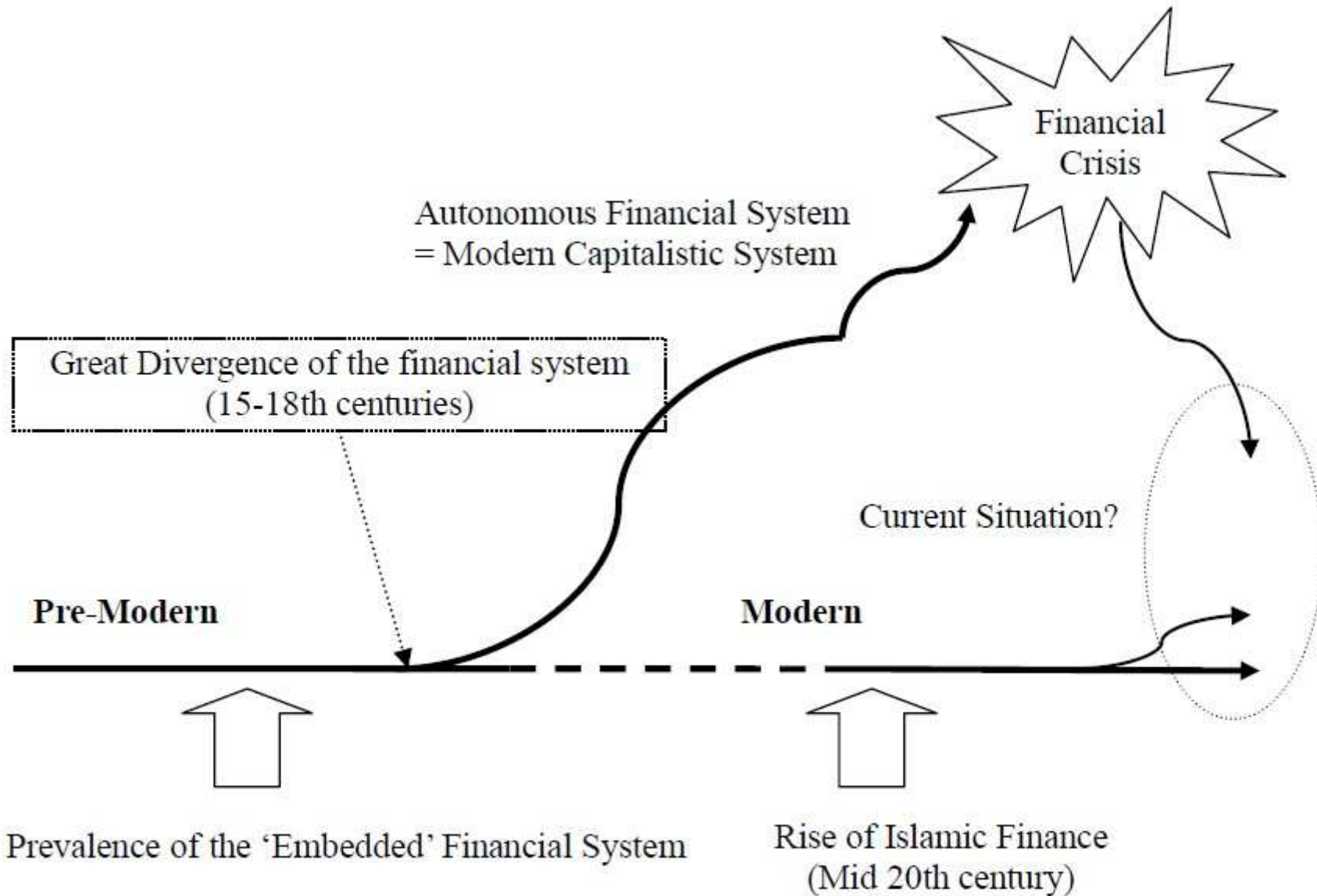
## 8. Implication to the Economic Fluctuations (9)

- Impact of the current financial crisis to the existing Islamic finance (**theoretical insight**)
  - Direct positive impact > Indirect negative impact via real economy
    - Impact of the financial crisis is positive
  - Direct positive impact < Indirect negative impact via real economy
    - Impact of the financial crisis is negative
  - Empirical fact?
    - Recent incident of the default of *Sukuk* issued by

## 9. Historical Significance of IES and IF (1)

- What does the distinctive feature “**embeddedness**” imply from the historical perspective?
- Question:
  - Has the interest-based modern capitalist financial system been a universal one in any period in history?
  - An analysis into the historical background of the pre-modern Islamic world and the medieval Mediterranean world

# 9. Historical Significance of IES and IF (2)



Thank you for your kind attention!

