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The Relevance of Islamic Finance Principles in Economic Growth

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Abstract: Islamic finance is one of the most rapidly growing segments of the global financial system. The emergence of Islamic finance can be traced back to 1963 in Egypt, while its importance comes to the global financial system only after the global financial crisis occurred in 2008. It has been reported that the continuing volatility in bond and equity markets, combined with the uncertainty surrounding the Euro Zone, has opened up the Islamic finance industry to a new segment of potential investors looking to diversify away from traditional investments. However, despite the increasing importance of Islamic finance, particularly in developing economies in the Middle East and South-East Asia, religious and social complexity has acted against a wholistic understanding by policymakers, researchers and practitioners. This paper provides a review and analysis of the definition, principles, and instruments of Islamic finance that is provided by most Islamic banks. Also, this paper tries to answer the question as to what are the key principles of Islamic finance which led to economic growth. We find that the Islamic finance principles are conducive to the growth of economy as they help in reducing inflation, monetary volatility, and unemployment, besides in achieving social justice and optimum allocation of resources.

Key worlds: Islamic finance, Economic growth, Islamic banks, Social justice

1. INTRODUCTION

Islamic finance is growing as a source of finance for Islamic and other investors around the world. During the past years, one of the rising stars in the world of finance, has been Islamic finance. From the skyscrapers of Dubai and Kuala Lumpur, to the XIX century palaces of Paris, there has been a growing interest in this business. Islamic finance involves structuring financial instruments and financial transactions to satisfy traditional Muslim strictures against the payment of interest and engaging in gambling. It is a field of growing importance for conservative Muslims, especially in the Middle East and large Muslim population in South-Eastern Asia countries, who are uncomfortable with Western-style of financial system and banking that involve explicit payments of interest.

The year 2012 marked a turning point for Interest –free banking growth, as new markets and new regulations in the Mid East, helped the sector to flourish. According to Ernst and Young, globally assets of Islamic finance managed in line with Shariah (The Path", term of Islamic law consists of Islamic instructions based on the Holy Quran and Sunnah) will reach in 2013 to U.S. $ 1.8 trillion, from U.S. $ 1.2 trillion in 2012. Neither the ongoing turmoil in the Middle East nor the Euro Zone debt crisis could prevent Islamic banks in the Middle East from reaching out to new markets and more business. This rapid growth has been fuelled by surging demand for Shariah-compliant products not only from financiers in the Middle East and other Muslim countries, but also by investors globally, thus making it a global phenomenon.

Lately, the Vatican (2009) noted that Western banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. Despite the financial crisis which has plagued the economies of both industrialized and developing nations, the Interest –free banking industry has been flourishing, and has enjoyed a 29 percent growth in assets to reach more than U.S. $ 600 billion in 2008 (Figure1).

Source*:* Deutsche Bank, (2011)

In recent years, growth in Islamic financial assets has generally outperformed conventional financial instruments, particularly following the onset of the financial crisis that has been gripping the world since 2008. The performance and relative stability of Islamic financial institutions during the financial crisis that hit the world in 2008 stems from the distinctive features of the instruments they offer. Islamic finance emphasizes asset backing and the principle of risk sharing, prohibition of interest, ensuring a direct link between financial transactions and real sector activities. The return on savings and investment is closely linked (determined by the real sector, not the financial sector); giving Islamic finance modes a flexible adjustment mechanism in the case of unanticipated shocks. The adjustment mechanism ensures that the real values of assets and liabilities will be equal at all points in time, and prohibits excessive risk taking, thereby avoiding several forms of complicated securitization (Chapra, 2008).

Despite the rapid growth of Islamic finance, and its importance in the global financial finance, many financial researchers and policy makers don't understand the key principles of Islamic finance and their advantages on the economy. The

present study tries to explain and discuss the principles and modes of Islamic finance, and how these principles participate in economic growth and social justice to the society.

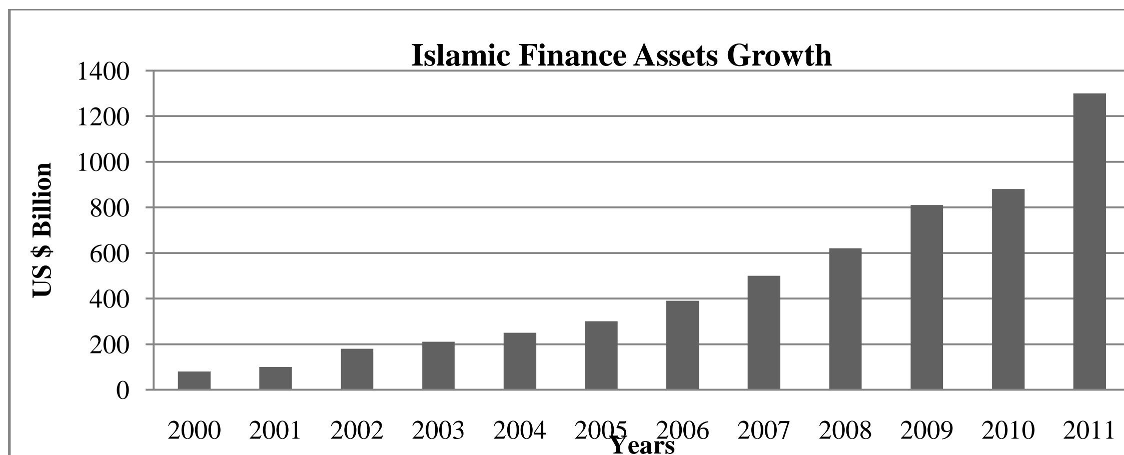

Fig.1 Global Shariah-Compliant Financial Assets (2000-2011)

2. RESEARCH PROBLEM AND OBJECTIVES

Many studies have focused on the impact of finance on economic growth. However, few studies have examined the impact of Islamic finance principles on economic growth. To fill this gap in literature, this paper investigates the potential effects of Islamic finance principles and its instruments on economic growth. We believe that the results of this paper will help decision makers and finance scholars to understand the advantages of Islamic finance principles, and their role in enhancing growth of economy of any nation.

3. RESEARCH METHODOLOGY

The qualitative method has been used. The qualitative approach is used to review the existing literature from all resources such as academic, scholarly journals, magazines, documents, workshops, and other related literature of Islamic finance industry.

4. ISLAMIC FINANCE DEFINITION

The term Islamic finance refers to a system of financing that is consistent with the principles of the Islamic Shariah, which in turn is based on the Quran (the holy book of Islam) and the Sunnah (the recorded life, times and deeds of Prophet Mohammad). All forms of Islamic financing must comply with certain Islamic Shariah principles. Most notably, Islamic Shariah prohibits riba (interest) and particularly the payment or receipt of interest. Warde (2000) defines Islamic finance as, roughly, "all financial practices that are based, in their objectives and operations, on Qu'ranic principles". This is a broad definition, but it captures the essential nature of Islamic economics as an attempt to reconcile religious principles with economic activities. This goes far beyond interest-free banking to include, for example, refusing to do business with companies that operate in morally impermissible sectors (such as gambling). That said, in the actual operations of Islamic financial institutions, and for the purposes of this paper, the essential defining feature of Islamic finance is the explicit prohibition of transactions that involve riba (interest).

5. THE DEVELOPMENT OF ISLAMIC FINANCE IN THE WORLD

Since the mid-fifties, a debate on the possibility of a finance model consistent with the Shariah law (Shariah compliant) has been opened in Muslims societies. Islamic finance originated in the Egyptian village of Mit Ghamr. It was the year 1963 when an agricultural bank, created to copy German agricultural banks, started to provide small private entrepreneurs with micro loans, thus also promoting the individual habit of saving. Both the recipient of funds and the investor were members of the bank and shared its profits in accordance with Islamic ethic. The economist Ahmad El Najjar, founded the first religious oversight board composed of ''ulama'' (i.e. Muslim legal scholars). The first oil crisis in 1973-1974 provided Arab countries with the necessary capital to found Islamic financial institutions. In 1975, the Islamic Development Bank was created by the Organization of Islamic Conference.
The aim was to promote the development of all Muslim communities in accordance with the principles of Shariah. In the same year, the Dubai Islamic Bank, the first Islamic commercial bank not owned by a government, was established. Other Islamic banks were then established in Arab countries, the Philippines, Malaysia and so on. In 1979, Iran has Islamized the entire national banking system, followed by Pakistan in the early eighties and then the Sudan in 1992. In 2003, the first Islamic bonds (Sukuk) were issued in dollars by sovereign countries and then by companies. In 2004, the German state of Saxony-Anhalt issued the first €100 million Sukuk outside a Muslim country. The same year, the commercial bank Islamic Bank of Britain was established, while the first bank in Europe of this type was established in

1978 in Luxembourg. In 2006, the first investment bank of the continent, the European Islamic Investment Bank, was fully operational (Gabriella, 2012).

Today, there are more than 20 traditional institutions offering Islamic products in London. In addition, there are several Islamic credit banks in the US. During the last three decades, the number of Islamic financial institutions has risen from one institution in one country in 1963 to over 300 institutions operating in more than 75 countries worldwide (Qorchi, 2005). The sector is increasingly open, innovative, sophisticated and competitive. The major western banks operate in Muslim countries either with traditional and Shariah-compliant credit or through branches dedicated to Islamic financial products. In short, the importance of Islamic finance in the world depends on its extraordinary growth rate and its management model, which is subordinate and/or competitive with the traditional one.

6. THE KEY PRINCIPLES OF ISLAMIC FINANCE

Islamic finance theory promotes economic development in three main ways: its direct link to the real economy and physical transactions, its prohibitions against harmful products and activities, and its promotion of economic and social justice. Islamic finance cannot support such conventional finance activities as debt rescheduling, debt swap, speculation, and other purely monetary or financial activities that do not add to the real economy (Kahf, 2007).

Shariah is the body of Islamic religious law that determines the legal framework within which the public and private lives of Muslims are regulated. A large portion of Shariah is dedicated to how the economy of Muslim societies should operate. Part of the body of law regarding the economy, forms the foundation of what has become the modern Islamic finance industry. The root of the Islamic financial system is the prohibition of riba (interest) in society besides many other viable principles that if applied, not only Muslim economies have enhanced but also the global economy will become healthier. Islamic finance is based on the themes of community banking, ethical banking, and socially responsible investing. Its goal is to be an ethical, indigenous, and equitable mode of finance. If global banking practices adhere to the principles of Islamic finance, which are based on noble ideas of entrepreneurship and transparency, global financial crisis would have been prevented. The following are the main principles of Islamic finance:

1. Prohibition of Riba (interest): Riba is an Arabic word for “growth” or “increase” and denotes the payment or receipt of interest for the use of money. The Qur’an expressly forbids riba, which includes any payment of interest (not only excessive interest) on monetary loans. The Quran states, “O You who believe! Fear Allah and give up what remains of your demand for usury, if you are indeed believers.” Usury encompasses any payment of interest. Muslim scholars have interpreted riba to mean any fixed or guaranteed interest payment on cash advances or on deposits (Mahmud, 2004).In prohibiting riba, Islam seeks to foster an environment based on fairness and justice. A loan with a fixed return to the lender, regardless of the outcome of the borrower’s course of action is viewed as unfair. Riba is also believed to be exploitative and unproductive because it is considered to represent sure gain to the lender without any possibility of loss as well as a reward in return for no work.

These factors are believed to lead, in turn, to inflation and unemployment and to stifle the social and infrastructural development of a nation. Dependence on interest prevents people from working to earn money, since the person with dollars can earn an extra dollar through interest, either in advance or at a later date, without working for it. The value of work will consequently be reduced in his estimation, and he will not bother to take the trouble of running a business or risking his money in trade or industry. This will lead to depriving people of benefits, and the business of the world cannot go on without industries, trade and commerce, building and construction, all of which need capital at risk. Further, permitting the taking of interest discourages people from doing good to one another, as is required by Islam. If interest is prohibited in a society, people will lend to each other with goodwill, expecting back no more than what they have loaned, while if interest is made permissible, the needy person will be required to pay back more on loans (than he has borrowed), weakening his feelings of great good will and friendliness toward the lender. (This is the moral aspect of the prohibition of interest).

Finally, the lender is very likely to be wealthy and the borrower poor. If interest is allowed, the rich will exploit the poor, and this is against the spirit of mercy and charity, (This is the
social aspect of the prohibition of interest). Thus, in a society in which interest is lawful, the strong benefits from the suffering of the weak. As a result, the rich become richer and the poor become poorer, creating socio-economic classes in the society separated by wide gulfs. Naturally, this generates envy and hatred among the poor toward the rich, and contempt and callousness among the rich toward the poor. Conflicts arise, the socio-economic fabric is rent, revolutions are born, and social order is threatened (Warde, 2000).

Recent history illustrates the dangers to the peace and stability of nations inherent in interest-based economies. Friedman (1969) has demonstrated that a zero nominal interest rate is a necessary condition for an optimal allowance of resources. Fixing a zero interest rate, traders will have no reason to substitute real resources for money, so more resources will be conducted to investments. Therefore, when fixing a positive price for money, traders would economize money for a fixed return and to reduce their transaction costs. It is demonstrated empirically that zero interest rate is both necessary and sufficient for efficient allocation in general equilibrium models (Wilson, 1979). Thus, Islam prohibits interest in the finance system to promote economic and social justice.

2. Risk and Return Sharing: Shariah prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards between the parties to a transaction (no pain no gain strategy). This profit sharing mechanism is believed to encourage people to become partners and work together rather than to enter into a creditor–debtor relationship. Partnership promotes mutual responsibility for the outcome of the financed project, which is believed to increase the likelihood of success of the venture. A tangential aim of the partnership approach is to help increase the growth of successful projects, also provide stimulus to the economy. On the basis of "z-scores" analysis, Cihák and Hesse (2008) proved that Islamic financial system is financially stronger and less risky than conventional banks. In the conventional system, a depreciation of assets due to an exogenous shock downgrade the bank Equity capital, since its depositors have fixed value securities (the deposits), and which may lead to risks to provoke the bankruptcy. In an Islamic system, the possessors of investment accounts don't have fixed value securities, in macroeconomic or bank-specific crises investment depositors automatically share the risk, which allows an adjustment of the liability, in case of asset reduction.

3. Avoidance of Gharar: Shariah prohibits financial transactions that involve Gharar, which is often translated as "deception," "excessive risk," or "excessive uncertainty". Gharar refers to any transaction of probable items whose existence or characteristics are not certain, due to lack of information, ignorance of essential elements in the transaction to either party, or uncertainty of the ability of one party to honor the contract. The Islam has forbidden the purchase of the unborn animal in the mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to distribution, the purchase of charities prior to their receipt, and the sale of fish in the sea.

All Islamic finance scholars agree that Gharar should be avoided in commercial exchange contracts. As Islamic Shariah forbids riba (interest) because it leads to exploitation and injustice in the society, it also forbids Gharar in any transaction to protect the two parties from deceit, ignorance, and uncertainty. All Islamic financial and business transactions must be based on transparency, accuracy, and disclosure of all necessary information, so that no one party has advantages over the other party. Islam has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. It may be in the form of hazard leading to uncertainty in any business, or deceit or fraud or undue advantage.

The rationale of Prohibition of Gharar is to ensure full consent and satisfaction of the parties in a contract. Without full consent, a contract may not be valid. Full consent can only be achieved through certainty, full knowledge, full disclosure, and transparency.

4. Shariah Approved Activities: Islamic finance integrates Islamic moral and ethical principles and, as such, prohibits financing harmful products and activities. For example, Islamic banks prohibit financing to such industries as alcoholic beverages, tobacco, casinos, and pornography. Islamic banks do not participate in financing activities that are harmful to society and that would consequently hinder development. By following this principle, Islamic banks improve the productivity in the economy and reduce the social and economic costs of such harmful products and services (Siddiqi, 1999). To ensure that all products and services offered are Shariah compliant, each Islamic bank has an independent Shariah supervisory board.

5. Sanctity of Contract: Islam views contractual obligations and the related full disclosure of information as a sacred duty. Full disclosure is intended to reduce financial speculation (gambling), which is strictly prohibited by Islam, by providing as much information as possible for investors to make accurate assessments about the risks and rewards of an investment. The conditions that are necessary for a contract to be valid include a competent understanding of the underlying assets and the profit-sharing ratio, as well as the presence of a willing buyer and seller. Contracts must also not offend Islamic religious and moral principles; if they do, they will be deemed illegal and unenforceable (Shanmugam, 2009).

6. The usage of money: Money is a means for conducting transactions and not a commodity to be traded is another important principle in Islamic finance. Islam recognizes money as a medium of exchange and prohibits the sale of money as a commodity. The Islamic concept of money is such that the value of money is the reflection of the value of the commodity and has no value of its own. Therefore, it is not to be traded but to be used as a medium of exchange in order to facilitate the transactions undertaken by the society.

7. Paying and Collecting of Zakah (payments to the poor): Metwally (2006,) provides a comprehensive definition of Zakah as follows: "Zakah is the cornerstone of the financial structure in an Islamic economy". Literally, Zakah means purification. Technically, it means a contribution of a proportion of wealth for the use of the poor and needy people. Also it's important to notice the experience of Islamic banks in alleviating poverty through the use of Zakah funds to improve the socio-economic development in the society. This is by either making the poor and needy people more productive, which in turn contribute to the economic development, financing human welfare activities.

Based on the above principles, the Islamic finance system has the following advantages over the conventional finance system as shown in figure 2.

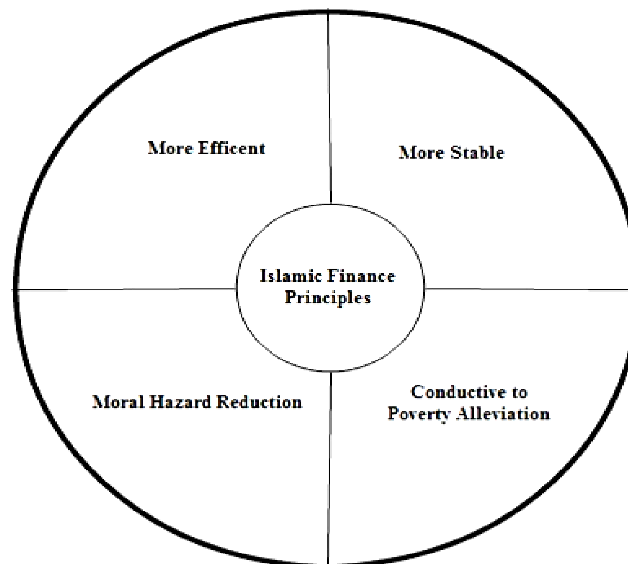

Fig. 2: Islamic Finance Principles Advantages

7. KEY ISLAMIC FINANCE INSTRUMENTS:

Central to Islamic finance is the fact that money itself has no intrinsic value. As a matter of faith, a Muslim cannot lend money to, or receive money from someone and expect to benefit. This means that interest is not allowed and making money from money is forbidden. Money must be used in a productive way, by which wealth can only be generated through legitimate trade and investment in assets. The principal means of Islamic finance are based on trading. Any gains relating to the trading are shared between the party providing the capital and the party providing the expertise. As a result, the Islamic banks have developed six main Islamic financing techniques, which are: Mudaraba, Musharaka, Murabaha, Ijara, Istisna and Salam (Karim, 2002).

1. Mudarabah (Trust financing): Contracts are profit-sharing agreements, in which a bank provides the entire capital needed to finance a project, and the customer provides the expertise, management and labour. The profits from the project are shared by both parties on a pre-agreed (fixed ratio) basis, but in the cases of losses, the total loss is borne by the bank (Schaik, 2001).

2. Musharakah (Partnership): Contracts are similar to joint venture agreements, in which a bank and an entrepreneur jointly contribute capital and manage a business project. Any profit-and-loss from the project is shared in a pre-determined manner. The joint venture is an independent legal entity, and the bank may terminate the joint venture gradually after a certain period or upon the fulfillment of a certain condition (Alam, 2003).

3. Murabahah (Cost-plus mark-up): Murabaha financing is based on a mark-up (or cost plus) principle, in which a bank is authorized to buy goods for a customer and resell them to the customer at a pre-determined price that includes the original cost plus a negotiated profit margin. This contract is typically used in working capital and trade financing (Suleiman, 2000).

4. Ijara (Sale and leaseback): A bank buys an asset for a customer and then leases it to the customer for a certain period at a fixed rental charge. Shariah (Islamic law) permits rental charges on property services, on the precondition that the lessor (bank) retain the risk of asset ownership.

5. Salam (Future delivery): Salam is structured based on a forward sale concept. This method allows an entrepreneur to sell some specified goods to a bank at a price determined and paid at the time of contract, with delivery of the goods in the future.

6. Istisna (Construction / manufacturing): Istisna contracts are based on the concept of commissioned or contract manufacturing, whereby a party undertakes to produce a specific good for future delivery at a pre-determined price. It can be used in the financing of manufactured goods, construction and infrastructure projects.All above instruments are based on the principle of riba (interest) prohibition, and all seek to maintain Islamic business ethics.

8. CONCLUSION

In this paper, we have explained and discussed theoretically the role of Islamic finance principles, and its modes of financing in enhancing the growth of the economy. It contributes to the literature by reviewing the main principles, advantages and key modes of Islamic finance industry. The main principles of Islamic finance include the prohibition of Riba (interest), Gharar, Speculation, and encompassing the full disclosure of information and removal of any asymmetrical information in a contract. Islamic finance theory promotes economic development through its direct link to the real economy and physical transactions, its prohibitions against harmful products and activities, and its promotion of economic and social justice.

The study revealed that the Islamic finance industry is more stable, efficient, less moral hazard, and conducive to poverty alleviation than conventional finance, due to its principles of prohiption of interest, Gharar and use the risk and return sharing in any form of transactions. Islamic modes of financing like Murabahah, Mudharabah have many advantages, for the society by enhancing trade and production, thus leads to creating new jobs, reduce unemployment and achieve poverty alleviation. The findings of research will be of interest to western and Islamic financial practitioners, policy makers and academicians, who are interested in Islamic finance industry.

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