# Islamic Finance in the Global Economy

*Ibrahim Warde*

EDINBURGH UNIVERSITY PRESS

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# A NOTE ON TRANSLITERATION AND DATES

Most scholarly works dealing with Islam use a transliteration system based on classical Arabic. In a book dealing with a variety of Islamic settings, most of them non-Arabic speaking, such transliteration would make no sense. Indeed, most common words dealing with the Islamic religion or tradition have their origin in the Arabic language but are written or pronounced differently. In a Turkish, Persian, Urdu or Malay setting, the purist system of transliteration would be confusing, if not outright misleading. This book will therefore dispense with diacritical marks and common symbols – apostrophes, horizontal strokes, etc. – (except in direct quotes using such characters), using instead a simplified system of transliteration. Thus, Koran will be used in preference to Qur'an and Shariah in preference to Shari'a. When possible confusion may arise (Malaysians use Syariyah for Shariah, Iranians use zarura for darura), both transliterations will be used.

All dates are based on the Gregorian calendar.

# ABBREVIATIONS

| | |
|---|---|
| AAOIFI | Accounting and Auditing Organization for Islamic Financial Institutes |
| ABC | Arab Banking Corporation |
| BCCI | Bank of Credit and Commerce International |
| BIMB | Bank Islam Malaysia Berhad |
| BIS | Bank for International Settlements |
| BMA | Bahrain Monetary Authority |
| BMI | Bank Muamalat Indonesia |
| BNL | Banca Nazionale del Lavoro |
| BNM | Bank Negara Malaysia |
| BSE | Bahrain Stock Exchange |
| CIA | Central Intelligence Agency |
| DIB | Dubai Islamic Bank |
| DJIM | Dow Jones Islamic Market Index |
| DMI | Dar Al-Maal Al-Islami |
| EBRD | European Bank for Reconstruction and Development |
| FBSEA | Foreign Bank Supervision and Enhancement Act |
| FDIC | Federal Deposit Insurance Corporation |
| FDICIA | Federal Deposit Insurance Corporation Improvement Act |
| FIBE | Faisal Islamic Bank of Egypt |
| FIS | Front Islamique du Salut (Islamic Salvation Front – Algeria) |
| GCC | Gulf Cooperation Council |
| GDP | Gross Domestic Product |
| GNP | Gross National Product |
| HIFIP | Harvard Islamic Finance Information Program |
| IAIB | International Association of Islamic Banks |
| IAS | International Accountancy Standards |
| IBP | Islamic Banks' Portfolio |
| ICIEC | Islamic Corporation for the Insurance of Investment and Export Credit |
| ICMI | Association of Moslem Intellectuals (Indonesia) |
| ICRIE | International Center for Research in Islamic Economics |
| IDB | Islamic Development Bank |
| IDS | Islamic debt securities |
| IIBID | International Islamic Bank for Investment and Development |
| IICG | Islamic Investment Company of the Gulf |
| IIMM | Islamic Interbank Money Market |
| IKIM | Malaysian Institute of Islamic Understanding |
| IMF | International Monetary Fund |

| | |
|---|---|
| IMMCs | Islamic Money Management Companies |
| IRTI | Islamic Research and Training Institute |
| ITFO | Import Trade Financing Operations |
| IUT | Islamic unit trusts |
| LTCM | Long-Term Capital Management |
| LTTFS | Longer-Term Trade Financing Scheme |
| MESA | Middle Eastern Studies Association |
| MFI | Micro Finance Institutions |
| MUI | Indonesian Ulemas Council |
| NATO | North Atlantic Treaty Organisation |
| NEP | New Economic Policy (Malaysia) |
| NIEO | New International Economic Order |
| NIF | National Islamic Front |
| OBU | Offshore banking units |
| OEC | Organization of Economic Cooperation |
| OECD | Organization of Economic Cooperation and Development |
| OIC | Organization of the Islamic Conference |
| OPEC | Organization of Petroleum Exporting Countries |
| PERLs | principal exchange rate linked securities |
| PLS | profit-and-loss sharing |
| RAVs | repackaged asset vehicles |
| ROSCAs | Rotating Savings and Credit Associations |
| SAMA | Saudi Arabian Monetary Agency |
| VAR | value-at-risk |
| WTO | World Trade Organization |

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# INTRODUCTION: ISLAMIC FINANCE IN THE GLOBAL ECONOMY

Islamic finance can no longer be dismissed as a passing fad or as an epiphenomenon of Islamic revivalism. Islamic financial institutions now operate in over 70 countries. Their assets have increased more than forty-fold since 1982 to exceed $200 billion. In 1996 and 1997, they have grown at respective annual rates of 24 and 26 per cent.[1] By certain (probably overly optimistic) estimates, up to half of the savings of the Islamic world may in the near future end up being managed by Islamic financial institutions.[2]

The first Islamic banks were created in the 1970s, at the time when the *aggiornamento* of Islamic doctrine on banking matters was taking shape. At the time, Islamic banks were typically commercial banks operating on an interest-free basis. Today, as a consequence of broad changes in the political–economic environment, a new generation of Islamic financial institutions, more diverse and innovative, is emerging as the doctrine is undergoing a new aggiornamento. Perhaps the most important development has been the growing integration of Islamic finance into the global economy. There is now a Dow Jones Islamic Market Index, which tracks 600 companies (from inside and outside the Muslim world) whose products and services do not violate Islamic law. Foreign institutions such as Citibank have established Islamic banking subsidiaries, and many conventional banks – in the Muslim world but also in the United States and Europe – are now offering 'Islamic products' that are sometimes aimed at non-Muslims.

Islamic finance is thus in many ways well suited to the global economy. This is all the more striking and paradoxical in that it is often said that Islam is incompatible with the 'new world order' that emerged with the end of the cold war.[3] In addition, how could a medieval economic system be relevant in a world of revolutionary, technology-driven global finance? And how could an interest-free system fit within the broader interest-based financial system?

One of the arguments of this book is that the globalization of finance has allowed Islamic finance to thrive and that there has been in recent years a fusion of sorts between Islamic and conventional banking. Whereas the traditional world of finance, dominated by commercial, interest-based banking, could raise potentially troublesome theological issues, the new world of finance, characterized by the blurring of distinctions between commercial banking and other areas of finance, the downgrading of interest income, and financial innovation, has been rife with opportunities for Islamic financial institutions. Indeed, Islamic finance has driven financial modernization in many parts of the Muslim world.

A related argument is that the aggiornamento of the 1970s – the period when Islamic teachings were updated to create the first Islamic banks – is falling into obsolescence, and that a new aggiornamento, barely noticed in most writings on the subject, is emerging. The two updates have evolved under sharply different contexts. The first occurred at a time of Islamic assertiveness in the midst of a fleeting belief in a New International Economic Order (NIEO) that would favour the South at the expense of the North. It was dominated by oil-producing Arab states (primarily Saudi Arabia), with some input from Egypt and Pakistan. Since that period, the world of finance has undergone a dramatic transformation. The visions of banking or of the world economy that prevailed in the seventies are barely relevant today. The new aggiornamento is characterized by the increased multipolarity of the Islamic World, with emerging nations such as Malaysia playing a key role, and by vast transformations in international finance, driven by technological change, innovation, deregulation and globalization.

Perceptions of Islamic finance in the West cannot be separated from general perceptions of Islam, as a monolithic, unchanging and somewhat fossilized belief system. In reality, Islamic finance reflects the diversity of a 14-century-old, 1.2 billion strong religion spread over every continent. Islamic financial institutions come in all shapes and forms: banks and non-banks, large and small, specialized and diversified, traditional and innovative, national and multinational, successful and unsuccessful, prudent and reckless, strictly regulated and freewheeling, etc. Some are virtually identical to their conventional counterparts, while others are markedly different. Some are solely driven by religious considerations, others use religion as a way of sidestepping regulation, as a shield against government interference, as a tool for political change, or simply as a way of attracting customers. It should finally be noted that there are considerable disagreements among Islamic scholars as to which financial instruments are religiously acceptable.

Islamic finance is a complex and paradoxical phenomenon. A brief overview of a leading Islamic banking group suggests the limits of facile and sweeping generalizations: Dar Al-Maal Al-Islami (DMI), the largest transnational Islamic group, is headquartered in the Bahamas and operates primarily out of Geneva yet uses the language of the Islamic *umma*; although controlled by Prince Mohammed al-Faisal al-Saud (the second son of the late King Faisal, after whom the principal subsidiaries of the group are named), the group does not operate a commercial bank in Saudi Arabia, a 'fundamentalist' country that has been instrumental in bringing about modern Islamic banking yet is one of the least hospitable countries to Islamic banks; to complicate things further, the DMI group has nonetheless been a significant conduit of Saudi money and influence throughout the Islamic world. In sum, the story of Islamic finance is a vastly complicated one, and cannot be captured without a full understanding of religion and finance, and also of history, politics, economics, business and culture.

The first part of the book provides background information on Islam and Finance (Chapters 1 to 3). It debunks common myths about Islam and Islamic finance, traces the historical evolution of Islamic economics and finance, as well as the mechanisms by which Homo Islamicus and Homo Economicus were reconciled, and considers religious injunctions as they pertain to finance. One of the underlying themes is the contrast between traditional interpretations with their emphasis on literalism and legalism, and modern ones, which are more adaptive and more likely to focus on the spirit, or the 'moral economy', of Islam.

The second part of the book introduces and describes the world of Islamic finance (Chapters 4 to 7). It traces the birth and evolution of modern Islamic finance and places it in its proper political and economic context. It accounts for the diversity of the industry by analyzing the ways different countries have introduced and dealt with Islamic finance, and by providing a typology of Islamic financial products.

The third part (Chapters 8 to 12) deals with the issues and challenges facing Islam from five vantage points: management, strategy and culture (how the practices of Islamic financial institutions differ from those of conventional ones; the strategies developed by Islamic financial institutions to expand their markets; the managerial problems encountered by Islamic financial institutions; the problem of the 'Islamic moral hazard'; the cultural barriers to the implementation of true Islamic financial systems); economics (the role of Islamic finance in mobilizing savings, allocating funds, and promoting development; Islamic capital markets; the macro-economic implications of Islamic finance); regulation (the regulatory issues raised, domestically and internationally, by Islamic finance; the impact of the regulatory norms of the global economy on Islamic institutions); politics (the connection between Islamic finance and domestic politics; Islam in the New World Order; the alleged ties of financial institutions to Islamic terrorism); and religion (the battles over religious interpretation in historical and comparative perspective).

## Notes

1. Author's database.
2. In the words of Adnan Al-Bahar, Chairman of International Investor, an Islamic bank based in Kuwait: 'It is my belief that Islamic banking will be responsible for managing up to 50% of savings in the Islamic world in the coming five to 10 years.' *Los Angeles Times*, 11 August 1996.
3. Samuel Huntington, *The Clash of Civilizations and the Remaking of World Order*, New York: Simon and Schuster Touchstone 1997, p. 211.

# 1

# ISLAMIC FINANCE IN THEORY AND PRACTICE

## 1.1 Defining Islamic Finance

What is Islamic finance? Definitions range from the very narrow (interest-free banking) to the very broad (financial operations conducted by Muslims). A useful definition is the following: Islamic financial institutions are those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from 'conventional' institutions, which have no such preoccupations. This definition goes beyond simply equating Islamic finance with 'interest-free' banking. It allows to take into account operations that may or may not be interest-free, but are nonetheless imbued with certain Islamic principles: the avoidance of riba (in the broad sense of unjustified increase) and gharar (uncertainty, risk, speculation);[1] the focus on halal (religiously permissible) activities; and more generally the quest for justice, and other ethical and religious goals. Two aspects of Islamic finance must be singled out. First is the risk-sharing philosophy: the lender must share in the borrower's risk. Since fixed, predetermined interest rates guarantee a return to the lender and fall disproportionately on the borrower, they are seen as exploitative, socially unproductive and economically wasteful. The preferred mode of financing is profit-and-loss sharing (PLS). Second is the promotion of economic and social development through specific business practices and through zakat (almsgiving). Most but not all Islamic institutions have a Shariah board – a committee of religious advisers whose opinion is sought on the acceptability of new instruments, and which conduct a religious audit of the bank's activities – as well as other features[2] reflecting their religious status. In sum, the defining difference is that while 'conventional' finance usually seeks profit-maximization within a given regulatory framework, Islamic finance is also guided by other, religiously-inspired goals.[3]

No definition of Islamic finance is entirely satisfactory. To every general criterion – a financial institution owned by Muslims, catering to Muslims, supervised by a Shariah Board, belonging to the International Association of Islamic Banks (IAIB) etc. – one can find some significant exception. Indeed, even the criterion of self-identification – i.e., an Islamic institution is one that calls itself Islamic – would leave out the Turkish Finance Houses or Saudi Arabia's Al-Rajhi Banking and Investment Company, which, for reasons explained later in the book, do not refer explicitly to their Islamic character. As for the principal focus on profit-and-loss sharing (PLS) activities, it remains more an ideal than a reality.

Islamic finance also involves more than banking. It includes mutual funds, securities firms, insurance companies and other non-banks. Where once – in the mid-seventies – Islamic banks were few in numbers and easily identifiable, the phenomenon has become quite amorphous with the proliferation of Islamic institutions and the blurring of the lines between traditional banking and other forms of finance. Another complicating factor is that a growing number of conventional financial institutions, inside and outside the Islamic world, have in recent years created Islamic subsidiaries or have been offering Islamic 'windows' or products in addition to conventional ones.

For the outside observer, the inevitable question is: how can a financial system operate without interest rates? The answer is that it can through the development of profit-and-loss sharing mechanisms, or through alternatives such as imposing fixed service charges or acting as buying agents for clients.

## 1.2 About Statistics and Performance Assessments

As of early 1999, Islamic financial institutions, including banks and non-banks (securities firms, mutual funds, insurance companies, etc.) were present in more than 70 countries. Their assets exceeded the $200 billion mark.[4] Based on a more limited definition that excludes non-banks and on 1996 statistics, the International Association of Islamic Banks (IAIB) puts the total assets of Islamic banks at $137 billion and their number at 166. IAIB statistics are shown in Table 1.1.

I have resisted the temptation to overload the book with detailed statistics, for the simple reason that they are often misleading, if not downright meaningless. This section is less about data than about the need to be careful with data. Indeed, detailed tables and charts are a staple of financial literature, often providing necessary 'padding' for skimpy analysis. Noting the endless quest of financial analysts for 'hard data', even when such data is fabricated, *The Economist* has titled an article on emerging markets statistics, 'The insatiable in pursuit of the unquantifiable'.[5]

Why are such markets so prone to misleading statistics? First is the quality of the raw statistics. Most emerging countries lack a tradition of transparency, strict accounting rules and rigorous reporting. Detailed statistics on Islamic finance typically contain caveats to the effect that there are unexplainable anomalies, inconsistency in accounting rules, and arbitrary shifts from one balance sheet item to another. Second is the

Table 1.1: Islamic Banks and Financial Institutions, Financial Highlights 1996

| *Region* | *No. of banks* | *Capital* | *Total Assets* | *Deposits* | *Reserves* | *Net Profit* |
|---|---|---|---|---|---|---|
| South Asia | 50 (31%) | $962 (13%) | $45,201 (33%) | %27,042 (27%) | 1,849 (32%) | 350 (21%) |
| Africa | 35 (21%) | 213 (3%) | 1,951 (1%) | 603 (1%) | 418 (7%) | 39 (2%) |
| Southeast Asia | 30 (31%) | 136 (13%) | 3,801 (33%) | 1,572 (27%) | 1,943 (32%) | 182 (21%) |
| Middle East | 24 (14%) | 4,060 (56%) | 67,142 (49%) | 54,288 (53%) | 347 (6%) | 373 (22%) |
| GCC[a] | 19 (11%) | 1,340 (18%) | 18,084 (13%) | 16,494 (16%) | 1,095 (19%) | 686 (41%) |
| Europe-America | 8 (5%) | 559 (8%) | 952 (1%) | 1,164 (1%) | 93 (2%) | 54 (3%) |
| **TOTAL** | **166** | **$7,271** | **$137,132** | **$101,162** | **$5,746** | **$1,684** |

*a* Gulf Cooperation Council
*Source*: International Association of Islamic Banks

history, geography and evolution of Islamic finance. Whenever Islamic financial institutions start operating, they usually enjoy spectacular early growth, which can be explained by pent-up demand for Islamic products. With new competition and the inevitable growing pains, 'maturity' soon sets in. Depending on the selection of periods, one can 'prove' anything.

Also, a comprehensive census of financial institutions is now nearly impossible. In the early years of modern Islamic finance, most institutions were located in the Arab Middle East, owned by well-known investors, and belonging to the International Association of Islamic Banks (IAIB). In recent years, Islamic finance has spread to all parts of the world. Identification is all the more difficult since a majority of the new institutions do not belong to the IAIB, and many have sprouted in areas (such as Central Asian republics that were once part of the Soviet Union) where statistics are scant. In addition, much of the growth has occurred among non-banks (insurance companies, securities firms, credit unions, mutual funds, etc.) and other categories that do not appear in aggregate banking statistics.

Another complication is related to statistical anomalies. Sudden growth spurts in Islamic finance were often not caused by organic growth or even by the creation of new institutions, but by decisions by certain governments – Pakistan, Iran or the Sudan for example – to Islamicize their financial systems. Overnight, the numbers and assets of Islamic financial institutions would jump, yet such increase would be meaningless in judging the success or failure of Islamic finance. Other statistical anomalies (the lack of consistent categorization of assets and liabilities; different calendar years; etc.) make comparisons between conventional and Islamic institutions – and even comparisons among Islamic banks – pointless. In many instances, gaps are found as institutions fail to publish their accounts for certain years, usually without explanation.[6] Despite efforts by the IAIB and other organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),[7] there is still no agreement on accounting rules and procedures.[8] Finally, currency fluctuations at a time of global financial turmoil make international comparisons hazardous.

Perhaps the best illustration of the fact that analysts can 'torture the numbers till they confess' is the sharply different interpretations of the same sets of data. Perhaps the most widely 'analyzed' financial institution is the Faisal Islamic Bank of Egypt (FIBE). Yet even apparently careful monograph authors have been unable to explain what certain accounting categories included or what specific numbers meant.[9] Not surprisingly, while using the same sets of data, authors have arrived at different conclusions. One author has concluded that the experience was a great success.[10] Another that it was largely a failure.[11] A third has drawn a mixed picture.[12]

Leaving aside statistical vagaries, there is enormous diversity, even within a single country, among Islamic financial institutions. In Egypt, the three main Islamic banks have little in common. The Faisal Islamic Bank of Egypt is part of the principal, Saudi-controlled, global Islamic financial network. Its Egyptian shareholders include the country's political, economic and religious elite. The bank was created at the height of the infitah years and of the Saudi–Egyptian cooperation. Most of its activities are commercial and international in nature. In contrast, the International Islamic Bank for Investment and Development (IIBID) had no foreign investors and none of the political–economic connections that the FIBE enjoyed. Its activities were primarily domestic. As for the Nasser Social Bank, it is primarily concerned with social goals and works in close coordination with the government's social welfare agencies. Any broad generalization about Egyptian Islamic banks – let alone about Islamic banks in general – is thus likely to be meaningless.

Another mistake is to discount the context – political, economic, competitive – within which specific Islamic banks operate. In recent years, the most consistently profitable Middle Eastern bank has been Al-Rajhi Banking and Investment Company, Saudi Arabia's sole Islamic commercial bank. The reason is not that Islamic banks are inherently more profitable than conventional ones but simply that the bank enjoys a monopoly in a lucrative niche. Yet the temptation to generalize based on a sample of one (at best, of a handful) remains strong. This book attempts to highlight both diversity and context.

## 1.3 The Literature

Quantity, not quality, is the defining feature of writings on Islamic economics, and more particularly on Islamic banking. The vast majority of the scholarship on Islamic finance belongs in the theological, apologetic or exegetic category. Unfortunately, very little is available that is of a comparative or political–economic nature, or that qualifies as rigorous, social-scientific research. As a result the bulk of the literature misses much of the big picture and glosses over important issues. Overall, scholarship is marred by four flaws: the ‘authorized’ nature of a significant portion of it; narrow geographic focus and lack of comparative analysis; reductionism (religious, financial and legal); and faulty assumptions about the relation between theory and practice.

### *1.3.1 The Problem of Authorized Literature*

A preliminary step to assessing the scientific validity of any type of research – whether on the health effects of cigarette smoking or on the therapeutic value of a new drug – is to know who financed it. Research sponsors usually have an agenda and expect the research to produce specific conclusions. From that standpoint, much of the research on Islamic finance should be used with caution. Indeed, the sudden emergence in the 1970s of Islamic finance has created a pressing need: Islamic economics was in its infancy and modern Islamic banking was a new concept, so substantial research was necessary. Islamic financial institutions have been very generous in funding research institutes and promoting publications, conferences, symposia and seminars on Islamic finance. But the pressure instantly to generate a body of literature oriented toward certain conclusions explains both the vast output and its disappointing quality. Literally thousands of books, pamphlets and articles have been produced in the past few years on the subject, but very few rise to the level of serious, rigorous research. Over a dozen periodicals deal principally or even exclusively with Islamic finance. In addition, the business press – national, regional and international – carries frequent articles on the subject, much of which is of an ‘advertorial’ nature. Indeed, even in prestigious publications, one can find, annually and sometimes more often, the obligatory ‘sponsored section’ on Islamic finance. Such articles usually reprise the authorized discourse, reiterating the analysis and quoting the same numbers and the same ‘experts’. Overall, as in many areas of finance, it becomes hard for the researcher to separate independent investigation from public relations spin or in-house promotional literature.

### *1.3.2 The Geoeconomics of Islam*

Because of patterns of academic specialization, studies of Islamic economics and finance tend to be slanted toward the Arab or Persian world, and most classifications are derived from political as opposed to economic factors. In the academic world, the study of Islam usually falls under the Middle Eastern studies category. Yet Arabs represent only about 20 per cent of the Islamic world, and the Arab, Turkish and Persian components of Islam taken together barely exceed one-third of Muslims worldwide. In the ranking of Muslim populations, Egypt, the most populous Arab country, comes only in eighth place. In his 1994 Middle Eastern Studies Association (MESA) Presidential Address, Rashid Khalidi acknowledged:

> [W]e in Middle East Studies have frequently failed to reach beyond our own area of interest to make connections with those studying other regions, including neighboring ones with characteristics and problems quite similar to those of the Middle East – like Central Asia, Africa, South Asia and the Mediterranean.[13]

This focus has led many analysts of Islamic finance to dismiss developments that have occurred outside the Arab Middle East.[14] In reality, significant innovation has occurred outside of the Middle East. In addition to pioneering countries such as Pakistan and Malaysia, there are Islamic experiments throughout the Islamic world, as well as within Islamic communities outside the Islamic world. By the same token, most Western perceptions of Islam are shaped by some of its most extreme political manifestations (the Iranian revolution, the Taliban, terrorism, etc.) that are representative neither of the mainstream of the religion nor of its economic aspects. The geoeconomics of Islam is indeed sharply different from its geopolitics. The largest Islamic communities are in Indonesia, Pakistan, Bangladesh and India, and not in the Middle Eastern core (see Table 1.2).

Table 1.2: Largest Islamic Populations

| Country | Population Size |
|---|---|
| Indonesia | 190 million |
| Pakistan | 125 million |
| Bangladesh | 120 million |
| India | 100 million |
| Iran | 62 million |
| Turkey | 60 million |
| Nigeria | 55 million |
| Egypt | 50 million |

*Source*: Yves Thoraval, *Dictionnaire de civilisation musulmane*, Paris: Larousse 1995, p. 123. Also United Nations Population Statistics.

Also, substantial Islamic middle classes have emerged in Asia, Africa, Europe and the United States. And Central Asian countries which were once part of the Soviet Union – Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan – are, largely due to their oil, gas or other natural resources, poised to play a growing role in the world economy. In addition, certain countries or communities – one thinks of the sultanate of Brunei or of the Ismaili sect – possess great wealth while being politically insignificant. Any study of Islamic finance must acknowledge such geoeconomic diversity.

### *1.3.3 Religious, Financial and Legal Reductionism*

Most writings on Islamic finance fall into one of three categories: theology, finance and law. Theological writings tend to assume an ahistorical world where timeless religious principles apply. Writings by finance experts – of the kind found in the international business press and in finance textbooks – on the other hand have little patience with the intricacies of religious tradition or the complex environment within which financial institutions operate.[15] The richest and most rigorous writings on Islam finance have been produced by legal scholars. The main flaw of such writings however is that they tend to define Islamic banking as 'modern banking based on medieval Islamic legal doctrines as interpreted, modified, and implemented by competent Islamic legal authorities'.[16] In other words, Islamic finance is all about law and it can only be understood by a return to usul el fiqh (principles of jurisprudence) and the rediscovery of the contracts of the classical age of Islam and their interpretation by the different schools of jurisprudence. Empirical studies of Islamic finance suggest that legalistic concerns are only one aspect, and probably not the most crucial one, of real world Islamic finance (see, for example, Chapters 6 and 7).

In sum, the literature on Islamic finance is deeply disappointing principally because it is neither empirical – based on the evidence – nor interdisciplinary – thus looking at all the facets of a complex and multidimensional phenomenon. The most learned volumes tend to wallow in endless hairsplitting, a proclivity common to jurists and theologians. The others tend to be shallow and faddish, focusing on the 'emerging market' of the day and on Islamic finance as either a hot or a fizzling new trend. Hence their catechism-like flavour, offering a simple – often simplistic – perspective on a complex topic.

### *1.3.4 Islamic Banking from Commitment to Implementation*

One of the many paradoxes of Islamic finance is the contrast between the strong commitment of Islamist groups to the principle of Islamic banking and their lack of involvement in its implementation. On the one hand, Islamicizing the financial system is usually at the very top of the demands of Islamist groups. One reason is that the injunction against riba is a distinctive feature of Islam. Yet the practical implementation of Islamic finance is seldom part of the realm of 'high politics', since Islamic movements seldom have a specific economic programme for putting their ideals to work. They tend to talk in generalities about implementing the Shariah, but have no proposals for making the Shariah induce economic prosperity or true social justice. This is due to the ambiguity of Islamic economic norms, making a consensus on actual policy prescriptions elusive,[17] and also to the fact that economic policy is usually secondary to political or cultural issues. As the Ayatollah Khomeini reportedly said, 'The revolution is about Islam, not about the price of melons'.[18]

Although theological and legalistic approaches assume that the Islamicization of finance proceeds according to a strict application of religious law and jurisprudence, the empirical evidence tells us otherwise (see Chapter 6). Economic issues, and in particular the specific implementation of financial legislation, do not rank very high on the agenda of Islamic groups, and most headline-grabbing Islamic groups – such as the FIS, Hezbollah or Hamas – have no clearly defined economic agenda.[19] On such matters as banking legislation, expediency is likely to prevail over 'Islamic correctness'. Typically, the wording of the legislation would conform to general principles but would be broad enough to accommodate a wide variety of interpretations. The general interest (maslaha) and overriding necessity (darura) – the need to achieve economic welfare and the requirements of a global economy – whether articulated or not, usually trump theological or legal concerns.

## 1.4 Perceptions, Labels and Classifications

### *1.4.1 Common Perceptions of Islam and Islamic Finance*

Outside a small circle of practitioners, Islamic finance is little known. There are, however, within the general public as well as within the smaller communities of scholars and financiers, broadly shared perceptions about Islam in general (and sometimes even about Islamic finance).

In a recent American poll, over half the respondents described Islam as inherently anti-American, anti-Western, or supportive of terrorism – though only five per cent of those surveyed said they had much contact with Muslims personally.[20] Such attitudes are also pervasive among the policy elites. If we consider the influence of the likes of Francis Fukuyama or Samuel Huntington, we realize that lack of familiarity with Islam seldom deters people from making the kinds of sweeping pronouncements that soon become working assumptions in intellectual and policy debates.

When Fukuyama discusses the timeless conflict between Islam and liberalism,[21] or when Huntington states that '[i]n Islam, God is Caesar' or that '[t]he Koran and the Shariah constitute basic law for Islamic societies',[22] they are not only engaging in gross oversimplification. They are also making statements that do not stand up to rigorous historical or social–scientific analysis.[23]

In the abundant journalistic literature on Islam, the same stereotypes are usually expounded upon. Islamic finance is usually associated with political Islam.[24] A recent French book titled *The Fatwa against the West* devotes a few pages to Islamic finance, implying that the main if not the sole purpose of Islamic financial institutions is to finance terrorism.[25]

A recent survey of European and American bankers revealed that a majority were only vaguely aware of the existence of Islamic finance.[26] When asked what words and ideas the notion of Islamic finance evoked, the following were cited: 'monolithic', 'rigid', 'anti-Western', 'incompatible with modern finance', 'archaic', alongside 'oil money', 'BCCI', 'terrorism', 'Arab'. A few respondents did mention 'interest-free' and thus seemed aware of some of the distinctive features of Islamic finance. Within that category of respondents, two sets of attitudes were common. One was the view that Islamic financial institutions, being interest-free, cannot possibly work. (The interviewer would invariably find himself on the receiving end of a lecture on the role of interest rates in finance.) A variation on that theme – and one also leading to the conclusion of non-viability – was the equation of 'interest-free' with 'non-profit'. The other common set of attitudes was that Islamic financial institutions were no different from conventional ones, since interest, albeit under different names and guises, was used.[27]

Any religion that has survived for 14 centuries, and that has some 1.2 billion followers spread in every part of the globe, must have some measure of flexibility and diversity. Any such religion should be resistant to broad-brush generalizations. Statements to the effect that 'Islam says …', 'Muslims believe …', must include significant qualifiers and caveats. Yet Islam is usually represented in terms of a monolithic umma (community of believers) and a fossilized belief system that has not changed since the seventh century. In that respect, Islam is unique: although every major religion has numerous, often contradictory, strands – intolerant and inclusive, moderate and radical, pietistic and political, obscurantist and progressive, peaceful and violent, mystical and worldly, etc. – not to mention its share of objectionable features and lunatic fringes, only Islam is likely to be systematically associated with its most extreme manifestations. An implicit assumption is that only the most backward form of the religion represents true Islam. John Esposito has observed that 'non-Muslim scholars sound more like mullahs':

> When faced with new interpretations or applications of Islam, they often critique them from the vantage point of traditional belief and practice. On the one hand, Islam is regarded as fixed, and Muslims are seen as too reluctant to accept change. On the other hand, when change occurs, it is dismissed as unorthodox, sheer opportunism, an excuse for adopting that which is outside Islam.[28]

In the late 1990s, the emblematic figures of Islam in the Western mind are radical fundamentalists – the likes of Afghan Taliban or terrorist figures such as Usama bin Laden – who by their statements and positions 'realize the wildest fantasies of Orientalism'.[29] Sami Zubeida has noted the convergence 'between the adherents of the Islamist movements and Westerners writing in the Orientalist tradition. Each postulates a cultural essence which underlies and unifies Islamic history and distinguishes it from an equally reductionist notion of the West.'[30]

One of the more misleading generalizations is that Islam, unlike other religions, is a 'complete way of life'. For one thing, this could be said of any religion, since most enjoin virtuous behaviour in everyday life. The implication is that the demands of Islam are not compatible with the requirements of modern life. Yet in many ways, Islam has less 'structure' than other religions. What all Muslims share is a core of basic principles, the so-called 'five pillars' of the faith.[31] Islamic clerics do not administer religious sacraments. They are more akin to religious/legal scholars who interpret the scriptures. Unlike other religions, the conversion process is simple: it consists in a witnessed profession of faith (shahada). Islam has no baptism or other initiation ceremony. Muslims do not belong to congregations. Mosques are open to all and do not maintain membership rolls. Islam also teaches that each person has a direct relationship with God and that no intermediary is needed. Many of the traditions associated in the Western mind with Islam (the use of the veil for women, for example) are not mandated by religion but can be explained either in terms of local customs or as 'fundamentalist' reinterpretation of Islam.

The association of Islam with 'a total way of life' leads to two common assertions with regard to politics and economics. One is that Islam prescribes very specific norms. The other is that Islam is inherently and primarily political. In reality, as will be seen throughout this book, Islamic norms on political and economic matters are broad and somewhat ambiguous, thus accommodating a wide variety of interpretations.[32] Many Islamic scholars actually draw a distinction between 'political Islam' and 'enlightened Islam'.[33] As for the propagation of the Islamic faith, most of it is non-political – though the casual Western observer would not know it. Indeed, a number of students of Islam have noted that extremist political organizations – such as Hezbollah or Islamic Jihad – whose numbers run in the thousands or sometimes in the hundreds, receive wide coverage, while apolitical organizations of a pietistic or missionary nature – such as Jamaat

Tabligh – have millions of members yet are totally ignored by the media and the most widely quoted 'experts' on Islam.[34]

### *1.4.2 The Diversity of Islam*

Despite the prevailing clichés, a striking feature of Islam is its sheer diversity. Muslims constitute a majority of the population in some 50 countries in Africa, the Middle East, Central, South and Southeast Asia. They are a minority, often a fast-growing one, in most parts of the world, including Western and Eastern Europe, Russia, the Americas and Australia. The diversity is also religious, racial, ethnic, political, social, economic and cultural. Despite the language of a unified umma, Islam is fragmented and decentralized, with no 'clergy' and no centralized, 'Vatican-like' Church. Only a few countries – most prominently Iran – have a tradition of autonomous and hierarchically-structured clergy.

Most people are familiar with the Sunni–Shia divide. But there is a far greater diversity of religious groups, beliefs and practices. Differences can be attributed to religious schisms, but more commonly to different historical paths as well as exposure to outside influences. In certain areas, such as what is now Saudi Arabia, there is a tradition of religious homogeneity (with the exception of a small Shia minority). Non-Muslim presence has been virtually absent and outside influence scant (the Ottoman influence was nominal and significant contacts with the West started only with World War I). Being the birthplace of Islam is also of course a crucial element in the country's identity and religious beliefs and practices. But Saudi Arabia is a minority of the Arab world (18 million out of 200 million), which is itself a minority of the Islamic world (200 million out of about 1.2 billion).

In the Islamic world at large there are numerous traditions – Persian, Turkic, Indo-Pakistani, Indonesian, Malay, etc. – that have little in common with the experience of the Arabian Peninsula. The nature of the Islamic beliefs and traditions are shaped by numerous factors ranging from when and how the area was Islamicized to the nature of pre-existing beliefs and institutions, to subsequent outside influences. In Indonesia and Malaysia, the Islamicization process occurred primarily around the fifteenth century. The local population was converted by merchants, not conquering armies. The brand of Islam that took root was mostly influenced by sufism. It thus had a mystical foundation as opposed to the theological and literalist bias that could be found in other parts of the Islamic world. It was also cut off, for geographic and historical reasons, from the great Islamic empires. As a result, the brand of Islam that developed was idiosyncratic as well as syncretic, integrating a wide array of local and regional influences.[35]

In Eastern Europe and the former Soviet Union, Islam was long suppressed or ignored, only to re-emerge in a context of turmoil and foreign encroachments. In the Balkans, some eight million Muslims form today a distant legacy of centuries of Ottoman rule. In the former Yugoslavia, much of Bosnia-Herzegovina, Macedonia and the Kosovo province are Muslim. So are the majority of Albanians and a minority of Bulgarians. 'Ethnic cleansing' by Serb forces resulted in NATO bombings over Bosnia-Herzegovina (1995) and in an all-out war against Serbia over Kosovo (1999). Within the Russian Federation, the Muslim Chechens, a long-persecuted minority, have engaged in a full war of secession against the Russian army. In the Caucasus, Muslim Azerbaijanis have a long historical enmity with Christian Armenians. In Central Asia, Kazakhstan, Turkmenistan, Uzbekistan, Kyrgyzstan and Tajikistan have either a majority or a plurality of Muslims. What all of these groups have in common is that they lived for decades under a political system that was anti-religious. In some cases such as Albania, Communist governments engaged in aggressive religious suppression. In others, such as in the former Soviet Union, cultural and linguistic traditions persisted, but the role of religion was considerably reduced. In a post-Communist era, religion surfaced with a vengeance. Many communities which were only nominally Islamic found in Islam an essential component of a long-suppressed identity, and a number of Islamic countries – such as Turkey, Iran and Saudi Arabia – have been attempting, for a combination of political, economic and religious reasons, to export their own brand of Islam to that region.

Another phenomenon is the increased presence (mostly through recent immigration) of Muslims in non-Muslim lands. In the United States, Islam is expected to become in a few years the second largest religion. One-third of its five million adherents are black Americans. The others are mostly of Arab, Persian or Pakistani–Indian ancestry.[36] Western Europe is home to some 14 million Muslims, although national origins, governmental policies and degrees of assimilation differ greatly.[37] French Muslims are primarily from Northern Africa – Algeria, Tunisia and Morocco – and are subjected to a specific mode of individual integration based on the tradition of 'laïcité'. In Germany, Muslims are usually from Turkey, and are subjected to different rules and practices. Their status, and that of their descendants, is that of 'guest workers' (making them ineligible for German citizenship). In the United Kingdom, Muslims are overwhelmingly from the Indian subcontinent and are integrated in the British society 'as a group and not as individuals'.[38]

For all these reasons, one can identify a very broad range of Islamic beliefs and practices, that is in fact similar to what could be found in other religions such as Hinduism, Christianity and Judaism. At one end of the spectrum, there are strict Muslims who would like religion to extend to all aspects of political and economic life.[39] Even within that category though, the understanding of religion and its tenets varies greatly, and there are significant disagreements as to how (and whether) Islamicization can be achieved.[40] At the other end of the spectrum, there are 'nominal Muslims' or 'sociological Muslims' who do not usually practise their religion and know little about it. Many Muslims around the world today have confined religion to the private domain of personal laws and separated it from economic and socio-political activities. It would thus be more accurate to talk about 'Islams' rather than 'Islam'. In the words of Aziz Al-Azmeh, 'Islam is not a generic essence, but a nominal entity that conjoins, by means of a name, a variety of societies, cultures, histories and polities'.[41]

### *1.4.3 'Fundamentalism' and Other Labels*

The dilemma of the researcher is that for purposes of description and comparison, labels are necessary, yet most of these labels belong to Western categories and perceptions that do not always fit Islamic realities. Labels used to describe different types of Islam – Islamism, fundamentalism, neo-fundamentalism, revivalism, modernism, traditionalism, liberalism, conservatism, Islamic totalism, establishment Islam, populist Islam, etc. – are to varying extents misleading.[42] Perhaps the most misleading of all, and the most overused, is the 'fundamentalist' label. The word originated in connection with American Protestantism, signifying a literal reading of the Bible. ('Intégrisme', its French counterpart, was used to describe Catholic traditionalism.) In the Western mind, the word 'conjures up images of mobs shouting death to America, embassies in flames, assassins and hijackers threatening innocent lives, hands lopped off, and women oppressed'.[43] In all too many instances, fundamentalism is used interchangeably with Islam and with radical extremism.

The 'fundamentalist' label, which is supposed to have both religious and political overtones, has been applied to the governments of Libya, Saudi Arabia, Pakistan, Iran, and the Sudan, and to virtually every Islamist group and organization. In terms of both religion (the brand of Islam they follow, the role of clerics in the political leadership) and politics (the nature of political institutions, the ties with the West, the degree to which they want to export their institutions), the countries cited are sharply different. As for 'fundamentalist' parties, they come in all shapes and forms. One study estimated that, as of the early 1990s, there were 175 Islamist groups (three-quarters of them 'militant' or 'radical') in the Middle East.[44] Another study found 45 'Islamist' groups in Egypt alone.[45]

The confusion stems from the fact that the word can have different meanings. Ian Lustick's definition is that of an uncompromising political style characterized by (1) the motivation to achieve radical transformation of society (2) according to directly felt transcendental imperatives and (3) through political means.[46] Fundamentalism can also refer to those who want to return to early Islamic practices or who strive to adapt, sometimes but not always in a 'radical' manner, the 'fundamentals' of Islam to modern conditions; for example, by reinterpreting traditional Islamic concepts such as shura (consultation) and ijmaa (community consensus) in the light of modern realities. Fundamentalism is thus not necessarily the same as literalism, and modernism is not necessarily contradictory with a quest for authenticity.[47] A 'fundamentalist' can therefore either be a traditionalist or a modernist, indeed even a liberal. Leonard Binder has observed that 'fundamentalist Islam and liberal Islam draw on the same religious sources, they often employ the same type of reasoning, they usually concentrate on the same authoritative pronouncements, and in some cases the differences between the two may be difficult to discern'.[48]

Historical figures ranging from Ibn Taymiyya (1268–1328) to the Ayatollah Khomeini (1903–89) were at once fundamentalists and modernists. They were creatures of their respective eras who had internalized many of the 'alien' beliefs of their contemporary setting yet fought against alien influences. In their desire to strip Islam of foreign influences and accretions and return to a pristine tradition, they often unwittingly innovated, if only by virtue of transposing ancient ideas, concepts or institutions to a radically different environment. The Ayatollah Khomeini introduced and applied countless innovations to traditional Islamic doctrine.[49] He developed the concept of the rule of the pre-eminent jurist (velayet-e Faqih), and created a republic and a parliamentary democracy (both modern Western concepts) with a Constitution based on an innovative, and sometimes controversial (including in traditional Islamic circles), application of Islamic principles.[50] By the same token, many of today's radical fundamentalists have internalized Rousseau, Fanon or liberation theology and yet invoke authenticity.[51]

The great Islamic modernists of the *Salafiyya* movement could also be characterized as fundamentalists.[52] Edward Mortimer noted that Rashid Rida (1865–1935) undertook the reinterpretation of Islam in the name of fidelity to the distant past (the salaf) and of strict adherence to the basic texts of Islam. He adopted a modernist interpretation of riba but was also an admirer of the militant Wahhabi puritans: 'If "fundamentalism" means an effort to define the fundamentals of one's religion and a refusal to budge from them once defined, then Rida was a fundamentalist indeed. (But surely anybody with serious religious beliefs of any sort must be a fundamentalist in this sense?)' Mortimer concludes: '[T]he precise meaning of [fundamentalism] when used in the context of Islam eludes me'.[53] Similarly, John Esposito has noted that fundamentalism 'tells us everything and yet, at the same time, nothing'.[54] William Shepard summarized best the researcher's dilemma:

> On one hand, such labels have undoubtedly often functioned as obstacles to understanding the actual people and tendencies involved, in part because they are frequently used without explicit definition, in part because they perforce lump together widely differing phenomena, and in part because they often convey an implicit bias or

> value judgment. In my view, this is particularly true of the label 'fundamentalist'. On the one hand, we cannot avoid labels if we are to talk about things, and we certainly cannot begin to make sense of an area as vast and complex as the modern Muslim world unless we can analyze its manifold phenomena into a manageable number of categories with suitable designations.[55]

Another source of confusion is that different groups of scholars have their own codes and conventions. In the French-language scholarship on contemporary Islam, a distinction is drawn between 'Islamists', who have an explicitly political agenda and undertake 'Islamicization from above', and 'neo-fundamentalists', who are associated with 'Islamicization from below' and are primarily concerned with Islamicizing society and promoting religiosity. Within that framework, 'Islamists' and 'neo-fundamentalists' would represent the more recent manifestations of Islam, while 'fundamentalists' would refer to more traditional political movements such as the Muslim Brothers.[56]

In this book, the word 'Islamist' is used generically to encompass groups seeking to upgrade the role of Islam in political and economic life, and the word 'radical' in reference to those, usually anti-Western, groups who seek to attain political power through the use of force. One cannot – despite all the reservations expressed – escape the use of the word 'fundamentalist', if only in the broad sense of 'seeking a return to the fundamentals of Islam'. Whenever the word (and other comparable labels) is used in this book, the precise connotation will be circumscribed by context.

### *1.4.4 Traditionalism and Modernism*

For the purpose of studying modern finance, a useful if imperfect dichotomy is that of 'traditional' vs 'modern' approaches, based respectively on the propensity, when it comes to financial products and concepts, to adopt a literalist, scholastic and legalistic approach, as opposed to the propensity to accept non-Islamic innovations based on an understanding of the 'moral economy' of Islam (see Chapter 3). To put it differently, the key distinction is between those more likely to follow the letter of religious texts (including the fiqh of classical Islam) and those more inclined to reason based on the spirit of the religion.

These are of course 'ideal types' since things are far more complicated in practice. Toward the extremes of the spectrum would be respectively those who have no quarrel with interest rates and therefore see no need for Islamic banking, and those who on principle reject the very concept of banking because it does not go back to early Islam.[57] Most Islamic thinkers, however, fall outside such extremes and could be situated along the continuum. Different shadings and combinations of traditionalism–modernism produce infinite variations. Also, there is no agreement as to what constitutes 'progress', and the old and the new are likely to co-exist in unexpected ways. As discussions of Iran in this book show, many 'modern' ideas were internalized by 'traditional' clerics. Another illustration of selective adoption of innovations is of course the instrumental use made by the Ayatollah Khomeini of modern technologies during his exile. At the time, audio-tapes of his fiery denunciations of the Shah's regime and of all things Western were duplicated and played throughout Iran.[58] Another even more vivid example of the co-existence of the old and the new would be the use of the Internet to issue wholesale condemnations of modern finance. Thus in a 'cyberfatwa' titled 'The Fallacy of the "Islamic Bank"', Umar Ibrahim Vadillo writes:

> The so-called 'Islamic bank' is a usurious institution contrary to Islam. The 'Islamic bank' is an absurd attempt to resolve, as was done in the case of Christianity, the unswerving opposition of Islam to usury for fourteen centuries. Since its origin, the 'Islamic bank' has been patronized and promoted by usurers.

The author dismisses such a 'usurious institution' as an invention of Western colonialism designed to incorporate the world's Muslims into the international financial and monetary system, adding:

> In contrast to the modernist confusion, the position of the Shariah of Islam is clear and does not admit any controversy. From this it is clear that the Muslim must not only abandon usury but that he is also obliged to fight against usury.[59]

Still, for the purpose of analyzing the role of Islamic finance in the global economy, the traditionalist/modernist distinction is useful. Two strands can be found in the Islamic tradition. One is more 'purist', and worried about foreign influences, the other is more cosmopolitan, more secular and readier to accept the more admirable innovations of non-Muslims. Both strands of course claim authenticity.[60] As various sections of this book show, both have at various times and places been invoked to condone or prohibit certain economic practices. Given the decentralized nature of the religious hierarchy, especially in the Sunni world, virtually any position could be legitimated by some approving fatwa. As usually happens in religious controversies, each side will claim to represent 'true' Islam, and bolster its position through the familiar game of quoting and counter-quoting. For the traditionalists, the words of the Koran and the Hadith, as well as classical fiqh, are sacred, and the interpretive leeway must be limited. Anything new or different is frowned upon. In contrast, modernists, insofar as they believe Islam to be fully compatible with progress, rationality and science, do not feel it necessary to replicate the exact conditions of early Islam, but try to find proper Islamic responses to new challenges.[61] They are likely to draw a distinction between God's law (as expressed in the Koran) and man-made law (the jurisprudence developed in the early years of Islam).[62] Their ideal is that of the time when Islamic cities were centres of learning and culture, and they praise the flexibility of Islam and the diversity of Islamic economic thought as 'a manifestation of the inherent and natural potential of the divine Word of Allah, i.e., its ability to be interpreted differently and to accommodate varying cultures'.[63]

While the traditional strand may better fit Western stereotypes about Islam, the modern one is probably more common – and likely to achieve further gains in the future – in the areas of banking and finance. Consider for example new, complicated products such as derivatives. The traditional approach would consist in breaking them up into all their components and seeing what the schools of classical fiqh have to say about each of these components. The modern approach, relying on the basic principles and on the moral economy of Islam, would probably be more useful in the global economy.

Or consider zakat (almsgiving). Traditionalists have argued that 'no authority on earth has any right to alter the zakat rates'.[64] They looked upon the fiscal system established at the time of the Prophet and his immediate successors as a perfect and unchangeable system of redistribution that could not be modified. Under that system, rates on certain livestock, fruits and grain are specified with great care. For example, Caliph Umar decreed that dates and grapes were subject to zakat, while peaches and pomegranates were not. A strict application of such rules could have absurd results. And indeed, over time, zakat became an 'ossified, dysfunctional ritual, increasingly divorced from its original purpose'. Contemporary schemes to impose traditional zakat resulted in farmers, many of whom lived below the poverty line, being subjected to the tax, while most property owners and wage earners were exempted.[65] A modernist approach would re-evaluate zakat and recreate it in the light of contemporary institutions and context, rather than simply replicate ancient practices.

### *1.4.5 Oversimplification and its Consequences*

Assessments of Islamic banks tend to fall into one of two categories: excessive claims or outright dismissal. The authorized literature tends to paint an idyllic picture of Islamic finance and economics, a world where 'no inflation, no unemployment, no exploitation and no poverty exist'.[66] In contrast many scholars have been dismissing the Islamic banking phenomenon entirely. Most recent books on Islam have the requisite chapter (or paragraph, or sentence) on Islamic finance, usually containing sweeping and unsubstantiated generalizations about the phenomenon and its significance. One often encounters statements such as this: 'Economic Islam is nothing but "rhetoric" dressing up either a socialist and Third

World statism (Iran under Khomeini), or an economic liberalism oriented more toward speculation than toward production.'[67] On the political implications of Islamic banking, one scholar sees in Islamic finance a potential tool for political transformation,[68] while another sees it as a 'technocratic and non ideological' tool that is designed to adapt the financial sector to the global economy, while 'leaving the social and political order unchanged'.[69] On the issue of how different Islamic banking is from conventional banking, one encounters the same tendency toward sound bites and sweeping pronouncements. Islamic finance is either conventional finance by another name,[70] or a 'financial system fundamentally different from the system currently dominant throughout the world'.[71]

Such claims are not helpful in understanding a complex and multi-faceted phenomenon. The Islamic banking system is by some measures a success, by others a failure. It is in some ways unique, but at the same time, most operations of Islamic banks tend to mirror those of conventional banks. A binary approach cannot capture the nuances of Islamic finance. On the issue of interest, one can be dismissive of all of Islamic finance because 'time has a price measured by interest rates, and no economic system can ignore that'.[72] The argument of Islamic scholars is more subtle. Islamic law in fact accepts the notion of the time value of money or opportunity cost.[73] In the words of Fuad Al-Omar and Mohammed Abdel-Haq: 'The Shariah does … recognize a difference in value due to a time element, and does not prohibit realizing the time-value of money. What is prohibited is any claim to the time-value of money as a predetermined quantity calculable at a predetermined rate'.[74]

Similarly, on the issue of the role of Islam in the global economy and its compatibility with the 'New World Order', a binary approach would be misleading. As this book shows, Islamic finance has thrived in the global economy. Yet while Islam is well-integrated economically, it is often denigrated culturally and politically in the New World Order.[75]

## 1.5 Capturing the 'Big Picture' of Islamic Finance

This book does not purport to advocate a specific reading of the Shariah in regard to banking and finance. Rather it seeks to show how and why, at various times and places, interpretations and practices have differed. The purpose of this book is to dispel myths and stereotypes, and to present Islamic finance in all its complexity and diversity. Most broad questions on the subject (are Islamic banks successful? are they truly different from conventional banks? what is their political significance? etc.) can only be answered by 'it depends' – surely a disappointing response for those accustomed to sound bites and definitive, if uninformed, opinions on the subject.

As already mentioned, most studies of Islamic finance are characterized by theological, financial and legal reductionism. In addition, most have a strong case-study orientation, focusing on a single country, sometimes on a single bank, to draw broad conclusions. Such approaches give short shrift to the diversity and complexity of the phenomenon. They also prevent capturing the 'big picture' of Islamic finance – putting it in perspective and allowing a better understanding of the significance and likely evolution of the phenomenon. In order to counter the common monolithic, abstract, and dogmatic perspectives, this book will adopt, insofar as it is possible in a single volume, an empirical, historical, comparative and interdisciplinary approach to shed light on a multidimensional topic.

### *1.5.1 An Emphasis on Context*

Writings on Islamic finance tend to have an abstract, idealized character. Few facts are offered, many statistics are fudged or meaningless. A lot is based on the analyses and precepts of the first aggiornamento, with little attention paid to changes in global finance, let alone to the actual practices, results and performances of Islamic banks. Much of the literature posits for example that Islamic banking is all about profit-and-loss sharing, when in reality such operations account for only a tiny part of Islamic banking.

Most studies of Islamic finance assume a closed, monolithic, unchanging world.[76] In contrast this book underscores the diversity of Islamic finance, its dynamic nature and its interaction with its environment. Hence the emphasis on context – historical, political, economic, social and cultural. Examples abound of how deeply embedded Islamic financial institutions are, in their institutional and cultural framework. Saudi Arabia was founded as a 'fundamentalist' Islamic state, in the sense that its society and institutions were based on a strict and 'purist' interpretation of Islam. Paradoxically, this has made the issue of Islamic banking and finance a politically sensitive one. The reason is that by the time Islamic banks came into existence, Saudi Arabia was a wealthy state – to a large extent a rentier economy, living off its oil production and the substantial revenues from its foreign investment and interest income. Its economy was thus heavily dependent, directly and indirectly, on interest. Creating Islamic ('non-interest') banks would make existing banks un-Islamic, in a country where the rulers repeatedly have had to fend off accusations of impiety.

In Egypt, the story of Islamic finance cannot be separated from government policies: in the early seventies the government promoted Islamic banks as a component of infitah ('open-door') policies and as a counterweight to left-wing and Nasserite opposition; in recent years, just as the government's policy against Islamic groups has toughened, the economic – and rhetorical – war between conventional and Islamic institutions has heated up, each side accusing the other of being un-Islamic. In secular but cash-strapped Turkey, Islamic banks (mostly from oil-rich Gulf states) were welcomed, but were not allowed to use the word Islam in their name, nor refer explicitly to their Islamic character. In Jordan, the policy towards Islamic banks has reflected the accommodative policy towards Islamic groups in general. In Malaysia and Indonesia, Islamic finance has reflected the more syncretic brand of Islam, the developmental nature of government policies as well as a variety of domestic considerations.[77]

In addition to discussing variations of Islamic finance based on different national contexts (Chapter 6), this book will emphasize the evolving context of Islamic finance with reference to the two aggiornamentos. The birth of Islamic finance is a product of the political economy of the 1970s (the increase in oil prices and the new assertiveness of the South, the ascendency of Saudi Arabia in regional politics and its control of the nascent pan-Islamic movement). Since the 1980s, the international political economy has changed beyond recognition. For lack of a better phrase, we will refer to the global economy, the widely used catch-all concept encompassing a wide range of phenomena: the end of the cold war and the emergence of a unipolar world, deregulation and increased openness of markets, the growing role of finance, the acceleration of technological change, etc. A number of sections, particularly in Chapter 5 and in Chapters 8 to 12, will dwell on aspects of the global economy without which the evolution of Islamic finance would not be intelligible.

### *1.5.2 A Historical Approach*

Timur Kuran has written that Islamic economics 'shuns confrontation with historical evidence'.[78] A historical perspective is necessary to dispel the myth of an immutable model. Since its earliest days, economic Islam has known adaptation and change. Indeed, 'the history of Islam's early period contains valuable lessons concerning the need to devise new institutions to cope with new circumstances'.[79] A historical perspective is also necessary to understand the changing nature of the relations between Islam and the West, and the consequences of the alternation of eras of growth and ascendency with periods of stagnation and decline. At a time when Europe was still in the Dark Ages, culture and knowledge thrived in the Islamic world. Later, as the West went through its 'great transformation',[80] the Islamic world remained stagnant. By the nineteenth century, most of the Islamic world was brought into a Western-imposed economic order for which it was ill-prepared. Between the golden age of Islam and this encounter, the world of ideas and institutions had changed dramatically. Most institutions with relevance to finance that exist today – capital markets, corporations, etc. – did not exist in the early days of Islam. Equally important though less visible were changes in mindsets – new understandings of cause and effect on matters of wealth creation; new empirical and normative perspectives on debt, risk, wealth, etc.

The modern 'market system' revolutionized political, economic, social and human relations. An intellectual and institutional revolution preceded and accompanied these changes.[81] The 'modern' society was characterized by a different ethos, and different institutions and belief systems. The 'science' of political economy, later 'economics', based on the interaction of self-interested individuals in a world of scarcity, dealt a blow to the communal bases of pre-modern or proto-economies. Although financial transactions had existed for a long time, there were, until the fourteenth century, no institutions exclusively devoted to banking. The birth of modern banking occurred in northern Italy and soon spread to all of Europe.[82] One intellectual development is especially worthy of mention in connection with modern financial instruments: new attitudes toward risk made possible by new discoveries in mathematics and probabilities in due course revolutionized finance.[83]

Along with economic and political transformations came new perspectives on debt and indebtedness. The long-held view could be summarized by the famous lines from Hamlet:

> Neither a borrower, nor a lender be;
> For loan oft loses both itself and friend,
> And borrowing dulls the edge of husbandry.
> (I, iii, 75–7)

Then, following the rise of capitalism and the industrial revolution, credit acquired a positive connotation. Walter Bagehot wrote in the nineteenth century: 'In countries where there is little money to lend, and where that little is lent tardily and reluctantly, enterprising traders are long kept back, because they cannot at once borrow the capital, without which skill and knowledge are useless'.[84]

In the Islamic world, ideas and perceptions have also changed, though not necessarily in the same way. The law has evolved,[85] as did rhetorical arguments on most issues.[86] In the effort to interpret Islam in the light of changing circumstances, or to reconstruct old paradigms, it is essential to relate ideas to their specific context. From that standpoint, Islam may not be as irreconcilable with modern finance as many think.

Indeed, in some respects, classical Islam anticipates modern finance. Islam innovated in its perspective on private property, its emphasis on written contracts, and more generally, its favourable view of business endeavours. Some Islamic business forms, such as the commenda partnership, have found their way in European legal codes. And when medieval Europe tried to circumvent its own restrictions on interest, it adopted certain Islamic hiyal.[87] Many of the advances in knowledge had an impact on future discoveries. In particular, the role played by the Arab numbering system and other mathematical discoveries marked the crucial link between ancient Indian knowledge and discoveries of the modern age.[88] Many contributions proved critical to later advances in probabilities, statistics, and eventually risk analysis and modern financial tools. Omar Khayyam (1050–1130), best known as a poet and philosopher, was also a mathematician whose findings 'formed the basis of concepts developed by the seventeenth-century French mathematician Blaise Pascal, one of the fathers of the theory of choice, chance and probability'.[89] It should therefore not be surprising that the word hazard comes from the Arabic *al-zahr* (meaning dice), that the word algebra comes from *al-jabr* (meaning the assemblage of broken parts), or that the word algorithm (rules for computing) comes from Al-Khawarizmi, a ninth-century mathematician.

Yet if the Islamic world seemed throughout its golden age to be on the cusp of great discoveries, the period between the fifteenth and the twentieth centuries was one of stagnation and decline. Mohammed Arkoun noted that, during that period, much of the Islamic world experienced a double break – with its own past (the classical era of the seventh through the fourteenth century), and with the West. In the field of knowledge, 'a huge area was not thought about, and was thus unthinkable'.[90] In Bernard Lewis's formulation, 'The Renaissance, the Reformation, even the scientific revolution and the Enlightenment passed unnoticed in the Muslim world.'[91] Hence the discontinuity between the fifteenth and the twentieth centuries, and the need for Muslim revivalists to reconstruct or reinvent the Islamic past. In the words of Muhammed Arkoun, a 'tinkered coherence was found based on arbitrarily selected fragments and traditions'.[92]

In terms of available financial instruments, the Islamic world was, at least until the thirteenth century, far more advanced than the West. Although banks did not exist (as noted by Abraham Udovitch, it was a world of 'bankers without banks'), innovative financial instruments, many of which anticipate later conventional ones, were a part of commercial life. (Some have argued that the word check [cheque] derives from the Arabic *shakk* [written non-monetary document].)[93]

In Udovitch's interpretation, the reasons why banks did not develop in the Islamic world had to do with the structure of economic life. For one thing, finance was never an autonomous activity; it was always a subset of commerce. And to a much greater extent than in the European economies of the late Middle Ages, financial relationships were embedded in personal and communal ties. Western banking arose as a combination of two factors: the generation of capital by means of deposits of the many on the one hand, and money lending and the provision of credit for the few on the other. In the Islamic world, there was a disconnection between deposit and credit, and financial intermediation (the conversion of deposits into loans) was therefore not necessary. Indeed, money in the Islamic world was deposited for safekeeping (al-wadia), whereas in Europe deposits could be used by the safekeepers.[94] In one case it was to be returned untouched while in the other it could be used for credit purposes. In the Islamic world, credit and financing operations were conducted through transactions, usually involving profit-and-loss sharing, unrelated to safekeeping.

In addition, the need to aggregate small deposits and lend them was driven by the needs of perennially impecunious European princes. In Islam, advances of cash to the public treasury and ruling dynasties took the form of tax farming arrangements ‘in which individuals possessing liquid capital – presumably generated from commercial profits – advanced cash to the government in return for the right to farm the taxes of a given region for a given period’.[95]

Such historical considerations are crucial to understand the evolution of Islam, and to extract the spirit or the moral economy of the religion, yet they are virtually non-existent in the writings on Islamic finance.

### *1.5.3 A Comparative Approach*

In addition to historical references, there will be frequent comparative references (mainly in Chapters 3 and 12). Comparisons are of course necessary to put any phenomenon in its proper perspective, and draw useful parallels. In the case of Islam, and of Islamic finance, they are all the more necessary so that common myths evoked earlier can be dispelled.

On the ‘uniqueness’ of Islam as a ‘comprehensive way’ of life, John Esposito writes:

> What most forget is that all the world’s religions in their origins and histories were fairly comprehensive ways of living. While the relationship of religion to politics has varied, religion is a way of life with a strong emphasis on community as well as personal life: the way of the Torah, the straight path of Islam, the middle path of the Buddha, the righteous way (dharma) of Hinduism. They provide guidance for hygiene, diet, the managing of wealth, stages of life (birth, marriage, death), and ritual and worship.[96]

On matters of economics and finance, the Bible has over 2,000 references to debt, saving, and charitable giving.[97] The Talmud provides detailed injunctions on all aspects of business behaviour. The Canon law of the Church discussed usury in excruciating detail. Nor are secular financial institutions necessarily divorced from religious considerations. In late nineteenth-century Germany, Frederic Raiffesen, a Protestant, and in early twentieth-century Canada, Alphonse Desjardins, a Catholic, created mutual savings societies out of a moral/religious impulse (neither of them was a banker) to save poor farmers from the clutches of money-lenders.[98] Today, a substantial amount of social investing is done by religious groups[99] and on most issues of finance, ethical concerns (which are themselves heavily coloured by religion) are ever-present. By the same token, the religious revivalism movement is not exclusive to Islam, though it is seldom discussed from a comparative perspective.[100]

### *1.5.4 An Interdisciplinary Approach*

In order to capture the many facets of Islamic finance, an interdisciplinary approach is necessary. Most of the issues evoked can be looked at from different angles. Looked at from a purely economic angle, the riba debate may not seem like a big deal given that something equivalent to interest is likely to be devised, albeit under a different name. Yet this very issue is quite consequential if considered from a marketing or from a religious standpoint. The economist may conclude that 'there is no such thing as Islamic finance' while for a banking executive – considering that 'product differentiation' is essential to strategy – devising and selling an 'Islamic product' will be significantly different from devising and selling a 'conventional product'. Similarly, from a religious standpoint – that of a devout customer or that of religious authorities – differences that are invisible to the secular eye could be far from inconsequential. Five dimensions of the Islamic banking phenomenon are singled out for discussion in the last chapters of the book: management, economics, regulation, politics and religion.

## Notes

1. For more specific definitions, see Chapter 3.
2. For example, prayer rooms, business hours that do not conflict with prayer and other religious obligations.
3. A complicating factor in classification is that a distinction must be drawn between 'Islamic financial institutions' whose entire product line is Islamic, and 'Islamic products', increasingly offered by conventional institutions in addition to their conventional products.
4. Author's database.
5. *The Economist*, 5 March 1995.
6. Hamid Algabid, *Les banques islamiques*, Paris: Economica 1990, p. 217.
7. The AAOIFI has established standards that were officially effective at the end of 1995. Many Islamic institutions however still follow their own procedures.
8. Algabid, pp. 110–111.
9. Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law*, London: Graham and Trotman 1995, pp. 90–1.
10. Ray, p. 150.
11. Elias Kazarian, *Islamic Versus Traditional Banking: Financial Innovation in Egypt*, Boulder: Westview Press 1993, p. 227.
12. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses Universitaires de France 1997.
13. MESA Bulletin 29 Middle Eastern Studies Association, July 1995.
14. Ray, p. 3.

15. Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International 1998, p. 45.
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17. Karen Pfeifer, 'Is there an Islamic Economics?' in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, pp. 161–2.
18. Alan Richards and John Waterbury, *A Political Economy of the Middle East*, Boulder: Westview Press 1996, p. 351.
19. See for example Hugh Roberts, 'Doctrinaire Economics and Political Opportunism in the Strategy of Algerian Islamism', in John Ruedy (ed.), *Islamism and Secularism in North Africa*, New York: St Martin's Press, p. 60.
20. *US News and World Report*, 20 July 1998.
21. Francis Fukuyama, *The End of History and the Last Man*, New York: Avon Books 1993, pp. 46 and 217.
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23. Compare for example with Leonard Binder, *Islamic Liberalism: A Critique of Development Ideologies*, The University of Chicago Press 1988, and Olivier Carré, *L'Islam laïque ou le retour à la Grande Tradition*, Paris: Armand Colin 1993.
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27. Ibid.
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29. Aziz Al-Azmeh, *Islam and Modernities*, London: Verso 1993, p. 140.
30. Sami Zubaida, 'Is Iran an Islamic State?', in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 103.
31. See Chapters 2 and 12.
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33. William E. Shepard, 'Muhammad Sa'id Al-Ashmawi and the Application of the Shari'a in Egypt', *International Journal of Middle East Studies* 28 (1996).
34. Esposito, p. 202. See also Yahya Sadowski, '"Just" a Religion: For the Tablighi Jama'at, Islam is not totalitarian', *Brookings Review* Summer 1996, Vol. 14 No. 3.
35. Bernard Botiveau and Jocelyne Cesari, *Géopolitique des islams*, Paris: Economica 1997, pp. 40–1.
36. Yvonne Yazbeck Haddad (ed.), *The Muslims of America*, Oxford University Press 1993.
37. Rémy Leveau, 'Maghrebi Immigration to Europe: Double Insertion of Double Exclusion?', in Charles E. Butterworth and I. William Zartman, *Political Islam, The Annals of the American Academy of Political and Social Science*, November 1992, pp. 170–80.
38. Botiveau and Cesari, pp. 84–90.
39. Carré, p. 58.
40. See Chapter 12.
41. Al-Azmeh, 1993, p. 1.
42. William E. Shepard, 'Islam and Ideology: Towards a Typology', *International Journal of Middle East Studies* 19 (1987), pp. 307–36.
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47. Joel Beinin and Joe Stork, 'On the Modernity, Historical Specificity, and International Context of Political Islam', in Joel Beinin and Joe Stork, *Political Islam: Essays from Middle East Report*, University of California Press 1997, p. 3.
48. Binder, p. 357.
49. Chibli Mallat, *The renewal of Islamic law: Muhammad Baqer as-Sadr, Najaf and the Shi'i International*, Cambridge University Press 1993.
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55. Shepard, p. 307.
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100. Among the exceptions are *The Fundamentalism Project*, a multi-volume book series edited by Martin E. Marty and R. Scott Appleby and published by the University of Chicago Press, and a few books such as Gilles Kepel, *La revanche de Diew: Chrétiens, juifs et musulmans à la reconquête du monde*, Paris: Editions du Seuil 1991.

# 2

# ISLAM, ECONOMICS AND FINANCE

Any successful belief system, whether religious or secular, has seemingly contradictory characteristics: it is malleable enough to adapt to a variety of geographical settings and survive the test of time, yet it must be able to maintain its specificity, or else it would disappear or become fused with competing belief systems; it is idealistic, sometimes even utopian, yet capable of adjusting to human imperfection and making the kinds of compromises that are endemic to political and economic life. With this in mind we can better understand how a system rooted in the Middle Ages could survive, and thrive, in the global economy.

Following a broad overview of the parallel evolution of religion and history, this chapter explores the mechanisms by which Islam adapted to changing circumstances, and explains how Islam could accommodate itself with modern economics and finance.

## 2.1 Historical and Religious Background

The tenets of the Islamic religion can be conceived as a pyramid. At the top stands the Koran, considered by Muslims to be God's word as conveyed to the Prophet Mohammed. Below it are the Hadith and the Sunna. Often used interchangeably, the first actually refers to the words and deeds of the Prophet while the second refers to the tradition or path established by those words and deeds. In other words, the Hadith, in the form of a large and ill-defined number of short texts, relates stories about and sayings (specific pronouncements, deeds, or approvals of other people's actions) of the Prophet, whereas the Sunna consists of the practices and rulings deduced from such narratives.

As for issues and questions not addressed by those primary sources, the proper Islamic view can be obtained through ijmaa and qiyas. Ijmaa means consensus, and is based on the notion that the communal mind of Muslim scholars of a particular age provides assurance of freedom from error. Qiyas refers to reasoning by analogy or by logical inference based on primary sources. Jurists, through devout and careful reflection and effort (ijtihad) can derive appropriate rulings, by figuring out how the Prophet and his four immediate successors – the 'right-guided caliphs' – would have acted, or what the accumulated wisdom of the community would prescribe. The Shariah is the Divine Law derived from all these sources. Though usually translated as Islamic Law, the Shariah is in the eyes of certain scholars a broader term not designating law per se, but 'designating good order, much like nomos'.[1]

Indeed, in various matters including economic ones, there are sharp disagreements as to what the Shariah dictates. The further down the pyramid, the broader the possible interpretations. The Koran, a short, specific text, is considered divine and eternal since it is the revealed word of God. The Hadith – a collection of narratives which were not set down in writing until two or three centuries later – provides a first area of controversy. A great number of Hadiths were deemed apocryphal, typically fabricated to support a particular political faction or opinion, and a long process of authentication did not dispel all doubts about the veracity of certain texts. Interpretations can still differ quite significantly. Also, different traditions authenticate different Hadiths. In addition, Islamist groups over the ages have disagreed on the relative importance of the various tenets of the religion, some, for example, having called for reliance only on the Koran, and for a disregard of the 'man-made' elements of religion that developed over time.[2]

Such disagreements explain why different schools of jurisprudence (fiqh) developed over the years, each contributing different interpretations of the Shariah. By the tenth century, four main schools had emerged within the orthodox Sunni tradition (the Shia had their own, separate schools): Hanafi, Shafii, Maliki and Hanbali. Every Sunni is in theory a follower of one of these schools. In classical Muslim society, four qadis (judges) in each major city would apply one of these four traditions to fill in areas of the law that were left undiscussed in the Koran and Sunna. Over the years, however, each school found particular favour in certain localities, hence the geographical concentration of adherents that can be found nowadays. Hanbalis are primarily concentrated in Saudi Arabia. Malikis predominate in North and West Africa. Shafiis are a majority in Indonesia, Malaysia, East Africa, Yemen, and parts of Egypt. The most widespread of the schools is the Hanafi, which was once the official school of the Ottoman empire, and is thus influential in Turkey as well as Egypt, Syria, Lebanon, Jordan and Iraq. It is also adhered to in much of the Indian subcontinent.

The legal methodologies of these schools differ, combining different proportions of textual authority and analogical reasoning: the Hanbalis tend to adhere to literal interpretations of religious texts, while the Malikis and Hanafis allow wider discretion in the interpretations of such texts. On a specific issue, different schools may be clear, ambiguous or silent. They also may be lenient or strict. In addition, individual countries differ in their eclecticism: in Algeria or Morocco, for example, only Maliki interpretations of the Shariah are allowed in court, while in Egypt interpretations based on any of the four schools are admissible.[3]

A combination of external influences and idiosyncratic evolution has led to significant diversity throughout the Islamic world, which in turn translated into growing doctrinal differences. All this of course runs counter to common generalizations. Thus, though the language of Islam emphasizes a unified 'umma' (Islamic nation), the reality is far more complicated. A truly unified and coherent community only existed in the early years of Islam. In 657, the first schism occurred, involving the Kharijites ('the goers-out'). An even more significant split occurred in 661 when followers of Ali refused to acknowledge the authority of Muawiyah (the founder of the Umeyyad dynasty) and his successors, thus creating the Shia–Sunni divide. By the tenth century, with the appearance of rival caliphates in Egypt and in Spain, the notion of a unified 'umma' became even more of a fiction.[4] In later centuries, such fragmentation increased significantly.

It is thus a mistake, common perceptions notwithstanding, to see Islam as a monolith. It follows that most facile generalizations deserve to be nuanced. For example the extent to which Islam fuses church and state ('din wa dawla') depends upon the period or the region under consideration. Under the Prophet Mohammed (622–32) as well as the first four ('rashidun' or 'rightly-guided') caliphs (632–61) – Abu Bakr, Umar, Uthman and Ali – temporal and spiritual power were inextricably linked. This period, which also coincided with remarkable territorial expansion, embodies the ideal of Islamic rule and social organization, a model that successive generations have striven to emulate.

But soon afterwards, with the advent of the Umeyyad dynasty (661–750), some measure of separation of temporal and spiritual functions appeared. According to historian Philip Hitti, Muawiyah, by introducing 'innovations' opposed by religious conservatives, by surrounding himself with non-Muslims, and by creating a hereditary dynasty, 'secularized Islam and transformed the theocratic caliphate into a temporal sovereignty'.[5] Nor is the impact of foreign influences on Islamic doctrines and practices sufficiently understood. Again, in the Umeyyad era, as explained by Albert Hourani, 'The ruler, his governors and special deputies, the qadis, dispensed justice and decided disputes, taking into account the existing customs and laws of the various regions'.[6] Further expansion and absorption of foreign influences occurred in the Abbassid era (750–1258). Although it was accompanied by bureaucratization, centralization, and attempts to reassert religious legitimacy, the cosmopolitan nature of the Abbassid empire further diluted the original Arab influence. In sum:

> Just as the Shariah had grown up by a slow and complicated process of interaction between the norms contained in the Koran and Hadith and the local customs and laws of the communities brought under the rule of Islam, so there was a continuing process of mutual

> adjustment between the Shariah, once it took its definitive form, and the practices of Muslim societies.[7]

The 'definitive form' occurred in theory with the 'closing of the gates of ijtihad'. Yet when and why the gates were closed – and most importantly whether those gates were really ever closed – is still being debated.[8] One common explanation for the insistence that the Shariah had taken its final form is that with the increased dilution of the original Arab–Islamic norms which occurred with the gradual weakening of the Abbassid empire, and culminating with the Mongols' invasion of Baghdad in 1258, Muslim jurisprudents, fearing that alien customs and norms would subvert the Islamic legal system, arrived at a consensus: from then on, no new laws would be produced.[9] With the formal collapse of the Abbassid empire, the centres of power moved further away from the Arab core towards the Turkic world, and the Islamic world grew ever more fragmented.

Though the rhetoric of the unity of spiritual and temporal power remained, secularist trends have been on the rise since the tenth century. In the words of Edward Mortimer:

> In a sense … all genuine political authority in the mainstream Muslim tradition was secular after the loss of effective power by the Abbassids in the tenth century AD. Virtue and justice were no longer regarded as indispensable qualifications of a ruler. Full enforcement of the Shari'a came to be seen as an ideal rather than a necessity. Political power was no longer the instrument through which the ideal community could be realized, but merely a prosaic necessity for the maintenance of order and security, and thus of the minimum conditions in which the faith could be practised and the Muslim community survive.[10]

Similarly, Olivier Carré has argued that after the tenth century, the 'great tradition' and the 'real orthodoxy' of Islam separated politics and religion. Divine law was limited to improving a government's policies by prescribing certain social correctives.[11]

Throughout its golden age (roughly the seventh to tenth centuries in the Middle East, and the eleventh to fourteenth centuries in North Africa and Spain), the Islamic world did not fit the image of a narrow-minded theocracy. Great libraries and translation centres were established where the great works of philosophy, literature, medicine and science from East and West were collected and translated. Such knowledge was improved upon and formed a necessary link to later advances in the West. Bernard Lewis noted that in that golden age Europe looked from the Islamic world 'as central Africa looked to Victorian England'.[12]

So where does the persistent image of an Islam incapable of separating mosque and state – indeed incapable of dealing with modernity and change – come from? The answer lies in the parallel evolutions (and