

## **4. Islamic moral economy as the foundation of Islamic finance**

**Mehmet Asutay**

*in*  
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**Edited by**  
**Valentino Cattelan**

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### INTRODUCTION

The reform movement in the Muslim world can be traced back to the mid-nineteenth century and the search for authentic Islamic institutions has dominated the objectives of the reform movements of the Muslim societies since the beginning of the twentieth century. In the case of financial institutions the major developments have taken place in the last quarter of the twentieth century in the form of Islamic banks and financial institutions (IBFIs). With the establishment of the first Islamic bank (IB) in 1975 in the Gulf region the institutional development of Islamic banking took the 'commercial form' as opposed to the short-lived experience of Islamic social banking in the case of Mit Ghamr in Egypt in the 1960s.

Since the first IB in 1975, IBFIs have not only successfully expanded in their asset bases, diversity and sophistication of products they offer but also in terms of numbers of such institutions. An important reason for the success of IBFIs is that they managed to find ways into the financial centres of the Western world as well; the UK, France, Germany and Luxembourg being amongst other countries that have attracted IBFIs.

Against the backdrop of global financial crises, IBFIs have managed to achieve modest growth in their asset base and also in other institutional and financial variables. Therefore, the issue of the 'resilience of IBFIs' has become a popular topic in conferences and writings, while the observed 'resilience' has been attributed to the religious-ethical foundations of Islamic banking and finance (IBF). However, a very limited number of defaults have also been observed in this specialized industry.

It is, however, important to essentialize Islamic moral economy (IME), which provides the moral foundations of IBFIs. The discourse on IME is shaped around social justice and conducting economic and financial activities in considering their larger social impact and contribution to social good. This chapter, hence, aims to discuss the foundational issues in IME with the objective of identifying the moral nature of IBF.

A critical analysis of the progress, expansion and performance of IBFIs indicates that the values and norms of IBF have been compromised by a ‘financialization’ fostered by financial engineering, which has ‘endogenized’ the problems of the current financial system into the IBFI realm. It is therefore important to make reference to norms and values of IBF as formulated by IME, which provide authentic meaning to the ‘Islamicness’ of IBF. This chapter, hence, aims to present the IME framework in order to express the distinguishing nature of IBF as a value-oriented proposition.

## ISLAMIC MORAL ECONOMY: THE FOUNDATION

Islamic economics, or as argued in this chapter, IME emerged mainly in the post-1960s as a result of reform movements in the Muslim world since the beginning of the twentieth century. In the post-1960s period, the failure in economic development in the Muslim world and the rise of an Islamic political identity motivated certain academics, activists and financiers/bankers to discuss the initial foundational issues in what later becomes IME. Thus, IME is a religiously defined response to the economic development failure in the Muslim world, whether capitalist, socialist or nationalist, with an authentic meaning derived from the ontology of Islam, namely *Qur’an* and the *Sunnah* or the tradition of the Prophet Muhammad (Asutay, 2007a, 2007b). It is in a way a reaction and a problem-solving attempt to develop an ‘Islamic system’ of economics and economy in producing theoretical and policy bases for the underdevelopment of Muslim societies through the norms, values and principles of Islamic ontology with the objective of creating a human-centred development process.

A number of academics, such as Chapra (1992, 2000), Siddiqi (1981), Al-Sadr (2000), Ahmad (1980, 1994, 2003) and Naqvi (1981, 1994, 2003), as the founding fathers of IME in the modern sense, attempted to articulate the initial theoretical building blocks of IME and hence IBF. As a modernist movement, IME in the process has been socially constructed according to the ‘socially’ understood meaning of the Islamic ontology.

In this reading, and hence formulation, emphasis was placed on the consequentialist nature of economic development and the substance of the process, which produced a ‘social-welfare’ or ‘social good’-oriented developmentalist paradigm resulting in what can be termed as IME. The concepts of ‘*adalah*’ or ‘justice’ and ‘*haqq*’ or ‘right’ are the core objectives and operational principles around which the economic system of Islam has been formulated.

### Defining Islamic Moral Economy

Initially, 'Islamic economics' as a term was used as the Islamic equivalent of conventional or neo-classical economics in defining but also describing the nature of IME.

Al-Makarim (1974, p. 35) defines Islamic economics as 'the science that deals with wealth and its relation to man from the point of view of the realization of justice in all forms of economic activities'. In making reference to its distinctive nature, Hasanuzzaman (1984, p. 52) defines Islamic economics as 'the knowledge and application of injunctions and rules of the *Shari'ah* that prevent injustice in the acquisition and disposal of material resources in order to provide satisfaction to human beings and enable them to perform their obligation to Allah and the society'. In line with such an approach, Khan (1984, p. 55) refers to the distinctive objective of Islamic economics in stating that Islamic economics 'aims at the study of human *falah* [meaning 'salvation', but also 'prosperity' and 'welfare'] achieved by organising the resources of earth on the basis of cooperation and participation'. Such divine attachment is also evident in Arif (1984, p. 97): 'Islamic economics is the study of Muslim behaviour who organises the resources which are a trust, to achieve *falah*.' The same sentiments can be seen in Chapra (2000, p. 125): 'Islamic economics is the branch of science that helps to realize human welfare through the allocation and distribution of resources which are scarce in accordance with *maqasid*.'

In all these definitions, the social dimension of economics according to Islamic ontology and epistemology is emphasized as the distinctive nature of IME. These definitions suggest that the Islamic paradigm can lead to a different 'economics' understanding according to the Islamic sources of knowledge, which can be socially constructed in the modern world as a distinct way of managing economic and financial issues.

### Axiomatic Principles of Islamic Moral Economy

The initial attempts to formulate the 'Islamic system' of economics aimed at laying the axiomatic foundation of IME, with direct consequences and implications for the social aspects and developmentalist orientation of IME (Ahmad, 1980, 1994; Naqvi, 1981, 1994; Asutay, 2007a, 2007b; Zaman, 2008), are presented below.

1. The vertical ethicality of the equality of individuals in their relations to the Creator, God (individuals having equal opportunities for the bounties on Earth created by God) as *tawhid* ('profession of the unity of Allah') constitutes the first and the core axiom of IME. This

relates to 'social accountability' in terms of endogenizing the second dimension in the utility function, namely the Hereafter, which is considered as the dynamic nature of the IME. Thus, 'along with the idea of human accountability before God, or *akhirah* [the Hereafter], an Islamic economic system is similarly based on two-dimensional utility function, operating in a positive correlation with each other. For instance, the more social good one does in the temporal world, the more *sawab* or glad tidings one will receive in the Hereafter' (Asutay, 2007a, p.8). Within this conceptualization, individuals are expected to aim at reaching *falah* or 'salvation' as their objective function through the process of *ihsan* or 'beneficence'. However, individuals reaching *falah* through *ihsan* is not enough to maximize the utility in the Hereafter, as individuals are expected to help others through their beneficence to enable them to reach the same quality of life towards *falah*. *Tawhid*, thus, provides the necessary value framework within which economic activity is expected to take place according to Islamic norms.

2. Social justice and beneficence (*adalah* and *ihsan*) as the second axiom constitutes the horizontal equality between individuals within the *tawhidi* framework, implying that individuals are equal to each other in their everyday life. In addition, it implies that those in a better position are expected to conduct *ihsan* in order to reach salvation or *falah*. Therefore, as an essential axiom, it 'denote[s] a state of social equilibrium' (Naqvi, 1994, p.267). Thus, *adalah* and *ihsan* together implies 'giving everyone their due', and both in line with *tawhid* 'results in attaining high levels of good life (*hayat al-tayyebah*), both individual and collective' (Ahmad, 2003, p.193). Consequently, this axiom provides for the horizontal dimension of equality for 'all the virtues of the basic set of social institutions – legal, political and economic' (Naqvi, 1994, p.27). It is also important to note that this axiom refers not only to static social justice intra-generational terms, but puts heavy emphasis on inter-generational 'social justice', hence overcoming the conflict in utilization of resources between the current and future generations.
3. As a direct result of the vertical and horizontal ethical axioms, IME assumes growth in individual, social, economic and biological environments to take place in harmony with the stakeholders within the spiritual framework of *tazkiyah* ('purification'). Thus, it recognizes social and environmental limits to 'growth' and therefore articulates a balanced growth with the participation of all the stakeholders. 'The result of *tazkiyah* is [therefore] *falah*, prosperity in this world and the hereafter' (Ahmad, 1994, p.20).

4. IME, as a consequence of the above axioms, assumes in a functional sense the enabled individual, society and natural environment so that each of these can reach its perfection within the *tawhidi* framework, as God has chosen perfection as a path by definition for everyone and everything. This refers to *rububiyah* as the functional axiom, which is defined as the 'divine arrangements for nourishment, sustenance and directing things towards their perfection' (Ahmad, 1979, p.12). As the definition indicates, it directly refers to divine balance in the world and implies a coordinated perfection within all stakeholders in a society for every activity.
5. In fulfilling *rububiyah* in all aspects, that is, in the individual, society, economy and environment, the *tazkiyah* process aims to overcome the conflict between individuals and society. Therefore, IME assumes that in order to overcome the perceived conflict between individuals and society, voluntary action is not perceived to be enough; hence certain socially oriented financial and economic obligations are made mandatory, or *fard*, so that moral economy objectives should be achieved within *tawhid* as articulated by *al-adalah wal-ihsan*. Considering that individuals have responsibility towards God, society and themselves, 'these three facets of responsibility only underscores the central ethical principle that the individual, though possessing a distinctive personality of his own, becomes even more distinguished as an integral part of the totality of mankind' (Naqvi, 1994, p.33). In other words, 'being a conscious part of a society implies a functional responsibility towards society' (Asutay, 2007a). Consequently, in economic and financial terms, every asset owned or managed by private or public entities is attached with social responsibility.
6. The axiom of *ikhhtiyar* or 'free will' indicates that in the Islamic moral economy understanding, humans are believed to be endowed with free will. Although it is 'both unrestricted and voluntary' (Naqvi, 1994, p.29), it is guided by broad guidelines in order 'to interpret-reinterpret that freedom within specific societal contexts, and to suit the needs of changing times' (p.31). This, therefore, constitutes functional norms of individual behaviour in relation to economic activity in the Islamic economic system.
7. In operationalizing such expectations as expressed within the axioms of IME, as part of the *tawhidi* framework, the individual is perceived to be God's vice-regent on Earth, namely *khalifah*, to fulfil the expected duties in their social, economic and financing aspects and to be guided through a moral filter. By this 'his (or her) role, position and mission is described as *istikhlaf*, that is fulfilling God's will on earth, promoting what is good, forbidding what is wrong,

establishing justice (*'adl*) and promoting beneficence (*ihsan*), resulting in attaining high levels of good life (*hayat al-tayyebah*), both individual and collective' (Ahmad, 2003, p.193). As an axiom and as a state of being, the vice-regency role 'outlines responsibilities and provides the reasons of existence for the individual' (Asutay, 2007a, p.8). 'From this follows the unique Islamic concept of individual's trusteeship, moral, political and economic, and the principles of social organisation' (Ahmad, 1979, p.12). Consequently, 'the implications of the principle of *khilafah* include the notion of universal solidarity, sustainable consumption of resources, which are trust from God, pursuing a humble lifestyle and having human freedoms to conduct daily life' (Asutay, 2007a, p.8).

8. All these axioms, as the foundational framework of IME, are the articulation and operationalization aspects of *maqasid al-Shari'ah* or the 'objectives of the *Shari'ah*' process, which is defined as realizing 'human well-being'. In other words, the entire objective of IME and also its operational aspect of *Shari'ah* is considered to serve 'human well-being' which is the main and essential aim of all efforts within the *tawhidi* framework. The *maqasid al-Shari'ah* or the objectives of *Shari'ah*, consequently, 'provides the legal-rational framework within which Islamic economic activities should be conducted . . . [by] interpret[ing] the text and restor[ing] the principles of Islamic economics in relation to the objectives of *Shari'ah*' (Asutay, 2007a, p.8).

In sum, 'the Islamic concept of economics and economic growth and development follows from its concept of *tazkiyah* [purification]' as it addresses the problem of economic aspect of human life 'in all its dimensions'; *tazkiyah* is 'concerned with growth towards perfection through purification of attitudes and relationships. The result of *tazkiyah* is *falah*, prosperity in this world and the hereafter' (Ahmad, 1994, p.20). Thus, IME makes the achievement of *falah* the primary aim of life and the ultimate success within both dimensions of transitory life (this world) and the eternal life (Hereafter). Al-Ghazali mentions four means through which an individual could achieve the ultimate success: (1) goods of the soul; (2) goods of the body; (3) external goods; and (4) divine grace.

Overall, these axioms and foundational principles formulate the micro-foundations or the foundational principles of the IME as a system, which are unique to the Islamic system of understanding as based on Islamic ontology and epistemology. They, therefore, by definition, differ from the axioms and foundational principles of any other economic system. The universal ethical system based on these axioms:

implies that policies should not lead to dependency, limit opportunities that develop capabilities to the few, or reduce individual responsibilities to take action. Policies should enhance motivation to seek knowledge, enhance productivity, and enhance transparency in government. They should also enhance intra- and intergeneration equity (Sirageldin, 2002, p.2).

Due to being unique and having the internal consistency, these axioms provide the rationale for the Islamic economic system (see Arif, 1989; Naqvi, 1994, among others).

As regards the implications, through the consequentialist approach, the foundational axioms demonstrate that IME refers to economic and sustainable development, social justice and social investing-oriented principles (Zaman, 2008). They assume a human-centred development strategy with individuals aiming to reach *ihsan* or beneficence or excellence due to aiming for *falah* or salvation in this world and in the Hereafter as the aim of this life. Within such a framework, IME assumes the development of functioning individuals in terms of ‘doings’ and ‘beings’ through creating the right and just environment and opportunity spaces for such development to take place (Zaman and Asutay, 2009).

Thus, IME is a moral economic and social system providing a systemic approach to the economic sphere through a multi-dimensional and multi-disciplinary approach. IBFIs, hence, should be located within this framework and systemic understanding in order to serve the aims and objectives of IME and contribute to the *falah* process for individuals by expanding the *ihsani* social capital in society.

### **Operational and Institutional Features of Islamic Moral Economy**

After identifying the axiomatic nature and goals of IME, it is important to determine the operational and institutional features of an Islamic economic system to identify how the axioms are articulated.

Despite its ethical appeal and position, IME recognizes self-interest as an essential motivation factor for individuals. However, IME suggests a moral filter through which the economic and financial choices can be made. An important aspect of the moral filter that aims to develop the individual *taba'ya* (obedience, ‘vice-regency’) is the personal purification or *tazkiyah* achieved through the actualization of *ibadah* or worshipping in individual life, which limits the material impulse of an ‘economic man’ (Nomani and Rahnama, 1994, pp. 22 and 24). Thus, an IME suggests that not only self-interest but also social interest is to be served as well (Chapra, 2000). Such an understanding and filter mechanism aims to remove the conflict between self-interest and social interest.

In parallel to self-interest, IME essentializes private property and private



enterprise as the core of economic life, which is also filtered through the moral codes of Islam. In this way, individuals recognize that private enterprise and private property 'is a trust (*amanah*) [from Allah], and as such, property rights are subject to moral limits and used as a means of fulfilling ethical objectives – the *maqasid al-Shari'ah*' (Ahmad, 2003, p. 195; see also Arif, 1989, p. 86).

As an extension of self-interest and private enterprise assumptions, IME institutionalizes the market as the institutional framework for exchange in the economic sphere. However, the market mechanism is also filtered so that social priorities are served alongside individually oriented utility and profit-maximizing motives (Chapra, 2000). Thus, a moral filter is expected to regulate the market. It should also be noted that as a result of the moral filter system, to overcome the market and government failure, IME relies on third-sector institutions such as *waqf* (voluntary organizations, pious foundations) and *zakah* in serving the welfare needs of society.

In summation, as identified in the axioms, IME assumes individual liberty, freedom of choice, private property and enterprise, the profit motive, but, in the same instance, institutionalizes effective moral filters at different levels of life and activity to serve social and economic interests in harmony through its own distinct institutions. A statement by Ibn Khaldun (fifteenth-century scholar) is perhaps one of the best ways to contextualize the assumptions, aspiration and working mechanism of IME (Chapra, 2000, pp. 147–8):

The strength of the sovereign (*al-mulk*) does not become consumed except by implementation of the *Shari'ah*; the *Shari'ah* cannot be implemented except by a sovereign (*al-mulk*); the sovereign cannot gain strength except through the people (*al-rijal*); the people cannot be sustained except by wealth (*al-mal*); wealth cannot be acquired except through development (*al-'imarah*); development cannot be attained except through justice (*al-'adl*); justice is the criterion (*al-mizan*) by which God will evaluate mankind; and the sovereign is charged with the responsibility of actualising justice.

### Methodology of Islamic Moral Economy

The methodological postulates of IME in relation to the identified axiomatic framework aiming to produce a moral outcome can be summarized as follows (Asutay, 2007a).

1. As opposed to the methodological individualism prevailing in conventional analysis, IME assumes a sociotropic individual, who is not only concerned with individualism but also with social concerns, as a prerequisite.

2. As regards the behavioural postulates, IME assumes socially concerned God-conscious individuals who (a) in seeking their interests are concerned with the social good; (b) in conducting economic activity in a rational way in accordance with the Islamic constraints regarding social environment and the Hereafter; and (c) in trying to maximize his or her utility seek to maximize social welfare as well by taking into account the Hereafter.
3. In terms of institutional assumptions, IME converges to conventional analysis in accepting that market exchange is the main feature of economic operation of the IME. However, this system is filtered through a moral process to produce a socially concerned environmentally friendly system. In this process, the socialist and welfare state-oriented frameworks are avoided in order not to curb incentives in the economy.

This methodological framework is expected to produce a two-dimensional utility function (the present and the Hereafter) as part of the *falah* process by maximizing the *ihsani* social capital with individuals aiming to establish optimality between gains and benefits made in this world and their equivalence in the Hereafter as part of their everyday life. This leads to the conception of ‘homoIslamicus’, or as Arif (1989, pp. 92–4) names, ‘*tab’ay*’ (obedient) human being, which necessitates the operationalization of IME principles in every aspect of individual life.

## ISLAMIC BANKING AND FINANCE AS A VALUE-ORIENTED PROPOSITION

When the current global financial crisis hit the world, people from different circles criticized capitalism for its ‘moral deficiency’ and attributed the financial failure to ‘reckless financing’ instruments but also to ‘greed’ of the financiers and bankers. The financial crisis, as a result, brought the importance of ‘morality’ into the agenda with the objective of ‘moderating’ the consequences of the capitalist financial system. As discussed in the previous section, IME assumes and offers a moral-based value solution for the economic and financing problems faced by humanity. While the larger conceptualization of IME remains theoretical and ‘imaginary’, IBF as institutions of IME have been operating since the mid-1970s providing an opportunity to reveal the value-oriented nature of IME in practice.

As the IME framework suggests, ethicality in this value proposition in the original sense is not only the prohibition of *riba* (interest), as commonly assumed with regard to IBF, but relates to larger social and

economic development issues as discussed above (Asutay, 2007b, 2010). In other words, IME conceptualizes IBF as a financing proposition shaped by the rules (*fiqh*) but also moral values of Islam constituting the ‘substance’ (Asutay, 2008).

IME’s moral framework, thus, is aimed at shaping the nature and operation of IBF beyond the prohibition of *riba* or interest. In this moral-based financing proposition, a holistic approach to financing in society is assumed by IME. This Islamic value and norms-based nature of IBF can be described as follows (Iqbal and Molyneux, 2005; Asutay, 2007b, 2010; Ayub, 2007).

1. IBF is a tenet-based financing proposition and its fundamental tenets are derived from the ontological sources of Islam, which is articulated in the ‘absence of interest-based transactions’, ‘avoidance of economic activity involving speculation’ and the ‘prohibition on production of goods and services which contradict the values of Islam’.
2. IBF is principles-based, as the concept is grounded in ethics, values and norms derived from the Islamic ontology. Therefore, the principles of IBF are akin to ethical investing, and hence, ethicality in funding and investing beyond the prohibition of *riba* is essential. In addition, importantly, IBF puts special emphasis on risk-sharing and partnership or profit-and-loss sharing (PLS) contracts. In this financing proposition ‘credit and debt products are not encouraged’ and even eagerly discouraged so that real economy-embedded financing as assumed by IME can be developed.
3. IBF, as part of IME, proposes embedded financing – embedded in real economy, and therefore it offers an alternative financing paradigm. This is articulated in the principle of asset-backed transactions with investments in real, durable assets to contribute to the development of value added-oriented real economy-based financing of economic activity. As a consequence, IBF aims to bring about stability by linking financial services to the productive, real economy. On the demand side, IBF, as part of ‘homoIslamicus’, aims to restrain consumer indebtedness as credit is linked to real assets.
4. IBF is a society-oriented financing proposition, as it aims to serve the communities and not markets. Since IME aims to create a framework of developmentalist financing, instruments of poverty reduction are an inherent part of IBF. For this, in addition to Islamic financing of economic activity for development, *zakah* and *qard hasan* can be mentioned.

In addition to these framework principles, the operational principles of IBF within this moral economy can be listed as follows.

1. Prohibition of interest or *riba*, which is explicitly revealed in the *Qur'an* with the objective of providing a stable and socially efficient economic environment.
2. An important consequence of the prohibition of interest is the prohibition of fixed returns as provided by interest. Thus, by prohibiting interest, IME aims at productive economic activity or asset-based financing over the debt-based system. Thus, the asset-backing principle requires that all financial activities must be referred to tangible assets.
3. Money does not have any inherent value in itself and therefore money cannot be created through the credit system.
4. The principle of PLS is the essential axis around which economic and business activity takes place. This prevents the capital owner from shifting the entire risk onto the borrower, and hence it aims at establishing justice between work effort and return, and between work effort and capital. This implies that risk-sharing is another important feature of IBF.
5. An important feature, which is a consequence of the PLS principle, is the participatory nature of economic and business activity through participatory financing.
6. By essentializing productive economic and business activity, uncertainty (*gharar*), speculation and gambling are also prohibited with the same rationale of emphasizing asset and equity-based productive economic activity (Iqbal and Mirakhor, 2006).
7. A moral screening process eliminating certain investment areas and economic sectors from the Islamic economic and financial sphere, which are considered as harmful to human well-being. Thus, IME assumes an active moral filter in terms of what to earn, what to produce and where to invest as other essential moral principles of IBF.

The IBF working within these Islamic norms and operational principles are expected to fulfil the expectation of IME contributing to economic growth but also economic development through human-centred and sustainable development.

## CONCLUSION: EVALUATING THE SOCIAL PERFORMANCE OF ISLAMIC BANKING AND FINANCE

In the preceding sections, it is argued that IBF aims to fulfil the aspirations of IME by contributing to the development of the society through ethical

banking and investing. IME conceptually, thus, suggests that IBF should be more than financial contracts, as it represents a holistic approach to financing in society. In addition, conceptually, Islamic finance is rooted in developmental aims, and is therefore conceptualized as providing the financial means for the development of the societies rather than servicing the markets. Therefore, the embedding principle of IBFIs' financing in the real economy is an essential feature.

A critical analysis of the performance of IBFIs, however, indicates that there is a growing divergence between the aspirations of IME and the realities of IBFIs. In other words, one witnesses the overwhelming convergence of IFBs with conventional banks and financial institutions in terms of operations and products at the expense of the aspirations of IME. Over the years, as part of this convergence, IBF has compromised on its 'moral economy'-related objectives and outcomes by locating itself very pragmatically within neo-classical economics. In other words, IBFIs' attachment to 'efficiency' has been at the cost of 'equity', while IME (as the foundation and framework for IBFIs) prioritizes social as well as economic and financial optimality by placing emphasis on 'equity'.

The observed divergence between the aspirations and realities of IME, thus, is mainly demonstrated in ethical and social expectations-related areas, and therefore it is valid to claim the 'social failure' of IBFIs with the evidence produced by a growing body of empirical literature. The debate in recent years, hence, has been around 'form versus substance' or '*Shari'ah* compliant finance versus Islamic-based finance', which indeed brings the legitimacy of the current practice of IBF into question. It should be noted that the 'substance' in this debate is defined through the IME's suggested ethical and developmentalist or social economy-oriented value proposition, as explained above.

In concluding, since 'development' is a larger concept, IBFIs with their current structures have not been able to affect nor have they aimed at affecting the developments of societies in which they operate in a systematic manner. This does not mean that IBFIs do not have impact on economic growth; on the contrary, due to financial development and pooling of funds they do contribute to economic growth. However, development is beyond the growth of the economy, which is the aim of IME.

The correction of the observed 'social and developmentalist' failure is essential for the sustainable development and hence for fulfilling the promise of IME, which can respond to the search for an ethical economic and financial structure. In serving such objectives, new Islamic financial institutions beyond, but in addition to, IBFIs are necessary and essential. Therefore, in the new institutionalization stage, IBFIs should relate to

'substance' and 'consequences' rather than the 'form', which can help to moderate and remedy the divergences observed in the practices of IBFIs.

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## 5. Financial stability and economic development: an Islamic perspective

**Salman Syed Ali**

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### INTRODUCTION

The financial crises such as the global financial crisis of 2007–09 and its aftermath as well as the present sovereign debt crisis of Europe have adversely affected the economic conditions and the social fabric of many countries. The strong link between financial stability and economic development has been learned the hard way. The attention of economists and policy makers has therefore now been refocused on attaining financial stability and saving economies from going into prolonged depression. In this regard, Islamic economics and finance can offer help in devising new policies and providing a fresh perspective. This chapter provides an Islamic perspective on the design philosophy of a financial system that guarantees stability and comprehensive economic development. Specifically, we address the questions: (1) How should we define economic development? (2) How is the financial sector development linked to economic growth? (3) How does financial stability affect economic development? (4) How can Islamic finance help in stability and growth?

### DEVELOPMENT IN THE CONTEXT OF ISLAMIC ECONOMICS

The conventional economics literature generally defines economic development as ‘an increase in the productive capacity and production of a country at a rate higher than the increase in its population’ (Pazos, 1953, p.228). Hence, it considers gross domestic product (GDP) per capita growth as the measure of economic development.

Development in Islamic economics refers to comprehensive socio-economic development. It is measured by the level of protection and progress achieved along five dimensions: life (*nafs*), faith (*din*), wealth (*mal*), intellect (*‘aql*) and prosperity (*nasl*). These are viewed by Islamic