

IDEALS VERSUS THE REALITY: HAS ISLAMIC FINANCE FULFILLED ITS PROMISE?

Mehmet Asutay & Ercument Aksak
Durham University

**First Workshop on the Development of Islamic
Finance in Europe:**

“Business in-Between Cultures”

University of Sarajevo, Bosnia Herzegovina

Islamic Finance as a Rising Star

1970-1980

BIRTH

1980-2000

EMERGENCE

2000-2010

EXPANSION

• Commercial Islamic Banks

• Commercial Islamic Banks

• Commercial Islamic banks

• Islamic investment companies

• Islamic investment companies

• Islamic Insurance companies

• Islamic insurance companies

• Islamic investment banks

• Islamic asset management

• Islamic retail banks

• Islamic brokers

• Islamic internet companies

• Islamic capital and financial markets



Islamic Finance as a Rising Star (2)

- By 2010 655 IB&F institutions were operating in 55 countries (The Banker, 2010)
- IB&F industry has passed the 1 trillion USD market size and one of the fastest growing sectors in global economy

Impressive Economic Performances

- Economies of Muslim nations have achieved considerable growth:
 - S. Arabia, Indonesia and Turkey are among the largest 20 economies globally (G-20)
- Economies of Muslim nations have achieved wealth and prosperity:
 - Qatar, U.A.E. and Kuwait are among the top 20 globally for per person income
- East Asian (Malaysia and Indonesia) and current global crisis (i.e. *Sukuk* default in Dubai) have contradictory evidence):
 - not totally immune to the shortcomings

A Success Story?

Aspirations of Islamic Economics

- Islamic economics emerged as a reaction to the failure of conventional economic growth policies
- The aim was to achieve human development and well-being both in moral, spiritual and material dimensions
- Founding axioms underlying *Tawhid, Justice, Morality, Prudence and Solidarity*

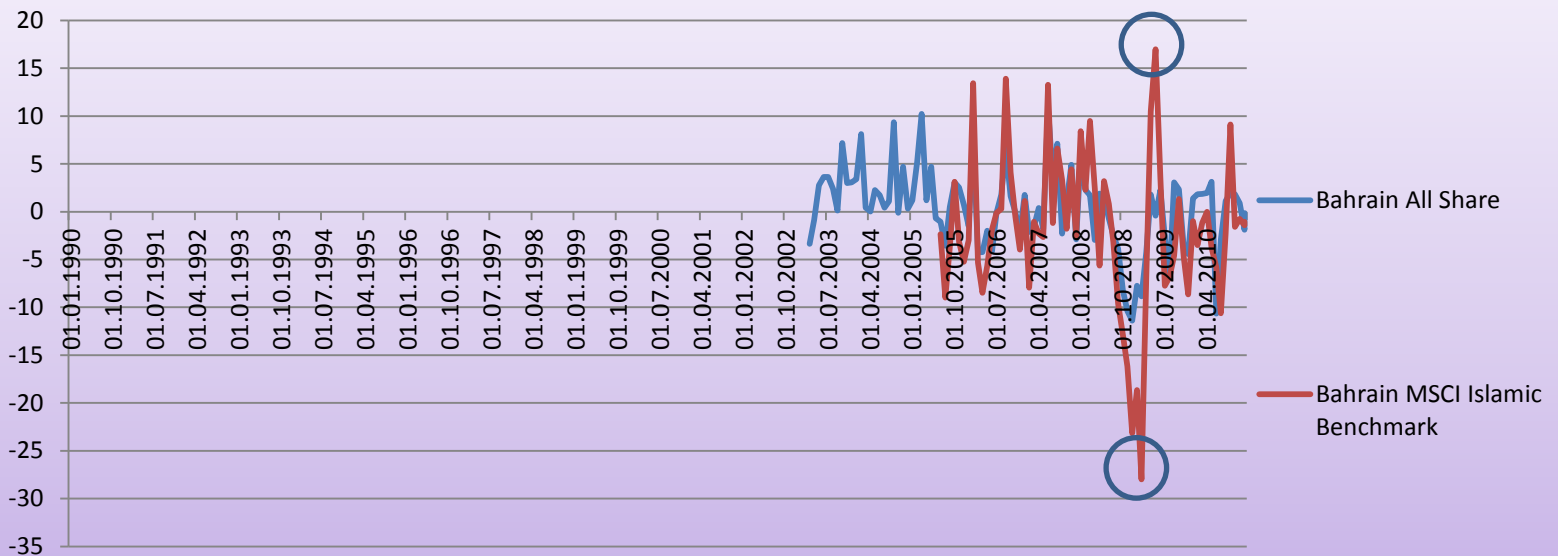
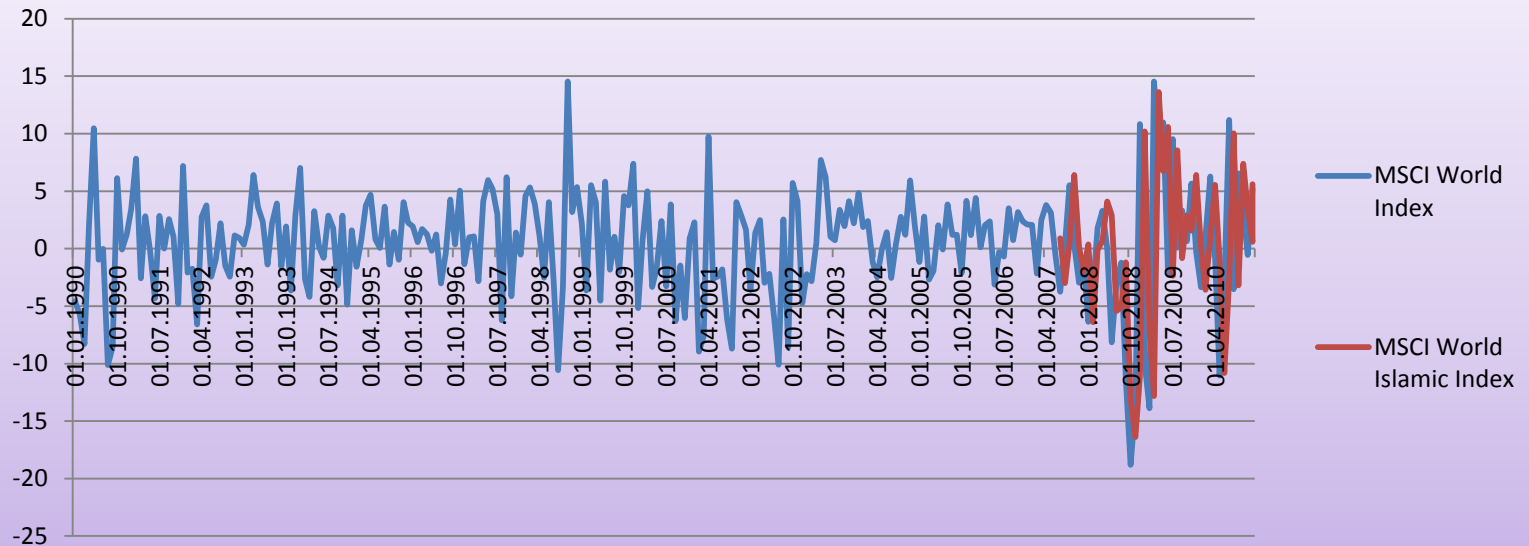
Aspirations of Islamic Economics (2)

- A just economic system based on the moral and ethical values of Islam
 - promoting economic activity
 - avoids uncertainty and risk and protects wealth
 - encourages entrepreneurship and trade
 - aiming at the well-being of the humans and societies through growth and development
 - underlining solidarity and social support

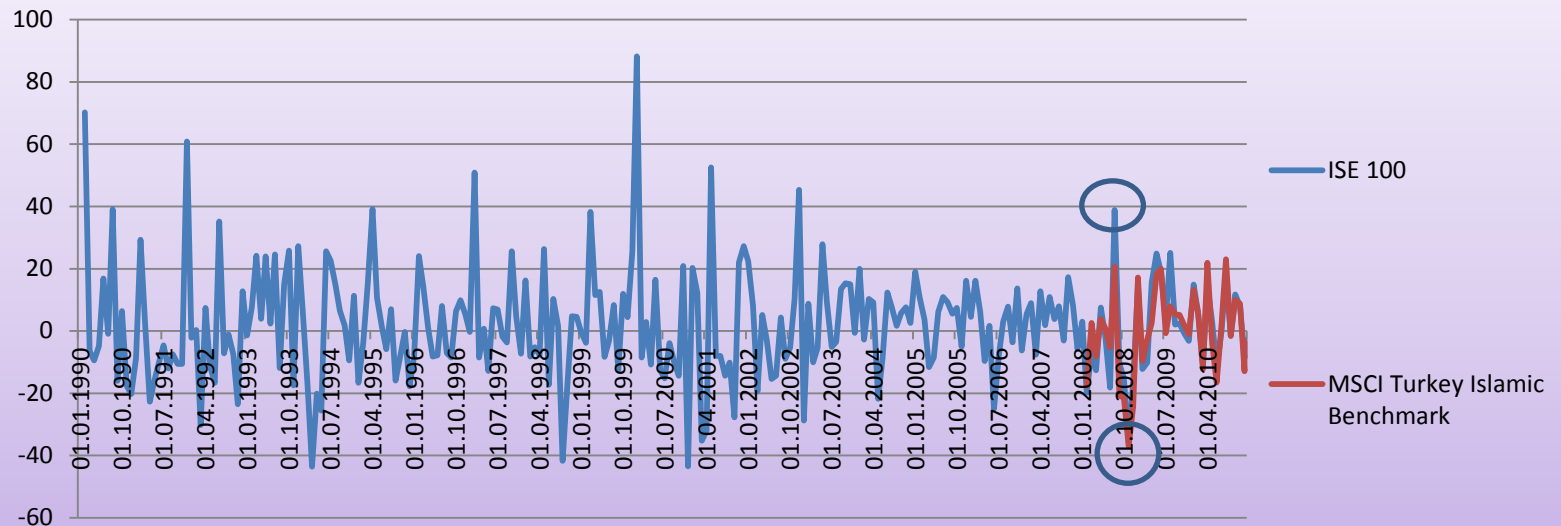
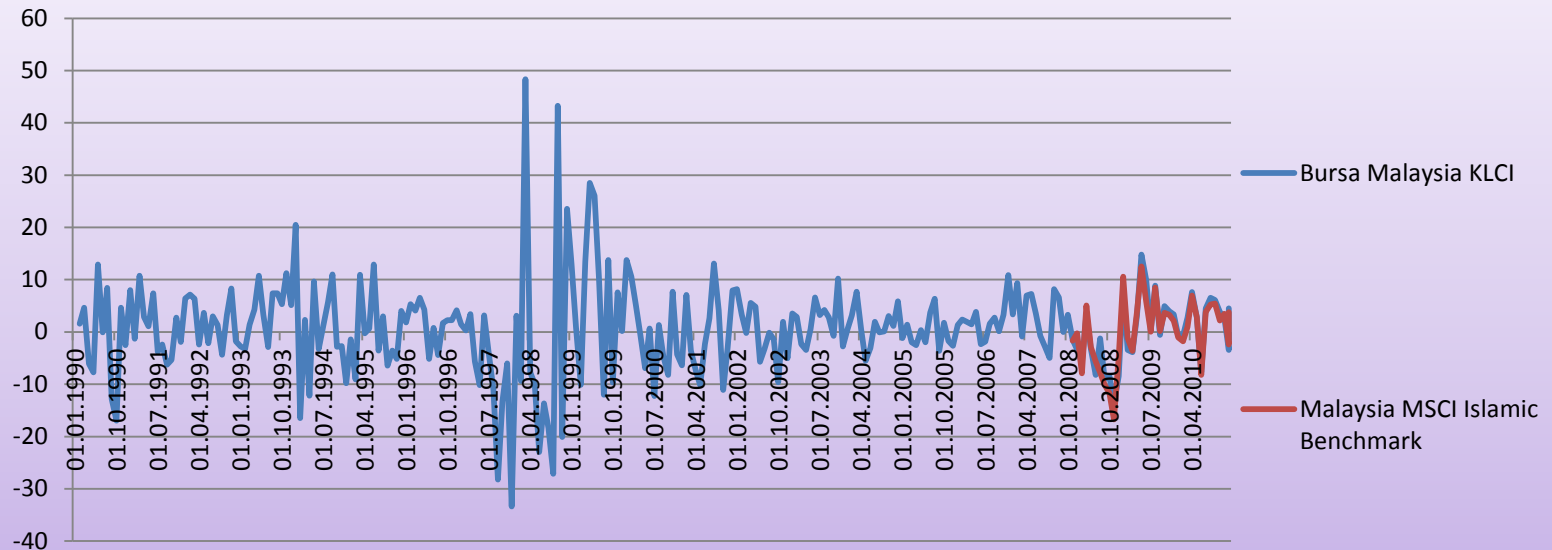
Islamic Finance in Islamic Economic Thought

- Expectations from Islamic finance as a tool of Islamic economic aspirations:
 - Stronger, more sound financial markets encourage participation from investors outlined before
 - Financial activity with minimised uncertainty, risks and speculation
 - Better links with the “Real Economy”
 - Financial support for trade and economic growth

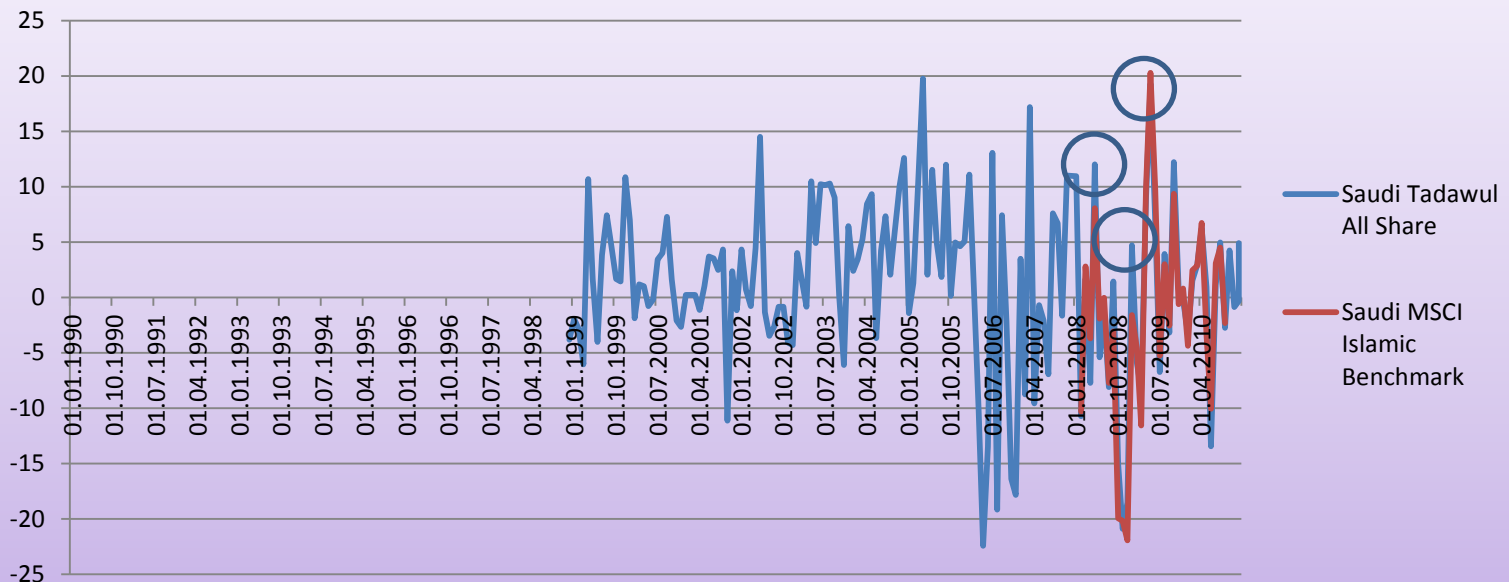
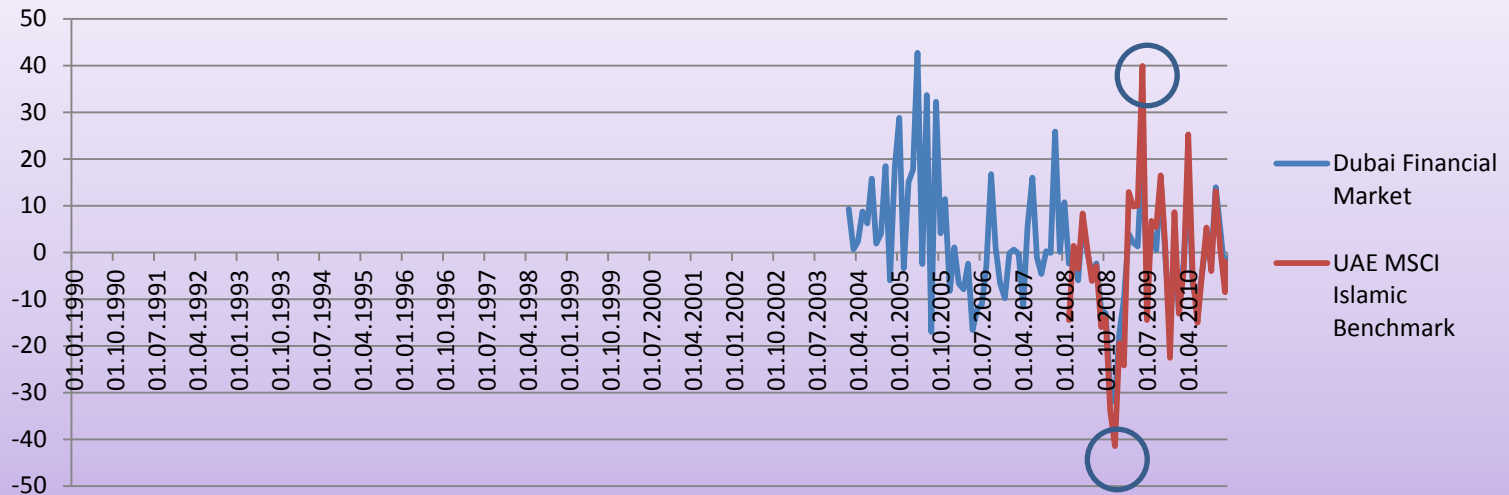
Stronger and Safer Financial Markets?



Stronger and Safer Financial Markets? (2)



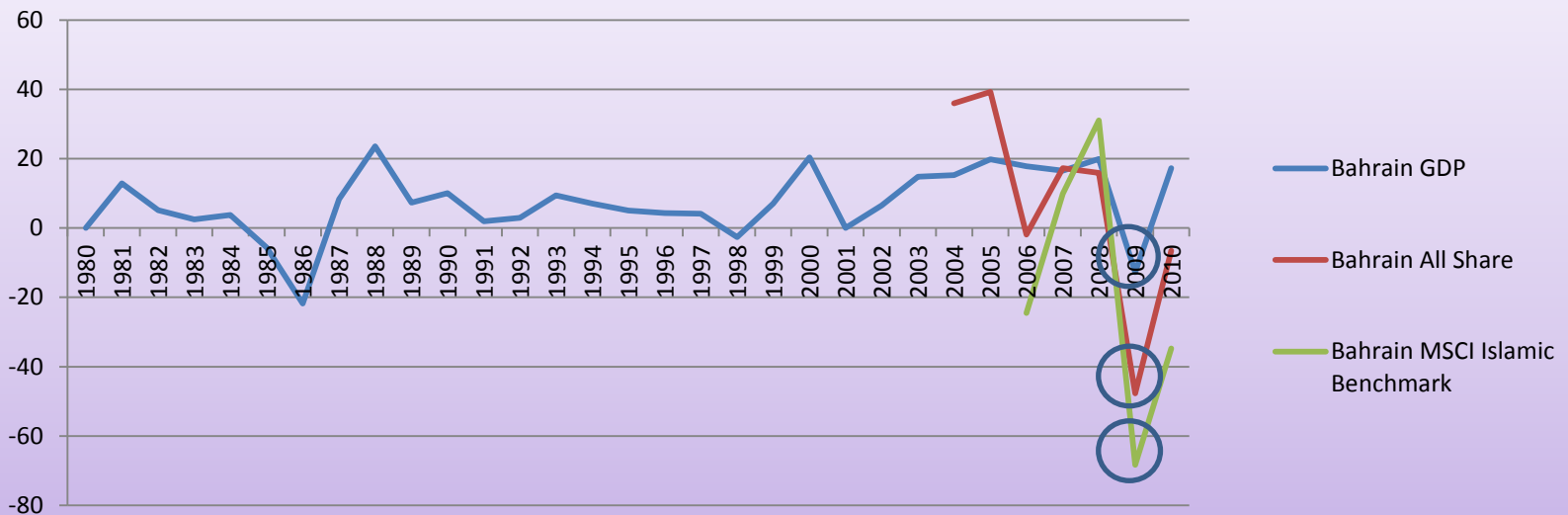
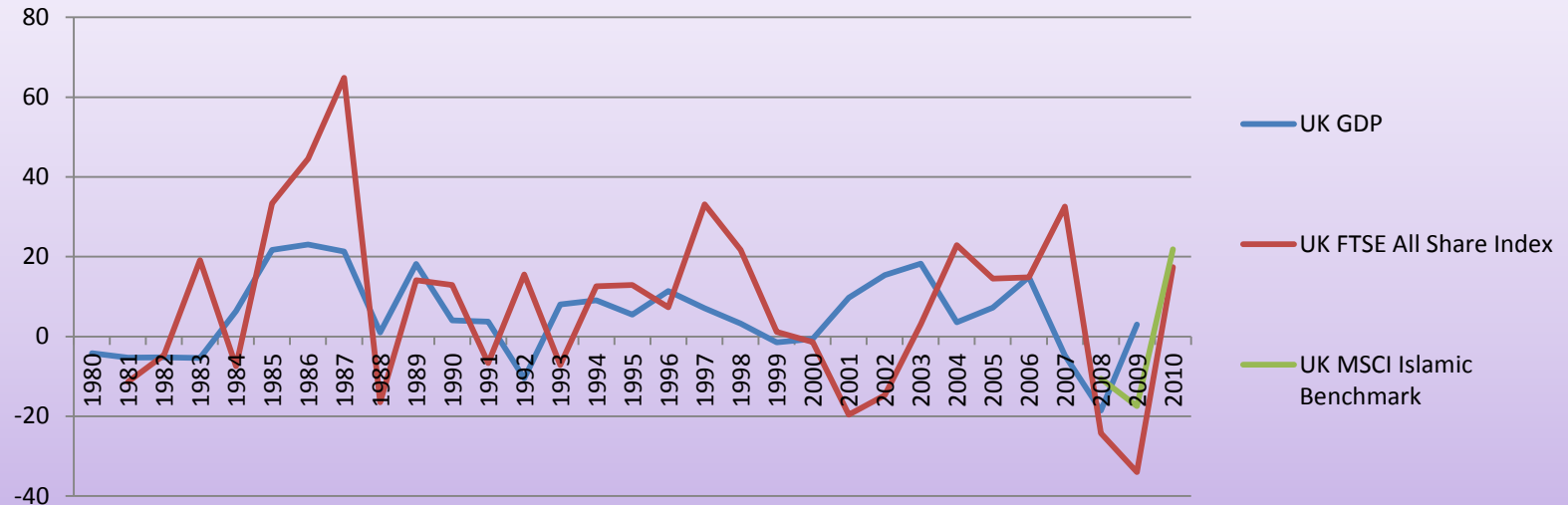
Stronger and Safer Financial Markets? (3)



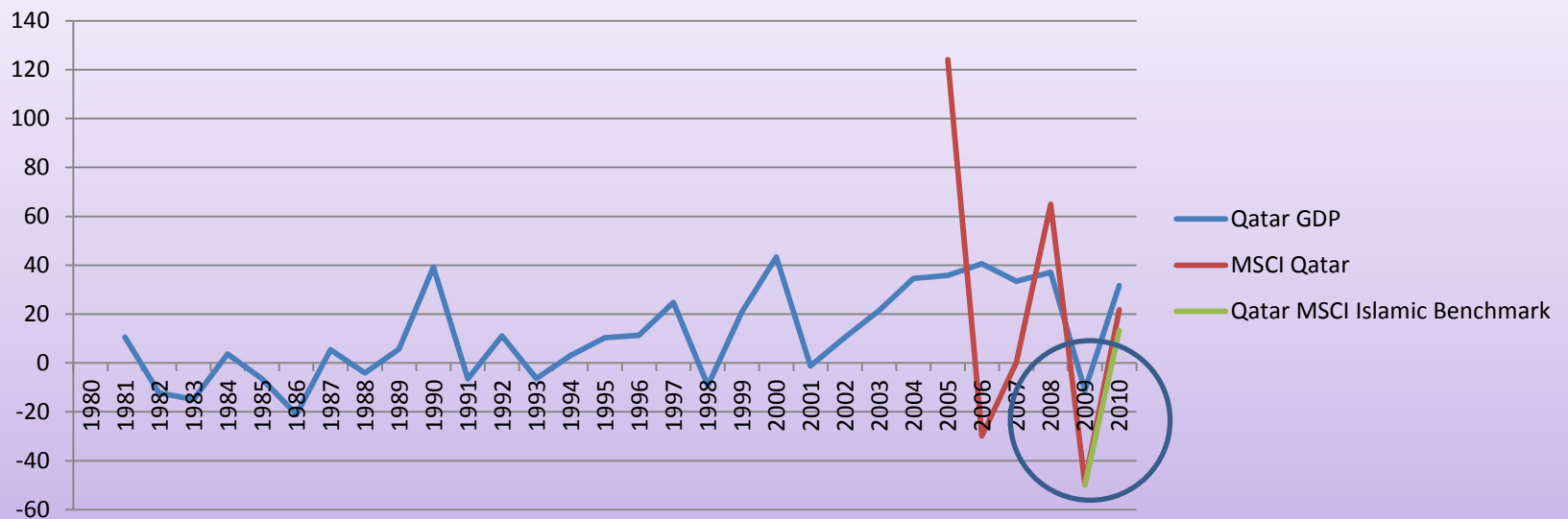
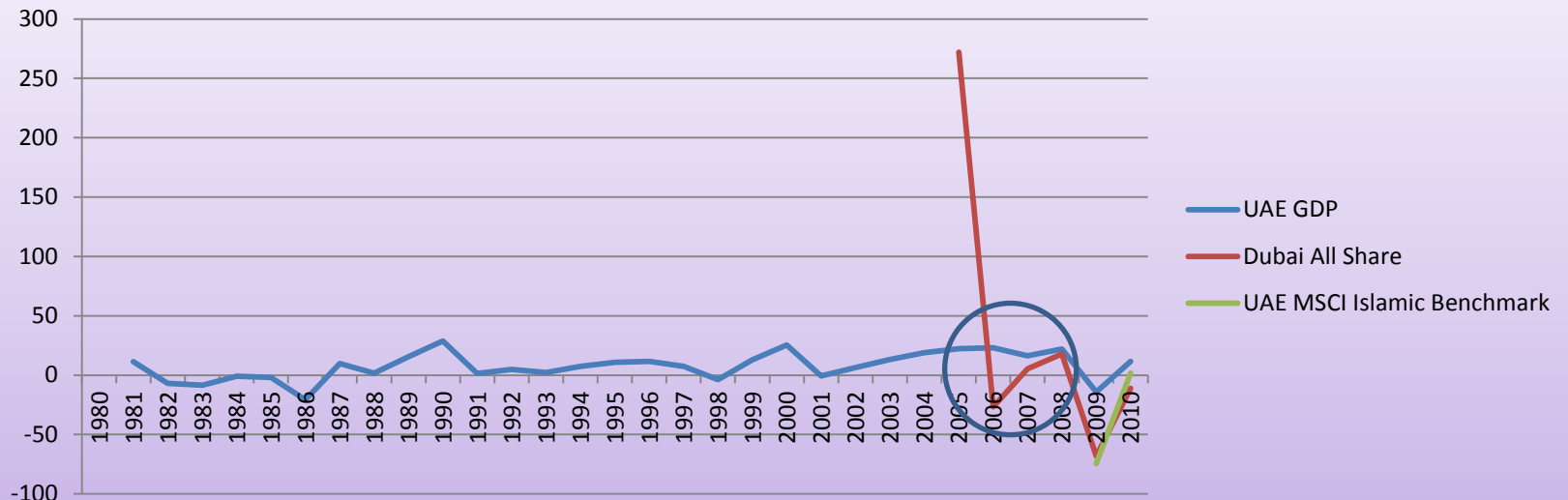
Stronger and Safer Financial Markets? (4)

- No strengthening effect
 - Conventional and Islamic indices move in parallel and very closely correlated – almost mimicking
- No conclusive evidence for additional safety
 - No apparent differences in the volatility of returns
 - Bahrain and UAE: significant fluctuations during crisis

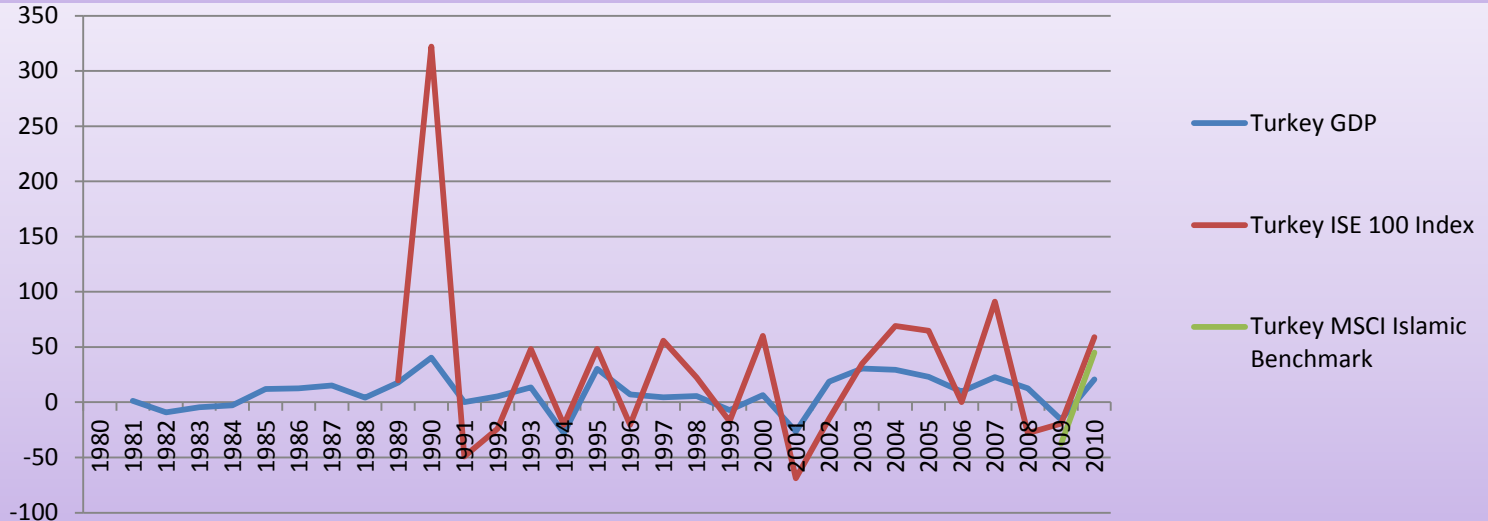
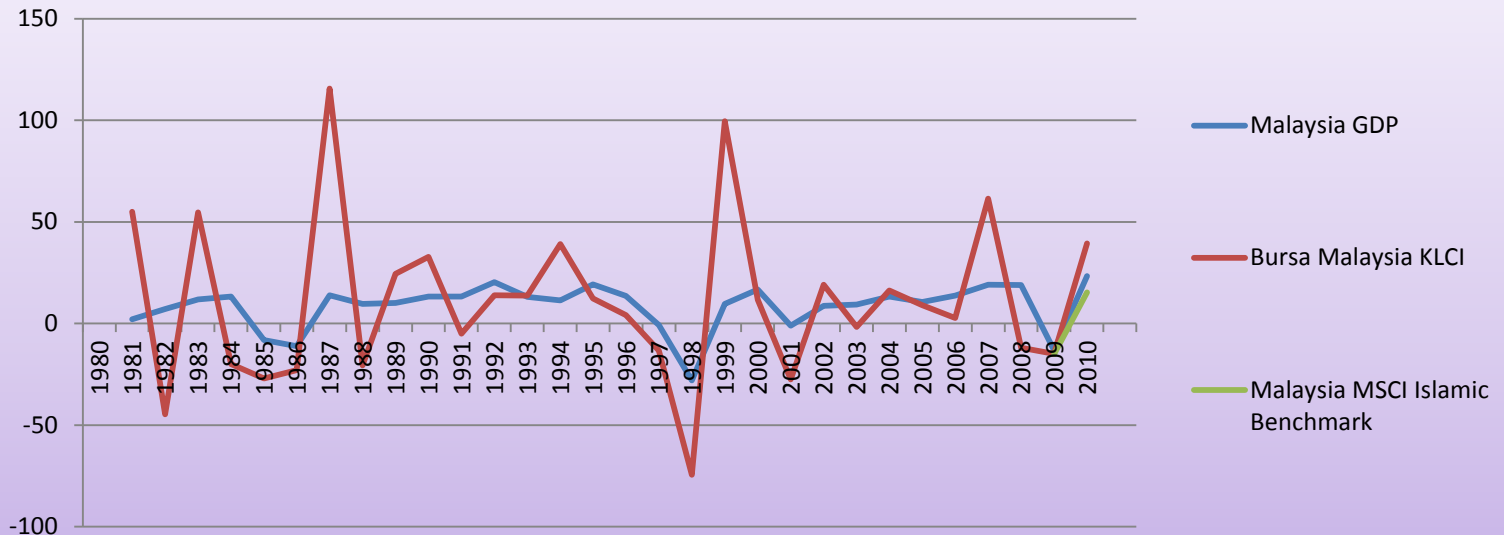
Better Ties to the Real Economy?



Better Ties to the Real Economy? (2)



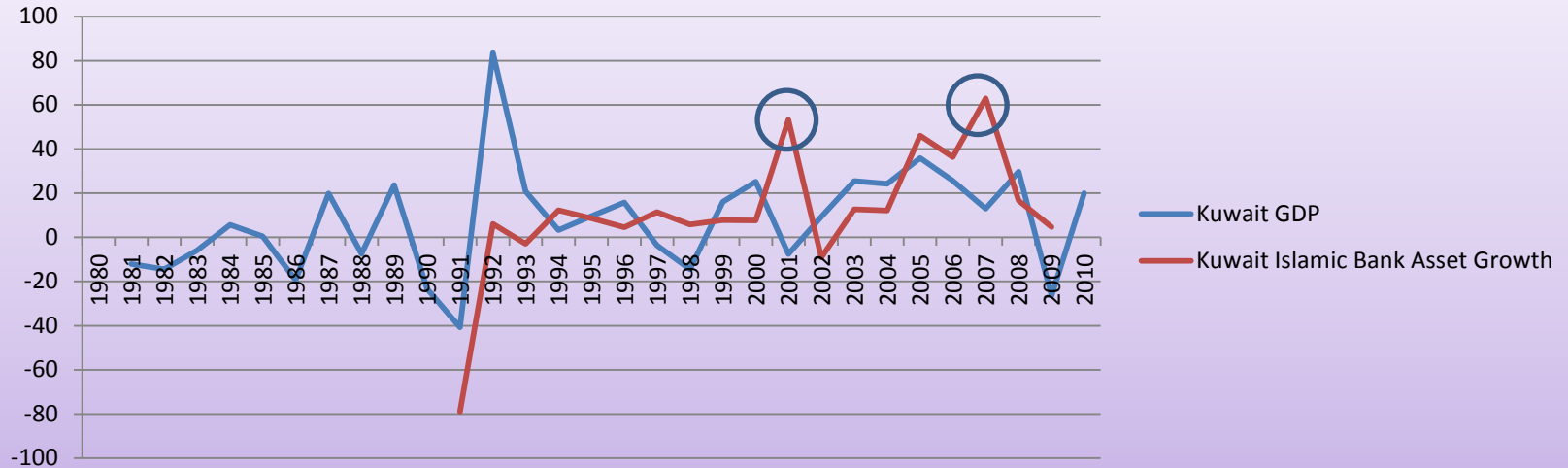
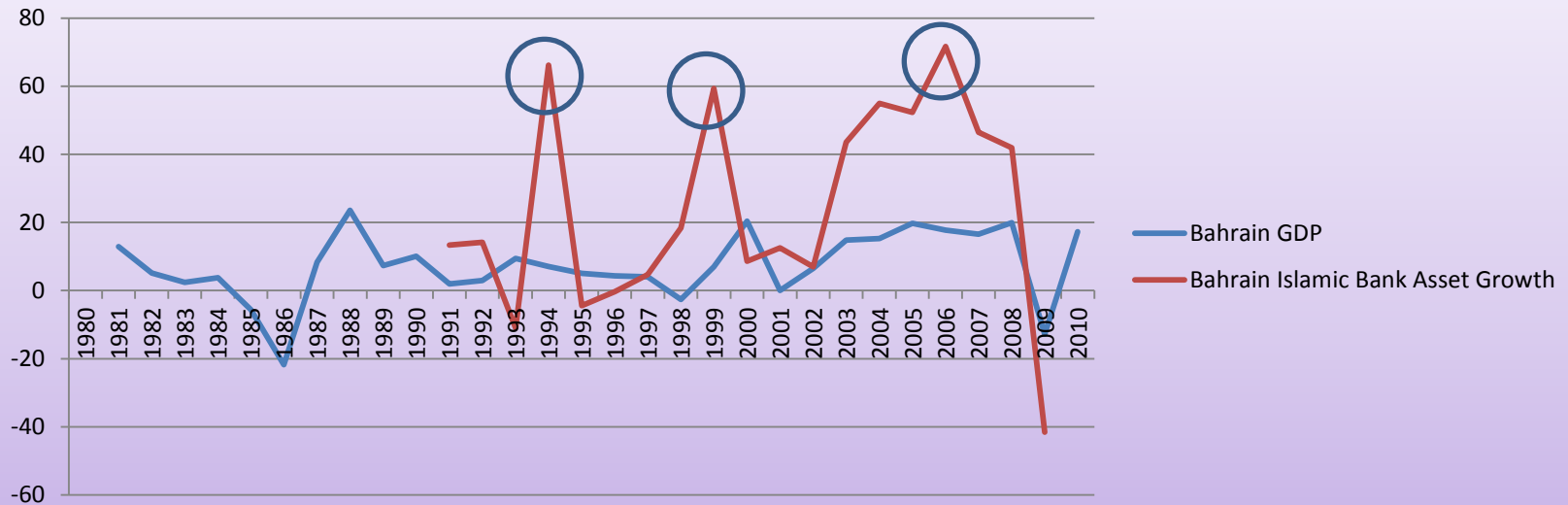
Better Ties to the Real Economy? (3)



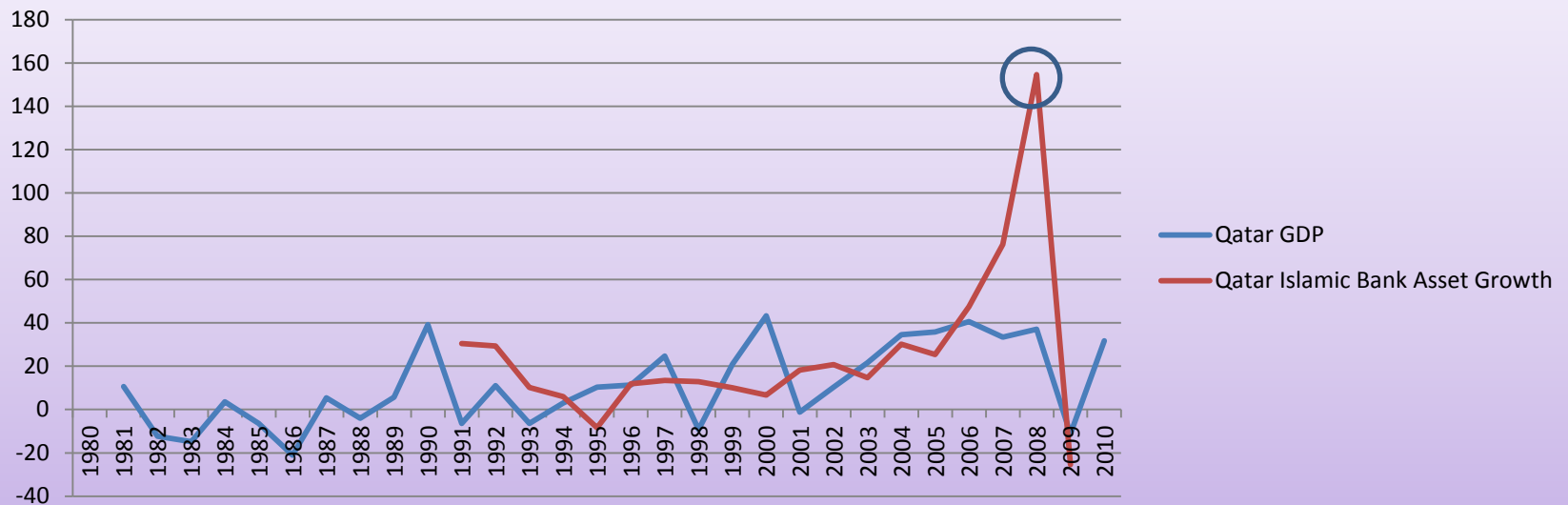
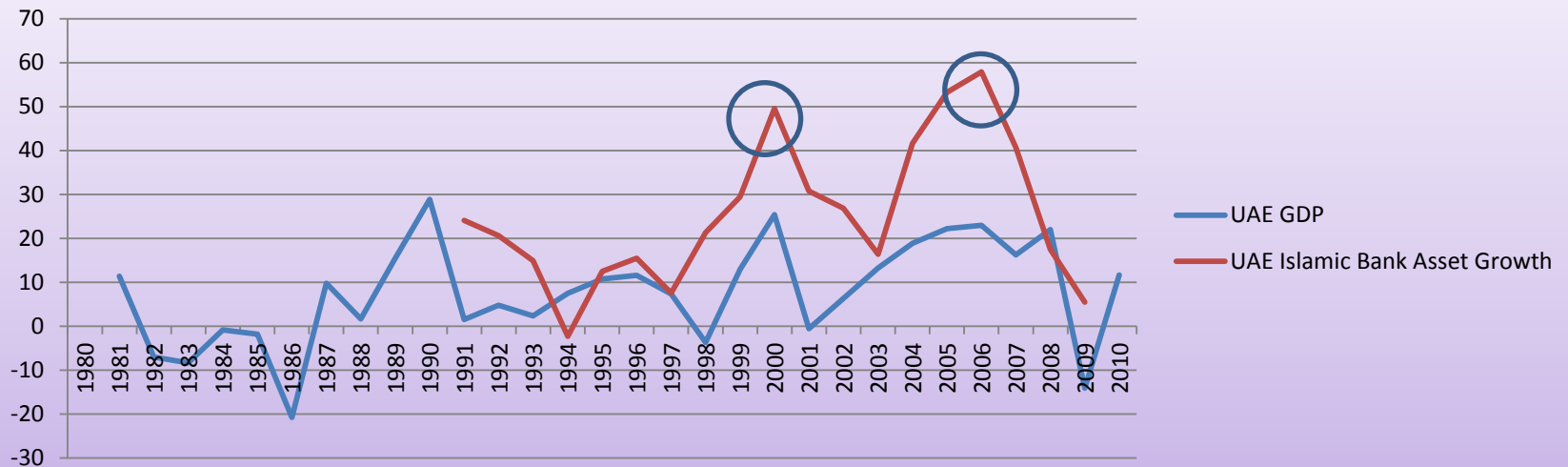
Better Ties to the Real Economy? (4)

- Much stronger ties to the conventional financial markets than the “Real economy” and excessive volatility compared to real economic activity
 - Size disadvantage: Islamic finance is still smaller
 - Tendency of Islamic finance investors to use the conventional markets as a benchmark for their diversification purposes
 - Evidence that Islamic finance has become a part of pro-cyclicality of financial markets. Can be protective during bull markets, but counter-productive during crisis
 - Two slightly better results in Turkey and Malaysia after the experience of financial crises

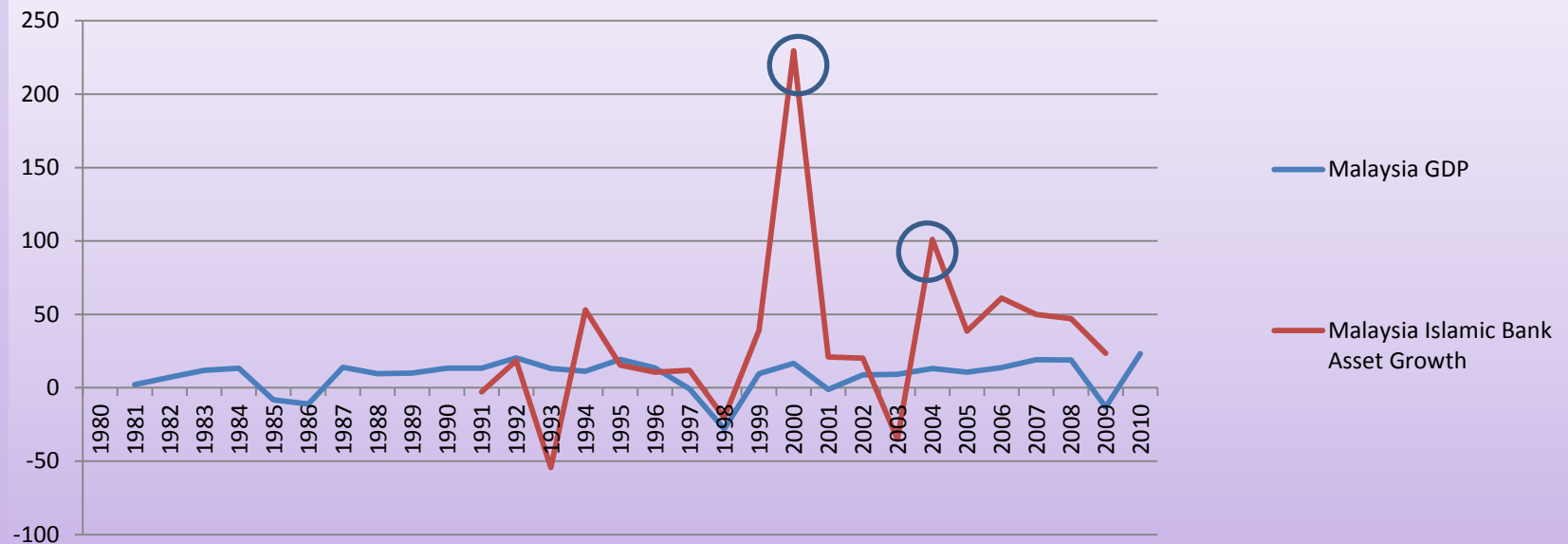
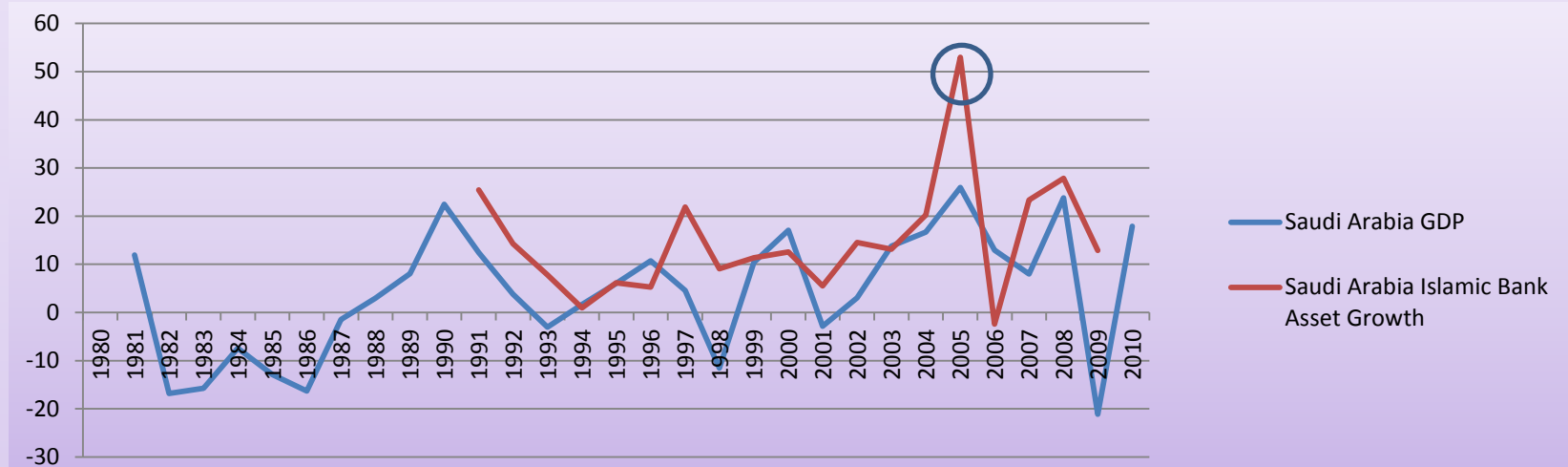
Support for Economic Growth?



Support for Economic Growth? (2)



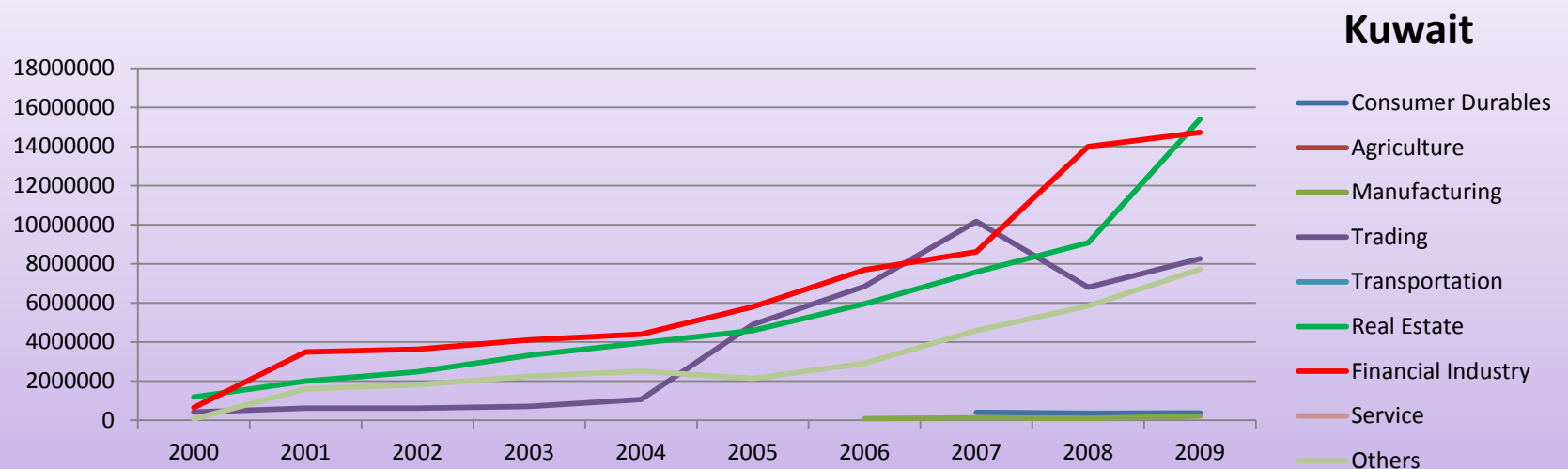
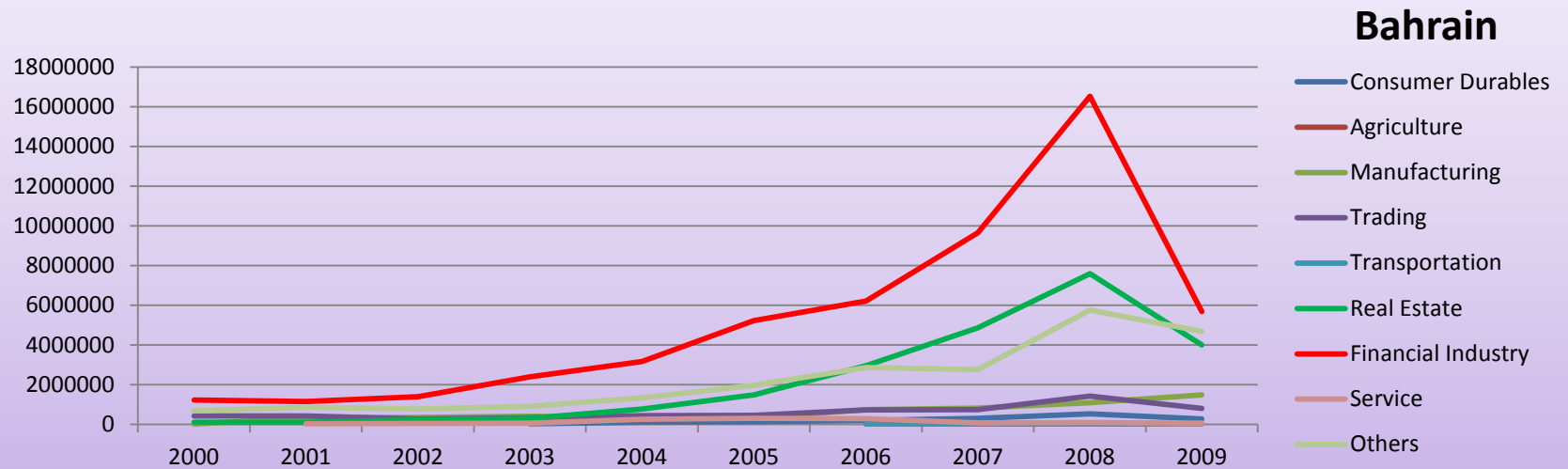
Support for Economic Growth? (3)



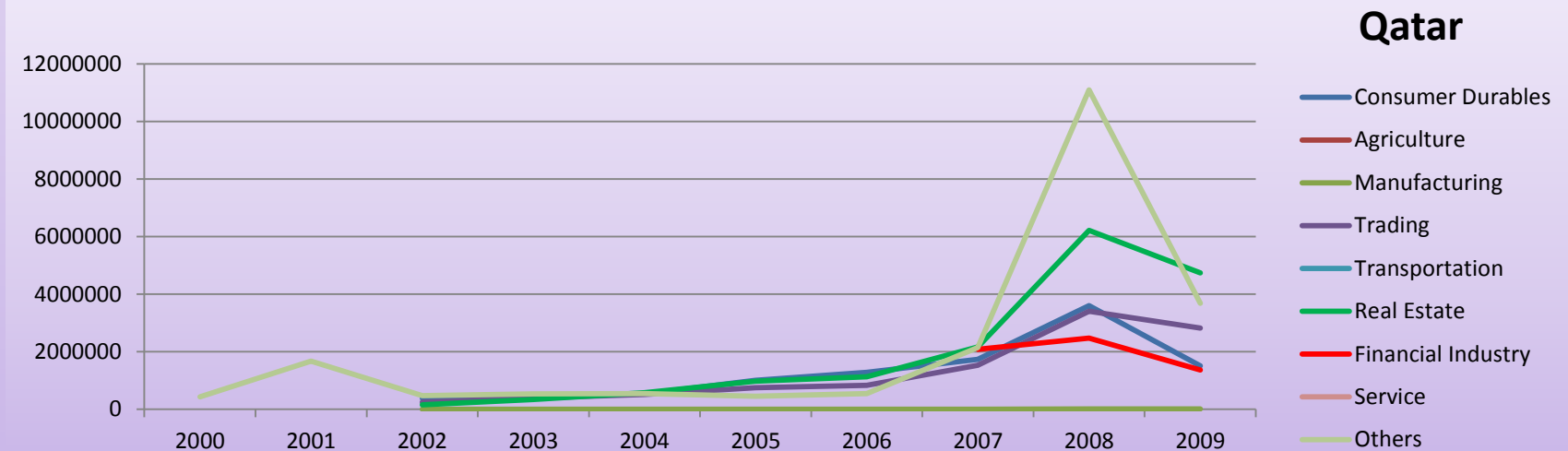
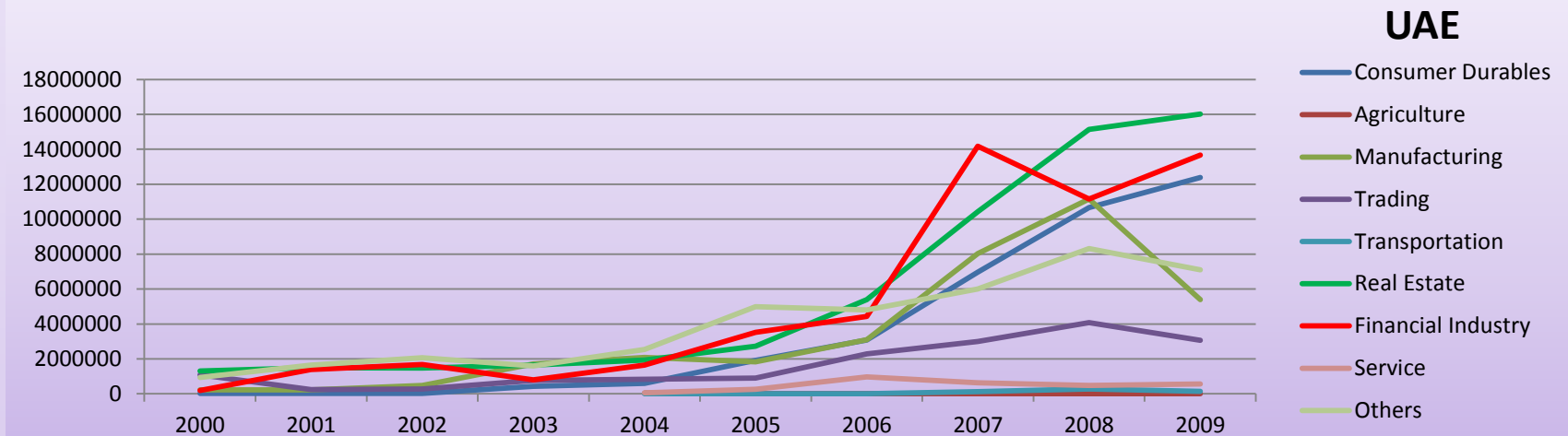
Support for Economic Growth? (4)

- Severed links with general economy
- Growth of Islamic bank assets far exceeds economic growth, especially before economic crisis
- Excessive growth before crisis suggests a speculative asset bubble similar to the characteristics of conventional finance

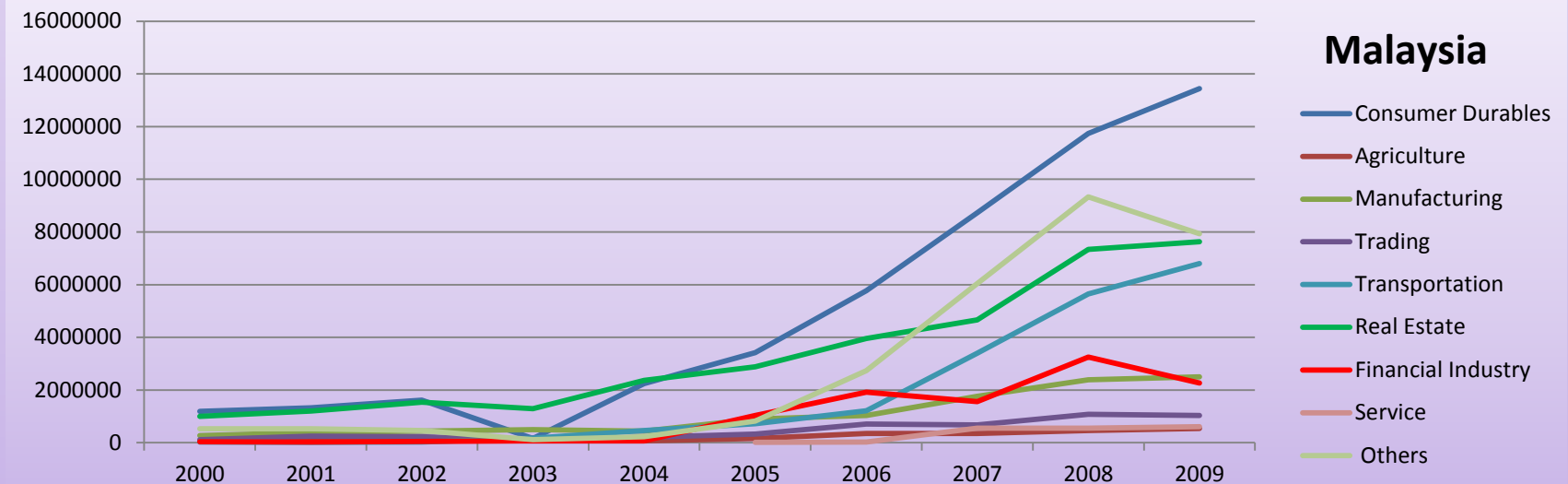
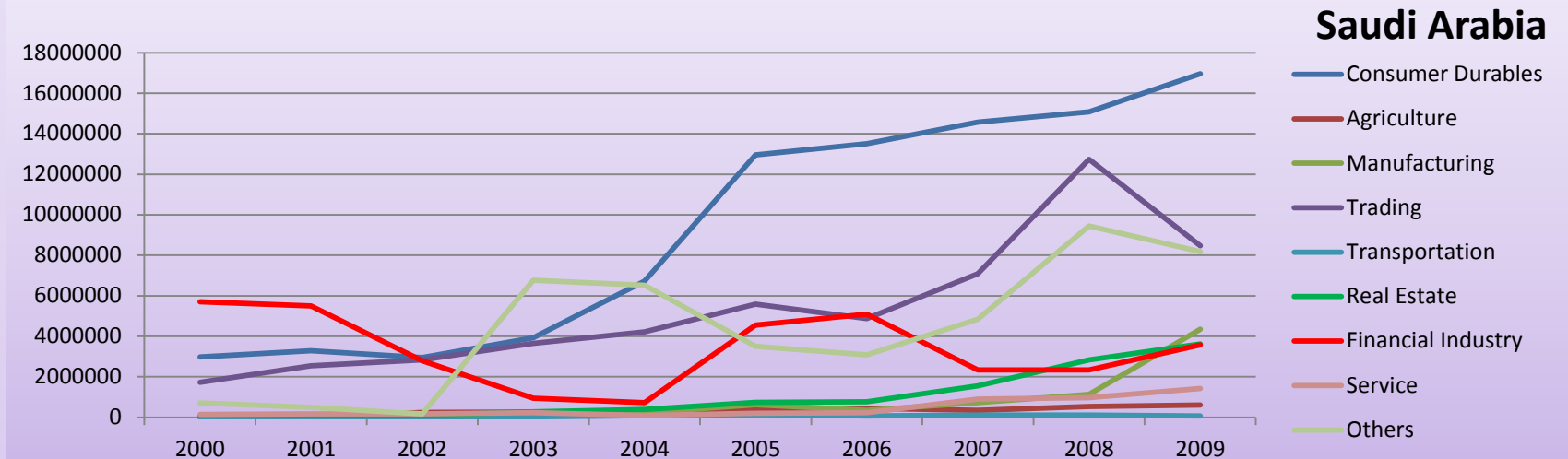
Islamic Banks and Funding



Islamic Banks and Funding (2)



Islamic Banks and Funding (3)

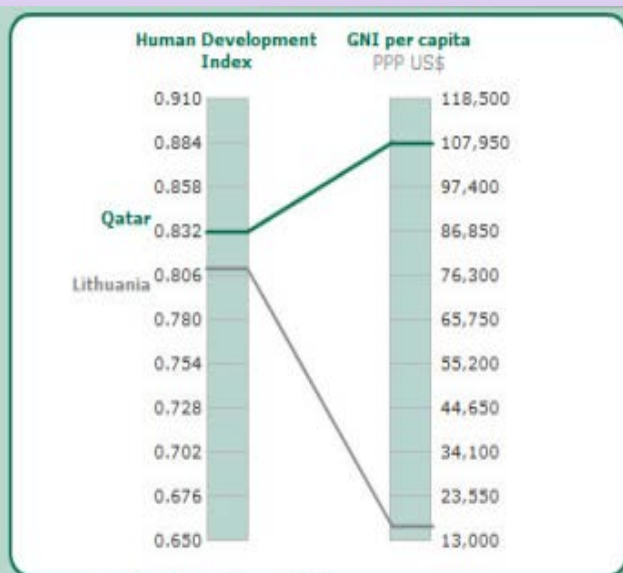


Islamic Banks and Funding (4)

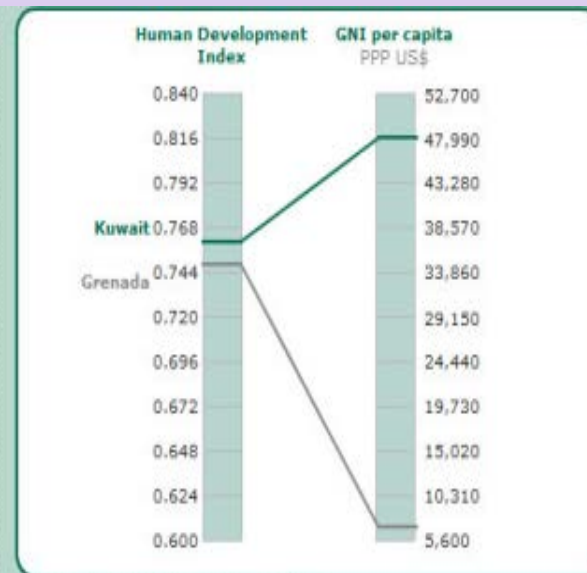
- Financial services & banking, real estate and consumer funding takes the largest share
- “Others”, as an umbrella group has also an important share
- However, trade, manufacturing and transportation do not seem to be on the frontlines

Development beyond Growth

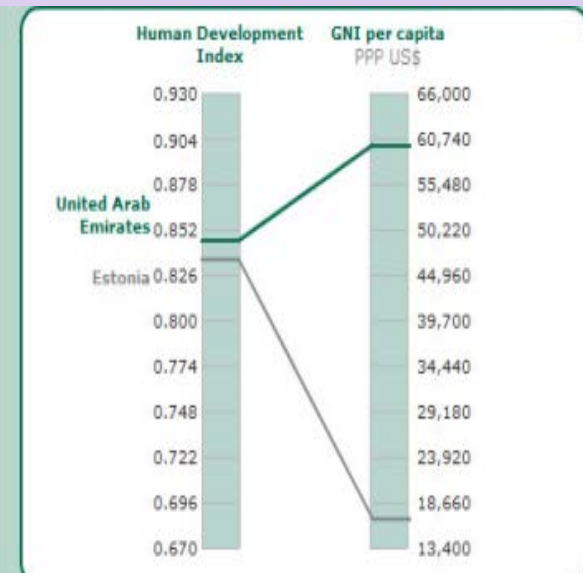
- El-Ghazali:
 - “... the whole concept of development needs to be reviewed in order to incorporate human ...needs and not just the rates of growth...”
- United Nations Human Development Index:
 - A different story



Source: Human Development Report 2011



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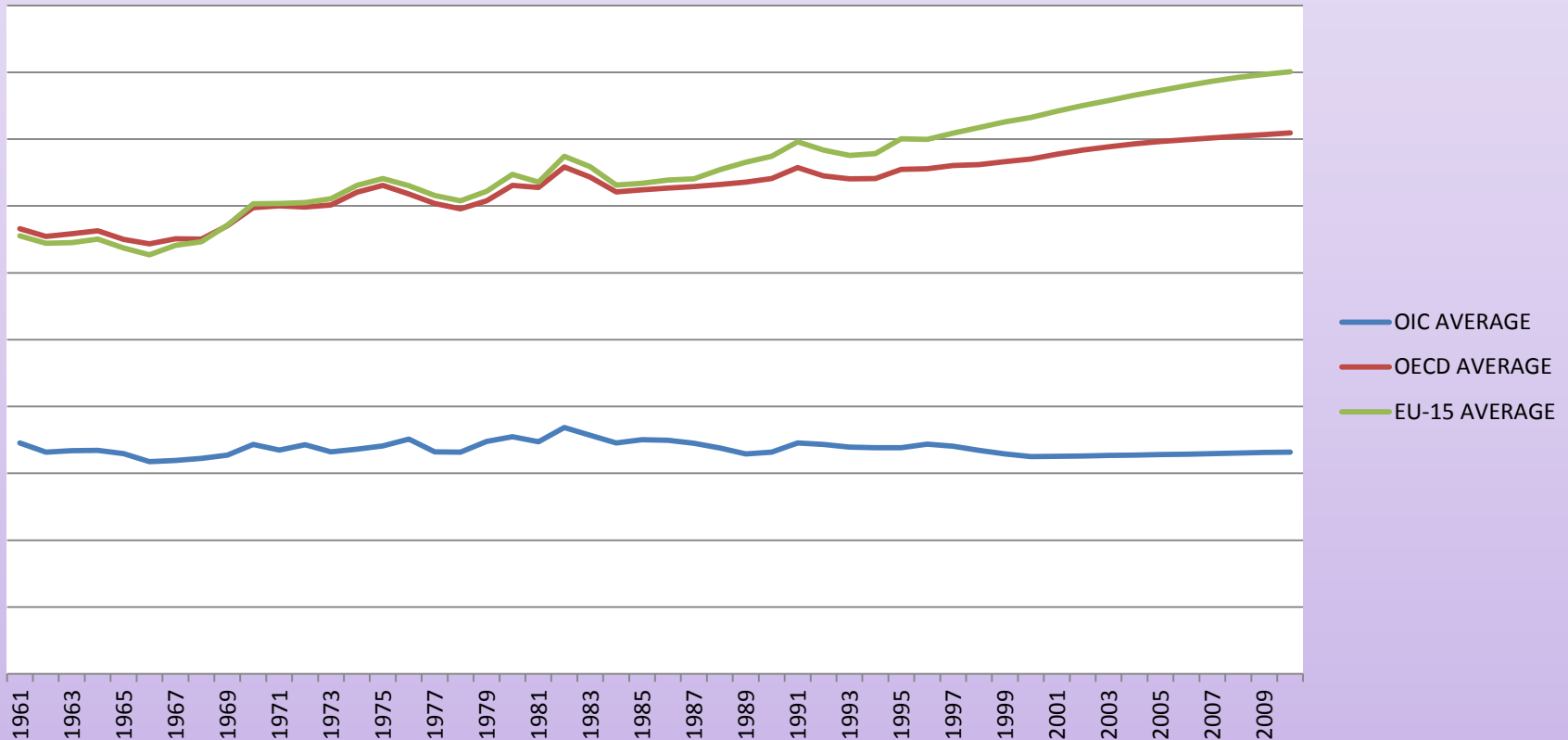


Source: Human Development Report 2011

Development beyond Growth (2)

What Went Wrong?

- Total Factor Productivity as an indicator for innovation and knowledge creation



Concluding Remarks

- Islamic finance, despite its impressive growth performance, is still a small branch of global financial markets
- Despite the efforts on standardization, disclosure, regulation and governance improvements as well as implementation of sophisticated risk management techniques, Islamic finance still has a long way improve in these areas
- Developments in IB&F have so far failed to fulfil the aspirations and ideals of Islamic economic thought, with regards to the ties with the real economy
- Islamic economics have also failed to progress towards human development

Thank you

Questions?