

The Development of Islamic Banking and its Importance in the Emergence of Economic Democracy –
A brief compilation of pertinent materials with comments by Thomas H. Greco, Jr.

In June of 2001, a Symposium on Islamic banking and finance was held in Malaysia. Below is the text of a welcoming keynote speech given by Malaysian Prime Minister, Dr. Mahathir Bin Mohamad. I did not attend this symposium, but learned about it later. I've recently had occasion to learn more about the proceedings from correspondents in the UK and Europe who attended. I find this speech to be very interesting and important on several counts.

First, it indicates the current thinking of at least one influential Islamic leader on the state of global economic power relationships, the difficulties of reconciling Islamic faith with present global monetary and financial realities, and the possibilities for the development of interest-free financial arrangements and trade agreements that provide independence from global currencies like the US dollar.

Secondly, Dr. Mohamad describes some steps already taken by Malaysia to address the difficulties imposed by the current global financial regime. Most important among these is the formation of bilateral trading agreements with third world countries that utilize credit clearing, eliminating the need for payment in US dollars or any other outside currency. He suggests the emergence of an Islamic trading bloc based upon such bilateral and multilateral trading agreements.

Thirdly, it looks beyond diverse rigid scriptural interpretations and emphasizes the importance of agreement as to what constitutes ethical practice and procedures that are consistent with the tenets of religion, and foresees structures and procedures that will have more universal acceptability beyond the Muslim world.

I have made a careful study of the speech and have highlighted in bold type, the points that seem to me particularly interesting and important. Further, following each point, I have inserted [in square brackets] my shorthand interpretation of Dr. Mohamad's point, along with my comments on it (in parentheses). I have also indented and italicized them to make it easy for the reader to distinguish them from the original text of Dr. Mohamad's speech.

In addition, I have appended a news update, which reports some important recent developments in the direction of Dr. Mohamad's projections.

Thomas H. Greco, Jr., November 21, 2002

Al Baraka Symposium

By : DATO SERI DR MAHATHIR BIN MOHAMAD

Venue: THE SHERATON IMPERIAL HOTEL, KUALA LUMPUR

Date: 25_06_2001

Title : THE 20TH AL_BARAKA SYMPOSIUM FOR ISLAMIC ECONOMIES

It is a great pleasure for me to be invited to officiate the 20th Al Baraka Symposium for Islamic Economy this morning. I am informed that this is the first time this symposium is held outside of the Middle East. We are indeed honoured that Kuala Lumpur has been chosen as the venue for this year's symposium. The significant number of eminent speakers and Syariah scholars that are gathered here will, I am sure, produce stimulating and constructive deliberations. Considering your contributions to the world of Islamic banking and finance, I'm confident that the symposium will achieve its noble objectives.

2. During the height of the great Islamic civilisation, trade was among the most important activity in wealth creation. Today in a world that is being rapidly globalised, trade has become even more important, facilitated by the advancements in information and communication technology and the greater capacity and speed of transportation. Whereas in the past trade could be carried out through the barter of goods, today the volume is such that barter is not practical any more. The goods and the services are paid for in the currencies of the world.

[The expansion and globalization of trade has made barter trade less practical, and the use of currencies for payment almost imperative.]

3. But the currencies of the different countries are not of equal value. **To make payments the relative values of the currencies, i.e. the exchange rates must be determined. This is not so easily ascertained because the cost of living of different countries differ greatly and so do the inflation rates.** The value in terms of purchasing power of a currency even within the country is therefore continuously changing, some more rapidly than others. This must mean that the exchange rates between the different countries must differ at different times.

[The determination of fair exchange rates between currencies, and their fluctuation over time remains a vexing problem.]

4. All these make trading difficult as between the time the goods are dispatched and the goods are received the exchange rates may change and may affect the profitability of the transaction.

[The exchange rate risk makes the profitability of a given trade uncertain.]

5. **The Bretton Woods Agreement tried to overcome this uncertainty by fixing the exchange rates and fixing the value of the US Dollar against a fixed amount of gold.** But very soon it became necessary to devalue the US Dollar against gold as inflation affected the price of gold and those of goods and services differently. In the other countries too the value of gold and goods did not stay static but increased or decreased at different rates.

6. Very soon some countries found it necessary to devalue their currencies in order to be competitive. For obvious reasons the devaluation had to be done without informing the public before hand about the intention. Once a major trading country devalues, the whole fixed exchange rate system of Bretton Woods was thrown into disarray.

[The abandonment of the Bretton Woods fixed exchange rates.]

7. The speculators then moved in and forced the Governments to allow the market to determine the exchange rates. This was fine as long as the speculators depended on the actual performance of a country's economy and trade, and therefore on the demand or lack of demand for a country's currency to determine the value in exchange rate terms of a currency. But the volume of trade between different countries, the trade balance, etc. between them and the perception of the different currency speculators made it difficult to determine the exchange rate between different countries at different times.

[The methods of currency speculators make the free market determination of currency exchange rates problematic.]

8. Since there was no longer a gold standard, by common understanding the US Dollar, itself unstable, was used as a standard. In the end the US Dollar became a kind of common world currency used for payment of international trade.

[The US dollar has become the de facto value standard and global currency.]

9. **This acceptance of the US Dollar as an international currency confers on it tremendous power.** The demand for US currency becomes very high and this demand must give strength to the dollar which otherwise it would not have. Its very status and use as an international currency creates certain opportunities for profitable manipulation by the unscrupulous.

[The use of the US dollar as world currency causes the dollar to be overvalued and creates opportunities for manipulation of exchange rates.]

10. Ordinarily there would be a need to exchange one currency into another only to pay for trade between nations. Since the US Dollar is the currency most frequently used for payment, there is always a need to change for the US Dollar. The rate of exchange between any currency and the US Dollar therefore becomes important. **Since there is no gold standard and Governments can no longer fix the exchange rate, the exchange rate between a country's currency and the US Dollar has to be determined on the basis of supply and demand. Currency traders, ever in search of more profits for themselves, soon discovered that they can artificially create shortages or excess of supply of any currency at will.**

[The supply and demand for currencies can be manipulated.]

11. Initially they had to hold the relevant currencies in order to do business. Today that is no longer necessary. They can offer to sell forward currencies that they don't have in the hope that their sale would push down the value of the currencies. Once the value goes down they can buy back and deliver to the earlier purchasers who had bought at the higher price.

[Short selling can drive down the value of a currency.]

12. If there is a need to guarantee delivery they can leverage their holdings with the big banks. The leveraging can be as high as 100 times their holdings. In other words hedge funds with capital of one billion can offer to sell as much as 100 billion. Few central banks can counter them by buying up the national currencies offered for sale by the traders.

[Leveraged trading and short selling can have enormous impacts on currency values.

(Is leverage of 100 to 1 really possible/common?.)]

13. From being mere money changers these currency traders have become unbeatable manipulators of the exchange rate of any currency. In the process they made billions of dollars.

[Currency traders have become very powerful. (What are the structural and procedural elements of the currency markets that make speculators "unbeatable," and what is the logical antidote to this kind of manipulation?)]

14. International traders can hedge against the fluctuation in the exchange rates but this cost money and obviously increase the cost of doing business. But when currency traders actually devalue or revalue currencies within very wide ranges, hedging becomes not only expensive but very difficult for traders. The cost of trade must escalate and world trade will not be able to expand. Poor countries as usual will suffer the most.

[Legitimate trade is hampered by the high costs of managing the exchange rate risk.]

15. Malaysia has fixed the exchange rate against the US Dollar. RM3.8 equals one US Dollar. Since 85 percent of our trade is paid in US dollar this makes trading easier. There can be no doubt that this fixed exchange rate has contributed much to the high growth of Malaysian world trade post turmoil. We are now the 17th biggest trading country in the world and we hope this year, insha_Allah, to achieve total trade of 200 billion US Dollars, of which export would be slightly bigger than imports.

[Malaysia has been successful in coping with the problem by fixing the exchange rate of its currency against the dollar. (How can a dictated rate be sustained in the market? Will Malaysia follow in the footsteps of Argentina, reaching the point where their fixed rate can no longer be upheld?)]

16. Unfortunately since the currencies of our trading partners fluctuate against the US Dollar, their earnings or losses cannot be correctly ascertained. So far our trading partners have not been affected too much by the uncertainties in their exchange rates against the US Dollar.

[Since Malaysia's trading partners do not have fixed exchange rates, much uncertainty remains for them.]

17. Trade between the Islamic countries cannot be totally separated from world trade. But it would still be useful for Islamic countries to evolve a system of exchange rates which would enhance trade between them. It is entirely possible for us to devise a payment system which is not dependent on the US Dollar.

[A Muslim trading bloc could be formed that would use a payment system independent of the dollar. (It is merely a matter of agreement that determines the payment medium that will be used. to settle accounts)]

18. Malaysia had introduced what we called a "Bilateral Payments Arrangements" in which total trade between two countries are computed over a fixed period of time and only the balance between the total value of export and imports paid in an agreed currency. Within the country a central agency would collect payments from an importer in local currency and pay an exporter also in local currency. The balance between total exports and imports can be paid in the currency of the exporting country or in other acceptable currencies. Alternatively the balance can be retained by the central agency or Central Bank in order to pay for future transactions. This will eliminate the need to hold foreign currencies or the US Dollar.

[Malaysia has set up a credit clearing intermediary for imports and exports. Balances between countries are settled at fixed periods in some agreed currency, or carried forward. This eliminates the need to hold any foreign currency. (It is very encouraging to know that they have discovered credit clearing as the logical approach to financial independence, and are implementing it among their trading partners.)]

19. Obviously this bilateral payments arrangement will enable countries without foreign exchange i.e. the US Dollar to trade or to increase their trade volume. It would certainly be good for world trade. **Since the introduction of the arrangements and agreements reached between Malaysia and many developing countries, trade with these countries has increased by more than 400 percent over a few years. Malaysia is ready to enter into a bilateral payments arrangement with Islamic countries in order to improve trade. The bilateral payments arrangement can be extended so that trade between more than two countries can also be settled in the same way.**

[Such clearing arrangements with developing countries has led to an enormous increase in trade with them. Malaysia is ready to extend such arrangements to multilateral clearing and to form an Islamic trading bloc. (The importance of such a development should not be overlooked. This could become a model for other countries to follow, and a means of freeing themselves from dependence upon the dollar or other national currencies. As the effectiveness of clearing is demonstrated, non-Islamic countries will want to follow suit.)]

20. Basically the bilateral payment arrangement is a more sophisticated form of barter trade. And barter trade is the fairest way of trading as we get the goods that we want at the price we want in local currency. We know that some goods are very cheap in one country because of over supply or lack of demand but very expensive in another country. The exporting country can get a fair price from the export of the locally cheap goods based on the acceptable price in the country where demand is better. The terms of trade would thus be fairer through barter trading. But since barter trading is cumbersome, the payment arrangements can facilitate large scale trading more effectively.

[(The author sees clearing as a "sophisticated form of barter," and recognizes that it is inherently more fair than having to use some other national currency as a means of payment. Money allows us to transcend the limitations of barter. Credit clearing allows us to transcend the limitations of money. There is no need to use any currency at all. What is needed is an agreed upon common measure of value in which to price the goods to be traded.)]

21. The Islamic countries can also create their own common currency. This should not belong to any country because it would give undue advantage to the country whose currency is accepted as the trading currency of the Islamic nations.

[A common Islamic currency could also be created. (Actually, what is needed is not a common currency, but a common measure of value and unit of account.)]

22. Recently there was a proposal to create a gold dinar which can have a specific value in the currencies of

the different Islamic countries. All the Islamic countries must have a share in the international Islamic dinar as a trade currency and as national reserves. The dinar must be in gold and not paper. How practical this will be will have to be dealt with later when the volume of trade becomes big.

[A gold dinar has been proposed (and now, actually exists). The gold dinar could be used as the Islamic trade currency and as national reserves. (It would be more practical to use the gold dinar only as the unit of account and credit clearing as the means of payment.)]

23. Effectively the use of the Islamic dinar will create an Islamic trading bloc. Such a trading bloc will be a powerful voice in International trading regimes and the shaping of the new financial architecture.

[(The use of a common value measure, be it a gold dinar or something else, and credit clearing mechanisms, will create a powerful Islamic trading bloc. By enabling efficient trading among its members without the use of dollars or some other outside managed currency, these countries will collectively lead the rest of the world toward a more just and harmonious system of international trade and finance.)]

24. There has been much talk about an Islamic economic community. It is very difficult to realise this but the international Islamic dinar is quite achievable and can be the beginning of a closer economic cooperation between the Muslim countries. Islamic banking can really take off as all the Muslim countries adopt standard practices in banking and finance, compatible with Islam.

[The Islamic dinar can create closer cooperation between Islamic countries and the adoption of standard practices can give Islamic banking a great boost. (I agree.)]

25. However it would not be wise to reject the commercial banking practices as found today. The Muslim world would still have to trade with the rest of the world as individual countries or as a regional group or as an Islamic Financial Community. With both systems existing there will be a choice for everyone. We have already found in Malaysia a readiness to accept Islamic banking if it suits the needs of the businesses. It would be a mistake to suddenly change to Islamic banking. All changes are disruptive. Sudden and complete change even for the good is most disruptive of all. In all matters we Muslims must never be fanatical. Gentle evolution is far better than sudden drastic revolution. So it is for politics, so will it be for the financial systems.

[Existing commercial banking practices cannot be totally rejected, and the shift to Islamic banking must take place gradually. (Alternative systems should be developed alongside existing systems and crossover should be made gradually as circumstances allow. Most of the mechanical details of the old system can be carried over into the new.)]

26. Islam is a way of life. There is nothing that we do that is not governed by the injunctions of Islam. Certainly the economic activities of the Muslim society are governed by Islamic perceptions of what is right and what is wrong. The transaction involved in a simple sale is a contract which requires the agreement on the part of the seller to sell at a certain price and the buyer to buy at that price. Whereas an ordinary purchase need not involve a written agreement, the Quran stipulates written undertakings where the transaction is substantial, involving cash payments or credit or delayed payments. While no interest is permitted the price may be determined based on the amount of the goods involved, the time of delivery and reasonable profit. The financier in an Islamic transaction earns a part of the profit and accepts also the possibility of a loss.

[Islamic perceptions of right and wrong play a role in financial dealings.]

27. The Al_Quran is the ultimate guide but as we all know the interpretation of Quranic injunctions differ with different people. It would not do for people involved in business and, in particular, in financial transactions to have each making his own interpretation of what he has undertaken or committed to. It is important therefore to have standard interpretations which are agreed to by everyone. If Islamic banking is to be universally accepted including by non_Muslims, the practices must be documented and standardised.

[Islamic banking must be based on standardized interpretations of the Quran, so as to be universally acceptable.]

28. **The Islamic Financial Services Organisation or IFSO is an institution which has been proposed to set up the specific standards and financial practices in Islamic banking.** Malaysia has offered to host this institution. The setting up of this institution will help establish and maintain the soundness of Islamic banking. Considering the huge amounts of money held by the Muslim countries, and their being deposited outside the Muslim world where Islamic banking is not available and where they cannot earn any interest, the loss to the Muslim world is enormous. Yet there are so many Muslim countries in need of funds and they are forced to accept loans under the riba system. **Thus while Muslims cannot earn interest Muslims are paying interest. In certain cases it is Muslim money which is being lent by others who earn interest on them.**

If we are able to set up Funds and Islamic Banks, we can not only earn from the investments but we will be reducing the burden of our poor Islamic brothers. I am sure if we are able to set up IFSO and establish the standards and practices of Islamic banking, we will all benefit. **For banking in Islam is not purely for the lender to make profits at the expense of the borrower, but for both parties to benefit from the financial transaction.** I believe that Islamic banking is far superior to the present commercial banking practices.

[An organization should be set up to standardize sound practice so that Muslim countries can cooperate financially and avoid paying interest and get a return on funds that are now invested outside at no interest.]

29. Globalisation is already upon us. So while the inflow of foreign capital can be beneficial to a country, its sudden outflow can destroy decades of hard work in developing a country's economy. **Under present conditions globalisation can have a disastrous effect on the economies of Muslim countries, which are all developing economies.** Even the richest of us are actually developing for we have little capacity except to produce and sell raw materials, principally oil.

[Even the richest Muslim countries remain undeveloped, depending mainly upon the exportation of raw materials.]

30. **Muslims must never forget that we missed the Industrial Age completely.** We have practically no industrial capacity because when the Industrial Revolution was taking place we could not decide whether it was compatible with Islam or not. In the end we were left behind and found ourselves totally dependent on the industrialised countries for our needs, including of course our defence needs.

[Because Islamic countries missed the industrial revolution, they are totally dependent upon the industrialized countries.]

31. Today we see the rapid advance of the Information Age. Whether we like it or not it is going to have a tremendous impact on our society and on our religion. We cannot isolate or insulate ourselves from the Information Revolution and the technology which is driving it. Our economy will certainly be affected by it.

[Muslim countries will certainly be impacted by the information technologies.]

32. While we are thinking about Islamic banking, our trade and our economy, **we have to learn how to deal with the information age and to acquire and make use of the technology and its applications** so that we would be able to sustain ourselves and our economies.

33. This involves not just learning and mastering Information technology but in many instances the development and innovation in the applications, the software and even the hardware by us. We have to be on guard so that our religion and our values are not undermined. Remember how the spread of socialistic ideologies actually resulted in some Muslim countries abandoning Islam because they saw the failures of Muslim countries and wrongfully attributed it to the Islamic religion rather than the wrong interpretations of Islam by their countries. We see how Muslim countries were conquered because they were materially weak and how many Muslims abandoned the religion and even became atheists.

[We must be active in developing applications, software and even the hardware, but do so in a way

that does not undermine our religion or values.]

34. We cannot afford to have our countries fail in the Information Age through our own failure to acquire the technology to protect and prosper our countries. Spiritual and religious tenets of Islam must be maintained but at the same time the economic well-being of the Muslim countries must not be behind those of the developed countries. Only with equal spiritual and material strength can we hope to sustain the Islamic way of life and Islam itself. Terrorism are mere pin pricks which achieve nothing for the ummah.

[The well-being of Muslim countries depends upon both spiritual and material strength]

35. We all share a common belief and, to varying degrees, a common culture and tradition. There is no serious ideological conflict. Inevitably, there are political differences but none that cannot be overcome for common good. **We are all part of the world with a pressing need to improve the social and economic conditions of our people.** It is therefore important to ask ourselves how we can put our hands together to increase the pace of socio-economic progress of the Muslims against the background of a troubled world economy.

36. The last time the world ushered in a new millennium, the Islamic civilisation was at its peak. However, at the end of that millennium, Islamic civilisation was at its lowest ebb. In our endeavour to achieve the advancement in Islamic banking and finance, we are in fact trying to resuscitate the glorious Islamic civilisation. We still have a long way to go. **We have to change our attitude if we want to avoid losing out again as we did in the Industrial Age.** The road ahead for all of us will be difficult and challenging, but if we collectively as an Ummah rise to the challenges, insha_Allah we will succeed. I pray that this 3_day symposium would be able to guide us in addressing some of the pressing issues facing us.

Sumber : Pejabat Perdana Menteri

*Here follows a news update from Reuters which I received via Peter Challen. **Emphasis has been added.***

A Reuters report on developments reached at Oct 22 2002

Muslim Nations Sign up to Liberate 'Debt Slaves' 06.11.2002

KUALA LUMPUR - **Eight Muslim countries launched a global agency this week to set standards for an Islamic financial system that will end "debt slavery"**, says Malaysian Prime Minister Mahathir Mohamad. The basic principle of Islamic banking is the prohibition of usury or interest. It also outlaws investments in companies involved in gambling, alcohol or pig farming. The **Islamic Financial Services Board (IFSB)**, inaugurated in the Malaysian capital, Kuala Lumpur, is entrusted with setting standards for Islamic institutions and ensuring they conform with principles of Islamic sharia laws.

Mahathir, in an address to about 1000 delegates from around the Muslim world, said **a hallmark of the Islamic system was that risk was equally shared between lender and borrower.** The international banking system stacked deals heavily in favour of lenders, he said, and some countries ended up in "debt slavery". "They are not going to lend if they cannot gain control over their borrowers in order to recover their loans, irrespective of the misery this might cause.

"Clearly, debt slavery has not been abolished in the international financial system," said Mahathir, who refused to accept a bail-out from the International Monetary Fund during the Asian crisis in the late 1990s, or submit to IMF policies that caused economic pain for neighbours.

Bankers attending the inauguration of the board said **growing demand for ethical investments cut across religions, and non-Muslims were increasingly investing in Islamic concerns.** Some Arabs who withdrew

investments from the United States in fear of a backlash after the September 11 attacks were also putting more money into Islamic banks, they said.

"The backlash against Muslims following September 11 is in fact helping Islamic banks," said one Malaysian banker. One estimate said about US\$200 billion (\$416 billion) of Muslim funds had fled the United States. A Western banker said Islamic funds run by mainstream Western banks were also attracting interest from non-Muslims riding an ethical investment bandwagon.

There are about 200 Islamic banking institutions in at least 48 countries with combined assets of about US\$170 billion (\$345 billion). **Under Islamic laws, banks make money through profit-sharing from returns and approved investments.** The Islamic banking industry, which has grown more than 10 per cent a year over the past 40 years, is expected to grow by the same rate over the next decades, says the Bahrain-based General Council for Islamic Banks and Financial Institutions.

Efforts are also underway to develop an Islamic capital market to tap the estimated US\$1.3 trillion in Islamic funds that are invested in conventional markets. Mainly Muslim Malaysia has been running an Islamic banking system alongside a conventional financial system, a trend that Mahathir said would continue.

Malaysia's central Bank Negara governor, Zeti Akhtar Aziz, said Islamic banking and finance had been described as a "mirror of the sea". "For until and unless we have the courage to explore its depth, we would never be able to uncover the treasures that reside within," she said.

Islamic banks in Malaysia represent about 8.8 per cent of the country's total banking assets, worth about 65 billion ringgit (\$35.4 billion). In June, Malaysia completed the world's first Islamic global bond issue, lead-managed by HSBC.

The IFSB's founding members are Malaysia, Indonesia, Bahrain, Saudi Arabia, Sudan, Iran, Kuwait and Pakistan. - REUTERS

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It would appear that the Islamic world is leading the way in making economic and social justice the top priorities in money, banking, and finance. The achievement of those goals, in turn, should lead to greater economic and financial stability, and a lessening of global conflict.

At the opening of the newly formed Islamic Financial Services Board (www.ifsb.org) on November 3, 2002, Dr. Zeti Akhtar Aziz, governor general of the Malaysian central bank (www.bnm.gov.my), had this to say:

"The Islamic financial system has an in-built dimension that promotes financial soundness and stability, as it resides within a financial trajectory underpinned by the forces of Shari'ah injunctions. These Shari'ah injunctions interweave Islamic financial transactions with genuine productive activities and prohibit involvement in illegal and unethical activities. This intrinsic principle of governance contributes towards insulating the Islamic financial system from the potential risks of financial stress triggered by excessive leverage and speculative financial activities. Indeed, the Islamic financial system derives its strength and stability from its faculty to uphold Shari'ah principles. This demands the internalization of Shari'ah principles in Islamic financial transactions, in its form, spirit and substance. This epitomizes the objectives of the Shari'ah in promoting economic and social justice."

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