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Frontier of Islamic Economics and Finance: New Challenges

Preface

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Middle Eastern Studies has argued various economic issues which are specific to the region, such as its oil-driven economy, the nationalization/privatization of its industry and foreign labor migration. From the mid-1970s onward, this region encountered a new economic phenomenon; that is, the establishment of, and the subsequent flourishing of, Islamic banks, and the rise of the commercial practice of Islamic finance. Its rise coinciding with the re-emergence of the Islamic world, Islamic finance has gradually developed into a considerable economic factor in the economies of the Middle East and other regions with Muslim populations, forming a new economic sphere of the emergent Islamic world. Although many economists have recognized its importance, they have neither had a proper methodology nor the capability to utilize Islamic finance for solving the existing economic problems in their regions.

On the other hand, on intellectual and academic levels, since the middle of the twentieth century, relentless efforts have been made toward restructuring the economic system according to Islamic principles, especially in the Middle East and later in Southeast Asia. Although, in the beginning, these looked like piecemeal attempts to find ways to avoid the elements forbidden in Islamic law, such as *riba* (interest/usury) and speculation, it soon appeared that the ultimate collective objective was to implement, or at least, to try implementing, an alternative form of economic and financial system, which differed substantially from the modern capitalist standard. These efforts resulted in the development of the novel academic discipline called "Islamic economics."

The fruits of such endeavors were partially materialized when the first commercial Islamic banks were launched in the latter half of the 1970s. The subsequent flourishing of Islamic banks and other Islamic financial institutions, and their success in affirming their economic viability, however, did not necessarily imply that the practice of Islamic finance had directly reflected the theoretical proposals or framework of Islamic economics, presented by renascence Islamic economics.

This disparity between the actual practice of Islamic banks and the vision of an ideal Islamic finance continues up to the present day, with Islamic banks for the most part adopting debt-based financial products, instead of the equity-based products suggested by major Islamic economists.

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Widening the gap even further, the current practice of Islamic finance encourages the development of new products which replicate the latest innovations of financial engineering in the globalized market, crafted by the conventional main-stream banks, in order to be competitive in the international financial markets. Those who view such a situation with critical eyes insist that the practice of Islamic finance has departed from the substance of the concept of Islamic economics, or has never reached it, and that there is a need to shift toward the realization of the fundamental idea.

In this sense, Islamic economics continues to be a frontier science. It had already opened a new horizon for the Islamic revival in the economic domain, and attracted popular attention among the *riba*-conscious Muslims. Its contributions had already created a space in which actual Islamic banks were able to operate, and these banks' activities had brought in more *riba*-conscious customers, partly because they strongly advocated their anti-*riba* stance to bolster their competivity against the non-Islamic banks. These Islamic banks, however, opted more often than not to rely on Islamic financial products that were not ideally Islamic but judicially permissible, managerially viable, and operationally profitable. This gap between the ideal and the practical has given rise to many arguments and controversies about the nature and substance of Islamic finance.

We should accept the aspect of managerial viability and operational profitability in a positive way, because the gap between the ideal and the actual always generates efforts and endeavors to narrow the discrepancy, as happens in any domain of our society. By providing ideals, ideas and theories, Islamic economics have a huge potential to unveil new horizons and are indeed continuing to reveal such horizons.

The current global economic system and the economic sciences which support this system have manifested a substantial number of fundamental problems, such as global economic disparity, the vulnerability of the global eco-system under unsustainably rapid development, and the economic instability highlighted by the current financial crises. Towards solving these problems, any serious proposals for alternatives or alterations are of fundamental importance, if mankind is going to have a brighter future. The role of Islamic economics in this respect seems quite apparent, both for the economies of the Islamic world and the global economic system as a whole.

With this vision, the Center for Islamic Area Studies at Graduate School of Asian and African Area Studies, Kyoto University and Durham Centre for Islamic Finance and Economics at Durham University have been collaborating to evaluate the achievements of Islamic economics, actual correlations of conflict and accordance between the theories of Islamic economics and the practice of Islamic finance, and subsequently the prospective roles of Islamic economics in this age of globalization, especially in relation to the critical condition of the current economic system. Our team has organized several conferences at Kyoto, Durham, Cairo and Barcelona since 2007, and provided several publications on Islamic economics and finance. This special feature with the title "Frontier of Islamic Economics and Finance: New Challenges" is the latest in a series of the fruits of our collaboration, and focuses particularly on new challenges facing Islamic economics and finance, such as corporate governance, CSR (Corporate Social Responsibility) and asset management.

Mehmet Asutay's paper focuses on Islamic moral economy. In the late 1960s and early 1970s, this concept emerged in the modern sense as an attempt to develop an authentic understanding of the Islamic economic system. Although Islamic banks and financial institutions are considered as the institutional aspects of this moral economy, the transformation of Islamic banking into a commercial banking form since the 1970s has been at the expense of the aspirations of Islamic moral economy. This paper aims to explore the social failure of Islamic banks and financial institutions and locate the sources of this failure, and suggests that a third institutional development in the form of non-banking financial institutions should be created with the objective of serving the social and developmental needs of Muslim societies.

Nagaoka Shinsuke's paper illustrates the historical development of Islamic economics as a science and Islamic finance practiced in the real world from a unique perspective. He argues that the emergence of the commercial practice of Islamic finance, after the birth of Islamic economics as a discipline, has created a tension between theory and practice, and that this tension has resulted in a division of the scholars of Islamic economics into two groups, namely, the aspiration-oriented school and the reality-oriented school. The former emphasizes the ideals of Islamic economics and adheres to what he calls the "*mudaraba* consensus," which considers the *mudaraba* contract as the best Islamic solution for non-*riba* finance, while the latter gives importance to the economic feasibility of Islamic finance and accepts the current practice of commercial Islamic finance that relies on debt-based financial products. This division has promoted the development of Islamic economics through arguments between the two schools. However, he points out that both schools share a common ground regarding the definition of *riba* as inclusive of all forms of bank interest, and those who try to exempt some forms of bank interest from the definition of *riba* are comparatively marginalized.

Shifa Mohd Nor's paper focuses on Corporate Social Responsibility (CSR) in Islamic economics and finance. The escalating social and economic problems in particular during the current financial crisis have raised new questions as well as expectations about corporations' governance, ethics, and social responsibilities. Commentators have raised ethics as the missing link in financing and also in the running of financial institutions. CSR has emerged and developed with the aim of defining and directing the responsibilities of firms toward the society. The main objective of this paper is to study the concept of CSR from an Islamic perspective. Importantly Islamic banks are criticized for not considering the social dimensions related to development, which is an essential distinguishing point of Islamic moral economy. This paper therefore attempts to respond to this by suggesting a new paradigm within CSR framework to help Islamic banks and financial institutions to overcome the gap between aspirations and realities.

The paper by Shehab Marzban and Mehmet Asutay focuses on *Sharia*-compliant investments. *Sharia*-compliant investments are managed in a *Sharia*-compliant manner which goes beyond defining a set of rules or guidelines to generate a static list of automatically screened equities. *Sharia* screening is about identifying the set of investments that adhere to *Sharia* principles and would thus be considered eligible for an Islamic investor to invest in. Generally, different *Sharia* mandates can be found across the industry that may result into different asset universe sizes and constituents. The main distinction between the different rulebooks is the use of either total assets or market capitalization as base to value a company and to use as denominator for the different financial ratios. By using the top 200 large cap companies in the United States as well as Japan, their paper reveals that different *Sharia* mandates result in discrepancies in asset universe size, constituents, asset allocation and most importantly, return and risk. Therefore an analysis of the *Sharia* mandates is crucial before launching a new Islamic fund to ensure that the advantages and disadvantages of the different mandates are recognized and taken into consideration. Their analysis also revealed that different mandates might be advantageous in different regions and time spans.