Islamic Finance for Sustainable Development: Its Historical Background and Potentialities in the Modern World

Shinsuke Nagaoka¹

This paper aims to explore the potentialities of Islamic finance for sustainable development of the modern economy and the Islamic world. Recent studies and articles on Islamic finance frequently mention the impact of the current world financial crisis on Islamic finance, and conclude that Islamic finance holds comparative advantage in terms of robustness and stability against such a crisis over conventional finance and will be one of the better solutions to improve the current situation of the world economy and the Islamic world. However, detailed theoretical examinations based on the economic and historical analysis have not been appropriately conducted. Therefore, this paper primarily examines the distinctive feature of Islamic finance over conventional finance by analyzing the structure of Islamic financial products which are legitimized by Sharia scholars. In the paper, it can be said that the distinctive feature of Islamic finance is described as the “embedded” system of the monetary domain of the economy into the real domain. On the basis of the above analysis, this paper clarifies the historical significance of Islamic finance. In the existing mainstream literature, nobody has doubted the proposition that the interest-based financial system is regarded as the universal financial system. However, if we revert to the history of the pre-modern Islamic world and the medieval Mediterranean world, it is clear that such a financial system had not been necessarily prevailing; instead, the “embedded” financial systems were found to exist with sustainable systems in many regions in the pre-modern world, particularly in the pre-modern Islamic world that was one of the global centers during that period. If we can discard our prejudice, we may say that the interest-based modern capitalist financial system has not necessarily been a universal one, but it has been, radically speaking, a peripheral system. It can be also said that the rise of the modern capitalist financial system is not a result of the linear development of the financial system, but a result of the great divergence from “the universal financial system”. Here, we should bring a new definition of “the universal financial system” as the embedded financial system with great deal of experience of sustainable development mentioned above. From such a

¹ PhD, Associate Professor, Graduate School of Asian and African Area Studies, Kyoto University, JAPAN
E-mail: officenagaoka@gmail.com & nagaoka@asafas.kyoto-u.ac.jp
Website: http://homepage3.nifty.com/~nasafas/
historical framework, it can be concluded that Islamic finance stays on the genealogy of such a universal financial system with modern configuration, and can give us an idea of an ideal financial system for sustainable development in the modern economy and the Islamic world.

Keywords: Islamic Finance in Economic History, Embedded Financial System, Great Divergence, Sustainable Development

1. Introduction

The commercial practice of Islamic finance emerged in the 1970s as a “new” financial system different from interest-based conventional finance. At its earlier stage, many bankers consider it as an eccentric financial system. Until now, Islamic finance has achieved a great success with rapid growth, and wins the understanding that it plays a part of the International financial system. Despite this, some even call Islamic finance “ethereal investment” [Bloomberg 2005: 70] based on religious belief. Behind such a labeling, there is a view that Islamic finance is a brand-new and marginal financial system throughout economic history. However, when examining the distinctive feature of Islamic finance of the modern world and reviewing the history of the pre-modern Islamic world and Europe, it can also be observed that Islamic finance shares its feature with financial activities in the pre-modern era. Therefore, we can propose a hypothesis that Islamic finance is neither a brand-new financial system nor a marginal one throughout economic history. Based on these motivations and preliminary observations, this paper primarily examines the distinctive feature of Islamic finance by comparing the schemes of both financial products between Islamic and conventional finance. Subsequently, the paper reviews the historical experience of financial activities in the pre-modern Islamic world and Europe, and clarifies the universal aspect of Islamic finance in the context of economic theory with challenging the proposition that conventional finance is taken to be the universal financial system. From these theoretical and historical analyses, this paper tries to adopt a new definition of “the universal financial system” to the Islamic financial system with great deal of experience of sustainable development, and explore the potentialities of Islamic finance for sustainable development of the modern economy and the Islamic world.

2. Distinctive Feature of Islamic Finance

2.1 Distinctive Features in the Existing Literature

By reviewing the existing Islamic economics literature that investigates the features that distinguish Islamic finance from conventional finance, it is clear that it can be classified into
two types. First, those who study from a theoretical viewpoint emphasize that the very essence of Islamic finance is “a sort of the sharing system.” According to an earlier overview by Muhammad Nejatullah Siddiqi [Siddiqi 1981], there appears to have been wide consensus on this statement, since the revival of Islamic economics in the middle of the twentieth century. From the viewpoint of the desirable financial system that is based on the doctrine of Islam, most studies consider that partnership-based financial instruments, such as Mudaraba and Musharaka, reflect the spirit of Islamic finance, and they therefore, encourage the use of such instruments. This is because these instruments are designed around profit and loss sharing scheme. Indeed, two pioneer works by Islamic economists in the 1940s had already mentioned the implementation of partnership-based financial instruments into Islamic finance. Anwar Iqbal Qureshi stated in his book, published in 1945, that “Islam prohibits interest but allows profits and partnership. If the banks, instead of allowing loans to the industry, become its partners, share the loss and profit with it, there is no objection against such banks in the Islamic system [Qureshi 1945: 158-159].” Around the same time, Mahmud Ahmad also stated his preference for partnership-based systems saying “The Shirakat banks would lend money to industry and commerce on the basis of Shirakat, that is, they would share the profit with their debtors rather than burden industry and commerce with a fixed rate of interest [Ahmad 1947: 170].”

The second type of literature examines the feature of Islamic finance from the practical standpoint from its industry. This type focuses on the structures of financial products that are adopted by Islamic banks, and concludes that the financial system in accordance with Islamic teachings stresses the importance of the strong linkage between the financial instruments and the real assets. For example, Taqi Usmani asserts that one of the most important characteristics of Islamic finance is an “asset-backed” feature [Usmani 2000(1998): 18]. From the bankers’ side, Joseph DiVanna and Antoine Sreih also mention that banks in the Islamic financial system act as hands-on intermediaries, as they deal and trade in assets purely for the purpose of income generation or profit; they also suggest that the uniqueness of Islamic finance lies in the fact that Islamic banks convert money into assets, based on their utility [DiVanna and Sreih 2009: 19]. In fact, most financial instruments in Islamic finance—such as Murabaha, Ijara, Salam, and Istista, which are alternatives to debt-based instruments in conventional finance—require the existence of real assets in order to ensure the legitimacy and raison d’être for Islamic finance.

Although there is some truth in the way each type of literature describes the distinctive feature of Islamic finance, each opinion is determined by only focusing on one aspect of the financial instruments in Islamic finance. That is, the former focuses only on the partnership-based financial instruments like Mudaraba and Musharakah, while the latter

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2 This paper calls such consensus “Mudaraba Consensus.”
3 There “Shirakat” indicates the principle of Musharaka.
focuses only on the alternatives to debt-based financing, like Murabaha, Ijara, Salam, and Istista. Therefore, it can be said that these features, described in the existing literatures, do not necessarily clarify the distinctive characteristics of Islamic finance as a whole. The following statement given by Shamshad Akhtar, who was the former governor of the State Bank of Pakistan, is evidence of the limitations of the existing literatures, with regard to the distinctive features of IES [Akhtar 2007: 27].

What distinguishes Islamic finance is its emphasis on trading of goods and services and its advocacy for profit and risk sharing in businesses supported by a variety of partnership arrangements—this is in sharp contrast to loan based financing in conventional banks. By virtue of these characteristics, Islamic finance offers prudent financing options being asset backed or equity based; particularly linkage of assets with financing ensures that transaction is less prone to debt crisis and funds are used for their prescribed purpose minimizing defaults resulting from improper use of borrowed funds.

Her statement clearly shows that the two features—“sharing” and “asset-backed”—are not fully integrated. By reviewing the limit of the existing literature critically, it is clear that this paper needs to clarify the comprehensive feature of Islamic finance that has the commonality between partnership-based and debt-based instruments.

2.2 Distinctive Features of Partnership-Based Instruments

Mudaraba contract is a form of a business contract in which one party offers capital and another party undertakes some business with this capital; the former is termed Rabb αλ–Mal and the latter Mudarib. The profit is distributed between both party in a ratio agreed beforehand while the entire loss is born by Rabb αλ–Mal unless Mudarib has a defect (see Figure 1).

Figure 1: Scheme of Mudaraba in Islamic Finance

Source: Prepared by the Author.
Musharaka contract is a form of a business partnership in which multiple parties invest. In Islamic finance, Sharika al-Inan is used as a variation of Musharaka. The profit is distributed between both party in a ratio agreed beforehand according to Hanafi school and Hanbali school of Islamic law, meanwhile shared in depending on the amount of investment according to Maliki school and Shafii school. On the loss being born depending on the amount of investment, there is the consent of each school. A right to participate in managing their business partnership is given investors, but this right is entrusted to each investor (see Figure 2).

As it has already been mentioned above, partnership-based instruments adopt a profit-sharing and a substantial loss-sharing procedure in distributing any resulting profit. The essential point of profit-loss-sharing is to “share” any result by all relevant parties. In terms of economics, any risk involved in partnership-based instruments is shared by all relevant parties, which implies that all the relevant parties are allowed to access any resulting profit in return for bearing a reasonable risk of loss. As many Islamic economist and practitioner working at the Sharia boards of Islamic banks emphasize, this manner of “risk-sharing” is said to be highly consistent with one of the fundamental notions of Islamic teachings [Kahf and T. Khan, 1992: 22; Bendjilali, 1996: 44]. Therefore, it can be said that this structural analysis of “risk-sharing” confirms the feature of partnership-based instruments mentioned in the existing literature.

Looking at the scheme of partnership-based instruments from the aspect of the cause of their profit and loss, the potential profit or loss for all the relevant parties depends entirely on success and failure of the relevant business. In term of economics, it can be stated that any profit or loss in partnership-based instruments are legitimized because all the relevant parties
appositely bear the market risk of the relevant business.

2.3 Distinctive Feature of Debt-Based Instruments

As for debt-based instruments in Islamic finance, this paper picks up two instruments; Murabaha, which has been the most popular in debt-based instruments; and Tawarruq, which provides immediate cash to the customer.

(i) Murabaha

Murabaha is a form of a contract wherein a seller sells a product to a buyer at a price comprising its cost and the seller’s margin, approved by both parties. The settlement is generally made in lump sum payment or in installments. Murabaha had been used as an instrument for commodity transactions in the pre-modern era. The practice of Islamic finance adopts its instrument as a financial product with some innovations.4 The general procedure of Murabaha provided by Islamic banks is as follows (see Figure 3): a bank’s customer primarily specifies a product that he/she wishes to purchase before the contract award of Murabaha by using “the Purchase Order” (Wad) scheme. According to this order, the Islamic bank buys a product specified by its customer on his/her behalf from the market, and then, sells it to its customer at a price that comprises the product’s cost and the bank’s profit, which is called ‘mark-up.’5

![Figure 3: Scheme of Murabaha in Islamic Finance](source: Prepared by the Author.)

Since the 1970s, Murabaha has been the most popular financial product in the asset side of Islamic banks as an alternative financial instrument for interest-based short-term loans. With regard to the share of Murabaha, a majority of Islamic banks in both the Middle East and Malaysia exhibit a widespread preference for Murabaha. For example, in Dubai Islamic Bank, which was established in 1975 as the world’s first commercial Islamic bank, Murabaha

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5 In a precise sense, Murabaha only indicates the final transaction between an Islamic bank and its customer.
has occupied higher shares, even if the annual shares in the 2000s are smaller than those in the 1980s and 1990s (see Table 1). In Bank Islam Malaysia, established in 1983 as the first commercial Islamic bank in Southeast Asia, Murabaha (including *Bay Bi-thaman Ajil* that is similar to *Murabaha*) has also occupied the highest share of total financing on its asset side every year (see Table 2). Al-Harran estimates that 80–90% of financial instruments on the asset side of Islamic banks were *Murabaha* from the 1970s through the first half of the 1990s [al-Harran 1995: xi].

Figure 4: Dubai Islamic Bank: Mode of Financing (% to Total Financing)

Source: Calculated from *Annual Reports* of Dubai Islamic Bank, 1984-2009.
However, *Murabaha* is a controversial product in light of Islamic jurisprudence because it is often pointed out that the nature of ‘mark-up’ is similar to ‘bank interest,’ which is prohibited in Islam and is regarded as *Riba*. Ziauddin Ahmad, who had theoretically supported the Islamization of the economic system of Pakistan in the 1980s, clearly points out the similarities between interest and mark-up [Ahmad 1985: 19-20]:

> There is genuine concern among Islamic scholars that if interest is largely substituted by devices like ‘mark-up’ it would represent a change just in name rather than in substance, and the new system would not be rid of the iniquitous nature of the interest-based system.

Therefore, many Islamic economists criticize the use of *Murabaha* in the practice of Islamic finance, and do not consider *Murabaha* to be the first-best solution. For example, Muhammad Nejatullah Siddiqi mentions *Bay Muajjal*, which is a contract similar to *Murabaha* [Siddiqi 1983: 139]:

> I would prefer that *Bay Muajjal* contract (nearly equal to *Murabaha*) is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form we have the overriding legal maxim that anything leading to something prohibited

*Figure 5: Bank Islam Malaysia: Mode of Financing (% to Total Financing)*
stands prohibited. It will be advisable to apply this maxim to Bay Muajjal in order to save interest-free banking from being sabotaged from within.

In contrast, how do those who approve the use of Murabaha explain their legitimacy? A number of the legal resolutions (Fatwa, Fatawa in the plural) that legitimize the use of Murabaha have hitherto been issued by the Sharia supervisory board. One of the more consistent explanations among them is found in the resolution issued at the first Al-Baraka Symposium in 1983. This resolution clearly resolves the disputable similarity between Murabaha and interest-based loans that the critics mention. This resolution starts with the following question [ABS 2006: 21-23]:

**QUESTION:** Some people cast doubts on the legitimacy of Murabaha because this form of contracts appears to include some elements of Riba.

The first and third parts of the answer to this question are as follows:

**ANSWER:**
(1) Murabaha does not involve a sale of something that seller does not possess, because the agreement of the Murabaha contract is conducted after actual possession.

(3) In Riba-based loans, a transaction is conducted in the form of exchange of similar goods. In such a transaction, the lender stipulates that the payment of interest (for example, 10 riyals) be made on the maturity date by a borrower who takes a loan of 100 riyals. In Murabaha with deferred payment, a transaction is conducted in the form of exchange of different goods, particularly the exchange of real goods for money. A specific feature of Murabaha that distinguishes it from Riba-based loans is that even if the mark-up amount is predetermined, the seller’s profit will be influenced by the market price of the relevant real good. Therefore, any profits in Murabaha are expressed as a function of supply and demand in the real goods market, rather than the monetary market.

(ii) Tawarruq

Tawarruq is a form of contract for monetary liquidization. According to Zuhayli, it seems that the name Tawarruq had been mentioned in classical Islamic jurisprudence [Zuhayli 1997]. The practice of Islamic finance directly succeeds the function of Tawarruq in classical Islamic jurisprudence (see Figure 6). In this case, an Islamic bank primarily buys a real good from the commodity market at the current market price on behalf of its customer.

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6 The following text is translated by the author.
who needs instant liquidity. Then, the Islamic bank sells it to the customer by Murabaha scheme. Subsequently, the customer sells it back to the commodity market at the current market price to gain monetary liquidity. Finally, the customer pays the amount specified by the Murabaha agreement on the date of maturity.

Figure 6: Scheme of Murabaha in Islamic Finance

The scheme of Tawarruq is similar to that of Bay Ina in that the main purpose of both products is monetary liquidization by using spot sale and Murabaha. However, there is a crucial difference between Tawarruq and Bay Ina in that Tawarruq involves multiple parties in its transactions, while Bay Ina only features bilateral relationships.

According to a concise review [al-Shalhoob 2007] and the author’s independent field survey regarding the current practice of Tawarruq in Islamic finance, the National Commercial Bank (NCB) in Saudi Arabia is a pioneer in using Tawarruq as a financial product under the brand of Tay sir in 2000. After this launch, several Islamic banks in the Gulf countries began to adopt Tawarruq, and presently, it is a very popular financial product for consumer loans. Currently, Malaysia is endeavoring to find a way to adopt the scheme of Tawarruq as a liquidity management tool for Islamic interbank overnight and short-term deposits under the brand “Commodity Murabaha Program” (CMP).

With regard to Tawarruq, there is controversy over the legitimacy of Tawarruq bundling.

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7 The scheme of Tawarruq generally involves metals (zinc, bronze, nickel, tin, and copper) in its transactions while dealing with large international commodity markets such as the London Metal Exchange (LME).
8 There is a wide variety of product brands that are based on the scheme of Tawarruq: Mal by Saudi British Bank, Dinar by Bank al-Jazira, Tawarruq Khayr by SAMBA, Khayr by Abu Dhabi Islamic Bank, and Tashir by Bahrain Islamic Bank.
9 In April 2007, Bank Negara Malaysia (the Central Bank of Malaysia), along with the Securities Commission of Malaysia, Bursa Malaysia (the Malaysian stock exchange), and industry players, launched the CMP involving crude palm oil as the underlying commodity traded for investment (Arab News, 18 June, 2007).
and stipulating the “resale and liquidization process” (No. 4 & 5 in Figure 2) with the original sales. In most cases, Islamic banks arrange and manage the whole process of Tawarruq, and only receive the difference between the price for the Murabaha scheme and the market price. Critics of Tawarruq mention that this stipulation makes Tawarruq merely a fictitious instrument to avoid interest-based loans because in such a practical application of Tawarruq, the actual transactions of the real good tend to become just nominal on paper. They consider that such application ignores the real purpose of Tawarruq. For example, Siddiqi emphasizes that Tawarruq is identical to interest-based loans not only in the functional level, but also from the macroeconomic perspective [Siddiqi 2006: 16]. Furthermore, Monzer Kahf insists that the use of Tawarruq must be limited because it may be economically worse than the practice of interest-based loans [Kahf 2004: 6].

The revision of the legal resolution issued by the Fiqh Academy at the Muslim World League (MWL, Rabita al-Alam al-Islami) reflects this tendency of critique of recent practical applications of Tawarruq in Islamic finance. Until recently, the Fiqh Academy at MWL issued two legal resolutions on Tawarruq. In the first resolution issued at the 15th meeting held on 31 October, 1998, the Fiqh Academy approved Tawarruq with no reservations (No. 5 resolution of the meeting) [MWL 1999: 161-162].

However, along with the prominence of Tawarruq in Islamic banks, particularly in the Gulf countries, the Fiqh Academy revised the former resolution and divided Tawarruq into two types (Tawarruq Haqiqi and Tawarruq Munazzam). According to the resolution issued at the 17th meeting held during 13–17 December, 2003, the Fiqh Academy approves Tawarruq Haqiqi, while it disapproves Tawarruq practiced in Islamic finance—the so-called Tawarruq Munazzam (No. 3 resolution of its meeting) [MWL 2004: 287-288]. As per this resolution, the Fiqh Academy defines Tawarruq Munazzam, which includes the following three impermissible factors:

1. An Islamic bank is involved in a resale and liquidization process (No. 4 & 5 in Figure 2) as an agent of its customer.
2. The involvement of Islamic bank in the entire process of Tawarruq makes the transfer of the title of the relevant good unclear.
3. Providing Tawarruq becomes merely a stable way for the bank to earn profits.

Most recently the Fiqh academy at OIC issues the new resolution on Tawarruq at the 19th meeting held during 26-30 April, 2009, which is under auspices of MWL. Although this resolution fundamentally confirms the second resolution by the Fiqh Academy at MWL, it

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10 In both papers by Rabiah and Dusuki, they mention that these resolutions were issued by the Fiqh Academy at the Organization of the Islamic Conference (OIC) [Adawiah 2008: 141; Dusuki 2008; 184]. However, according to the present author’s cautious examinations in this paper, there seems to be some confusion with regard to two different institutions having the same name of Fiqh Academy.
adds one more condition for defining impermissible *Tawarruq Munazzam*. In the second resolution by MWL, the involvement of Islamic bank in the entire process of *Tawarruq* is not allowed as impermissible *Tawarruq Munazzam*. The latest one by OIC reinforces this rule by defining *Tawarruq Munazzam* more clearly [OIC 2009: 12-13]:

The contemporary definition on organized *Tawarruq* is: when a person (*Mustawriq*) buys merchandise from a local or international market on deferred price basis. The financier arranges the sale agreement either himself or through his agent (*Tawkil*).

The important point in this statement is that even the involvement of the agent of Islamic bank becomes to be impermissible. This resolution causes many arguments among bankers in the Gulf countries because many Islamic banks in the Gulf countries use the scheme of *Tawarruq* with their agent. Most Islamic bankers and *Sharia* scholars do not feel pessimistic about the latest resolution. For example, Nizam Yaquby, who takes care of a number of *Sharia* supervisory boards of Islamic financial institutions, comments that because all these Islamic finance tools have certain amounts of organization, it is very difficult to do something which is not organized. He concludes that if proper procedures are implemented, then *Tawarruq Munazzam* is a useful tool and can be used. It seems that although the scope of *Tawarruq* that satisfies such conditions mentioned at the above resolutions comes to get narrow more, bankers and *Sharia* scholars will search a prudential way to utilize *Tawarruq* in the practice of Islamic finance.

(iii) Implications of Murabaha and Tawarruq Resolutions

On the basis of the above overview of the legal resolutions on *Murabaha* and *Tawarruq*, here examines the logic of these resolutions behind their approval or disapproval of the aforementioned products.

Firstly, both resolutions for approving *Murabaha* and *Tawarruq* assert that the actual involvement of the real good in the relevant transactions is strongly required. In the first part of Al-Baraka resolution on *Murabaha*, actual transfers of the real good are explicitly required as an essential condition. In the Muslim World League resolution on *Tawarruq Munazzam*, it is not permissible to include an unclear transfer of the title of the relevant good. This means that no skips of actual transfer procedure of the real good are required in the permissible *Tawarruq*. These requirements imply that both *Murabaha* and *Tawarruq* are legitimized because they are neither ‘monetary,’ nor ‘nominal’ transactions, but are transactions based on the ‘actual buying and selling of goods.’ Thus, it can be said that this implication confirms the

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12 Another resolution on *Murabaha* issued by Kuwait Finance House states that it is not permissible to include an unclear transfer of the title of the relevant good [KFH 1989: 61].
Secondly, both resolutions also mention the source of the legitimacy of profit in these products, which will clarify another feature of debt-based instruments not mentioned in the existing literature. In Murabaha, the Al-Baraka resolution requires that any profits should be expressed as a function of supply and demand in the real goods market. With regard to several studies on the legitimacy of profit in Murabaha [Masri 1976; Shihata 1987], this statement implies that the source of legitimacy of profit in Murabaha is considered to be an opportunity cost of the real goods in the relevant market. In contrast, it can be considered that the source of prohibition of interest in conventional interest-based loans is regarded as an opportunity cost of the monetary good. According to the review of the Muslim World League resolution on Tawarruq Munazzam, the involvement of Islamic banks in resale transactions is prohibited. This statement means that the source of legitimacy of profit in permissible Tawarruq relates to the real goods market. Thus, this implies the same conclusion as in the case of Murabaha. In terms of economics, it can be stated that any profits in the scheme of Murabaha and permissible Tawarruq are legitimimized because these schemes appropriately bear the market risk of the relevant real good.

2.4. Islamic Finance as ‘An Embedded System’

On the basis of the above overviews on partnership-based (Mudaraba and Musharaka) and debt-based (Murabaha and Tawarruq) instruments, this part tries to clarify the comprehensive feature of Islamic finance that has the commonality between partnership-based and debt-based instruments.

Both implications from the above analyses show that the financial instruments in Islamic finance consist of the schemes so that all the relevant parties appropriately bear the market risk of the relevant real good or business. And then, this is the source of legitimacy for each instrument. Considering this insight from the perspective of the economic system as a whole, it can be said that the financial system highly depends on the real domain in the economic system. Karl Polanyi, who is known as an economic anthropologist, criticized the modern economic theory, and stated that economy is not autonomous as it must be in economic theory but subordinated to political and social relations. He expressed this statement as “the human economy was always embedded into the society [Polanyi 1977].” Paraphrasing his idea and concept, the distinctive feature of Islamic finance is described as the “Embedded” system into the real domain of the economy.

3. Universal Aspect and Modern Novelties of Islamic Finance

3.1 Financial Activities in the Pre-Modern Islamic World

Following on from the preceding analysis, this section examines the universal aspect and
modern novelty of Islamic finance in the context of economic theory. Before these examinations, the first part of this section describes the historical dynamics of financial activities in the pre-modern Islamic world.

It is well known that the pre-modern Islamic world did not have anything like the comprehensive financial systems such as structured banking that are available in today’s world. However, contrary to the opinion expressed by Raymond de Roover [De Roover 1954], it was not as if the Islamic world operated without a financial sector at that time. The Sarraf, for instance, played the role of moneychangers and were a crucial cog in the money-transmitting business by virtue of their management of bills and checks. Although some of them put their own money into businesses, they were not allowed to receive deposits and use them as seed money for their investments. Instead, Wadia, which was known for arranging custody agreements, provided the deposit service [Udovitch 1979: 265-270; Imamuddin 1997: 128-138]. These facts imply that there was no credit creating function in those days, something that is common in the modern banking system. This is one of the primary differences between the financial activities in the pre-modern Islamic world and those that are commonplace in the modern banking sector.

In addition to the role of the money brokers mentioned in the last paragraph, it is also well known that merchants in the pre-modern Islamic period used certain trade instruments that were approved by the Islamic jurisprudence; these functioned as the financing instruments of the time. For instance, Shelomo Dov Goitein reads the Genizah documents and shows that the trade merchants of Cairo during the eleventh and twelfth centuries were given to the use of the scheme of Mudaraba and Musharaka for the purposes of financial trade [Goitein 1967: 247]. Nelly Hanna also mentions that the rich merchants of Cairo in the sixteenth and seventeenth centuries used Musharaka and Salam to finance their businesses [Hanna 1998: 54, 83]. These historical facts illustrate that there was a situation in which various sectors overlapped to create a financial system. In his paper, Abraham Udovitch terms the financial situation of the pre-modern Islamic world as one of “Bankers without Banks” [Udovitch 1979: 255].

What was the situation with regard to interest-based loans in the pre-modern Islamic world? Maxime Rodinson asserts that moneylenders lending at a usurious rate of interest was quite common in the pre-modern Islamic world; therefore, the prohibition of Riba became increasingly irrelevant at the time [Rodinson 1966]. Indeed, several empirical studies seem to exemplify Rodinson’s proposition. For example, Haim Gerber shows proof of the existence of interest-based loans known as Istighlal in Bursa during the seventeenth century [Gerber 1988: 128]. Further, Toru Miura considers litigation documents related to Damascus in the nineteenth century, and explains with the help of a case study interest bearing transactions between a guardian and a ward [Miura 1999: 322-326]. Nobuaki Kondo clarifies the prevalence of Bey-i Shart transactions in Tehran during the nineteenth century, which were
similiar to interest-based loans [Kondo 2005]. Although the empirical studies conducted by
the researchers cited above refer to these instruments as ‘interest-based’ loans without any
reservations, a detailed review shows that the schemes involving these instruments were
different from transactions based on interest-based loans. This is because these instruments
were based on Bay Ina transactions.

Bay Ina literally implies double sales, and is basically an alternative financial
arrangement for a customer who needs immediate cash. The complete procedure is outlined
as follows. First, a prospective creditor buys some asset from a customer (prospective debtor)
who needs immediate cash, and then, the customer immediately buys back his asset from the
creditor by means of Murabaha. The initial trade is a spot transaction, while the subsequent
trade is a deferred transaction with a higher price than that in the initial trade. Herein, the
creditor provides the customer with financial liquidity and earns profit from the price gap
between the initial and subsequent trades. As pointed out by the critics, it can be held that Bay
Ina is merely a fictitious instrument engineered to sidestep interest-based loans. However, a
Bay Ina transaction is not entirely the same as an interest-based loan because the former is
conducted in the form of an exchange of real goods for money. Then, which can we classify
Bay Ina into the interest-based or “embedded” financial system?

3.2 Universal Aspect of Islamic Finance

The prohibition of interest is not peculiar to Islam. If we were to trace back through
history, a number of examples of such prohibition can be found, from Aristotle to Michael
Ende. Among them, the doctrine of Christianity was the most influential on the subject of
avoiding interest in medieval Europe. There are many verses in the Bible that mention the
prohibition of interest. For example, the Gospel of Luke talks about a steward who wastes his
employer’s goods in order to prevent the debtors of his employer from paying interest on
their loans. Then, the Gospel continues, his employer commends the steward because he has
done wisely (Luke 16: 1-8). In the Middle Ages, Thomas Aquinas formulated a theory on the
prohibition of interest, and the canon law, based on his theory, condemned all interest bearing
transactions [De Roover 1974: 185].

Therefore, it is said that medieval European locals were obliged to use the peripheral
Jewish moneylenders with their high rates of interest [Chazan 1987: 179-191; Stow 1992:
210-230], or developed the alternative instruments which avoid interest bearing transactions.
The latter case can be classified into two trends; firstly, they used partnership-based
instruments known as Commenda, which shares the same origin as the Islamic system of
Mudaraba, to finance their business [Udovitch 1964]. Secondly, they invented debt-based
instruments which did not include interest bearing transactions. For example, the House of
Medici earned profits from money lending by means of a system of bills of exchange in
which the exchange rate varied from one region to another [Oguro 2006: 204-213]. To
present another example, Jelle Riemersma shows that the merchants of Calais in the fifteenth century raised their funds by using buy back transactions of the commodity [Riemersma 1952: 19-20], which were very similar to Bay Ina scheme in Islam. These instruments enabled them to earn profits from money lending without deviating from the canon law.

On the basis of a study of the existing mainstream literature, it is evident that nobody has ever doubted the proposition that the interest-based financial system, which is today regarded as the way of “conventional finance,” should be accorded the status of the universal and sustainable financial system. However, if we were to revert to the ancient and medieval financial activities outlined above, it would become clear that such a financial system was by no means always prevalent and sustainable. Instead, the “Embedded” financial system is found to have existed in many regions in the pre-modern world, even in Europe, with great deal of experience of sustainable development. In addition, recent studies show that the dawn of the interest-based financial system was not the result of deviation from the Christian doctrine of the prohibition of interest due to the spell of sustainable economic development that swept through Europe during the late medieval period. Mark Koyama explains that the seeds of the interest-based financial system unexpectedly originated in the relentless effort by merchants to balance its doctrine with commercial success [Koyama 2008].

Therefore, if we were to discard this prejudice, we would be in a position to state that the abovementioned proposition with regard to the interest-based financial system is merely a dogmatic view, that is, the interest-based financial system has not necessarily been a universal and sustainable one; rather it has been, radically speaking, a peripheral system. Furthermore, paraphrasing the term used by Kenneth Pomeranz [Pomeranz 2001], who challenges the typical framework of the European economic development by using the term “the great divergence,” it can be said that the rise of the interest-based financial system in Europe is not a result of the linear development of the financial system, but a result of “the great divergence” from the true universal and sustainable financial system that was embedded in the real domain of the economy.

Under this new framework, and divested of our prejudice on the subject of the interest-based system, the controversial Bay Ina-based instruments can be classified as an instrument of the true embedded instruments. This clarification implies that the historical dynamics of the financial activities in the pre-modern Islamic world can be regarded as a universal experience in economic history, and that the distinctive feature of “embeddedness” can be shared by the financial activities with sustainable development in the pre-modern world and Islamic finance in the modern world. Therefore, it can be concluded that Islamic finance has had a universal aspect in economic history in terms of the “embeddedness.”

3.3 Modern Novelties of Islamic Finance

The emergence of Islamic finance opens a new page in the history of both Islam and
finance. As has been already overviewed above, the comprehensive financial systems did not exist in the pre-modern Islamic world. Therefore, the current practice of Islamic finance is an unprecedented experiment in the history of Islam. On the other hand, a structured banking system without interest has never existed in the history of finance, too. Therefore, although Islamic finance stays on the genealogy of the “embedded” universal financial system, the modern novelties of Islamic finance can be observed.

Most instruments adopted by Islamic banks were not necessarily used as financial instruments in the pre-modern era. For example, Murabaha was originally a trade contract to assist a buyer who was not familiar with business customs in the market. Ijara was simply a lease contract in accordance with the unique structure of ownership in the Islamic jurisprudence. The formulation of Islamic finance as a modern banking system required the innovation of these trade contracts for using as financial instruments. In the process of such formulations, Islamic banks developed financial instruments by combining one trade contract with another. Not only does Ijara continue to play the role of lease, it is also transformed as a “finance lease” instrument called “Ijara wa Iqtina” by adding a sale contract to the end of the lease period (see Figure 7).

Figure 7: Scheme of Ijara wa Iqtina in Islamic Finance

![Diagram of Ijara wa Iqtina](image)

**Source:** Prepared by the Author.

Another example is that of the combination of two Mudaraba transactions through Islamic banks called the two-tier Mudaraba, developed as a credit creating function, which has never existed in the pre-modern Islamic world (see Figure 8).
New interpretations by Sharia scholars also enable trade contracts to function as new financial instruments. Murabaha is renewed as a short-term loan instrument by the new approval of Sharia scholars, which allow adding Wad procedure before the original Murabaha as explained above. Thus, financial activities in accordance with Islam are refurbished in the modern world with a new design of the modern banking structure, which is called “Islamic finance.” Therefore, one of the modern novelties of Islamic finance is the above innovation (or renovation) by combining and transforming erstwhile Islamic trade contracts.

The other novelty of Islamic finance is its coexistence with the conventional finance. Although many interactions were observed in Mediterranean trade in the pre-modern and early modern world, financial systems in both the Islamic world and Europe were separated by region. However, the current practice of Islamic finance not only provides services within the Islamic world but also expands its businesses to Europe and the international financial markets. Therefore, although Islamic finance in principle is embedded in the real domain of the economy, its practice is heavily influenced by the conventional financial system. For example, a mark-up rate of Murabaha is theoretically determined by the supply and demand balance of the relevant real goods. However, in reality, the mark-up rate tends to be adjusted to coincide with an interest rate of short-term loans through arbitrage. In another instance, the newly developed financial instrument in Islamic finance tends to be a recycled design of the leading products in conventional finance like financial derivatives and highly liquid instruments. Obviously, these situations are the outcome of the growing competitiveness of Islamic finance with respect to the conventional finance. From the aspect of economic history, these situations of Islamic finance implies that the embedded financial system in the modern world can come to exist with the support of an external system such as the conventional system of finance; this is the second modern novelties of Islamic finance.

**Source:** Prepared by the Author.
4. Potentialities of Islamic Finance for Sustainable Development

This paper clarifies the distinctive feature of Islamic finance as the “embedded” financial system, wherein the monetary domain of the economy is embedded into the real domain. This paper reverts to the history of the pre-modern Islamic world and Europe to show that the rise of the interest-based financial system in Europe is not because of the linear development of the financial system but because of “the great divergence” from the universal and sustainable financial system that was embedded in the real domain of the economy. It shows that then, Islamic finance stays on the genealogy of such a universal and sustainable financial system. On the other hand, this paper clarifies two modern novelties of the system of Islamic finance. One is the innovation of Islamic trade contracts for using as financial instruments by combination and transformation of them, which results from the formulation of Islamic finance as a modern banking system. The other is the dependence on an external system such as conventional finance, which is due to the coexistence of two financial systems in the modern world. On the basis of these implications, it can be concluded in the context of economic history that Islamic finance is one of the universal and sustainable financial systems with a novel design having a modern banking structure.

The current financial crisis questions the superiority and stability of the conventional financial system and makes bankers focus on Islamic finance. As a result, a number of banks in conventional finance are now on the way out from speculative and vague financial transactions which are “not embedded” into the real domain of the economy, and go back to the “embedded” transactions. To the contrary, Islamic finance maintains the pace of its growth despite the global recession that was caused by the financial crisis. Radically speaking, these current situations, which occur in both international and regional financial markets, can support my conclusion, which is that the “embedded” financial system is universal and sustainable. Although Islamic finance is not necessarily very robust and stable against financial crises, Islamic finance, which shares its feature with financial activities in the golden age of the pre-modern Islamic and Mediterranean world, can give us an good idea of the more sustainable economic development.

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