

ISLAMIC FINANCE. INCLUSIVE GROWTH AND POVERTY ALLEVIATION

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Most of the attention on Islamic finance has so far been focused on the regulatory framework, products and services offered, comparability with conventional finance, risk management characteristics, Shariah compliance, and expansion and penetration issues. Very little work has been done to explore the unique features of Islamic finance for the larger good of the society particularly in the context of economic growth and poverty alleviation. I would argue this morning that Islamic finance can be a powerful tool for inclusive growth and amelioration of the conditions of poor in the Muslim countries.

2. Let me clarify at the outset as to what is meant by inclusive growth. Economic growth can either be broad based in which the benefits are shared widely and particularly by the bottom quintile of the population or highly skewed where the benefits accrue disproportionately to a small elite group of society. Income generation, asset creation, human capital formation and access to public services are some of the tested ways through which shared or inclusive growth can be achieved. The most successful example of shared or inclusive growth model is the experience of East Asia in the last half of the 20th century.

3. The predominant economic model of the day is the Capitalist model that has made impressive strides in improving the living standards of the nations across the world. Capitalist model relies on private property rights and the markets for efficient allocation of resources and does a fairly good job in generating high growth rates and lifting millions out of poverty. But it fails in ensuring an equitable distribution of incomes or benefits from growth. It must also be clarified that growth can help alleviate poverty but does not necessarily reduce income inequalities. The pattern of growth therefore becomes critical. The choice of strategies and public policies determines whether pro-poor growth can also reduce inequalities.

4. A recent study done by the IMF shows that income inequalities are rising and despite the unprecedented gains made by China in quadrupling its per capita incomes in a quarter century and bringing poverty to less than 10 percent during this period regional, inter-personal, rural-urban and gender income disparities have widened and are getting worse. Empirical analysis shows that technology rather than trade and financial globalization are behind these growing inequalities. Whatever the explanatory factor behind this phenomenon the dangers in form of social implosion, high degree of discontent among certain segments of population who feel they are left out of the process and the consequential instability, violence and in some instances acts of terrorism are assuming serious proportions. Although the relationship between social and economic exclusion and religious extremism

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and terrorism is neither straight forward nor quite strongly established, anecdotal evidence suggest that a sense of anger and resentment may precipitate with-drawl from the society and recourse to violent actions. Although the religious fervor has been misused to mobilize these disgruntled young men and women and provide the cover for the crimes against the society the underlying root cause, in my view, lies in the growing gap of perceptions and expectations between the well to do and the excluded segments of the population. If Justice and fair-play are denied to the less well-to-do and the courts take enormous amounts of time and money to adjudicate and if the essential basic public services such as education, health and security are not available to them the recourse to alternative modes becomes inevitable. Many parents of modest means have been forced to send their children to madrassahs, (it is a mistake to lump all madrassahs together as some of them are providing quality religious and modern education) because they couldn't afford even the government schools. Once these young minds are enrolled at these extremist institutions where they receive full lodging, boarding, clothing etc. they become captives to the preaching of their teachers with a peculiar world view. They get brainwashed for carrying out actions in the name of religion which any true Muslim would find difficult to fathom.

5. How can this flaw or shortcoming of the capitalist system be overcome and these inequalities between different classes of human beings be minimized if not completely eliminated? My reading of Islamic economic System of which Islamic finance is an integral part suggests that it is possible to achieve inclusive growth and poverty alleviation if we strictly and not ritualistically follow the precepts and practices of this system. The more difficult question that eludes us is how can the Islamic economic system that incorporates the inclusive growth in its true spirit be introduced and sustained in 53 member countries of OIC with such diversity in political, economic and social conditions, resource endowments and power relationships.

6. Unlike positive economics the entire edifice of Islamic economy is built upon a set of objectives or *maqasid*. In other words, Islamic economics is normative in nature with the objective of the Shariah being to promote the well being of all mankind which lies in safeguarding their faith, their human self, their intellect, their posterity and their wealth. Islamic system tries to promote a balance between market, family, society and the state. It does so by promoting both the material and the spiritual urges of the human self, foster peace of mind, enhance family and social solidarity. Some western thinkers and anti-globalization activists decry the western economic model as being suppressive of collective human rights, community and social well being, disruptive of family values and too much focused on selfish individual interests. Behavioral economists have also begun to challenge the assumption of rationality in the choices and preferences an individual makes in day-to-day life. Thus, the merit of Islamic economic model lies in its extension of western model in some fundamental and beneficial ways.

Unlike the western societies, Islam strikes a balance between individual self interest and social interest by limiting individual preferences to conform with social priorities and eliminating or minimizing the use of resources for purposes that frustrate the realization of the social vision. This then helps promote harmony between self-interest and social interest, uniformity in treatment of all individuals within that society and solidarity among the citizens of the state.

7. A legitimate question then is: if the Islamic Economic System is so good why do we see the plight of Muslims in such dire straits? The present segmentation we observe today in Pakistan and other Muslim societies based on caste, biradri, kinship, ethnicity is an outcome of the cultural and historical influences and is a negation of the fundamental norms of our religion that preaches equality for all. Similarly the fragmentation of Muslims among different sects and sub sects such as Deobandis, Bralevis, etc can also be attributed to some artificial constructs that do not find any validation from Quran and Sunnah. The huge income gaps between the kings, princes, sheikhs, political leaders on one hand and the majority of the population on the other in most Muslim countries have originated because of the blatant adherence to the Capitalist model of accumulation of wealth for individual utility in total disregard to social and collective utility and in violation of the basic norms and principles of Islam.

8. The upshot of the above discussion is that the Islamic economic system has not been allowed to function due to the interplay between cultural, historical and economic factors. How can these influences be minimized and the Islamic economic model be allowed to affect our daily lives? This is a very difficult question and there are no easy answers. But at least at a theoretical plane I would humbly venture to submit that it is both feasible and doable to achieve the desired results by following the Islamic model.

9. In Islamic economic model the market mechanism makes the allocation and distribution of resources subject to a double layer of filters. Unlike the Western model, the Muslim is not expected to behave in a way that is exclusively concerned with his immediate self gratification. He/ She has to consider as to how his/ her selfish behaviour impinges upon the collective interests of the society. For this restraining influence a Muslim realizes that his beliefs and Faith have embedded his/ her self interest in a longer term perspective-stretching it beyond the span of this world to Life Hereafter. Claims on resources are then exposed to the second filter of market prices. In this process, the influence that initial resource endowments are able to exercise in the allocation and distribution of resources may be reduced substantially. This interest in Hereafter cannot be served except by fulfilling his or her social obligations. This may induce individuals to voluntarily hold their claims on resources within the limits of general well being and thus create harmony between self-interest and social interest even when the two are in

conflict. The distortions in the capitalist system created by excesses of individual greed through profiteering, black marketing, hoarding, collusion, adulteration and cheating are nonexistent among the true followers of Islam. This makes the Pareto optimal solution of the market economy under the Islamic system superior to that prevailing under pure capitalist system. The promotion of simple living and the reduction of wasteful and conspicuous consumption helps reduce excessive claims on resources and thereby release a greater volume of resources for need-fulfillment by others who are not so well off. It may also help promote higher savings and investment and thereby raise employment and growth which will have positive impact on the economic conditions of the poor.

10. At the macro level, Islamic economic model in its ideal form tends to combine the positive aspects of the capitalist economy and socialist economy while minimizing their negative consequences. As pointed out earlier, Capitalist economy based on private property and market mechanism allocates resources efficiently but as it takes initial resource endowment as given, equity considerations do not figure in this system. Socialist system is very much concerned with equity and welfare of its population and ensures benefits from cradle to grave for its citizens. But as it relies on state ownership and bureaucracy it is poor in allocating resources thus creating inefficiency, waste and value subtraction. Islamic System overcomes the deficiencies of both the systems as it is solidly based on private property and market mechanism but has also explicitly built in equity and distribution through compulsory deduction of Zakat i.e. transfer payments from the asset holders to the poor segments of the population. Islamic economic model addresses the distribution issues explicitly after growth takes place and market has allocated the gains. It does so by a compulsory deduction of 2.5 percent of tangible wealth and net asset holdings from the incomes generated by the market mechanism for transfer among the vulnerable, sick, handicapped, indigenes and poor segments of the society. Although the deduction is compulsory the transfers are made voluntarily by the well-to-do to their poor relatives, neighbours and others whom they know to have legitimate needs. Thus the leakages, waste and corruption that are inherent in a state administered system of welfare payments are conspicuous by their absence under this system. Only really deserving persons and families or mustahaqeen receives these payments. In Pakistan, it is estimated that private transfers made voluntarily to the poor account for 2 percent of GDP annually. These welfare payments are a potent force in reducing poverty, helping the vulnerable to earn their own livelihoods and lower income disparities.

11. At the sectoral level, the introduction of Islamic banking has promoted financial inclusion by bringing those who have so far remained outside the conventional banking system thus deepening the financial sector. There are believers in Islamic Faith who do not use the Conventional banking system because of their strongly held views that this system is based on riba. They are, however, willing to deposit their savings into Islamic banks

and eager to borrow from these banks for expansion of their businesses or new investment. Thus a significant segment of population particularly in the rural areas, shanty towns in urban centres, mandi towns, comprising of small and medium entrepreneurs, small farmers and self employed persons that is currently outside the organized financial sector will be brought into its fold. During the last eight years the number of borrowers from the banking system in Pakistan has risen from 1 million to 5.5 million - an impressive rise. But this number can easily double if Islamic banks take measures to penetrate in the above geographical areas and serve those who are currently outside the banking system. Access to agriculture credit, including livestock, fisheries, dairy, SME finance including small mining and transport enterprises, low cost housing finance etc. provided by Islamic banks will relax the credit constraint these individuals and businesses face today in expanding their businesses or investing in productivity or building assets.

12. The goal of the banking is the general economic improvement of the public at large rather than of few groups. How can the Islamic banks help the poor and also help in reducing income inequalities? Most of the conventional bank presence is limited to metropolitan areas and big cities. Mandi towns and large rural areas are not served by them. As mentioned earlier, these places have a large untapped client base waiting for Islamic financial products to become accessible and available to them. Islamic banks can spread their geographical presence by locating their branches or other delivery channels in these potentially attractive but underserved areas and use IT tools and alliances with Post Offices, and other distribution outlets to develop cost effective business model. Rural areas in Pakistan are a reliable and sustainable pool for mobilizing low cost deposits which can provide a stable source of funding for Islamic banks that will not only cover their extra costs but also give them a competitive edge. IJARA products for agriculture implements, tube-wells, processing and dairy equipment, cold storage, warehousing, transport etc will be highly popular in these areas.

13. Second, Microfinance is catching on quite rapidly in Pakistan. The recovery record of the poor who are the main beneficiaries of Microcredit has proved to be quite robust even under adverse circumstances. But the penetration rates are still quite low while the scope for expansion is quite wide. One of the missing elements on the spectrum is the combination of Microfinance with Islamic Finance. I am glad that the State Bank of Pakistan (SBP) has recently taken the initiative and issued the guidelines for Islamic Microfinance. My own experience by visiting various parts of Pakistan has convinced me that there is a huge demand for Islamic Microfinance. Akhuwat in Lahore has pioneered this concept and is doing extremely well. But many more players are needed. This huge potential of millions of customers is waiting to be exploited. A few years ago I had suggested to my colleagues at the SBP that the Mosques can be used as a low cost launching pad for reaching out the segment of

the population that is quite hard to penetrate. Some of the mosque goers, who consider themselves outside the mainstream and are marginalized, need to be drawn into the organized economic activity. Their income generating activities will become the magnet for social integration and an antidote against withdrawal from the society. In addition to Micro Credit other products such as Microinsurance and Low cost housing finance for the poor will also mitigate some of the unforeseen risks and also contribute to asset formation.

14. Third, in order to win the confidence of their future clients Islamic banks have to take extra precautions and safeguards to ensure that they meet the exhaustive requirements to be Shariah compliant. The perception that Islamic banks are simply mimicking the Conventional finance products is not going to go well with the large illiterate and uneducated population that forms the bulk of the future client base for Islamic banks. This requires that the clients of Islamic banking must have business that should be socially beneficial for the society creating real wealth and adding value to the economy rather than making paper transactions. Commingling of funds and even a semblance of contamination with non-Shariah compliant products and services should be scrupulously avoided. A stringent Know Your Customer (KYC) policy is inherently an inbuilt requirement for an Islamic bank since the Islamic bank has to know the customer and his business before getting into a socially responsible Shariah compliant transaction. By their very nature, Islamic mode of financing and deposit taking discourages questionable/undisclosed means of wealth that form the basis of socially undesirable and Shariah repugnant operations. The disclosure standards are stringent because the Islamic banks require the customers to divulge the origins of their funds in order to ensure that they are not derived from un-Islamic means e.g. drug trade, gambling, extortion, subversive activities or other criminal offences. On the financing side, the Islamic banks must ensure that funds are directed towards identifiable and acceptable productive activities. Most Islamic financing modes ought to be asset backed, i.e. they are used to finance specific physical assets like machinery, inventory, equipment, etc.

15. Fourth, the role of the Islamic bank is not limited to a passive financier concerned only with timely payments and loan recovery. The bank is in fact a partner in business and has to concern itself with the nature of business and profitability position of its clients. In the case of loss in business, the Islamic financier has to share that loss. To avoid the loss and reputational risk, the Islamic banks have to engage in teaching coaching, guiding, advising and training their clients in book keeping, accountancy and principles of business management. This modest but laborious investment will have a beneficial impact on the banks themselves. As their clients master these techniques they will become better risks and generate high level of profits. It may not be feasible for every individual bank to provide these services on their own but pooling of resources by all the Islamic banks would be a practicable and worthwhile proposition.

16. Let me conclude by asserting that Islamic banks and Islamic financial institutions can accelerate their pace of expansion if they consider the proposals I have outlined this morning. This expansion will not only help poverty alleviation but also reduce income inequalities and foster inclusive growth. The truth of the matter is that most of the poor possess only one asset i.e. their unskilled labour. But to produce income and take care of their consumption as well as investment needs they require some capital to add to their labour. This credit constraint can be eased by Islamic banks by locating their branches in underserved areas, catering to neglected economic activities.