ISLAMIC FINANCE AND ECONOMIC DEVELOPMENT
The Case of Dubai

Kapetanovic, Harun

Awarding institution:
King's College London

The copyright of this thesis rests with the author and no quotation from it or information derived from it may be published without proper acknowledgement.

END USER LICENCE AGREEMENT

This work is licensed under a Creative Commons Attribution-NonCommercial-NoDerivatives 4.0 International licence. https://creativecommons.org/licenses/by-nc-nd/4.0/

You are free to:
• Share: to copy, distribute and transmit the work

Under the following conditions:
• Attribution: You must attribute the work in the manner specified by the author (but not in any way that suggests that they endorse you or your use of the work).
• Non Commercial: You may not use this work for commercial purposes.
• No Derivative Works - You may not alter, transform, or build upon this work.

Any of these conditions can be waived if you receive permission from the author. Yourfair dealings and other rights are in no way affected by the above.

Take down policy

If you believe that this document breaches copyright please contact librarypure@kcl.ac.uk providing details, and we will remove access to the work immediately and investigate your claim.
ISLAMIC FINANCE AND ECONOMIC DEVELOPMENT

The Case of Dubai

Harun Kapetanovic (1262005/1)
PhD Thesis

Department of Middle Eastern Studies
Faculty of Social Science and Public Policy
King’s College London
Abstract

Emerging in the early 1970s, the Islamic financial industry has recorded impressive growth, in excess of 15 per cent per annum, and has spread across more than 70 countries. However, the widening dichotomy between the theory and practice of the Islamic economic paradigm seriously undermines the promise it holds as a potentially alternative system for greater social and economic justice. One of the key obstacles to achieve this is its inability to steer away from the path-dependence and straightjacket of the neoliberal economic doctrine. A case in point is that of Dubai, a city-state that has experienced impressive economic growth in the last two decades, pursuing an unconventional development strategy, while capitalizing on the economic and financial opportunities offered by the global economic system. Given this background, this research considers the extent to which Dubai’s economic development model may represent a useful framework to provide the new impetus sought for a more authentic development of Islamic finance. In that respect, we have addressed three research questions: Is the Islamic economic and finance paradigm worth operationalizing? Does Dubai have ingredients for a more substantial development of the industry? If so, is Dubai ready to implement the Islamic system more substantively? Given that the ideal Islamic economic system does not exist yet in practice, we first assess whether the Islamic economic paradigm and the Islamic financial system can constitute a viable alternative system to the conventional one. We then conduct a thorough analysis of Dubai’s development path, prospects, policies and institutions from the perspective of Islamic economics and finance. This has led us to put forward a novel interpretation and model of Dubai’s economic development. Lastly, we conduct semi-structured interviews with some of Dubai’s key protagonists of the business and financial industry to probe the direction of the industry’s development and Dubai’s readiness to implement the Islamic paradigm more substantively. We conclude that the paradigm indeed holds the promise for more sustainable and stable economic development. Moreover, we show that Dubai’s non-orthodox development approach has indeed significant ingredients to serve as catalyst for a more genuine development of the industry. However, our empirical research on Dubai’s readiness to capitalize on such ingredients to implement the Islamic economic framework more comprehensively has yielded rather mixed findings.
Table of Contents

Abstract ................................................................................................................................. 1

Table of Figures .................................................................................................................... 7

Abbreviations ......................................................................................................................... 9

Introduction ............................................................................................................................ 10

1. Research overview ........................................................................................................... 10
   1.1. Why Dubai .................................................................................................................. 14

2. Research questions, aims and objectives ......................................................................... 16

3. Research methodology and strategy ................................................................................. 17
   3.1. Research design .......................................................................................................... 19
   3.2. Research method ......................................................................................................... 20

4. Theoretical framework ..................................................................................................... 23
   4.1. Historical context ....................................................................................................... 23
   4.2. Interaction between Islamic and conventional finance ............................................ 25
   4.3. Islamic economics as an alternative system: A fiction or a reality? ......................... 27
   4.4. Islamic finance: a factor of stability? ............................................................................ 29
   4.5. At the cross-road ......................................................................................................... 30
   4.6. The case of Dubai ......................................................................................................... 32

5. Research challenges and limitations .................................................................................. 35

6. Contribution of the thesis .................................................................................................. 36

7. Research structure ............................................................................................................. 37

Part 1: Review of Islamic Economics and Finance Theoretical Foundations and
Relevance for Sustainable and Stable Development .......................................................... 40

1. Theoretical Foundations of Islamic Economics ............................................................... 41
   1.1 Evolution of economic development ............................................................................. 41
      1.1.1 Relation to Islamic economics ............................................................................... 46
   1.2 Islamic economics – sources, scope and objectives ..................................................... 47
      1.2.1 Sources of Islamic economics ............................................................................... 48
      1.2.2 The role of the worldview and Maqāsid Al Sharī’ah ............................................ 49
      1.2.3 Scarcity in Islam .................................................................................................... 52
      1.2.4 Self-interest in Islam ............................................................................................... 53
3.3.6 Islamic financial instruments – déjà vu? ................................................................. 110
3.3.7 Regulating Islamic financial industry – to lead or to follow? ............................. 111
3.3.8 Governance of Islamic finance industry: a missing link in practice .................. 113
3.4 Points of departure from the theoretical model ................................................. 114
3.4.1 Formalistic development: form versus substance ............................................ 115
3.4.2 Convergence without integration ...................................................................... 115
3.5 Growth vs development ......................................................................................... 116

Part 2: Dubai Economic Development Model: Performance, Distinctive Features and
Relevance to Islamic Economic Paradigm .................................................................. 119

4 Dubai’s Development Model: Success and Limitations ........................................ 120
4.1 Dubai’s economic model ....................................................................................... 120
4.1.1 Rentier state theory and Dubai ........................................................................ 121
4.2 Key elements of Dubai’s model .......................................................................... 123
4.2.1 The UAE setting ............................................................................................... 124
4.2.2 Government-led, value-based economic development ..................................... 125
4.2.3 Domestic investments and development orientation ....................................... 126
4.2.4 Unhindered access to capital and labour markets .......................................... 130
4.2.5 Protectionism and legal dichotomy ................................................................ 134
4.2.6 Economic and business diversification ......................................................... 135
4.3 The stress test: Dubai debt crisis ........................................................................ 137
4.4 Dubai’s unorthodox approach ............................................................................ 140

5 Dubai’s Development Policies and Incentives ....................................................... 142
5.1 Government policies: fiscal policy and its implications ...................................... 142
5.1.1 Fiscal policy without taxation ........................................................................ 143
5.2 Enabling environment and economic incentives ............................................... 148
5.3 Resulting development paradigm: A synthesis .................................................. 151
5.4 Dubai model: consistency with Islamic principles .............................................. 153
5.4.1 Islamic finance advantage: organic development .......................................... 156
5.5 Dubai vulnerability through Islamic lenses ....................................................... 160
5.6 Avoiding vulnerability through Islamic based model ........................................ 162
5.7 Dubai’s enabling environment – in sync with Islamic finance ......................... 163
Part 3 - Islamic Financial Services in Dubai: Prospects and Readiness for More Comprehensive Implementation ........................................................................................................... 165

6 The State of Development of Islamic Finance Industry in Dubai ......................... 166

6.1 Dubai’s financial industry – growth vs. development ...................................... 167
6.2 Salient features of the financial industry in Dubai ........................................ 170
   6.2.1 Market and regulatory dichotomy ....................................................... 172
   6.2.2 Opaque information environment ..................................................... 174
   6.2.3 Inadequate business regulation ......................................................... 175
6.3 Structure of financial markets: Uneven developments ..................................... 176
   6.3.1 Banking Industry ............................................................................. 178
   6.3.2 Capital markets ................................................................................ 182
6.4 Financial services: Scope for development .................................................... 186

7 Dubai’s Islamic Financial Services: Viability and Prospects ................................ 189

7.1 Islamic financial services in Dubai: Global pioneer in local market ............... 190
7.2 Islamic vs conventional finance: Microeconomic analysis impact on stability ... 191
   7.2.1 The role of sukuk in economic development of Dubai ....................... 193
7.3 Operationalizing the Islamic economic framework ........................................ 194
7.4 Capitalizing on Dubai’s predisposition to develop the Islamic framework .......... 195
   7.4.1 Institutional developments .................................................................. 196
   7.4.2 Organizational developments ............................................................ 204
   7.4.3 Product developments ........................................................................ 207

8 Narrowing the Dichotomy: Dubai’s Readiness and Global Prospects .................. 210

8.1 Field data – methodology and results ............................................................. 210
8.2 Data collection analysis ................................................................................ 213
   8.2.1 Theory and practice of Islamic finance .............................................. 213
   8.2.2 Motivation behind economic development in Dubai ......................... 214
   8.2.3 Role of Islamic finance in Dubai ......................................................... 215
   8.2.4 Development of Islamic finance in Dubai, challenges and opportunities ... 217
   8.2.5 Benefits/impact of Islamic financial system ........................................ 217
   8.2.6 Dubai’s competitiveness in relation to Islamic finance ......................... 218
8.3 Pitfalls in the practice of Islamic finance in Dubai .......................................... 218
8.4 Fostering sustainability and stability through the Islamic framework ............... 220
8.5 Insights for reforming global Islamic finance for growth and sustainability .......... 222

9. Conclusion .............................................................................................................. 224

Appendix ..................................................................................................................... 231

Bibliography ............................................................................................................. 234
**Table of Figures**

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Relevant Situations for Different Research Strategies</td>
<td>18</td>
</tr>
<tr>
<td>2</td>
<td>Main Themes and Discussion Focusses</td>
<td>23</td>
</tr>
<tr>
<td>3</td>
<td>Economic growth over time</td>
<td>42</td>
</tr>
<tr>
<td>4</td>
<td>Types of Contracts in Islamic Finance</td>
<td>93</td>
</tr>
<tr>
<td>5</td>
<td>Islamic bank balance sheet structure</td>
<td>97</td>
</tr>
<tr>
<td>6</td>
<td>Risk profile of an IFI</td>
<td>100</td>
</tr>
<tr>
<td>7</td>
<td>Diversity in the legal, regulatory and supervisory arrangements</td>
<td>111</td>
</tr>
<tr>
<td>8</td>
<td>Dubai Real GDP and Growth</td>
<td>123</td>
</tr>
<tr>
<td>9</td>
<td>Dubai population</td>
<td>129</td>
</tr>
<tr>
<td>10</td>
<td>Infrastructure and Real GDP in Dubai</td>
<td>131</td>
</tr>
<tr>
<td>11</td>
<td>Leading sectors’ contribution to GDP</td>
<td>132</td>
</tr>
<tr>
<td>12</td>
<td>Aggregate labor productivity and labor force in Dubai</td>
<td>133</td>
</tr>
<tr>
<td>13</td>
<td>Employment and productivity</td>
<td>134</td>
</tr>
<tr>
<td>14</td>
<td>Oil contribution to Dubai’s GDP</td>
<td>136</td>
</tr>
<tr>
<td>15</td>
<td>Sector Contribution to GDP at Current Prices</td>
<td>137</td>
</tr>
<tr>
<td>16</td>
<td>Spreads of Selected Dubai Bonds</td>
<td>139</td>
</tr>
<tr>
<td>17</td>
<td>Summary Dubai Economic Development Model</td>
<td>141</td>
</tr>
<tr>
<td>18</td>
<td>Dubai revenues break-down</td>
<td>145</td>
</tr>
<tr>
<td>19</td>
<td>Dubai government revenues and expenditures</td>
<td>147</td>
</tr>
<tr>
<td>20</td>
<td>Laissez faire, market-based dev principle and market incentive system</td>
<td>151</td>
</tr>
<tr>
<td>21</td>
<td>Dubai’s Economic Development Model</td>
<td>152</td>
</tr>
<tr>
<td>22</td>
<td>Select GDP per resident and GDP per citizen</td>
<td>154</td>
</tr>
<tr>
<td>23</td>
<td>Positive impact of Dubai’s economic environment on Islamic Finance</td>
<td>159</td>
</tr>
<tr>
<td>24</td>
<td>Employment within the Financial Services Sector</td>
<td>169</td>
</tr>
<tr>
<td>25</td>
<td>Value Added of the Financial Services Sector</td>
<td>169</td>
</tr>
<tr>
<td>26</td>
<td>Structure of the Financial Services Sector</td>
<td>171</td>
</tr>
<tr>
<td>27</td>
<td>Dubai’s financial services development perspective</td>
<td>172</td>
</tr>
</tbody>
</table>
## Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>AED</td>
<td>Arab Emirates Dirham</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swaps</td>
</tr>
<tr>
<td>CSR</td>
<td>Corporate Social Responsibility</td>
</tr>
<tr>
<td>DED</td>
<td>Department of Economic Development, Govt of Dubai</td>
</tr>
<tr>
<td>DIEDC</td>
<td>Dubai Islamic Economy Development Centre</td>
</tr>
<tr>
<td>DFM</td>
<td>Dubai Financial Market</td>
</tr>
<tr>
<td>DFSA</td>
<td>Dubai Financial Services Authority</td>
</tr>
<tr>
<td>DIFC</td>
<td>Dubai International Financial Centre</td>
</tr>
<tr>
<td>DME</td>
<td>Dubai Mercantile Exchange</td>
</tr>
<tr>
<td>DOF</td>
<td>Department of Finance, Government of Dubai</td>
</tr>
<tr>
<td>EOSB</td>
<td>End of Service Benefits</td>
</tr>
<tr>
<td>ESCA</td>
<td>Emirates Securities and Commodities Authority</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investments</td>
</tr>
<tr>
<td>FPI</td>
<td>Foreign Portfolio Investments</td>
</tr>
<tr>
<td>FSA</td>
<td>UK Financial Services Authority</td>
</tr>
<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GFC</td>
<td>Great Financial Crisis</td>
</tr>
<tr>
<td>GRE</td>
<td>Government related entities</td>
</tr>
<tr>
<td>IFI</td>
<td>Islamic Financial Institutions</td>
</tr>
<tr>
<td>IFS</td>
<td>Islamic Financial Services</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fond</td>
</tr>
<tr>
<td>MENA</td>
<td>Middle East and North Africa</td>
</tr>
<tr>
<td>MENASA</td>
<td>Middle East, North Africa and South Asia</td>
</tr>
<tr>
<td>OIC</td>
<td>Organisation of Islamic Cooperation</td>
</tr>
<tr>
<td>RST</td>
<td>Rentier State Theory</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium Enterprises</td>
</tr>
<tr>
<td>SOE</td>
<td>State Owned Enterprise</td>
</tr>
<tr>
<td>UAE CB</td>
<td>UAE Central Bank</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>US</td>
<td>United States of America</td>
</tr>
<tr>
<td>USD</td>
<td>US Dollar</td>
</tr>
<tr>
<td>WB</td>
<td>The World Bank</td>
</tr>
</tbody>
</table>
Introduction

The Islamic financial industry continues to exhibit strong growth potential and yet, observers have drawn attention to a gaping schism between its theory and actual practice. The industry faces the challenge of either evolving more decisively in alignment with its own ethical principles or to continue the same pattern of growth, thus further reducing its distinctiveness relative to conventional finance. Hence, the Islamic economic paradigm and Islamic financial industry per se are in a precarious position. This research addresses two important issues related to Islamic finance in Dubai’s context: the city’s ability to offer a unique framework for a more authentic development of the industry, and its readiness to operationalize such a system in a more comprehensive way. Prior to that, however, we shall critically assess whether the Islamic economic paradigm is worth operationalizing in the first place.

1. Research overview

Our interest in Islamic finance arises from the promise that Islamic economics and finance holds as alternative system for greater social and economic justice. As will be elaborated in this research, based on the Qur’anic prohibition of *riba*\(^1\) or interest and framed within the Islamic worldview, the Islamic economic paradigm comprehensively combines social and economic objectives into a risk sharing financial system strongly aligned with the real economy (Presley 1994; Chapra 1996; Buiter and Rehbari 2015). Emerging in the early 1970s as the most developed manifestation of an Islamic economy, the Islamic financial industry\(^2\) has grown into a respectful niche with 1,291 Islamic financial institutions (IFIs) spread across more than 70 countries\(^3\).

Numerous researchers have argued that the Islamic economic paradigm offers a distinct perspective on developmental challenges, addressing the issues of production, exchange, allocation and re-allocation, wealth and income distribution as well as institutions based on a rule and value-based system (Khan 1990; Jarhi and Zarqa 2007; Pryor 1984). Islamic economists contend that, being a market and value based system focused on comprehensive human well-being, the Islamic financial system’s main function is to spread and allocate risk among market participants. The end aim is to promote economic development while ensuring market stability and overall sustainability (Iqbal and Mirakhor 2013). In contrast to the Islamic economic doctrine, Islamic economists further argue, the conventional approach

---

1 *Riba* is typically translated as interest. Later in the study we shall show that in fact not all interest is *riba* and vice versa, not all *riba* is interest.

2 Important to note is the interchangeable use of Islamic economic paradigm, Islamic finance and Islamic banking throughout this research. When aspirations of the system are discussed the term Islamic economic paradigm is used. Alternatively when practical implementation is debated then we refer to Islamic financial industry and/or banking sector.

3 Thomson Reuters (2016)
focuses primarily on economic variables and generally neglects moral, psychological, social, and political considerations. Conventional or contemporary finance and economics are based on the following premises: self-interest, private enterprise, market mechanism and profit motive along with an interest based financial system. While the Islamic paradigm shares many of these fundamental elements with the conventional system, as it will be explained in this research, the differences between the two systems remain anchored with comprehensive *riba* ban. The distinctive features of the Islamic economic paradigm, the interest-free and risk sharing system, bear important systemic, institutional and transactional implications for stability and economic growth. Being equity-based, the Islamic system tends to develop stronger and less distorted links with the real economy and to reduce financial instability in comparison with a debt-based system.

As practiced, Islamic finance has gained in appeal and witnessed accelerated growth in the past 20 years, largely in banking, reaching more than USD 2 trillion of assets globally. Even during the recent 2008-09 Global Financial Crisis (GFC), Islamic financial institutions remained largely unscathed barring the negative spillover effect of a generally weaker economic and business environment. The emergence of Islamic bonds, *sukuk*, and their widespread appeal to investors of all asset classes have additionally propelled the growth of the industry, allowed it to join global capital markets and added to the convergence of Islamic and conventional finance. Consequently, the industry has established itself as a firm component of the global financial landscape (Hesse, Jobst and Solé 2009).

As the industry developed, observers started drawing attention to increasing resemblance to conventional financial practices, questioning the industry’s authenticity, distinctiveness and future developmental role (Boudjellal 2006; Mirakhor 2009; Rethel 2010). Indeed, following the trend of ‘innovation’, many instruments developed by Islamic banks resemble conventional products, lending credence to arguments regarding the convergence of Islamic and conventional finance practices (Beck et al 2010). In fact, our research reveals that Islamic and conventional banks are actually more similar than previously thought. Even *sukuk* were often structured in such a way as to satisfy the form at the expense of substance, thus only nominally meeting the requirements of Shari’a, the Islamic law. The notable judgement of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), in relation to *sukuk* transactions where issuers commit to redeem values at predetermined future prices, have effectively ruled most of *sukuk* issuances as either contravening Shari’a requirements or at least not genuinely sharing the spirit of the Islamic economic paradigm. Therefore, it seems that

---

4 Estimated market size for Islamic finance assets in 2015 was USD 2 trillion whereas the projected market size in 2021 is USD 3.4 trillion (Thomson Reuters 2016)

5 The Chairman of AAOIFI, Sheikh Taqi Usmani, stated in November 2007 that 85 per cent of existing Sukuk issues would not satisfy basic Shari’ah principles (Maurer 2010)
the growth of the industry was at the cost of a wider gap between theory and practice, which seriously challenges the objective of the Islamic economic paradigm to evolve as a distinct and viable alternative to the existing international financial system (Rethel 2010). Consequently, the aspired systemic benefits of greater economic and social justice seem to be more elusive than ever before.

There seem to be at least two prominent factors that explain the precarious position of the Islamic financial industry. The first is the dominant size of conventional financial markets where Islamic assets account for merely 1 per cent of global financial assets (Kammer et al 2015). Given this small size, the competitive pressures of the conventional financial system practically force Islamic financial institutions to espouse practices that are similar, at least in form, to conventional practices. The second factor is the industry’s heavy concentration in Islamic banking which accounts for more than 80 per cent of total Islamic assets. This level of excessive concentration deprives the system from the benefits of risk sharing on which the Islamic economic paradigm rests.

Therefore, in view of the above constraints, developing a more authentic Islamic financial industry with closer alignment to substance, as opposed to form, faces almost unsurmountable challenges. As our research reveals, it seems that the ability to break free from the path-dependence of the neo-liberal financial system is a necessary condition to reach authenticity (Othman and Mirakhor 2013). However, this is easier said than done. Firstly, it is vague which salient features a modern economy requires in order to support a more substantive and authentic development of the Islamic economic paradigm. Markedly, this is true even in economies where this mode of finance has already reached a significant market share. Secondly, it is not clear how a particular economy may develop a path-independent financial industry based on interest-free and risk sharing principles while remaining integrated in the global economy. In summary, the dichotomy between theory and practice of Islamic finance remains the most significant challenge facing the industry.

Even Malaysia, which is regarded as having the largest and most advanced Islamic financial industry, is not immune from this criticism of the global Islamic financial industry. While the Malaysian government’s strategic approach has enabled a more systemic industry development, closer inspection of key drivers of growth of the Islamic finance industry exposes the critical importance of the initial, 

---

6 Various industry reports including the IMF show that Islamic banking and sukuk assets are in excess of 95 per cent of total assets managed by the Islamic financial institutions or invested in Islamic financial instruments [http://www.imf.org/external/themes/islamicfinance/]

7 Islamic Financial Services Board (IFSB) classifies Islamic banks as systemically important in jurisdictions where their market share crosses 15 per cent. There were 11 such jurisdictions in 2016 (Islamic Financial Services Board 2016)

8 Salleh and Hamat (1997) cite racial clash of 1969 and resurgence of Islamic awareness in 70s as two key factors contributing to formulation and establishment of Malaysian dual financial system, conventional and Islamic. The emerging system was to provide framework for stronger economic participation of Malaysian Muslims.
relatively lenient interpretation of Islamic Shari’a requirements where the sale of debt is tolerated (Rosly and Sanusi 1999). In addition, various tax incentives, including tax deductions for five years on expenses incurred in the issuance of Islamic bonds, played an important role in deepening Islamic capital and banking markets (Samah et. al. 2011). It is not a surprise then that the Malaysian Islamic finance industry, similar to its global peers, shares the same lack of differentiation, at least in its current form, from its conventional counterparts. As a result, it follows a similar trajectory to the conventional industry (Krasicka and Nowak 2012).

We should mention that some attempts have been made to develop a more authentic industry, which include repeated calls for increased product standardization, Shari’a standards harmonization, adoption of country level Shari’a committees, and improved regulation. In addition, there have been notable efforts to establish the global institutional architecture in support of more substantive development of Islamic finance. International Islamic financial infrastructure institutions have strongly contributed toward institutionalization and professionalization of the industry, thus making it more adaptable to global best financial practices. Still, all these efforts fall short of making an actual impact on economies where these institutions operate, as there seems to be a limited number of avenues for the Islamic financial system to develop more holistically.

In fact, in addition to its small market size relative to the conventional financial industry and heavy concentration in Islamic banking, the third factor contributing to the widening dichotomy, as some argue, relates to the scope, depth and rigour of available literature dealing with the subject of Islamic finance and economics. For example, Farooq (2013) argues that Islamic finance should have improved the Islamic economics literature, but “the reality is that Islamic finance seems to have emerged as a cart before the horse”. An important methodological deficiency in the academic literature, he argues, is its lack of a problem-solving approach, which causes Islamic economic theory to remain rather abstract and utopic. Reflecting the industry’s development path, the Islamic economic and financial literature initially focused on Islamic economic theory and critiques of one or more economic theories prevalent in the world (Hunt-Ahmad 2013). Almost 70 per cent of the literature published by mid 1970s dealt with

---

9 Tax incentives include: tax exemption for profits derived from Sukuk, 10-year income tax exemption for domestic and foreign fund managers who manage Islamic funds for foreign investors, 3-year stamp duty exemption of 20 percent on instruments related to Islamic financing, Tax deductions on expenses incurred in establishing an Islamic stock broking firm, Tax exemption on profits paid by licensed Islamic banks in Malaysia to non-resident customers (PricewaterhouseCoopers Malaysia, 2008)

10 “International infrastructure institutions are those that collectively facilitate monetary and financial policy-making at the national level, and promote national development, financial stability and international financial integration, by helping to develop standards, guidelines and best practices, coordinating national policies, and organizing international financial and technical support” (IDB, IFSB and IRTI, 2007). These include Islamic Financial Service Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI), General Council for Islamic & Financial Institutions (CIBAFI), the Islamic Research and Training Institute (IRTI), the International Islamic Financial Market (IIFM), the Arbitration Centre for Islamic Banks and Financial Institutions (ARCIFI).
themes of the Islamic economic system and the critique of conventional economics. With the emergence of Islamic banking and its growth in popularity, scholarly attention diverted from Islamic economic theory to issues primarily related to banking. This new trend in research focused first on the efficiency and general performance features of Islamic versus conventional banks, then shifted to issues of profit-sharing, competition, and financial inclusion. But importantly, studies relating to Islamic banking and finance essentially eclipsed the wider issues of Islamic economics. Even more recently, following the Global Financial Crisis (GFC) and in response to systemic challenges in the conventional financial system, some of the design features of the Islamic paradigm were highlighted in an attempt to position the Islamic economic and financial framework as an answer to conventional economic and financial ailments. However, the recent explosion of research on Islamic banking has not narrowed the dichotomy between theory and practice, given the mentioned constraints of economic realities and the path dependent framework within which Islamic banking operates. Hence, as Farooq (2013) highlighted, it seems that the academic literature inadvertently contributed to the identified dichotomy.

Our research is, therefore, positioned as dealing with the central issue of relevance of Islamic finance and the Islamic economic paradigm as a potential alternative economic and financial system. It explores some key theoretical aspects of the system in an attempt to address the challenge of the growing schism between its theory and practice. Within this context, we examine Dubai’s potential to provide a conducive framework to narrow the identified dichotomy as well as its readiness to operationalize the Islamic system. Combining these two perspectives offers an academic contribution to the on-going debate concerning the relevance of Islamic finance and its ability to be a practical solution to address actual economic vulnerabilities.

1.1. Why Dubai

Being small and open, Dubai has made remarkable achievements in transforming itself from a fishing village into a modern and globally recognized business capital. Largely owing to its pro-business, tax free environment and rather unique governance system, Dubai has capitalized on the economic and financial opportunities offered by the global economic system. Recognizing that the unique nature of the relationship between the state, or ruling family, and the merchants has resulted in a unique governance approach. Hvidt (2006) describes Dubai’s model as a ‘deviant case’ of economic development - a feature apparently needed for the Islamic economy to chart its development path outside the conventional

---

straitjacket. In addition, being home to the first commercial Islamic bank in the world – Dubai Islamic Bank, Dubai has a cultural predisposition where Islamic financial services have a natural fit. Notably, even the United Arab Emirates’ Constitution defines the Sharī’ah Law as the main source of legislation in the Union\(^\text{12}\), an article not commonly found in other contemporary legal systems. Interestingly, and perhaps incidentally, the Dubai government has in fact set the strategic objective to become a global capital of the Islamic economy through the development of a more comprehensive and holistic Islamic economic ecosystem.\(^\text{13}\)

However, developing an Islamic economic paradigm, or rather Islamic finance, in an economy that has used debt finance excessively while relying at an earlier stage on hydrocarbon resources, raises many issues. Indeed, as the international financial crisis of 2008-09 unfolded, Dubai revealed its vulnerability and exposure to systemic risks, which resulted in a significant economic slowdown and raised doubts about the sustainability of its development path. Thus, an interesting research question is whether the unorthodox development approach that has been pursued and the key salient features of Dubai’s economy are conducive to a more substantive development of the Islamic economic paradigm and Islamic financial industry. After all, if others have not succeeded to implement the Islamic economic paradigm more authentically why would Dubai? If it does, would it then be able to continue interacting with global and regional partners as it does today? Is Dubai’s model based on a rentier-type governance that wedges the government elite and economic development objectives? Does Dubai’s already tax-free environment support the development of Islamic finance bearing in mind the lack of important tax incentives?

Answers to most of these questions are hard to find in the existing academic research on Dubai’s economic development. Scholarly work is scant and Dubai’s economic model, its salient features, institutions and instruments are largely undocumented. One reason is the lack of a comprehensive and consistent macroeconomic and sector database. It is worth noting that there has been several attempts. For example, Hvidt (2009) proposes a description of Dubai’s model and its development path by defining nine parameters\(^\text{14}\) which chiefly refer to a unique role of the government and its governance mechanism. A rather comprehensive contribution to the research and historical analysis of Dubai’s economic development has been made by Davidson (2008). He provides a detailed account of Dubai’s

---

\(^{12}\) Article 7 of the UAE Constitution

\(^{13}\) In October 2013 the Government of Dubai announced plans and the strategy to develop a comprehensive Islamic economy across various sectors, including sukuk, halal parks and standards, takaful, Sharī’ah governance, financial services regulations, etc.

\(^{14}\) Nine parameters are: Government-led development (ruler-led); Fast decision making and “fast track” development; Flexible labour force; Bypass of industrialization—creation of a service economy; Internationalization of service provision; Creation of investment opportunities; Supply-generated demand (“first mover”); Market positioning via branding; Development in cooperation with international partners
development from the early days of Trucial States to modern times. Al-Sayegh (1998) also provided a deeper understanding of Dubai’s state governance model and its relationship to the local merchant community. These works provide some important perspectives on Dubai’s economic development efforts, policies and outcomes. However, these authors seem to conflate outcomes of Dubai’s development approach rather than define key drivers. Others such as Sampler and Eigner (2008), focus on elements of Dubai’s development but fall short of providing an assessment of Dubai’s economic development model, taking into account its development path, economic performance and structures, incentives and other idiosyncratic policies into a comprehensive model.

Hence, in order to address literature gaps, a thorough analysis of Dubai’s development path, prospects, policies and institutions from the perspective of Islamic economics and finance is carried out in this research. As a result, we attempt to develop a novel and more comprehensive model of Dubai’s economic development. Such a model will provide the opportunity for the assessment of its relevance against the theory of Islamic economics and finance.

2. Research questions, aims and objectives

Given this background, the key question in this research is whether Dubai’s economic development model has the significant ingredients to offer as a suitable framework for a more substantive and authentic development of the Islamic economic paradigm. Our aim is to evaluate Dubai’s model and its potential against the theoretical framework of Islamic economics. Two important issues arise in that respect, one relating to Islamic economics and finance and the second more directly to Dubai’s development model.

The first issue is whether the Islamic economic paradigm is worth operationalizing in the first place where its defining features and theoretical promise to deliver greater social and economic justice and stability need to be understood in light of current practices. The second is whether, in fact, Dubai has followed an unorthodox development model that has the ingredients required to steer the economy away from the conventional or neoliberal economic framework and towards a more substantive practice of Islamic economics. The third and last issue is to assess Dubai’s readiness to actually operationalize the Islamic paradigm. This question is highly relevant in view of both Dubai’s deep integration into the global economic and financial landscape as well as the legacy of overreliance on debt.

To contribute meaningfully to the current debates on the role and potential of Islamic economics and finance and the issue of its dichotomy, our research question has essentially a twin focus. The first part deals with the theoretical aspects of Islamic economics and finance to critically assess its strengths and weaknesses and identify the deep causes of the widening dichotomy between the theory and practice.
Understanding first the nature of the objectives, institutions and instruments of the Islamic economic system, as they relate to economic development, is indispensable before gauging the relevance of Dubai’s economic development model. The second part of our research question, deals with an empirical assessment of Dubai’s ability and readiness to operationalize the Islamic economic and financial system with the view to ensuring growth and sustainability.

3. Research methodology and strategy

Given the degree of elusive nature of the Islamic economic paradigm, in terms of scope, meaning and expected outcomes, an appropriate research methodology is of particular importance for the credibility of this line of research. Recognizing that the paucity of empirical evidence on a comprehensive implementation of the Islamic economic paradigm and the lack of data on Dubai’s economic model may hinder the scope of our analysis, we base our research on a deeper examination of the Islamic economic and financial theoretical framework on the one hand and relevant procedures or tools for collection and analysis of data related to the Dubai economic model on the other.

Given data limitations, the initial choice between a qualitative and quantitative methodology seems to naturally favor qualitative research. Indeed, as we aim to conduct an in-depth analysis, develop an understanding and interpret both the Islamic economic paradigm and Dubai’s model of economic development, this research falls under the qualitative approach. Numerous authors highlight the flexibility, attention to details and concern for the context in the qualitative approach, all of which are highly relevant for our research and particularly essential for the interpretation of Dubai’s economic development model. Therefore, our analysis is an exploration of the theory of Islamic economics and finance as well as an interpretation of Dubai’s economic model within that context.

For Dubai’s economic model and the examination of its relevance towards a more substantive development of the Islamic paradigm, we use the case study approach. Yin (2013) reminds us that in contrast to common misconceptions that various research strategies should be used rigidly only for a specific purpose, each strategy, i.e. the case study, experiment, survey, etc., can be used either for exploratory, descriptive, or explanatory purposes. The choice of the appropriate strategy depends primarily, among other factors, on the following three conditions: (a) the type of research question posed, (b) the extent of control an investigator has over actual behavioral events, and (c) the degree of focus on contemporary as opposed to historical events.
Following Yin’s definition, and insofar we seek to understand Dubai economic development model as a centerpiece of our research, the thesis is essentially seeking to answer the ‘how’ question in terms of how Dubai’s has developed over time, i.e. explaining its economic model. In addition, ‘why’ Dubai provides a conducive macroeconomic structure for the development of the Islamic economic system relates the value proposition of the Islamic economic and financial paradigm to Dubai’s economic realities. Both these questions define our research as explanatory, and according to Yin it naturally favors the selection of the case study strategy. In addition, our approach consists of an empirical inquiry addressing a contemporary phenomenon in depth, within its real life context. Clearly, the fact that we have no control over the subject matter, which is the Islamic economic paradigm and Dubai’s contemporary economy, supports our choice to use the case study strategy over other common research strategies in social sciences. Therefore, as we explore the relationship between the Islamic economic and financial paradigm and Dubai’s economic development model, the case study approach allows a more comprehensive and explanatory investigation of various factors at play beyond economics, including historical, social, political, and geographic factors. Perhaps unsurprisingly, given the degree of flexibility it provides, the case study approach has become one of the most common approaches in qualitative inquiry (Stake 2000).

Moreover, given that an in-depth analysis of Dubai’s model of economic development in relation to the Islamic economic paradigm is our focus, this research can be classified as an intrinsic case study in which the case itself is of primary interest in the research (Creswell 2007). It is essentially driven by a desire to know more about the uniqueness of a particular case, rather than in extending the theory or generalizing across cases. However, as Berg (2004) argues, even while not aiming to generalize findings to develop a new theory as in instrumental cases, it is still possible that the explanations and lessons drawn from Dubai’s case are relevant to developing an understanding of the causes of the dichotomy between theory and practice in Islamic economics and finance. Indeed, we shall draw analytical conclusions similar to what Yin (2009) defines as “analytic generalization” where case studies are generalizable to theoretical propositions and not to populations or universes.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Form of Research question</th>
<th>Requires control over behavioral events</th>
<th>Focuses of contemporary event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experiment</td>
<td>how, why</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Survey</td>
<td>who, what, where, how many, how much</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Archival analysis</td>
<td>who, what, where, how many, how much</td>
<td>no</td>
<td>yes/no</td>
</tr>
<tr>
<td>History</td>
<td>how, why</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Case study</td>
<td>how, why</td>
<td>no</td>
<td>yes</td>
</tr>
</tbody>
</table>

Figure 1: Relevant Situations for Different Research Strategies; Source: Yin (1994)
Another important aspect of the research strategy is the choice between the deductive and inductive approach. This defines whether theory guides research – a deductive approach, or theory is an outcome of research – an inductive approach (Bryman 2008). Creswell (2013) highlights that the inductive approach is appropriate in cases where there is little existing literature as this approach will generate new data and may lead to new theories. Additionally, the inductive approach is more appropriate for qualitative studies that attempt to explore in-depth economic phenomena. In contrast, the deductive approach provides more guidance where a theoretical framework is well established. Our research is an interplay between these two approaches, as Strauss and Corbin (1990) have argued, there is an interplay between induction and deduction. Hence, this thesis adopts a mixed approach. As the deductive approach assumes the existence of a well-established theoretical framework and a rich literature, we use it in developing the understanding of the theory of Islamic economic and finance paradigm. On the other hand, in studying the case of Dubai, a new model of economic development is suggested following the inductive approach.

It is clear therefore, using a qualitative methodology - adopting the case study strategy and mixed, inductive-deductive approaches - this thesis focuses on interpretation, including design and a methodology that incorporates subjectivity, flexibility in the process of conducting the research and concern with the context, as suggested by Cassel and Symon (1994). We have endeavored to address key issues within a logical framework to gradually develop an understanding of the research question as explained further below.

3.1. Research design

The research design is a blueprint for the collection, measurement, and analysis of data (Blumberg et al. 2005). Kothari (2004) defines the research design simply by reference to decisions regarding what, where, when, how much and by what means an inquiry or a research study is conducted. Research designs are also classified into exploratory, explanatory, descriptive and hypotheses testing (Saunders et al. 2009).

As mentioned, our research uses the case study strategy. In fact, some authors refer to case studies as a type of research design and not necessarily a strategy (Bryman 2008). However, as mentioned, we shall explore the relationship between the Islamic economic and financial paradigm and Dubai’s economic development model. Such exploratory research is typically conducted on a new issue where researchers have written little and on which there is limited information. Indeed, as will be more elaborated below, given the paucity in the academic literature on the subject, this thesis seeks to explore the extent to which Dubai’s economic structures may provide a useful framework to bring the needed impetus for a more authentic development of the Islamic economic paradigm and Islamic finance.
Being exploratory in nature, this research purports to be a contribution to the theory and practice of Islamic finance. However, it is worth mentioning that the research may also be classified as explanatory in so far as it deals with Dubai’s economic model far more comprehensively than the existing literature. Indeed, Yin (2009) defines that even a single-case study can be usefully applied to conduct an explanatory study and not merely an exploratory or descriptive one.

### 3.2. Research method

Being distinct from the research methodology, research methods are used in the course of studying a research problem (Kothari 2004). The research method reflects the methodology adopted whether qualitative, quantitative or both. Data collection and data analysis techniques are important elements of the research method discussed below.

#### Data collection and sampling

The thesis makes extensive use of the existing body of theoretical and empirical knowledge about Islamic economic development and Islamic finance, sustainable economic development, financial markets development (including Islamic finance), and on their contribution to economic development. The analysis draws on high quality and relevant publications that are recognized references in the field. In addition, we use available analytical research on Dubai, the UAE and the GCC’s economic and financial development. However, the scientific literature on Dubai’s development remains limited. We also consult the Quran and Sunnah to analyze the meaning of interest prohibition as well as other injunctions relevant to the conduct of economic activities. To gain insights into Dubai’s economic and financial strategy, primary interlocutors include Dubai’s Governmental departments, the Dubai Islamic Economy Development Centre, Dubai Financial Markets, and the Dubai International Financial Centre. The top official of these government agencies and departments along with some leading economists and private sector champions were approached for interviewing purposes.

Our field work is specifically designed to test key aspects of the research question to feed into critical analysis and draw relevant conclusions. As such, the research centres on the two focus areas as spelled out in the main research question. The first relates to the Islamic economic and finance framework as related to economic development and stability in general, and the second to Dubai’s economy and its development path. Both topics are addressed within the context of Islamic economics.

Our primary data is collected through in-depth semi-structured interviews. Given the paucity of readily available information on Dubai’s Islamic economic sector, semi-structured interviews with key decision makers in Dubai’s Islamic finance industry are used to test major propositions of this thesis and to gauge
Dubai’s leadership views as well. The approach used in the selection of interviewees followed the purposive sampling method or judgmental sampling method as a non-probability sampling procedure in which the judgement is used to select the cases that make up the sample (Saunders et al. 1999). Hence, the interviews are conducted with a careful and deliberate selection of Dubai business leaders and policy makers with deep insights and practical experience in Islamic finance and Dubai’s economic development in general.

The interviewing pool included five top public sector decision makers involved in the financial industry, small and medium size enterprises (SMEs) development and economic development in general: two chief executive level practitioners of Islamic finance, two Shari’a scholars including Dubai’s mufti, two leading economists, and one real estate industry leader with extensive experience in Islamic finance and development. The selected interviewees are considered insiders with a long track record and deep knowledge of Dubai’s strategy and insights on Dubai’s economic development in general and Islamic finance in particular. We are well aware, as Creswell (2013) has stressed, of the concern that a qualitative researcher may face in gaining access to potential participants as the selected interviewees may be regarded as a ‘gatekeepers’ or insiders, in this case with respect to Dubai’s economic development. In fact, this is one of the key obstacles associated with conducting interviews as a primary data collection method (Aberbach and Rockman 2002). However, given our familiarity with Dubai’s context15, we were able to establish rapports and contacts without difficulty. As it has turned out, all interviewees found the research subject highly relevant and timely in terms of Dubai’s strategic development alternatives.

The semi-structured interviews were conducted in two phases. In the first phase, a set of questions outlined below was prepared based on the research conducted on the Islamic economic paradigm and the newly proposed Dubai development model. These interviews were then carried out using a combination of techniques including one-to-one and emailed interviews. Keeping in mind that we have conducted interviews with some of the most senior individuals, and given Dubai’s cultural context, these techniques are better suited than telephone or focus group interviews. The same set of questions was addressed to all interviewees. Therefore, the choice of semi-structured interviews seems to be a logical outcome, given the range of topics and the multiple issues raised, while providing the direction and the agenda for the discussion.

15 The researcher spent 8 years working in Dubai’s financial industry and public sector as an economic adviser prior to inception of this research.
Data analysis technique

There were two sets of data used in this research, macroeconomic data on Dubai’s economic performance and qualitative data obtained from the in-depth interviews. The macroeconomic data lays the empirical foundation of Dubai’s economic model and was procured from credible sources such as the Dubai Statistics Centre, the Dubai Department of Economic Development, the UAE Central Bank and other Government sources. A common economic performance analysis was used to interpret this data. However, with respect to qualitative data, the flexibility in qualitative strategy brings a challenging analysis task as there are no common rules and procedures for extracting data and drawing conclusions (Creswell 2013; Miles and Huberman 1994). For this research, the data analysis strategy entailed documenting all the qualitative data obtained from in-depth interviews by audio-recording resulting in 296 min (4hrs and 56min) of recorded materials; only three interviews were received and documented by email, at the interviewees’ request. All the interviews were conducted in English except for a single interview that was received by email in the Arabic language and then translated into English by a professional translator.

For the qualitative data obtained, we have adopted the three-staged analysis consisting of data collection, data management and verification. This model is similar to that of Miles and Huberman (1994) which uses data reduction in lieu of data management. Hence, initially the qualitative data collected from the in-depth interviews were systematically organised into themes or categories and further broken down into specific discussion focus. The themes and discussion focuses were decided in the course of the research aligned with the purpose of the research, i.e. main research question, as well as findings of our mixed, deductive and inductive analysis of the Islamic economic paradigm and Dubai’s economic development model respectively. Table 3 below summarizes the main themes and discussion focuses:

<table>
<thead>
<tr>
<th>Main theme</th>
<th>Discussion focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Theory and Practice of Islamic finance</td>
<td>Distinctiveness of Islamic economics and finance and its dichotomy between theory and practice</td>
</tr>
<tr>
<td>2. Motivation behind the economic development in Dubai</td>
<td>Role of Islamic teachings and values in shaping Dubai’s economic model; Motivation to use and develop Islamic Finance</td>
</tr>
<tr>
<td>3. Role of Islamic finance in Dubai</td>
<td>The issue of integration vs convergence between Islamic and conventional economy; Past and present role of IF in Dubai’s economy and its main drivers; Challenges</td>
</tr>
<tr>
<td>4. Development of IF in Dubai, challenges and opportunities</td>
<td>Relation between conventional and Islamic economic and financial system, need to reform; Risk sharing and asset based, equity finance development; Islamic finance development in</td>
</tr>
</tbody>
</table>
The third stage is data verification where data obtained from the semi-structured interviews was related to secondary sources of information, including statistical macro-economic data as well as previous findings of this research. Importantly, data analysis is a dynamic process that starts with the very data collection processes and continues throughout research to produce valid conclusions.

In addition to primary data, the research draws on textual analysis of various secondary sources of information, especially those related to the theory of the Islamic economy and finance and Dubai’s economic model. In addition, we use hermeneutics or the interpretive analysis of texts to study and analyze the Quran and Sunnah.

4. Theoretical framework

The literature on Islamic economic thought and finance is quite vast, as it purports to take a more holistic, interdisciplinary approach that draws on social sciences beyond economics. A resulting challenge is to demarcate key aspects to focus on and to define key concepts, such as the Islamic economic paradigm and Islamic financial system, which seem to be quite abstract.

4.1. Historical context

At the very outset, it is vital to elucidate the theory and practice of Islamic economics and finance by contextualizing it within a historical perspective and differentiating the emergence of contemporary Islamic finance. Even though most contemporary writings on Islamic economics and finance do not dwell on it, the history of Islamic finance begins with the emergence of Islam in the 8th century and its spread from China to Morocco (Moisseron et al 2014). It was during this period that Islamic civilization was the most fertile ground for intellectual activity, including socio-economic thought that significantly contributed to the European renaissance (Ghazanfar 2003). In fact, a substantial body of contemporary economics is traceable to Muslim scholars of the time such as al-Ghazali, Ibn Khaldun and others (Ghazanfar and Islahi 1990). During this period, Islamic civilization represented about the most fertile environment of intellectual activity in almost all areas of then known endeavours, including socio-economic thought, and contributed to the promotion of culture and science including economics (Islahi
Historically, there is ample evidence that Islamic finance or the Islamic economic system was the order of the day during the peak of Islamic civilization. Many authors such as Çizakça, Udovich, and Islahi, highlight the important contributions the Islamic economic system made to modern day civilization and development. For example, Çizakça (2013) provides detailed accounts of Islamic leadership in trade, exchange and development where Western counterparts interacted, shared and even adopted features or even whole contracts from Islamic finance. However, following its fervent climb and after reaching its zenith, the Islamic civilization and its intellectual and political power started receding by the early 16th century (10th Hijri century) into oblivion and, as Chapra terms it, into a state of hibernation.

Interestingly, in his monumental work Joseph Schumpeter (1954, pp 73-74) identified ‘the great gap’ in the evolution and development of economic thought which coincided with the golden era of Islamic civilization. According to him, the five centuries between the Greeks and the Renaissance were simply “blank” centuries. In response, Islahi, Ghazanfar, Mirakhor and others have provided ample evidence refuting the ‘great gap’ thesis, highlighting contributions of Muslim scholars in preserving the continuity and growth of mainstream economics. Hence, a discontinuity of Islamic civilization as a consequence of intellectual hibernation has likely contributed to Islamic economics appearing anew raising questions about its relevance to modern economies.

It is therefore only pertinent to ask what role can Islam and the Islamic economic paradigm play in shaping some of the current debates on needed economic transformation (Moisseron et al, 2015). This question echoes the debate about whether Islamic institutions are inimical to the growth and development of Muslim societies, which also relates to a new Weberian critique of Islam and Islamic economics, arguing that Islamic institutions were incompatible with capitalism primarily because they had been dominated by a long history of patrimonialism (Turner 1974). Similarly, Kuran points to remnants of Islamic institutions as key reasons for the persistent underdevelopment of the Islamic world (Kuran, 2003). Kuran goes even further to argue that ‘the main purpose of Islamic economics is not to improve economic performance..., its real purpose is to help Muslims from assimilating into the emerging global culture whose core elements have a Western pedigree..’ (Kuran 1995). Hence, according to these authors, the underdevelopment of the Islamic world is traced back directly to Islam, as its institutional set up is effectively dissonant to progressive economic development and growth.

---

16 Islahi (2005, p 12) divides the history of Islamic Economic thought into three periods: First phase, the formation period covering the period just after cessation of the revelation to the end of the Companions’ era, (11–100 A. H./632–718 A.D.); Second phase, the translation period when foreign ideas were translated into Arabic and Muslim scholars got an opportunity to benefit from the intellectual and practical works of other nations (2nd–5th/8th–11th century). Third phase, the re-translation and transmission period, when Greco-Arab Islamic ideas reached Europe through translation and other contacts (6th–9th/12th–15th century).
Many authors have extensively countered by providing evidence of pitfalls in Weber’s and Kuran’s arguments. Perhaps the most obvious and most common counterargument is that Islamic finance and Islamic economic principles are not implemented anywhere today in a comprehensive and cohesive manner. Pryor (2007) conducted an extensive econometric study using 44 indicators of economic institutions to conclude that it is not Islam that holds back the development of predominantly Muslim countries. It is ‘rather the same factors unearthed by development economists that explain economic backwardness in so many other countries in the world’ (Pryor 2007, p1828). In fact, some argue that underdevelopment is largely due to the absence of the institutional scaffolding, collection of rules and norms with enforcement features, which are recommended by Qur’anic teachings (Askari 2013; Iqbal and Mirakhor 2011). It is therefore important not to confuse the current economic state of predominantly Muslim nations with their religious affiliations.

Importantly, the Western concept of economic development emphasizes efficient institutions— a political system that nurtures institutions and prohibits rent seeking and a social view that embraces human development such as education, health care, poverty eradication, a more even income distribution, sustainability and freedom (Askari 2013). These regulations are designed to protect those who will suffer from solely market-based policies, which reduces the gap between conventional economic models in the West and the ideal Islamic economic and financial model. Askari argues succinctly that the evolved conventional economic thought is akin to Islamic teachings, albeit with two differences. The first is that Islamic economics ‘embraces heavier doses of economic and social justice, morality humanity, compassion, generosity and charity, and the second is that – ‘Islam places more emphasis on rule and rule compliance’ (Askari 2013, p158).

4.2. Interaction between Islamic and conventional finance

Given the historical interaction of Islamic and conventional economies, the emerging nature of the modern form of Islamic finance and the hailed convergence with the conventional system, albeit at the expense of its own principles, the interaction between the Islamic and conventional economic and financial systems is particularly relevant for our research. The epistemological background of the contemporary economic and financial system, as known today, stems out of a paradigm laid down by Adam Smith in his book, The Wealth of Nations (1776). However, what is less known is that Smith’s vision of the economy was also framed in a moral-ethical system, described in his book The Theory of Moral Sentiments (1759) where the market’s ‘invisible hand’ is referred to as the design of the Creator (Mirakhor and Bao 2013). Since then, Chapra (2016) argues, conventional economics has moved away from its ethical roots and evolved into a contemporary positivist and pragmatic system focused on wealth creation and efficiency.
The central feature and the prime reason for the existence of the Islamic economic approach - the prohibition of interest, or *riba*, in all its forms, has remained over time. It is also worth mentioning that the prohibition of interest is not specific to Islam. Importantly, the Qur’anic prohibition of interest (*riba*) also includes the permissibility of trade (*al-bay’a*). *Al-Bay’a* or trade in Islamic finance as a contract of exchange is of paramount importance. It is a contract of risk sharing as opposed to *riba* which is a contract of risk transfer (Mirakhor and Bao 2013; Chapra 1993). Islamic finance as a system, therefore, requires not only the avoidance of interest, as it is the prevalent practice today, but more importantly the establishment of risk sharing mechanisms. As highlighted by Mirakhor and Krichene (2009) and Sheng and Sing (2012, p10), even Keynes argued that if interest did not exist, the financier would have to share in all risks the entrepreneur faces in producing, marketing, and selling a product. According to their interpretation, Keynes made a common cause with Christian scholars and medieval church in denouncing usury. He further argued that a non-market but low or zero interest rate is the right policy.

But, economic development barely existed as a field of economic research before the second half of the twentieth century (Harris 2000; Toye 2003). Since then, conventional economic thought has progressed from focusing on objectives of structural transformations and productivity issues to including wider general human-development concerns. Lately, due to its fundamental flaws particularly exposed during the recent GFC, the conventional economic system seems to be closing the gap between the two systems, at least in theory. It seems that there is increasing realization of the importance of the convergence of economic, social and environmental objectives in defining development alternatives (Harris 2000). This convergence increasingly reflects the increasing role of Corporate Social Responsibility (CSR) in microeconomic affairs. Notably, Porter and Kramer (2011) argue that the prevailing conventional system is missing a connection between societal and economic progress and the CSR is not sufficient to address the societal objectives as it is not at the core of business but rather peripheral. Similarly, Colander et al. (2004, p.485) posits ‘that economics is moving away from a strict adherence to the holy trinity—rationality, selfishness, and equilibrium—to a more eclectic position of purposeful behaviour, enlightened self-interest and sustainability’. It is not a surprise then that some authors ask whether the two systems, Islamic and conventional, should converge (Cavalier 2013). Following the analysis of Canonical texts, Cavalier also concludes that the two systems in their origins are closer than it may appear.

We should also recall that the Islamic proposition of an interest free economy was initially considered as incompatible with modern day economic analysis and would result in gross misallocation of resources. But, following the GFC, it is clear today that most criticism alleged in early days is dispelled.

---

Sheng and Singh (2012) cite Mirakhor (2010) who summarized major criticism of interest free economy: that zero interest meant infinite demand for loanable funds and zero supply; such a system would be incapable of equilibrating demand for
by the states applying a zero interest rate policy as a part of a quantitative easing policy. This example is supportive of two points, the first that the Islamic finance principle has remained unchanged through time, and the second that conventional practices have evolved in practical terms to close some important gaps between the two. The evolutionary nature of conventional economics and rather the discontinuous development of Islamic economic or rather of Islamic finance, as well as their interaction are important to keep in mind while addressing an issue as important as that of the dichotomy in Islamic finance. In addition, it seems pertinent to keep the perspective that the two systems, Islamic and conventional, not only share some commonalities but are in fact attempting to address common economic issues and financial challenges. Focusing on differences rather than commonalities and thereby segregating Islamic framework may further lead to the absence of problem solving as identified by Farooq (2013). Such lack of relevance inevitably may further widen the dichotomy.

4.3. Islamic economics as an alternative system: A fiction or a reality?

Islamic economics was born in its modern version in the 1970s. The exact motivation for its emergence remains a moot point. Reflecting discontinuity of Islamic economic scholarship and even more importantly incoherence in its practice, there is no evidence that Islamic economics has emerged as the result of conscious efforts to introduce the system comprehensively. Hence, it seems that Islamic finance has emerged even prior to a more systemic Islamic economic thinking, as a practical endeavour to conduct interest free business activities.

Rather, it seems that Islamic economics or the first banking institutions compliant with the Shari’a have simply sought to provide an interest free alternative to prevailing conventional financial institutions. Specifically, it was largely the prohibition of interest that has prompted Muslims to initiate today’s modern version of Islamic banking and finance (Siddiqi, 2006 p2). Naturally, given the predominance of banking institutions, Islamic finance has then taken the form of contemporary Islamic banking.

and supply of loanable funds; with zero interest rate there would be no savings; this meant no investment and no growth; in this system, there could be no monetary policy since no instruments of liquidity management could exist without a fixed predetermined rate of interest; and, finally, this all meant that in countries adopting such a system there would be one way capital flight.

18 Islahi (2004) records that “the first article to introduce economic thought of Muslim scholars was written by Salih (1933) in Arabic entitled ‘Arab Economic Thought in the Fifteenth Century’ in which he discussed economic ideas of Ibn Khaldun, al-Maqrizi, and al-Dulaj. Next, alHashimi (1937) published his paper on “Economic Views of al-Biruni” again in Arabic. The same year Rifat (1937) wrote on ‘Ibn Khaldun’s Views on Economics’ in Urdu. The first paper in English was written by Abdul-Qadir (1941) entitled “The Social and Political Ideas of Ibn Khaldun”. And the first Ph.D. on the subject was awarded by Cairo University to Nash’at (1944) on ‘Economic Thought in the Prolegomena of Ibn Khaldun’ written in Arabic”.

27
Yet another and rather original view is that it was in fact conventional finance itself which has actually given birth to Islamic finance (Mirakhor and Bao 2013). This perspective appears to be contradicting the somewhat established perception that conventional and Islamic finance do not share the same intellectual frameworks and hence it would be hard to argue how and why conventional finance is the origin of the emergence of Islamic finance. According to these authors, the emergence of Islamic finance was due to the failure of conventional finance to satisfy the needs of specific market segments demanding Shari’a compliant financial intermediation. Given the explicit ban of interest in Islam, market segments of a religiously sensitive population were therefore left unattended by the conventional system. This view highlights the important perspective of complementarity between financial systems and the need for financial inclusiveness where Islamic finance may play an important role.

Given the varied views about the circumstances and motivation underlying the emergence of Islamic economics, there is some disagreement among scholars regarding the concept, methodology and the objective of the Islamic economics as a discipline. This includes even the very definition of Islamic economics. For example, Kahf (2003) argues that ‘Islamic economists need to rethink what economics is all about and whether we really have to create an alternative to ‘economics’ in the form of ‘Islamic economics’ or simply to have an Islamic perspective on the same discipline’. Kahf importantly defines a framework criteria to include the ‘existence of Islamic axioms in the social, political, and legal environment, a system of values and ethics which guide the economic behaviour of men and women in an Islamic society’ that need to be satisfied if Islamic economics is to be regarded as a system. In an attempt to define such determinants, Asutay rightly argues that Islamic economics represents an alternative system as it possesses the value system, axioms, and operational principles working according to its methodology (Asutay 2007,p12). Indeed, in line with Asutay’s argument, Islamic economics has the necessary features of a system that may be an alternative to the current capitalist modes of production.

Moreover, an important conclusion Asutay makes is that ‘Islam does not prescribe a particular economic system, but provides the core elements and principals, which form the basic philosophy of the system of an economy’. This echoes the conclusion that ‘the Islamic doctrine of economics permits degrees of individual freedom and state intervention, but leaves the determination of those degrees to the wisdom and conscience of those involved… This flexibility has made Islamic economics open to alternative options within its framework’ (Pryor 1984, pp198, 219). Indeed, this seems to be a reasonable explanation why the Islamic economic framework has not been firmed up or agreed upon by most economists.

---

19 Some question the need to use prefix ‘Islamic’ to ‘economics’, eg. Tayser Abd al Jaber in (Kahf 2003)
While it may not be particularly useful to observe systems as superior or inferior, Hefner sums it up as ‘Islamic economics is a modern movement that asserts that Islamic traditions of law and organization provide a more just and equitable model for economic growth than do the rival systems of Western capitalism and socialism’ (Hefner, 2006 p17). The superiority of any economic system, the Islamic one in particular, is rather challenging to prove given the lack of empirical evidence. Therefore, recognizing the divide between the theory and practice of Islamic economics and finance, the current form of Islamic finance practice is the second best solution where the first best framework provided by theoretical Islamic economic system being practically non achievable (Asutay 2007, p13).

4.4. Islamic finance: a factor of stability?

Rooted in the Islamic worldview, it is not only measures of wealth or growth that serve as objectives in Islamic economics. Islamic economics champions the concept of development in its broad sense, a comprehensive human development. A risk-sharing paradigm as a cornerstone of Islamic economic paradigm, so the theory argues, is the real basis for stable and sustainable development. Premised on risk sharing objectives, Islamic finance is essentially equity and asset based finance and largely a debt-free system.

This prohibition of *riba* and the development of risk sharing mechanisms essentially necessitate different economic structures that, in theory, should lead to increased economic stability and better allocation of resources. This is in contrast to the conventional financial system that allows, via debt instruments, risk concentration among borrowers (Hussain et al 2016). A non-leveraged economy is certainly a strong argument for more stable and sustainable development. Indeed, debt was the root cause of financial crises in the last 50 years, including the recent GFC (Reinhart and Rogoff 2010). Islamic finance intermediates by the provision of capital for either trade or production in close alignment with the real economy. Those with financial needs that are not related to trade or production may avail *qard-al-hassan* (benevolent loan), an interest free loan. Essentially, *qard-al-hassan* is the only debt-based instrument that is used for consumption smoothing by those who experience liquidity shocks. As such, the core function of the Islamic financial system is to spread and allocate risk among market participants (Mirakhor 2012).

Even banking in the Islamic framework is structured to avoid *riba*. This is accomplished by essentially combining 100 per cent reserve banking system and equity-based investment banking. Structurally, Islamic banking makes good appeal to proponents of 100 per cent reserve banking system which was debated as potentially a superior banking model supporting economic stability. It was in fact part of the Chicago Plan which envisaged the separation of the monetary and credit functions of the banking system (Benes and Kumhof 2013). A number of prominent economists strongly argued in favour of the
Chicago plan on the basis of its 100 per cent reserve banking proposal (Fisher 1936). More recently, following the GFC similar proposals for the abolishment of fractional reserve banking resurfaced but, likely due to the systemic changes required, its recommendations were not actioned. Notably, the design of business models of Islamic banking institutions, as explained above, has largely protected Islamic financial institutions from system shocks of the GFC. Islamic banks did not have exposure to toxic assets as fundamental Islamic principles prevent investing in excessively risky subprime assets and derivatives (Hasan and Dridi 2011).

However, beyond the system design differentiation, Beck et al. (2010) report little significant differences between Islamic and conventional banks, comparing indicators of business orientation, cost efficiency, asset quality and stability of conventional and Islamic banks. Therefore, there is widely accepted dissatisfaction with the pace and direction of progress made in Islamic economics and Islamic finance practices.

It is therefore fair to argue that the ideal Islamic economic system does not exist today in practice, even though some countries have adopted various features thereof. In fact, many markets have combined some features of Islamic and capitalist systems and established what may be referred to as a hybrid system which has effectively ‘upgraded’ the capitalist system with one or more features of the Islamic one (Iqbal and Mirakhor 2013). Typically, this has included Islamic banking and capital markets institutions and instruments. Hence, it is reasonable to question whether Islamic finance as a system aims to be a true alternative, given the direction of its development and the move towards capitalism it has taken (Tripp 2006). In fact, we can even ask if Islamic banks are not only changing the terminology i.e. ‘Islamizing’ the language of finance just to conduct the transactions in a more convoluted and complicated way. Indeed, it becomes relevant to question if it is feasible at all to translate the theory of Islamic economics and finance into a practice.

4.5. At the cross-road

Debates on the purpose and origins of Islamic economics and by the same token of Islamic finance reflect the challenge of differentiation in theory and practice. As indeed may be the case that the theory of Islamic economics and finance is following the practice (Siddiqui 2006), rather than the other way

---

20 Advantages of 100 per cent reserve banking system claimed by Fisher (1936) include: (1) Much better control of a major source of business cycle fluctuations, sudden increases and contractions of bank credit and of the supply of bank-created money. (2) Complete elimination of bank runs. (3) Dramatic reduction of the (net) public debt. (4) Dramatic reduction of private debt, as money creation no longer requires simultaneous debt creation.
around, the main challenge is to find ways to implement the system in a more comprehensive and authentic manner. While Kuran’s argument that Islamic institutions are responsible for the underdevelopment of the Islamic world is unconvincing, the lack of more meaningful application of Islamic finance, and sufficient empirical evidence, poses significant difficulties for the theory to develop and provide more significant insights for economic development. Indeed as research points out, a more comprehensive implementation of the system would require that the practical implementation leaves the straitjacket of conventional economic thought (Chapra 2000; Othman and Mirakhor 2013).

Interestingly, while the recent GFC revealed fundamental weaknesses in the current functioning of financial markets, raising serious questions about global economic relations and fundamentals, the Islamic economic paradigm and Islamic finance have remained largely on the side-lines of the on-going debates.²¹ The Islamic financial industry was largely shielded from the crisis and the adherence to Shari’ah principles in particular precluded Islamic banks from exposure to toxic instruments that have adversely affected conventional competitors (Hasan and Dridi 2010). This is despite strong similarities between Islamic and conventional financial institutions at the product level, as highlighted earlier. The GFC seems to be not only a prime example of a debt-driven financial and economic crisis of catastrophic magnitude, but it has also encapsulated other major systemic flaws that the Islamic economic paradigm prevents by its very design. This includes an inherently weak and unstable banking system, the issue of financialization of the financial sector, pronounced moral hazard issues, skewed incentive policies, and finally, systemic greed, among other factors. The root cause, Islamic economists argue, is the interest as a key driver of the whole system (Chapra 2008).

Therefore, it is indeed puzzling why Islamic economics has not been more actively involved in the debates on sustainable development. The Islamic economic paradigm therefore, may be argued, is self-imprisoned in the framework of the conventional, neoliberal economic system. As a result, it seems that the Islamic economic paradigm suffers from non-recognition not only by the West but also by Muslims themselves. As emphasized previously, Islamic civilization has contributed to the preservation and then development of various social and natural sciences, including economics. These contributions were possible only through focus on substance which seems to be missing from the contemporary practice of Islamic finance.

²¹ It has to be noted that some prominent Islamic institutions of global stature, such as Islamic Development Bank and International Financial Services Board along with the World Bank and the IMF and handful academic institutions and institutes, have produced research papers and analyses of the GFC from Islamic perspective. While praiseworthy these efforts seem to fall short of a stronger voice in the academia and practice alike.
4.6. The case of Dubai

Dubai has attracted our attention, as mentioned, not only for its economic achievements but more importantly due to what seems to be an unorthodox developmental approach. The Dubai\textsuperscript{22} model has also received many criticisms for being inherently unstable or as Walters et.al (2006, p87) put it ‘a country in which fantasy, sometimes rather than actual accomplishment is admired and rewarded’. However, whether being admired or critical, past research has not achieved yet a comprehensive assessment of Dubai’s economic model that integrates its historical, cultural, social, economic and other factors in a way that well defines its non-orthodox developmental approach.

Given the role played by natural resources at an earlier stage of its development, the analysis of Dubai’s economy drawing on the Rentier State Theory (RST)\textsuperscript{23} seems also to be pertinent. Some writings consider Dubai’s model by reference to that theory and to neo-partrimonialism. Originally Mahdavy and later Gray attempted to highlight economic challenges faced by the oil exporters and suggested ways for addressing such problems. But Ruthledge posits that the theory of the RST became more deterministic (and pejorative) in nature in the late 1980s and onwards (Ruthledge 2014). Gray discusses the RST theory in view of economic achievements firstly in Dubai, but also in Abu Dhabi and Qatar, and concludes that these states do not fit in the original framework of this theory (Gray 2011). El Katiri aptly describes the strong economic-welfare function and defines the GCC states as ‘Guardian States’ whereby a benevolent state elite aims to maximize social welfare supported by the state autonomy in decision making (El Katiri 2014). The relatively small population size, geographical position, and inherited governance mechanisms i.e. tribal societies etc., are some of the key reasons for the apparent divergence from the expected outcomes of the classic RST.\textsuperscript{24} Therefore, Dubai’s model is recognized as atypical, not falling into the usual rentier type of economies.\textsuperscript{25}

In relation to Dubai’s financial sector, some relevant analysis has been done such as Al Hassan et al (2010) and Woertz (2008), albeit discussing the regional financial and banking systems. There is also limited research on Islamic finance in Dubai despite a handful of papers are available on the broader regions of the GCC or MENA. Perhaps, a positive consequence of the GFC has been an increased

\textsuperscript{22} In some instances reference to Dubai and/or UAE is used interchangeably reflecting research findings and data/information availability that is common to, both, the Emirate of Dubai and the United Arab Emirates.

\textsuperscript{23} The first to define RST was Hussien Mahdavy in 1970 writing about Iran before the revolution. Later Hazem Beblawi and Giacomo Luciani were some of early proponents of this concept. The theory considers the state to be autonomous from society. It assumes that states do not need to impose any taxation as long as they distribute rent income to society. In turn the state does not need to have any development strategy.

\textsuperscript{24} Ibid, page 25

\textsuperscript{25} Rentier economies are typically associated with resource rich economies in which state is merely distributing wealth on the basis of their income from rents from oil and gas. As such the state does not need develop proper economic development plans.
recognition and awareness of the importance of financial institutions in the GCC and MENA economies and likely differential performance of conventional and Islamic banks. As a result, some research has emerged on the GCC-wide financial industry with some focus on Islamic finance. For example, Tai attempted to identify the efficiency levels and sources of banking system performance, including Islamic financial institutions (Tai 2014). Some of this analysis has addressed Dubai’s debt crisis. An inadequately developed financial industry, Islamic or otherwise, has significantly contributed to the emergence of the crisis. Combined with the GFC external shock, it led to significant negative consequences (Zaki et al. 2012). Nassehi argues that capital market liberalization, as championed by the IMF and the World Bank since 1990s, has proven again to be a destabilizing factor for Dubai’s economy (Nassehi 2013). Chailloux analyses the UAE Central Bank measures, such as the three-year guarantee of all bank deposits and the injection of further deposits of AED 70 billion into local banks in addition to a AED 50 billion credit facility, and concludes that the Central Bank’s proactive measures helped to send strong signals to the markets and hence stabilize the industry (Chailloux 2007).

In relation to the Islamic finance industry, Dubai has made significant strides and expanded the industry into a diversified network of service providers that include commercial banking, asset management, sharia consulting, takaful, awqaf etc. Today, Islamic assets represent about 21.4 per cent of market share with close to 15 per cent annual growth (Ernst & Young 2014). Dubai’s economy has recorded average GDP growth of 6 per cent p.a. from 2006-2012 while the financial sector grew at double-digits with an average growth of 13 per cent during the same period.

Importantly, Dubai has not followed the ‘classic’ path of industry development with strong government intervention and support via regulatory and fiscal incentives and institutional development. Dubai, or the UAE for that matter, does not fall into the category of jurisdiction with proactive government intervention such as Malaysia for example (Hasan 2010). Instead, Dubai invested directly into economic activities and corporate institutional development. As a result, its Islamic finance industry has recorded impressive growth and diversification rates. Therefore, it is not only outcomes but also the path of Dubai’s Islamic finance development that has relevance and lessons for the future of Islamic financial services.

Some work has been done on Dubai’s financial sector and Islamic banks’ performance. Miniaoui and Gohou (2011) find that prior to the crisis, conventional banks in the UAE performed better than Islamic banks. But, following the crisis, Islamic banks closed the gap for most performance indicators. Al Tamimi (2010) explored the factors influencing the performance of UAE’s conventional and Islamic banks to find that the liquidity available is a key factor for the performance of conventional banks, while in the case of Islamic banks it is the cost and strong presence in the retail market with the number of branches as a key indicator. Ali (2011) explains the better performance of Islamic banks on the account of (i) Islamic banks’ financing activities being more tied to the real economy, (ii) Islamic banks’ avoidance of direct
exposure to toxic debt and derivatives, and (iii) significant liquidity available. Beck et al. (2013) also add higher capitalization and better asset quality for Islamic banks in general. In contrast, Bourkhis and Nabi (2012) argue that there is no significant difference in terms of the effect of the financial crisis on the soundness of Islamic banks as opposed to conventional banks. Notably, the available literature on Dubai’s Islamic financial sector seem not to go beyond documenting, comparing and contrasting the sector against its conventional counterpart. A deeper analysis linking the sector’s prospects and challenges with the enabling economic environment and its vulnerabilities is largely missing from academic debates and discussions.

Therefore, keeping in mind the above and the fact that the Islamic economic paradigm has not been applied anywhere in its entirety, Dubai’s ability to implement a more comprehensive Islamic economic ecosystem is at the core of this research. The review of Dubai’s economic model and its past performance shows that it has made major strides on its path towards a diversified economy and a regional business capital. Unlike many others in the region, Dubai has succeeded in diversifying away from oil which today accounts for less than 2 per cent of its GDP. In the process, Dubai has also developed institutions and markets of global importance. Coupled with pro-business policies and the proactive investment role played by the government, Dubai’s zero tax regime is a major structural element that creates a distinctive economic environment that Dubai has used to its advantage. Among its effects is neutrality with respect to debt and equity since debt and ensuing interest payments do not receive any deductibility advantage in the absence of corporate income taxation. Furthermore, Dubai’s governance and incentive system and its unique government engagement critically contribute to the industry’s development. However, Dubai is still vulnerable to idiosyncratic risks due to its economic structure marked by a large transient expatriate population, pro-cyclical macroeconomic policies, underdeveloped financial markets and poor information disclosure requirements. The advantages and drawbacks that this model offers for Dubai to emerge as an Islamic economy global hub are critically assessed in the thesis.

Having pursued an unorthodox development approach, Dubai may offer such an opportunity for a more comprehensive and substantive implementation of the Islamic paradigm. However, a key question remains: whether the Dubai model has the significant ingredients required to become a catalyst for more substantive implementation of the Islamic economic paradigm? To assess this potential as well as prospects for implementation, we first outline a model describing Dubai’s economic development and relate it to the main components of the Islamic economic paradigm. But even if Dubai’s model provides

---

26 Dubai Statistics Centre
the needed economic framework conducive for a more comprehensive development of the Islamic economic paradigm, the question still remains whether the city is ready and able to implement it.

5. Research challenges and limitations

This research deals with the subject of economic development as contained in the Islamic economic and financial paradigm as well as that of Dubai’s economy. While the Islamic economy and its financial industry have attracted some high quality research, as explained, it generally lacks empirical evidence based on wider implementation of the Islamic economic model. The dichotomy between theory and practice adds to the perplexity of understanding the role, potential and development path of the Islamic financial industry. Moreover, even Islamic banking, despite achieving remarkable growth, has often been criticized for its formalistic, rather than substantive, adherence to the principles of Islamic finance. Hence, identifying the strengths and weaknesses of the Islamic model, against the background of weak empirical evidence and growing criticism of its practical application and the perceived lack of authenticity, has posed a major challenge to this research.

This challenge is amplified by Dubai’s aspiration to develop and be recognized as a global Islamic economy hub amidst conflicting and often controversial own developmental strategies. The paucity in research on Dubai’s economic development paradigm as well as the scarcity of reliable and timely economic data and information is yet another challenge in this research. Still, our work has been able to pinpoint certain structural weaknesses that put pressure on the sustainability of Dubai’s economic model, as demonstrated during the debt crisis.

The research investigates the extent to which the Islamic economy holds promises in general and whether Dubai’s economic structure in particular may be a good catalyst for a more genuine application of Islamic economic principles. The proposition defended in this thesis is that Dubai may have a unique opportunity to operationalize the Islamic economic and financial system more authentically by narrowing the gap between the theory and practice in Islamic economics, which would help achieve the dual objective of economic development and growth of the Islamic finance industry. However, we should emphasize that while our conclusions follow a logical set of inductive and deductive arguments, we have only explored a limited set of reforms that may be suitable to operationalize the Islamic economic paradigm while answering developmental challenges of Dubai’s economy.

Lastly, as explained above, the methodology of this research has been developed against the background of these challenges as well. We also recognize the limitations of our analysis given the qualitative and explorative nature of this research. However, we hope that this research will provide a new perspective on the pervasive issue of dichotomy between Islamic economic theory and practice as
well as on Dubai’s economic development alternatives and be a trigger for new and further in-depth research on the subject.

6. Contribution of the thesis

As explained, Islamic economics and finance has received a lot of attention and its paradigm has been assessed at various levels of details and perspectives. However, none of the research thus far has looked at Dubai’s model of economic development through the lens of the Islamic economic paradigm. Moreover, distinctively our research has focused on narrowing the gap between the theory and practice that goes beyond policy makers’ and regulators’ recommendations for improvements in regulations, increased standardization and the like. Our focus is on the broader and substantive development of the Islamic economic and financial paradigm.

The contribution of our thesis is threefold. First, we critically analyse the Islamic economic paradigm seeking to understand its challenges for more comprehensive implementation. Secondly, we look into Dubai’s model of economic development through the prism of Islamic economics and finance to identify ingredients that may potentially be an impetus for more organic and authentic development of the Islamic finance industry. This, to our knowledge, is the first such academic attempt. We carry out a comprehensive analysis and assessment of Dubai’s model itself including various factors at play that are commonly overlooked. Lastly, in analysing Dubai’s development experience and challenges and drawing important implications for reforming its own financial sector, we focus on the relationship between the foundations of Islamic economics and finance and the goals of sustainable growth and stability in order to address Dubai’s economic vulnerabilities.

Importantly, based on Dubai’s case, we show how the principles of Islamic economics and finance can be operationalized to narrow the dichotomy between its theory and practice and achieve alignment with the original objectives of the Islamic economic paradigm. We attempt to bring out the salient features of Dubai’s development model and assess its “success” story in a structured and systematic way to delineate its development model in relation to the principles of Islamic economics and finance. We hope that this will provide academic and practical insights about the potential that Islamic finance holds for economic development. Combining these approaches will ensure relevance of this research to academic work concerned not only with Islamic finance but also with Dubai’s economic development story.
7. Research structure

The research structure follows a logical framework and sequence that are appropriate for the research questions, starting from the theory of Islamic economics and finance to an in-depth examination of Dubai’s economic development model and its challenges, and then to the evaluation of its Islamic financial services industry and its readiness to implement the same more substantively. We have divided the research into three parts:

Part 1: *Review of Islamic Economics and Finance: Theoretical foundations and relevance for sustainable and stable development*

At the outset, we review the theoretical foundations of Islamic economics and Islamic finance comprehensively in the first three chapters in order to (i) synthesize contemporary thinking and available literature on the subject and (ii) assess its purpose, objectives and distinctiveness in relation to economic development. Here we identify key building blocks of the Islamic economic paradigm and highlight some of its development challenges. We start off with the discussion in Chapter 1 focusing on the raison d’être of Islamic economics and finance, the Islamic worldview, and its approach to distribution of wealth as a key problem in economics. The discussion draws attention to the comprehensive nature of the Islamic development approach with human well-being at its focus. The founding principles of Islamic economics and finance are then defined and contextualized within the Islamic worldview framework. A prohibition-nature of Islamic finance industry and its main elements such as the ban of interest are introduced and elaborated on in this chapter. The rationale and importance of risk sharing is introduced while the nature and role of property rights, contracts and trust, markets contextualized within the Islamic paradigm. We show the comprehensiveness of the economic system envisaged in the Islamic worldview to achieve sustainable and stable economic development. Challenges stemming from a partial understanding of the concept of *riba* in Islamic finance practice are also stressed in this chapter.

Next, in Chapter 2 we move our attention to the translation of the founding principles into a macroeconomic model of an Islamic economy and financial system, recognizing that Islamic macroeconomic theory continues to be a work in progress. Importantly, here we elaborate on a risk-sharing paradigm, highlighting its important, systemic, institutional and transactional implications as well as its bearing on stability and economic growth. In addition, we consider the case of the recent Global Financial Crisis (GFC) and analyse its root causes from conventional and Islamic perspectives. This analysis and the discussion that follows highlight distinctive approaches and solutions to stability offered by Islamic economics and finance theory.
Existing practices in Islamic finance, in terms of different approaches to developing the industry, are reviewed in Chapter 3. We distinguish between top-down and bottom-up approaches and discuss various challenges in implementing a more comprehensive Islamic economic paradigm. Moving from the system to the institutional level, a micro-model of the Islamic bank is also elaborated on while the current practices in Islamic banking are critically reviewed vis-à-vis conventional counterparts. As a result, this chapter will identify and elaborate various gaps between the theory and practice of Islamic finance. Furthermore, the important issue of IFI's convergence with conventional financial practices versus integration with economic development objectives will be considered, including its implications for the industry's development.

**Part 2 – Dubai Economic Development Model: Performance, distinctive features and relevance to Islamic Economic Paradigm**

The second part deals primarily with the assessment of Dubai's economic framework and whether Dubai's model contain ingredients that are conducive to the development of the Islamic paradigm. Hence, we turn our attention to Dubai's model in Chapter 4 by defining its development approach. Before getting into a deeper discussion, we consider whether the theory of rent seeking may apply in the case of Dubai as well. Following the qualification of Dubai's approach, we look into its development achievements and main economic drivers and assess their impact on its sustainability. Given Dubai's substantial openness and integration into international trade and finance flows, analysis of available sustainability measures is particularly important at this juncture. We highlight the economic structure of Dubai and we consider its unorthodox development model from the Islamic point of view, i.e. whether it can be considered as path-independent or not.

Continuing with the examination of Dubai's economic model in Chapter 5 we focus on its vulnerability to systemic risks, as exhibited during the Dubai Debt Crisis, but we also analyse the idiosyncratic risks resulting from its economic structure. More specifically, we consider Dubai's government policies and market incentive mechanisms, their impact on economic growth and gauge the extent of their alignment with the objectives of Islamic economics. Dubai's zero tax regime is considered a major structural element that creates a distinctive enabling environment. Among its favourable effects is the neutrality of debt and equity-finance since the debt and ensuing interest payments do not receive the tax deduction advantage. Furthermore, Dubai's governance, incentive system and its unique government engagement critically contribute to the industry's development. The third section of this chapter will deal with the debt crisis comprehensively in terms of its root causes and policy responses from an Islamic economics standpoint. The analysis leads us to outline a more comprehensive version of Dubai's economic model.
Part 3 - Islamic financial services (IFS) in Dubai’s financial architecture: Assessment of the sector’s role and future prospects

The third part focuses on Dubai’s Islamic finance sector within the context of the broader financial industry and assesses Dubai’s readiness to implement the Islamic paradigm. We evaluate its markets, institutions and products and their impact on economic stability. We start off with a comprehensive review of the financial services sector and its role in Dubai’s economic development, the definition of its main drivers as well as key challenges in Chapter 6. The structure of the sector and its development path is investigated in light of Dubai’s unique economic structure. Dubai’s banking industry and capital markets, equity and sukuk are assessed in order to determine their present roles and future development potential. The aim is to highlight the current challenges and avenues for growth and assess the contribution to overall economic sustainability and stability.

Moving from the industry level to a more practical and empirical assessment of Dubai’s Islamic financial industry, we assess Dubai’s Islamic banking industry and evaluate the impact of sukuk borrowing on issuing entities in Chapter 7. Given that some of Dubai’s large government related entities (GREs) have used sukuk, i.e. Islamic bonds, to raise funds in international markets prior to Dubai’s Debt Crisis, we critically assess the impact of Islamic instruments on the corporate and overall economic stability. We integrate the findings of the preceding analysis deliberating prospects for implementation of the Islamic paradigm within the context of Dubai’s economic model in line with sustainability and stability objectives while capitalizing on its inherent structural strengths.

In Chapter 8 we address our last research question more directly. We report the results of our semi-structured interviews conducted with key policy and decision makers from Dubai’s public and private sectors. We then broaden our discussion to the Islamic financial services in Dubai in general to highlight important pitfalls in current practices. We also explore the relevance of the lessons drawn from Dubai’s economic development model and the proposed operational framework to policy reforms for the global Islamic finance industry.

Finally, we summarize all of the preceding analyses in the concluding Chapter 9. The summarizing argument is that the Islamic economic and financial paradigm indeed holds the promise for more sustainable and stable economic development. Importantly, we conclude that Dubai’s non-orthodox development approach indeed has the significant ingredients to be a catalyst for a more genuine development of the industry. However, our empirical research on Dubai’s readiness to capitalize on such ingredients to implement the Islamic economic framework more comprehensively is largely mixed.
Part 1: Review of Islamic Economics and Finance
Theoretical Foundations and Relevance for Sustainable and Stable Development
1. Theoretical Foundations of Islamic Economics

The concept of economic development is at the core of policymaking and is of concern to virtually everyone. Over the time this field of study received increasingly growing attention. Perspectives and experiences in economic development are many, as if almost any conceivable factor may have relevance to economic development, at least at some point in time, in some economy. The economic development in the last fifty years has greatly advanced societies resulting in six fold increase in GDP from 1950 to 1998 with average growth rate of 3.9 per cent a year, the best performance than in any other time in the past (Maddison 2006). But, at the same time, by some accounts there were also more than a 100 different crises (Stiglitz 2003). The cost of these crises is significant. Described as the most devastating crisis since the Great Depression, the cost of the most recent Great Financial Crisis (GFC) alone is estimated at 40 trillion dollars, prompting some authors to consider it as a major setback to developed economies to the extent that now they should be referred as developing states (Weisbrot 2015). Hence, the history of economic development teaches us that the policy failure is clearly inevitable part of development. In fact, Hausmann and Rodrick (2003) describe the evolutionary nature of economic development, the trial and error, as a self-discovery process of learning of what one is good at producing. However, the cost of errors often exceeds mere financial or economic costs and translates into social, environmental and other challenges that are often not reversible. Hence, the concept of sustainable development emerges at the forefront of economic development debate.

Some authors, such as Chapra (2008), Khan (2009), Moisseron and Teulon (2014), Buiter and Rahbari (2015), claim that Islamic economic paradigm provides an answer to developmental challenges given that Islam proposes a distinct economic framework that deals with production, exchange, allocation and re-allocation as well as institutions as a part of its rule and value based system. Before we start exploring the fundamentals of Islamic paradigm in greater details later in this chapter we shall begin with a brief overview of some of milestones in economic development as an introduction and a context to a deeper elaboration of Islamic economic and financial paradigm.

1.1 Evolution of economic development

While some authors, such as Robbins (1968), trace the theory of development to mercantilism and even prior to that to the Middle Ages, the concept of development in fact, barely existed prior to the second half of the twentieth century, (Harris 2000; Toye 2003; Bell 1987). Our understanding of development has evolved over the time reflecting changing needs and circumstances of developing states. A common objective addressed by developmental economics is closing the income gap between developing and developed nations. Hence, increasing and sustaining the per capita income and moving the developing
countries up the developmental ladder is a key policy issue to which developmental economics seeks to provide an answer. Adelman (2000) stresses the need for a broader definition of economic development to include self-sustaining growth, structural change in patterns of production, technological upgrading, social, political and institutional modernization, and widespread improvement in the human condition. Achieving the vision of economic development, whether in its broad or narrow definition, is at the focus of a broad spectrum of policymakers, academia and various other stakeholders in any society.

Starting with agrarian economies where only small gains from the improvements in the allocation of resources were possible, development economics initially placed emphasis on the accumulation of factors of production and exogenous technological progress which then moved to policies and incentives endogenously affecting factor accumulation and innovation (Spolaore and Wacziarg 2013). The Industrial Revolution in early and mid-19th century and the quest for development resulted in technological advances which had a significant impact on industrial structures and enabled large productivity gains. As a result, divergence in income levels started to emerge. Figure 3 below provides powerful visualisation of economic growth over time and growing income disparity of the world from 1 to 2001 AD. As explained by Lin (2010), the chart shows per capita income in the developed countries of Western Europe increased to more than 20 times that of the developing countries by the end of the twentieth century.

![Economic growth over time](http://unstats.un.org/unsd/methods/icp/ipc7.htm.htm)

*Figure 3: Economic growth over time; Source: Maddison, A. (2006) in Lin (2010). The World Economy. Paris: OECD*  

Until the early twentieth century, most economists believed that *laissez faire* was the best system to attain sustainable growth in an economy. It was assumed that free markets, i.e. free of government

27 Gross domestic product (GDP) is calculated with 1990 international Geary-Khamis dollar. The Geary-Khamis dollar—also known as the international dollar—is a sophisticated aggregation method of calculating purchasing power parity (PPP). This facilitates comparing countries with one another. The statistical definition can be found at [http://unstats.un.org/unsd/methods/icp/ipc7.htm.htm](http://unstats.un.org/unsd/methods/icp/ipc7.htm.htm)
intervention, were the best facilitators for resource allocation decisions. The market determined prices would be therefore the best mechanism to allocate not only what, but how and for whom to produce. Markets would play the role of ‘invisible hand’ while economic agents led by their own interests would do what is best for the society as well. But as Kuznets (1966, 1973) explains, this approach had the major flaw of not accounting for the importance of the process of continuous, fundamental technological changes and industrial upgrading. That was the major difference between modern from pre-modern economic growth. Importantly, contrary to what Marxist economics implied, Kuznets argued, that process may not be as spontaneous for a successful economy. However, the laissez faire approach which advocates minimal interference of the state in economic affairs remained the dominant framework even though it was challenged by Marxist economists and communism.

Deepening the perspectives on economic development, some economists, such as Rodan (1943), argued that the virtuous circle of development depended essentially on the interaction between economies of scale at the level of individual firms and the size of the market. Rodan assumed that only with large enough markets traditional methods of production can be more productive given the necessity of paying higher wages necessary to induce productivity gains. Hence, the modernization process or the process of economic development will be self-reinforcing if it can start from large scales. Otherwise, countries will be indefinitely trapped in poverty. This approach gave rise to the structuralist approach to economic development which considers that developing nations face different structural challenges than that of high income countries (Chang 1949; Hirschman 1958).

Following the initial laissez faire approach, a series of important events such as the Great Depression, industrialization of the Soviet Union, and the rise of Keynesian economics, have emphasized the importance of market failures and the need for stronger government role in economic development. Thus, the role of government, public policy and its interaction with market forces became that essence of ‘development economics’. Many economists at that time argued that the government should play a leading role in the industrialization push, directly allocating the resources for investment, and setting up public enterprises in the large heavy industries to control the “commanding heights” in order to overcome market failures (Hirschman 1958; Rosenstein-Rodan 1943).

Another challenge was posed in the quest for economic progress and development of various newly emerged independent states. As a result of colonization, those states were typically heavily specialized in the production and export of primary commodities while they imported most of their manufactured goods. Ending the poverty cycle and starting rapid economic growth was high on the agenda of these new countries. However, the policy makers had different views on the right policies that should be used to break out. Some economists argued that developing countries need to boost their domestic manufacturing industries through a process known as import substitution. Krueger (1974) highlights that
import substitution policies had consequential higher costs: reflected in an increase in the price of imports and import-substituting goods relative to the world price and distortions in incentives, the fragmentation of markets, lesser competition and the monopolistic power of domestic firms. As a consequence, economic efficiencies were severely affected by an ensuing wrong incentive structure, the economies were pushed to consume the wrong mix of goods, and suboptimal economies of scale emerged with lower competition. Therefore, focusing on import substitution created incentives for rents and corruption, which in turn raised input and transaction costs. Others, such as Rodan, suggested that large and coordinated government investment programs stimulating the demand was the solution while others, such as Nurkse (1953), suggested that it was in fact the shortage of capital as the main inhibitor to development. Yet others, such as Hirschman, suggested that it was the lack of entrepreneurial abilities that constrained the development.

These debates marked significant policy shifts in which role of government moved from non-interventionist to one that takes economic development as their direct and prime responsibility. But, as Lin (2010) highlights, the results were disappointing in many cases to the extent that the income gap with developed countries widened instead of narrowing and government interventions failed. In the case of many socialist and developing countries poor economic performance is attributed to the mistake not to focus on their comparative advantage as determined by their endowment structures. Favoring instead the development of capital-intensive heavy industries at times when capital was scarce, these policies resulted in excessive protection of non-viable firms in sectors deemed as priority by the government (Lin and Li 2009). The final victory of the free market system seems to come with the fall of socialist economies in the late 1980s.

Hence, poor government-led interventionist strategies allowed the free market approach, laissez faire, to remerge and to start shaping yet again development thinking. This thinking was also reflected eventually in policy recommendations of the multilateral institutions, the World Bank and the International Monetary Fund, and contributed to a new development agenda based on a set of market-based policies termed the Washington Consensus, which was strongly advocated following the Latin American debt crisis in 1982 (Williamson 1990). It reflected a set of neo-liberal policies promoted by the international financial institutions, consisting of economic liberalization, privatization, and rigorous stabilization programs.

However, this new orientation in development thinking provoked strong criticism. As Gore (2000) explains, in the wake of East Asian financial crisis, economic growth in developing countries fell dramatically prompting to question the effectiveness of prevalent policies. The Asian financial crisis also sparked a series of debates on the effectiveness of the economic policies but also on the role of multilateral developmental institutions. He explains that the Washington Consensus has in fact seized to be relevant as the differences of opinion on the causes of the crisis and how best to handle it have emerged in Washington, between the IMF and the World Bank. Interestingly, earlier Krugman (1995) in his critique of Washington Consensus argued that market-friendly policies are actually being financial markets-friendly. Later on the concept of financialization has emerged largely reflecting the fact that one of reasons leading to the GFC is that financial institutions were only serving their own interests, a concept echoed in Krugman’s critique more than a decade earlier. Others, such Stiglitz (1998 a,b) and Rodrick (2006), have also argued that there is a need for a new set of policy reforms and that a new “post-Washington Consensus” development paradigm is needed.

Some attempts to put forward a new paradigm were made in early 2000s as the divergence in growth performance between developed and developing countries prompted new efforts to identify key drivers and policies enabling stronger convergence. For example, an alternative and more dynamic model, resonating nonlinear relationship among various development determinants, was developed by (Hausman et.at. 2005), the Decision Tree29 approach. Yet some others have tried to assess the impact of various development projects and programs to ensure that policy be based on scientific evidence. Such approach was initiated by the economists at the MIT Poverty Lab. More recently, an important perspective emerged emphasizing the importance of the investment climate and firm performance championed by the World Bank. However, in spite of these new directions, some economists think that development economics falls short of providing comprehensive solutions. Ravallion (2009b), for instance, highlights that “there is a risk the bulk of present day research in development economics appears to be too narrowly focused and/or of too little generalizability to help much in the fight against poverty and to facilitate structural change and sustained growth.”

The debate on economic policy and the development paradigm has moved away from the relationships between developing and developed nations. The recent Global Financial Crisis (GFC) and Eurozone crisis, because of their magnitude and institutional failures, have essentially brought to the study of developmental economics new relevance and dynamism to the extent that the new economic paradigm is needed by all, developing and developed nations alike. In fact, as Dow and Dow (2013) observe, the

29 Here the emphasis was on the structural change in economic development arguing that there are “binding constraints” on growth in each country implying that governments need to prioritize reforms thought the information revealed by shadow prices
recent crises are not only the result of the neoliberal ideology but rather it has also failed to predict the crises and moreover it conditions only marginal adaptations within the prevailing system. Hence, it comes as no surprise that the recent crises have prompted many to question the very fundamentals, economic ideas and institutions, of contemporary economic systems. Similarly, Chang (2002) argues that a marginal tinkering with the neo-liberal framework is not sufficient in relation to role of the state in economic development and, in fact, he proposes a new framework referred as institutionalist political economy.

Therefore, economic theory has evolved and changed with the ever-changing developmental strategies, successes and failures. Economic development models or paradigms are also influenced by political interests and views on social policies. Hence, the role of the government in economic development, is, for obvious reasons, a central issue in developmental economics. Depending on the particular set of circumstances, government intervention and/or free market mechanisms and anything in between have alternated with different degrees of success. Hausmann’s self-discovery process argues that governments need to play a dual role in fostering industrial growth and transformation by encouraging entrepreneurship and investment in new activities ex ante, but push out unproductive firms and sectors ex post. Rogers (2010) summarizes that effectively economic models should not rely blindly on the strengths of neither market nor government as both can fail spectacularly.

Therefore, it seems that income inequalities are here to stay. In fact, in his seminal work Piketty (2014), explains that inequalities are becoming more persistent and increasing over time as a result of a ‘central contradiction of capitalism’ that the private rate of return on capital can be significantly higher than the rate of growth of income and output. Yet another consequence of economic development and the race to the top, is the negative environmental impact. Global institutions are increasingly recognizing these problems and are seeking solutions and the current emphasis has shifted to a more sustainable development combining balanced economic, environmental and social policies and outcomes.

1.1.1 Relation to Islamic economics

Competing economic and social doctrines have strongly contributed to define various development paths. Cheng (2003) reminds us that it is the neoliberal doctrine that dominated the debates in the last quarter century. The role of multilateral financial institutions, the World Bank and the International Monetary Fund (IMF), seemed to be critical in spreading the doctrine globally in the developing world. Notably, in the period post Global Financial Crisis, the concept of sustainable economic development seems not to relate only to developing world but also to the developed countries of the Western hemisphere.
It seems lately that there is increasing realization of the importance of the convergence of economic, social and environmental objectives in defining development alternatives (Harris 2000). Therefore, Lin (2010) describes economic development as being a “point along the continuum from a low-income agrarian economy to a high-income industrialized economy, not a dichotomy of two economic development stages (“poor” versus “rich” or “developing” versus “industrialized”) thus aptly locating plurality of challenges, factors and outcomes, confronting economic development. All of these highlight rather questionable economic development paradigms and the need to look for alternatives. Colander et al. (2004) argues that economics is moving away from a ‘strict adherence to the holy trinity—rationality, selfishness, and equilibrium—to a more eclectic position of purposeful behaviour, enlightened self-interest and sustainability’. Hence, Yousri (2005) argues that the issue of sustainability has brought the concept of development closer to Islamic thought.

Given the chronology of economic development and the search for economic paradigm that will address multiplicity of issues more coherently, the Islamic economic and financial paradigm becomes increasingly relevant. This chapter provides an in-depth understanding of the salient features of the Islamic economics and finance paradigm. The implications of Islamic rules and principles on macroeconomic policies and financial system will be elaborated in the next chapter. This background will then be used to make assessment to serve as the framework for a more sustainable and stable development of Dubai’s economy. By the same token, we shall then evaluate Dubai’s ability to implement this paradigm and offer new avenues for the development of Islamic economic system.

In fact, we could start this discussion by highlighting the dire consequences of the recent Great Financial Crisis to gauge the proportions and severity of the problems faced by the contemporary economic system. This would undoubtedly show the importance of making substantive and fundamental changes in the global financial architecture, including necessary improvements in economic theory. Being considered as an alternative system, Islamic economics would then be highly relevant to address major economic challenges. However, we leave this discussion for Chapter 3 where we link such challenges to gaps in Islamic economics and finance to highlight commonality of problems and solutions.

1.2 Islamic economics – sources, scope and objectives

Instead, our objective is to understand first Islamic economics and finance in a more fundamental way. Therefore we begin the discussion of Islamic economic theory by looking into the question not only of what the Islamic economics is but also why we actually need it, or in other words, what makes Islamic economics distinct from the conventional economic thought.
It may be worthwhile mentioning at the outset that some critics state that an economic science based on Islamic principles is actually not even possible (Kuran 1995). While this seems to be a rather isolated view in a spectrum of differing views on place and role of Islamic economics and finance, it appears nevertheless that it is unanimously recognized among leading Islamic scholars that Islamic economics still has a long way to go to parallel conventional economic theories and models.

Given the general understanding that Islamic economics may offer an alternative economic paradigm in response to the growing realization and the urgent need to improve the global financial architecture, stands a consensus that a coherent and comprehensive body of theory of Islamic economics is yet to emerge. Therefore, it may be logically expected that the proposed paradigm, while still not being comprehensively implemented nor theoretically sufficiently modelled, must primarily deal with issues of substance to the economic and financial system.

1.2.1 Sources of Islamic economics

The sources of Islamic economics are the Holy Book – Qur’an – and the prophetic traditions – Sunnah. Fiqh as a discipline dedicated to the study of the understanding of the Qur’an and the Sunnah is therefore the root of Islamic economics, as highlighted by Khan (2002). Hence, as Khan further observes, Islamic economics as a distinct discipline will be recognized only if it can show that the Fiqh literature can lead to a different understanding of man’s economic behaviour.30 A seemingly minor issue needs to be highlighted here. As Fiqh literature contains significant materials relating to Islamic economics, this represents a challenge on two counts. First, Fiqh sources are vast and economic materials are not arranged according to economic themes, which makes the analysis and development of Islamic economic theory more difficult for those without sufficient knowledge of Fiqh matters. Secondly, most of the discussions and sources on Islamic economics are in Arabic, which leaves conventional economists or those concerned with the Islamic economic paradigm but with no knowledge of the language out of timely and in-depth discussions. As we shall see later, a lot of the debates and admittedly confusion is due to translation matters. For example, the concept of *riba* is translated as interest or usury31 whereas its meaning is somewhat different in both of these translations. Difference in meaning between the two and its implications on theory and practice of Islamic finance are

---

30 While there is a consensus that fiqh is a discipline containing rules relating to Islamic Economics derived from Qur’an, Sunnah and ijma, Siddiqi (2006) correctly identifies that one of reasons for retarded progress in Islamic Economics may also be too strong focus on *fiqh* itself. In addition, he further rationalizes that it was difficult for scholars to think outside twin boxes of *fiqh* and traditional economics.

31 Interestingly, Cavalier (2013) reminds that even the term ‘usury’ originates from Latin ‘*usura*’ which initially meant ‘*the practice of lending money*’ and only later ‘*excessive interest rate*’. In addition there is a third less known meaning that refers to ‘*any kind of disrespect to commutative justice*’. 
substantive. This therefore creates a lot of ambiguity in Islamic economics which can be detected in many academic papers.

1.2.2 The role of the worldview and Maqāsid Al Shari’ah

The goals of an economic system are determined by its world-view (Mirakhor and Bao 2013). In turn, a particular economic system gives rise to a model of financial system. Given the objective of a comprehensive attainment of human well-being, the Islamic world-view does not separate between positive and normative functions of economic methods (Chapra 1996). This is in contrast to conventional economics. Positive goals are those referring to the objectives of efficiency and equity in the allocation of scarce resources. Conventional economics considers achieving these objectives without value judgments. The other set of goals, normative, is the one that refers to universal socio-economic goals of full employment, optimal rate of economic growth, need fulfilment etc. that are in general considered as important for self-actualization of human beings. Conventional approach argues that the well-being can be best achieved if individuals are given full freedom to pursue their self-interest and to maximize their want satisfaction in accordance with their tastes and preferences. According to this view, it is competition and market forces that ensures that the self-interest is under check as well. However, as we shall see later the assumptions of perfect competition are at odds with reality leading to a number of market failures. Islam, on the other hand, does not dismiss the role of self-interest nor that of freedom. Rather it recognizes the limitations of both and suggests they need to be adjusted by moral values and good governance to ensure realization of well-being.

The belief system, as Askari (2013) elaborates, is the root criterion determining the distribution of economic resources, or set up of an economic system. The world-view, based on the Islamic beliefs, relies on the integrated roles of values and institutions, market, families, society, and the state, with the objective of ensuring the well-being for all. It does not rely primarily on either the state or the market for realizing its vision. In Islam, as we shall see, all behaviour is rule-based with ethical values underlying such rules. Importantly, there are many similarities between worldviews of major religions, Judaism, Christianity and Islam. In fact, this is also recognized by Islam as it is stated in the Qur’an that “Nothing has been said to you [Mohammad] that was not said to the Messengers before you” (Al Qur’an 41:43). The similarity is to the extent that to which the Message has not been lost or changed over time. Hence, common ban of interest, therefore, is not a surprise.

Notably, an important misconception is that Islamic economics is a new paradigm whereas in fact it is much older than the theoretical foundations of Western economic paradigms, (Presley and Sessions, 1994). Chronologically, the period of Enlightenment had a major influence on creating a value-neutral economic worldview. Conventional economic thought has progressed from focusing on objectives of
structural transformations and productivity issues to include wider, general human-development perspectives. Importantly, the epistemological background of the contemporary economic and financial system, as known today, stems out of a paradigm laid down by Adam Smith in his book, *The Wealth of Nations* (1776). However, Mirahkor and Bao (2013) highlight what is less known is that Smith’s vision of the economy was also framed in a moral-ethical system, described in his book *The Theory of Moral Sentiments* (1759). Here Smith qualifies the ‘invisible hand’ to refer to the design of the Creator. Therefore, the founder of the conventional economic system related the achievement of economic objectives to the belief in the One Creator as well.

The Islamic world-view is based on three fundamental concepts: *tawhid* (Oneness and Unity of God), *khilafah* (vicegerency of human beings), and ‘*adalah* (justice) (Chapra 1993). Importantly, the Qur’an provides a comprehensive framework and specific rules (institutions) for both individual and collective human development, while the traditions of the Prophet articulate the operational form of these rules (Askari 2013). The most important concept in Islamic world-view is that of *Tawhid* from which all other concepts are derived. Tawhid refers to unity of God, that He is the *One and Only*, creator of the Universe (Qur’an 116:1, 3:191, 38:27, and 23:15). The importance of the concept of *Khilafa* in economic terms is that its derivative states that all the resources available to human beings are a *trust*. Furthermore, ‘the concept of khilafa essentially stands for the fundamental, unity and brotherhood of mankind’, (Chapra, 1993, p6), which importantly underscores the universality of the message of Islam. And lastly, the concept of ‘*adalah* or justice ensures that the objective of all human relationships and interactions, including economic and financial, is to serve both *Khilafa* and *Tawheed*.

The Islamic value system is comprehensively contained in the Maqāsid al-Shari’ah, or the goals of an Islamic world-view. They provide a comprehensive context and raison d’être for Islamic economics and finance. Chapra (2007) highlights the comprehensiveness of Maqāsid with respect to human development that goes substantively beyond income and wealth measurements. The ideal Islamic financial system is therefore an outcome of an Islamic world-view and, by default, its mechanisms must reinforce Maqāsid al-Shari’ah. The most famous rendering on the Maqāsid or objectives of Shari’ah was done by Imam Abu Hamid al-Ghazali (d.505AH/1111AC) who classified them into five categories.

“The very objective of the Shari’ah is to promote the well-being of the people, which lies in safeguarding their faith (din), their self (nafs), their intellect (‘aql), their posterity (nasl), and their wealth (māl). Whatever ensures the safeguard of these five serves public interest and is desirable, and whatever hurts them is against public interest and its removal is desirable.”, Imam Abu Hamid al-Ghazali in (Chapra 2007)
This set of Maqāsid is widely accepted by scholars to constitute the main or primary objectives of Islamic law. However, secondary objectives that support the achievement of the primary ones exist as well. A concept of maslahah reflects the Islamic concept of wellbeing. It was Shatibi, a 14th century renowned scholar and philosopher from Andalusia, who greatly influenced Islamic economic thought through his treatise on Maqāsid and maslahah. Maslahah, as pointed out by Khan (2002), refers to the preservation of Maqāsid Al-Shari’ah. Those include (i) Preservation of Life (Nafs), (ii) Preservation of Property (Maal), (iii) Preservation of Religion (Deen), (iv) Preservation of Reason (‘Aql), (v) Preservation of Descendants/Procreation (Nasl). Importantly, whatever assures or preserves mentioned the five objectives is also considered to have maslahah whereas anything that fails to preserve them is considered as mafsadah.

A related issue to maslahah are grades of levels of their priorities. They are categorized in three grades: (i) Essential (darori) level, (ii) Complementary (haji) level, and (iii) Amelioratory (tahsini) level.

A comprehensive measure of well-being will have to take into account moral, psychological, social, political, demographic and historical and other factors that impact well-being in this broad sense. This view recognizes the fact that economic well-being is inseparable from social and other factors that interplay in the development of economic variables and outcomes. Essentially, this approach looks into maximizing or perhaps optimizing the complementarity of roles of different institutions such as the market, the family, society and the state in a way that they do not inhibit each other but rather support each other’s roles and performance. Indeed, such a multidisciplinary dynamic approach is one of most important contributions of Islamic economics. For example, Ibn Khaldun’s (1332-1406) Muqaddimah provides an important analysis and explanation of how different factors - moral, psychological, social, economic, political, demographic and historical - operate in an interrelated manner over a period time. He analysed the rise and fall of dynasties from such a multidisciplinary perspective.

Contextualizing Maqāsid within the economic development framework as an important aspect of comprehensive human well-being places development of the human self (nafs) as a starting point for the development and attainment of all other Maqāsid. Chapra (2007) comprehensively explains the relationship between primary and secondary objectives of Islamic law. In contrast to this limiting definition of well-being, a more comprehensive approach incorporates the spiritual dimension in addition to the material one. This clearly brings new complexity into the discussion of allocation and distribution of resources as its objectives transcend economic variables.

The issue of allocation and distribution is at the core of economics. The ultimate goal societies strive for, most will agree, is the goal of realizing human well-being (Chapra 2000). The divergences in the approach to realization and definition of the human well-being lead to significant differences in theories and practices. Some may define it entirely in terms of material outcomes, devoid of spiritual content while others may, on the other hand, view it holistically combining both material and spiritual dimensions.
The approach taken will consequently determine objectives of economic activities and therefore will lead to particular mechanisms of allocation and distribution of scarce resources. For example, defining the well-being in a purely material sense gives rise to the prominence of serving the self-interest and the maximization of wealth. Importantly, in this case value judgments may have to be kept out to allow individuals total freedom to decide for themselves what they wish. Consequently, market forces are deemed sufficient to affect desired allocation and distribution of resources. Moreover, while the redistribution of the wealth produced is considered important, it is only to the extent to which it does not interfere with the freedom of the individual to pursue his or her self-interest (Chapra 2000). It is important to note that in such order government role is maintained at a minimum, sufficient just to ensure effective market performance.

1.2.3 Scarcity in Islam

The concept of scarcity is closely related to the issue of needs and wants satisfaction. In contrast to conventional economics, Islamic economics deals with need fulfilment rather than wants satisfaction. This distinction may seem subtle but, in fact, it is substantive. Need in Islam is anything that has maslahah for people (Khan 2002). This positions the economic problem rather differently. “The economic problem is not merely a problem of choice to satisfy wants, it is a problem of meeting needs of individuals as well as the society” (Khan 2002, p66). Importantly, the concept of maslahah dictates efficient use of scarce resources which may not always be the case with the conventional approach. Scarcity is, therefore, recognized in Islam but is dealt with for different purposes.

It is the definition of needs vs wants that helps identifying the economic problem, not the issue of scarcity. In a way, scarcity is constant that is given regardless of the worldview. The concept of maslahah prioritizes our needs in an objective fashion without giving scope to discussion of wants. Hence in addition to important differences in the issue of needs versus wants, the second important aspect is allocation of those scarce resources. Some authors discussed the issue of scarcity as a prime economic problem. They highlight the difference between relative and absolute scarcity by drawing attention to Chapter 15, verse 19-21 in which Allah s.w.t.\footnote{Meaning of s.w.t. (Subhanahu Wa Ta’ala) is The Exalted, The Majestic and Sublime} says that He has provided means of living for mankind as well others. This verse clearly rules out the concept of absolute scarcity. In relation to relative scarcity, Ahmed (2002) makes vivid analogy of absolute and relative scarcity in relation to concepts of stock and flow. Absolute scarcity which, in Islamic worldview, is not accepted is linked to stock of natural resources.
Hence, stock of natural resources has been created in abundance but the ‘flow’ of natural resources or means of living at any given period of time to people is not abundant.

1.2.4 Self-interest in Islam

Self interest in conventional economics is an important motivating force in allocating scarce resources. According to the Islamic worldview, the three mechanisms that determine the use of resources in a society or economic system are filtering, motivation, and socio-economic and political restructuring (Chapra 1992).

Filtering refers to a mechanism in which different claims on limited resources are channelled in order to ensure that the agreed objectives of allocation and distribution are not breached. Three of these are central planning, market mechanism, and moral values. Central planning refers to socialist/communist type of economic order in which the state essentially determines who, how and what will be produced. Empirical evidence has shown that this system is not sustainable as it runs against the very essence of human nature. On the other hand the market mechanism has proved to be very successful. The interaction of supply and demand forces coupled with the competitive environment helps to filter out resource utilization in a way that leads to equilibrium. However, it is also possible to have several equilibria, depending on tastes and preferences of market participants. Using the same set of tastes and preferences may lead to optimal well-being. The question is, however, how to motivate market participants to act within a similar framework. This is where self-interest as a motivating force easily understood by most individuals gets into a picture.

The serving of self-interest has proved to be an effective motivating mechanism for increasing efficiency, whereas competition, public accountability, and government intervention have helped safeguard social interest (Chapra 2000). Interestingly, the Islamic world-view provides for the pursuit of self-interest as well. However, the concept of self interest in Islamic goes beyond the present, into long-term, into the Hereafter. 'It is not possible for competition and government intervention to always motivate a person to do what is morally right and to abstain from what is morally wrong, to cooperate with others and to make sacrifices for them. Governments can try to ensure competition and to pass laws to safeguard social interest' (Chapra 2016, p60).

Lastly, the political and social environments in which economies operate influence human behaviour. Hence, in addition to the filter mechanism and motivating paradigms, it is necessary to pay attention to the enabling environment, institutions and values, whether political or social, that are conducive to the realization of well-being objectives. Otherwise, as Chapra (2007) stresses, anything that prevents the
kind of filtering, motivation, and restructuring that the desired well-being requires may be termed as
distortion as it may lead to an unproductive allocation of resources.

Therefore, the Islamic worldview and its concept of Hereafter brings about innate goodness of human
beings and altruism that transcends the sheer pursuit of self-interest. Conventional economics is based
on the premise that man maximizes utility and self-interest. Self-interest in the context of Islam is
extended to include the Hereafter. We can serve our self-interest by fulfilling our obligations in this world
towards other fellow human beings, animals, environment etc. Hence, self-interest in Islam has a long
term nature and serves as a motivating force.

An interesting parallel to the relevance of filtering mechanisms may be found in exposition of the Islamic
economy system in relation to that of social market economic system. Nienhaus (2010) compares and
contrasts the two systems and highlights their commonalities. Property ownership, competition as a
basis of development, stability of economic environment, provision of public goods by the state,
sustainability, incentive compatibility etc. are systemic features with a high degree of commonality in
both systems. Social market economy makes a striking balance between the capitalist and socialist view
of economic systems. It asserts that competition is at its core while it does not preclude social aspects
of development. Miller-Armack (1978) defines this concept of social market economy that is similar to
Islamic economic proposition. Hence, while the roles of various institutions and players may be found in
the current economic paradigm, the Islamic worldview operationalizes its vision using a distinct set of
values and rules as contained in the Qur’an and Sunnah.

1.2.5 Definition of Islamic economics

Therefore, Islam does recognize the concept of relative scarcity and introduces it into an economic
equation.33 According to Ahmed (2002), therefore, the definition of Islamic economics is “the science
that studies the best possible use of all available economic resources, endowed by Allah, for the
production of the maximum possible output of Halal goods and services that are needed for the
community now and in future, and the just distribution of this output within the framework of Shari‘ah

33 Ahmed (2002) quotes Hadith Qudsi in which Allah swt says “Some of my worshippers are only reformed and best fitted
with poverty and if I enrich them this will spoil them, and some of my worshippers are only reformed and fitted with richness
and if I impoverish them this will spoil them.” Hence there is divine wisdom in limitation of resources and sustenance. As man
is unable to satisfy his unlimited wants according to his natural desires, in any given period of time, he will continuously work
utilizing natural resources to produce more. In pursuit of livelihood to meet his wants Allah test his faith as is evident when
He says: That which is on Earth as an adornment for it in order to test people as to which of them is best in deeds. Qur’an,
18:7
and its intents”. We shall not go deeper in explanation of the definition as it seems rather obvious what it is trying to achieve.

It may be worth noting, that there are two opposing thoughts at the spectrum of the definition of Islamic economics. On the one hand, some economists claim that Shari’ah rules and principles constitute the sum of Islamic economics. On the other hand, some claim that Islamic economics is relevant only insofar as zakat and riba only are concerned. In reality, Islamic economics does not fall under either heading, which is a consensus among the majority of scholars.

1.3 Elements of the Islamic economic system

In addition to providing an inseparable context to other spheres of human life by clearly defining its purpose and broad objectives, Islamic economic doctrine has also set a particular path to attaining such objectives. The economic, and thereby financial strategy in accordance to Islamic principles, is governed by the rules of *muamalat*, or Islamic law of transactions (Kamali 1996). While ibadaat or Islamic rituals are strictly limited only to the ones that are permissible, all muamalat or economic transactions and business dealings are allowed except those that are forbidden (Ahmed 2006). Hence, Islam ensures perpetuity, consistency of Islamic belief and its message by strictly controlling forms of worship. There is no room for improvisations, innovation and changes in worship. Worship is prescriptive not only in its substance but in its form as well. In other words, all forms of rituals of worship in Islam are forbidden except those that are allowed. On the other hand, conduct of business transactions, its form and substance, is entirely free and open save for those that are made forbidden. Business dealings (muamalat) are left widely open to innovation and evolution. Here the rule is, as mentioned, everything is allowed except what is forbidden. Prohibitions are standard and consistent throughout time. Islamic finance being founded on such a platform is therefore a prohibition-driven industry (El Gamal 2006).

Limitations prescribed by the Qur’an or Sunnah are few and therefore it is only natural they deal with fundamental issues of essential concern to human economic dealings. This framework of Islamic economics and finance is broad enough to provide answers to any human need throughout time. Hence, strict observance of forbidden dealings and rule compliance is a necessary requirement to achieve the ideal state of Islamic economy which is internally and externally consistent with its own objectives. As Askari (2013) highlights, rule-compliance assures justice while justice assures balance for individuals and for their collectivism. Typically, the two main prohibitions are *riba* (interest) and *gharar* (excessive uncertainty), or as El-Gamal puts it - *riba* refers to “trading in credit,” and gharar to “trading in risk”. As the most of important prohibition in Islamic economics is that of interest, we will begin from there.
1.3.1 Prohibition of Riba

In order to properly understand the essence of Islamic economics and finance we shall begin with a deeper exploration of the meaning, scope, purpose and implications of prohibition of *riba*. Indeed, its prohibition is a cornerstone of the Islamic economic paradigm and pivotal for understanding the Islamic finance industry today, its challenges and alternatives for its development. To begin with, we may recall that the prohibition of interest is not new to world religions. Judaism, Christianity\(^{34}\) and other religions provide clear prohibition of interest. Likewise, Islam has banned interest in all its forms, whether one is paying it, receiving it or even recording it.\(^{35}\) The ban of interest is a common element in the economic strategy of major world religions. But in sharp contrast to these prohibitions, the modern financial system is entirely based on interest. Interest rates are underpinning all financial transactions, whether explicitly or implicitly as a reference benchmark or pricing inputs.

*What is riba*

*Riba* is prohibited in both Quran and Sunnah. The definition of *riba* and its scope i.e. whether it includes interest in all its forms including modern bank interest was a subject of discussion. Dissonant and rather isolated voices considered bank interest as non-*riba* and were present for a long time.

However, it is a consensus among scholars\(^{36}\) today that *riba* includes, among other things, interest. Perhaps the most significant discussion on the origins, meanings and intentions of the prohibition of *riba* are contained in a landmark discussion by Mufti Taqi Usmani in front of the Supreme Court of Pakistan.\(^{37}\) He has concisely summarized major objections and challenges put forward by various parties while elaborating the meaning and scope of *riba* prohibition within the historical, economical, and jurisprudential contexts. While detailed discussion of these challenges is beyond this research, suffice to say that many contemporary scholars have dealt with these issues at length (Amin 2000; Ahmed and Kabir 2007; Al Masri 2004; Siddiqui 2004; El Gamal 2001; Usmani 1995). None of them has found any

\(^{34}\)For exact text please see Old Testament: Deuteronomy 23:19, Psalms 15:1, 2, 5, Proverbs 28:8, Nehemiah 5:7, Ezekiel 22:12. Also Cavalier (2013) provides examination of Canonical Laws in respect to interest and concludes that Islamic and Canonical systems seem not to be remote as it seems.

\(^{35}\)The famous hadith states: ‘From Jabir: The Prophet, may peace be on him, cursed the receiver and the payer of interest, the one records the transaction and the two witnesses to the transaction and said: “They are all alike [in guilt]” (Muslim, Kitab al-Musaqat, Bab la’ana akil al-riba wa mu’kilahu; also in Tirmidhi and Musnad Ahmad)

\(^{36}\)Many international conferences of leading jurists held for the purpose of discussing the issue of *riba* confirmed unanimously that *riba* includes contemporary interest as well. These conferences are Mu’tamar al-Fiqh al-Islami, Paris-1951 and Cairo-1965; OIC and Rabitah Fiqh Academy Meetings in Cairo-1985 and Makkah-1986; Pakistan Council of Islamic Ideology in 1980.

historical evidence supporting the challenges but rather have provided ample evidence and compelling explanations of the scope, rationale and economic implications of *riba* prohibition.

The root of the word *riba* is the verb *raba*, meaning to grow, expand, increase or inflate, or excess. However, *riba* is typically translated as interest and in some cases as usury. As we shall see later, neither of these usual translations give proper meaning to the *riba* mentioned in Qur'an and Sunnah. However, for the sake of convenience we shall refer to it as interest bearing in mind that its meaning is somewhat different from the conventional understanding of interest rates.

The remainder of this section will provide further analysis of the *riba* prohibition. The understanding of its scope is central for understanding of Islamic economics and finance.

_Sources of prohibition and types of riba_

As mentioned, *riba* is clearly prohibited in the Qur'an and Sunnah. Similar to some other prohibitions it was prohibited in stages over a period of time. Indeed its ban is the single most important injunction of Islam that fundamentally, along with other principles, creates a radically different economic paradigm. Usmani (1995) provides detailed discussion on revelation of particular verses in the Qur'an dealing with prohibition of *riba*, their historical context and meanings. The first mention of *riba* is in surah Ar-Rum, revealed in Makkah. Here *riba* is not prohibited but rather the surah provides a subtle indication that *riba* is not liked by Allah s.w.t. whereas charity is rewarded manifold.

> "That which you give in *riba* for increase through the property of (other) people, will have no increase with Allah: But that which you give for Zakah, seeking the Countenance of Allah (will increase): it is these who will get a recompense multiplied."

_[Qur'an 30:39]_

The second mention is in sura An-Nisaa, revealed in Madinah, and refers to the prohibition of *riba* to Jews in earlier scriptures.
“That they took riba, though they were forbidden; and that they devoured men’s wealth wrongfully; we have prepared for those among them who reject Faith a grievous chastisement.”

[Qur’an 4:161]

The third mention is in surah Al-Imran and importantly contains the first prohibition of riba for Muslims in clear terms. Having in mind the historical context of the revelation of this verse i.e. Battle of Uhud, indicates that the verse was revealed in the 2nd year after Hijra. This is an important insight for those who have claimed that riba was prohibited only towards the end of life of the Prophet so that he did not have time to elaborate on its meaning and scope.

“O ye who believe! Devour not riba, doubled and multiplied; but fear Allah; that ye may (really) prosper.”

[Qur’an 3:130]

The fourth mention is in surah Al-Baqarah where it is unequivocally prohibited. This type of riba is referred as riba al nasi’a38 or as Amin (2000) refers it - debt riba. In addition to clear prohibition of riba, this revelation contains important distinction between riba and trade.

“Those who take riba will not stand except as stands one whom the Satan by his touch hath driven to madness. That is because they say: ‘Trading is like riba’. But Allah has permitted trade and forbidden riba. Those who after receiving admonition from their Lord, desist, shall be pardoned for

38 El Gamal (2006): The etymological root of nasi’a is the three-letter past-tense verb nasiya, which means to defer (also to forget), implying that this type of riba occurs in time, i.e., through deferment of payments.
the past; their case is for Allah (to judge); But those who repeat (the offence) are companions of the
Fire; they will abide therein (for ever).”

Allah will deprive riba of all blessing, but will give increase for deeds of charity: for He loveth not any
ungrateful sinner.

Those who believe, and do deeds of righteousness, and establish regular prayers and give Zakat,
will have their reward with their Lord: On them shall be no fear, nor shall they grieve.

O ye who believe! Fear Allah, and give up what remains of your demand for riba, if you are indeed
believers.

If ye do it not, take notice of war from Allah and His Messenger: But if ye repent ye shall have your
capital sums: deal not unjustly, and ye shall not be dealt unjustly.

If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of
charity that is best for you if ye only knew.
And fear the Day when ye shall be brought back to Allah. Then shall every soul be paid what it earned, and none shall be dealt unjustly.

[Qur’an 2:275-281]

The warning contained in the last revelation unequivocally shows the importance placed in avoidance of *riba* in achieving the ultimate objectives of Islamic values espoused in Maqāsid Al-Shari’ah. The consensus of scholars is, based on historical evidence and analysis of situations to which particular verses were revealed, that *riba al-nasiah* or *debt riba* essentially means that determining a positive rate of return in advance on a loan as condition for waiting is not permitted by the Shari’ah (Usmani 1995; Gamal 2006; Chapra 2006). The key is predetermined and positive rate of return. It refers to specific types of loans in which the time element is involved i.e. the borrower is allowed to repay the loan in return for monetary or on-kind increments above the principal amount. Waiting for repayment of loan does not justify by itself a positive reward (Chapra 2006). It does not matter whether the additional increment is fixed or variable percentage, an absolute amount or perhaps even a gift or a benefit the lender receives.

In addition to preceding Qur’anic prohibition, *riba* was also clearly prohibited in the Sunnah of the Prophet Muhammad (p.b.u.h.). In the hadith, narrated by al-Bukhari and Muslim on the authority of Ubadah ibn al Samit, the Prophet (p.b.u.h) said:

*Gold for gold, equivalent for equivalent; silver for silver, equivalent for equivalent; dates for dates, equivalent for equivalent; salt for salt, equivalent for equivalent; barley for barley, equivalent for equivalent, and whoever exceeds or asks for excess, he practiced riba. Sell gold for silver as you wish if it is hand to hand (prompt delivery), and sell barley for dates as you wish if it is hand to hand.*

This type of *riba* is termed as *riba al-fadl* and it significantly adds to broadening the scope and meaning of Qur’anic prohibition. Amin (2000) refers this as *sale riba* whereas the former, *riba al nasiah*, as mentioned is referred as loan *riba*. Again, importantly and distinctively from *riba al-fadl*, *riba al nasia* contains a time element or delayed payment.

*Not all interest is riba*

It is critically important to highlight that interest, as *riba* is commonly translated, does not accurately reflect the scope of prohibition. Both translations as either interest or usury are inaccurate since not all
interest is *riba* and vice versa, not all *riba* is interest.\(^{39}\) This is an important as it implies that the application of Islamic economic and finance principles requires more than simple avoidance of interest, as we shall see later on.

Interest implies the concept of time-value-of-money or increases in amounts to be repaid in relation to the elongation of the repayment period. Blanket prohibition of interest would imply Islamic unacceptance of time value of money as well. In fact, this opinion would invalidate even some approved products such as murabaha (cost plus sale) or *ijarah* (rent contracts). As there is an obvious opportunity cost implied in a longer time period, the majority of scholars are in agreement that the time value of money is not prohibited in Islam. Hence, the element of interest relating to time value of money is not contradicting prohibition of *riba* (El-Gamal 2001).

*Also, all *riba* is not interest*

Likewise, not all *riba* is interest as well. Importantly, *riba al fadl* is broader than interest as defined in the conventional financial system. In the previously cited hadith, a case of barter transaction is referenced that gives rise to *riba*. This implies that not all *riba* is related to debt and/or loans. This is trade or sale related *riba*. The implications of above mentioned hadith are multiple, El-Gamal (2001) elaborates on the rationale of this type of *riba* prohibition to be the objective of justice which is, as explained earlier, sought by the Maqāsid Al Sharī'ah. El Gamal (2006) refers to Ibn Rushd a.k.a. Averroes, a 12\(^{th}\) century philosopher and a judge, for his articulation of *riba al fadl*. Ibn Rushd argued that the ratio of traded quantities should be determined by the ratio of prices, and that the latter should be equal to the ratio of their [marginal] utilities. This will lead to the creation of efficiency mechanisms which may be viewed as an important economic reason and implication of prohibition of *riba al-fadl*. The prohibition of *riba al fadl* clarifies that the main reason for the ban on *riba* is not to prevent exploitation but to ensure justice which is a much broader objective than exploitation itself.

In addition, Chapra (2006) highlights at least four ways of indulging in *riba al fadl* as mentioned by the Prophet (p.b.u.h). The first one refers to cheating an unsophisticated entrant into the market and rigging prices in an auction with the assistance of an agent. The second one is by accepting a reward for making a recommendation in favour of a person. The other one is through barter transactions due to difficulties of precise measuring counter values. The fourth one, which is a result of the previous ones, based on the hadith quoted above, stipulates that commodities of the same type should be exchanged in the same

---

\(^{39}\) As a side note, only Arabic text of the Qur’an is considered as divine revelation hence the only authentic source of meanings and definitions is the one in Arabic language. Any translation of revealed text is an attempt to translate its meanings to a foreign language.
quantities and weights, hand to hand, otherwise *riba* al fadl would arise. The implication of this requirement is the elimination of backdoor to *riba*.

While *riba* al-fadl does not include time element it still has a relation to it. According to the majority of Islamic jurists there are two main reasons for prohibition of *riba* al fadl: (i) to prevent circumvention of *riba* al nasiah as two of the same commodities traded on spot for different quantities can be easily combined with credit sales hence bring the same effect as deferment *riba*, and (ii) to ban gharar or excessive (avoidable risk and uncertainty) as neither party in trade knows whether trade is beneficial or harmful. Hence *riba* al fadl does not refer directly to conventional interpretation of interest and yet it is forbidden. Therefore, in this regards *riba* is a broader term than interest.

*Reasons for prohibition: Exploitation and injustice*

Siddiqui (2004) states five reasons for a *riba* ban that are directly derived from statements and associations mentioned in the Qur’an. For example, *riba* is related to *fasad* or corruption in surah Rum. Therefore, *riba* corrupts society, hence it was banned later. However, as it was the first mention of *riba* in Quran, it was its negative social consequences that were mentioned. Also, *riba* implies improper appropriation of other people’s property as referred in surah Al Nisa in reference to Jews and the ban on interest to them. Charging interest effectively amounts to the creation of instantaneous property rights. In other words, as soon as the lending agreement is signed the right to borrower’s property is created. As we shall see later in the chapter, this is unjustified in Islam.

The third reason is the declaration that *riba* leads to destruction. Here destruction (mahq) refers to decreases followed by other decreases resulting in a continuous process of diminishing. This, however, may seemingly be in contrast to observable increases in real GDPs. Aydin (2013) refers to this phenomenon as a crisis of happiness as measured by Easterlin Paradox which establishes lack of direct correlation between average life satisfaction to income per capita across nations. But also, considering the devastating nature of the recent global financial crisis may well prove the assertion that on aggregate over a period of time we are experiencing diminishing or destruction of wealth. We shall deal with this aspect in greater details in the next chapter. Siddiqui (2004), however, relates this point to social wealth. While *riba* may produce an increase in wealth in monetary terms, it fails to spur growth in social wealth. Instead that is done via charitable giving. The fourth reason is that *riba* demeans and diminishes human personality. This may be inferred from the verse 2:275 mentioned earlier. Importantly, demeaning and diminishing is the result of equating trade with *riba*. The difference between the two is explained later in this chapter. Finally, the fifth rationale for the prohibition of *riba* as inferred in the Quran itself, chapter 2:279, is that it is unjust.
Considering the above mentioned explanations, the most important and overarching reason of riba prohibition is to enable and establish a system that seeks to achieve and promote justice. As riba prohibition touches the essence of all muamalat relationships, it is not hard to see why ensuring justice is the prime rationale for its prohibition. Justice is the prime objective of Maqāsid Al Shari’ah and therefore riba ban is the reinforcement and practical translation of the justice objectives into the economic and business spheres. All other reasons, no matter how important, fall under the umbrella of justice.

For example, one of the reasons, among others, for the ban of interest in Islam is to put an end to exploitative practices that the interest mechanism exerts on less able members of a society. This seems to be one of the prevailing reasons agreed by jurists. But there is an important distinction between the exploitation and justice as prime reasons to riba prohibition. Justice as a reason implies that prohibition is indeed an economic norm whereas exploitation would consider the prohibition as more an act of kindness (El-Gamal 2001). Exploitation refers to a case whereby a debtor (less able member of society) needs to pay a premium for a deferred payment to a creditor (more able member of society). However, he further argues that this argument is rather weak. A person may sell property with a mark-up on a deferred basis without violating the rules of riba and thereby exert similar exploitation of the buyer just like in the earlier case. But this is not the only reason as it may be argued that buying sovereign bonds i.e. lending to government would be difficult to perceive as exploitation by the borrowing state. In fact, some have used this to argue that charging interest by banks today is not the riba that was prohibited (El Gamal 2001).

**Economic efficiency**

Indeed, there is also an efficiency perspective that needs to be mentioned. We have seen that prohibition of riba al-fadl requires the monetization to take place in case of barter trade of similar commodities. Such monetization, using the language of modern finance, is nothing else but marking-to-market goods that are being exchanged. Essentially, requiring goods to be exchanged for money and then using the proceeds to purchase initially intended goods protects individuals from engaging in potentially harmful trade. This mechanism effectively precommits traders to obtain relevant market information before concluding the trade. Hence, economic efficiency arises and, as El Gamal (2001) further elaborates, the marking-to-market or monetization requirement gives rise to Pareto efficiency. Any inefficiencies, however, may arise due to information asymmetries about the fair market prices/values of goods being exchanged. The efficiency argument further reinforces justice as a prime rationale for riba prohibition.

Importantly, El Gamal (2001, 2006) extends the efficiency concept to exchange over time such as credit sales, leases etc. As explained earlier, the price differential in credit sales does not amount to riba and
therefore is not prohibited. Applying the efficiency logic dictates that such credit sales should be
extended using an appropriate mark-up rate. This mark-up rate may be called interest rate as well, but
in order to avoid confusion we shall refer to it as a mark-up rate. El Gamal highlights that in this regards
conventional finance has played an important role by developing an interest rate discovery mechanism
for borrowers of various profiles. He further argues that in credit sales and lease to purchase
transactions, benchmarking mark-up rates to interest rates is quite appropriate. Consider the case of a
transaction where a customer is charged a 10 per cent mark-up rate of profit, as it may be accordingly
referred, while a similar conventional transaction for example is at 6 per cent interest. This is given all
else is equal in terms of cost and funding structures of institutions involved. This example shows that
while the Islamic transaction does not violate *riba* prohibition, excessive pricing violates the spirit of *riba*
prohibition on the ground of efficiency and justice. Moreover, Al Misri (2004) argues that Islamic banks
should stop referring to their mark up as a profit but should refer to it as interest instead. This is due to
the fact that profit is potentially unlimited whereas interest is capped by various regulations.

Given the above reasoning and somewhat blurred distinction between *riba* and interest in case of credit
sales and lease transactions, one may ask then what is the logic of requiring Islamic banks to purchase
an asset first and then to resell it to the customer on deferred payment basis. Would not the same
objectives be served more directly and in a simpler form through a secured lending transaction? El
Gamal (2006) offers two explanations to this question. The first argument takes into account myopically
excessive borrowing if a person is left to its own devices. Hence Islamic laws put restrictions on the
ability to borrow excessively and acts as an effective pre-commitment mechanism ensuring that
individuals do not abuse the availability of credit. This is an important lesson and protection mechanism
for individuals and society alike. The second argument is less intuitive. It builds on the premise that
adherence to religion is historically ensured through adherence to forms in a way that protects the spirit
of the law. The contemporary adaptation of classical contract forms to modern needs necessarily
introduces interim inefficiency. Hence, Islam aims primarily to protect individuals from the fallouts of
debt. As such, the protection is ensured at the individual level as well as at the system level. One may
argue that even conventional regulations aim to protect individuals. However, at best this is done as a
secondary goal. The main objective of conventional regulation is the general health of the financial
system. This is in contrast to conventional regulation that is mainly concerned with issues relating to the
system. The recent global financial crisis and the role of greed and subsequent markets meltdowns is
the best testimony to the negative consequences of availability of credit and myopic behaviour of
individuals and to the failure to account and control aggregate risks accrued at various markets.

*Founders of conventional economics support ban on interest*

Interestingly, with respect to mainstream economists and their view of interest in economic development,
one of the most notable economists of all times and father of conventional economics, John Maynard
Keynes, has also made references to interest or, in fact, usury. Famously, in *The General Theory of Employment, Interest, and Money* (1936), Keynes provided a powerful defence of zero interest rates and condemned usury (Sheng and Sing 2013).

The rationale for prohibition of interest nowadays seems to be clearer than what it may have been in the past. The periodicity and severity of recent financial and economic crises and moreover the inability of governments, regulators and financial authorities to effectively remedy the causes of such crises provides support to prohibition of interest.

Sheng and Sing (2013) further remind that initially the pivotal tenet of Islamic economics and finance, prohibition of interest, was heavily criticized by mainstream economists on the account of gross misallocation of resources. It was understood to be equal to zero interest rates with no return on capital. Given the recent lesson from the GFC and near zero interest rates as a way to promote economic growth, we have witnessed that even conventional experiences do not support distortions alleged by the mainstream economists. Sheng and Sing summarize the debate on zero interest rate in relation to economic growth objectives to say that while mainstream economists did criticize Islamic finance and its no-interest policy, they failed to take into account that even though Islamic finance did not reward financial investments with interest payments, profits on capital and enterprise were fully allowed. Their argument-- positive interest rates would promote economic growth-- was also incomplete without considering the case of negative interest rates which are often the result of government policies.

*Implications of riba prohibition and exchange contracts*

Referencing the same hadith mentioned previously, Çizakça (2013) explains an important monetization element contained therein. The hadith conditions the barter of commodities with different quality characteristics on prior monetization or using contemporary financial terminology, mark to market as a market value discovery mechanism. Any direct exchange, even with mutual consent of both parties, may lead to injustice and hence such exchange is forbidden. As Çizakça explains, this was a condition sine qua non for the establishment of international trade which was dominated by Muslims for centuries soon after the advent of Islam.

The repercussions of prohibition of interest are substantive and many. *Riba al nasiah* and *riba al fadl* are basically counterparts of the verse “God has allowed trade and prohibited riba” (2:275), according to Chapra (2006). As mentioned earlier, *riba al nasiah* refers to loans and is related to the second part of the verse whereas *riba al fadl* refers to trade and relates to the first part of the verse. As trade is allowed in general, this verse, however, implies that not everything is allowed in trade. As injustice
incurred due to *riba*, *riba* al fadl seeks to eliminate all such trade-related injustices i.e. absence of rigging, uncertainty and speculation, as previously explained.

In addition to the clear prohibition of interest, chapter 2 – verse 275 also explicitly mentions permissibility of trade (*Al-Bay’*). Importantly, the term for trade used in this verse is not *Al-Tijarah* which is the word used commonly to refer to trade. The distinction between the two meanings in Arabic terminology is that *Al-Bay’,* according to Mirakhor and Bao, refers to a contract of exchange or as ‘Mubadilah Al-Maal Bi Al-Maal’, exchange of property with property. Askari (2013) defined *bay’* as a contract between two participants to exchange, while *tijarah* is an action involving, specifically, buying and selling.

The implications of the contract of exchange are profound as it directly refers to risk sharing mechanisms which are a cornerstone of the Islamic economic system. On the other hand, contracts based on interest or *riba*, as argued by Mirakhor and Bao (2013), forgo the opportunity for risk sharing and instead enable risk transfers. The difference may appear subtle but the consequences are profound. The interest based contracts such as banking loans transfer the business risks to the borrower whereas the lender, while avoiding the business risk, takes on the risk of default. Hence, it may be argued that even the interest-based contracts do not result in asymmetric risks. It is merely taking on the default risk instead of business or venture risk.

It is exactly this fine distinction between sharing and transferring risks that makes substantive differences in Islamic economics and its financial system. It is not the risk taking function that makes certain transactions permissible but it is rather its risk sharing properties that make it justified and permissible. Take for example the case of gambling. The gambler is taking the risk as well. As a matter of fact, he or she takes an extreme binary type of risk. However, the contract of gambling is not allowed even though the gambler is taking the risk. Therefore, the explicit prohibition of interest in Islamic economic system is further reinforced by an injunction commanding risk sharing as opposed to mere risk transfers. This is the essence of Islamic economics and finance.

Askari (2013) supports this view highlighting that the Qur’an differentiates between a debt contract (dayn), a contract of exchange (bay’), and trade (tijarah). Debts while strongly disliked must be repaid on the agreed dates. Inability to meet deadlines for genuine reasons does not trigger any late payment penalties. Notably, a contract of pledge of political allegiance is called *mubaya’ah* (the root word is *bay’*), and is also considered to be on a contract of exchange. Bay’ therefore refers to any contract of exchange, including the exchange of commitments of fidelity to prescribed rules by a leader and by followers. Mirakhor and Bao (2013) further argue that *al-bay’* actually refers to long term and general contracts of exchange whereas *al-tijara* refers to short term trade of already produced products. Therefore, in *bay’* contracts, the two parties share the risk contained in the agreement to exchange.
Tijarah, on the other hand, refers to trade where one party is buying in order to sell with the intention of making a profit.

Hence, Islam not only prohibits *riba* for the sake of protection of individuals and society as a whole, but importantly lays down the rules enabling risk sharing. An exchange contract is primarily a means of risk sharing. Clearly, in order to effect exchange contract parties need to have property rights, a market place where exchange will take place, market rules facilitating efficiency and lastly regulation and enforcement.

The following sections shall further discuss these essential elements of the Islamic economic ecosystem.

### 1.3.2 Property rights

Following the definition of Al-Bay’ as an exchange contract of property with property, brings to forefront property related issues such as ownership, freedom to contract etc. Property rights in Islam are the cornerstone of its economic system through which economic growth and poverty alleviation is envisioned. The concept of property rights is a direct consequence of the Islamic worldview which states that humans are vicegerents of God (s.w.t.) on the Earth. The concept of Khalifa means that the right to access resources belongs to all humans universally. Moreover, Maqāsid Al Sharī'ah reinforce and promote property rights. Protection of one’s wealth (maal) is one of the pillars of Maqāsid. Hence, property rights in Islam are inviolable.

Importantly, the concept of property rights is directly related to issues of allocation and redistribution of resources. As the resources belong to all human beings and since everyone holds the same rights of accessing to resources effectively implies that even the less able or disabled members of society still have the same right over resources. Hence these rights must be redeemed. Consequently this introduces the concept of sharing with the less able (Askari 2013).

Mirakhor (2010) explains that inability of some people to access resources causing them not to be able to sustain their livelihood triggers redistribution in Islam. Redistribution is premised upon the concept of redemption of rights whereby the ones with excess resources give to the needy ones as an obligatory right of redemption. This is the concept of zakat in Islam which is often confused with act of charity or
donating. However, zakat is an economic category that is institutionalized in Islam and is considered one of the five obligatory pillars of Islam.40

Given that the concept of Khalifa stipulates maintaining property in trust for the next generations, hence the concept of Amanah (trust), Islam also puts limits on the freedom of disposing of property. On the one hand there is no absolute freedom for the owner to dispose of property, on the other hand there are symmetrical rules against extravagance, waste, destruction of property, or its use in prohibited transactions. Wealth is considered the life blood of the society and its circulation is necessary for the creation of investments, employment and general economic growth. Therefore, property rights in Islam are a means of inclusion of the less able in the income of and wealth of the more able as their rights must be redeemed.

In contrast to the concept of inclusion, property rights in the conventional system are a means of exclusion. Helping the less able in the conventional system is an act of sympathy and charity. In Islam, therefore, the zakat amount represent the right of the less able ones in the wealth of the able ones. Discharging the duty of redeeming this right, i.e. paying the zakat is the obligatory act for each able Muslim. Given this role of Zakat, Askari (2013) asserts that unemployment, misery, poverty, and destitution in any society are prima facie evidence of violation of property right rules of Islam, or non-implementation of Islamic instruments of risk sharing, or both. Importantly, given that the property rights are immutable means that the duty of sharing is sanctified and translated into property rights and obligations.

Individuals can gain property rights either through their creative labour, and/or through transfers—exchange, contracts, grants, or inheritance—from others who have gained the property rights title to an asset through their own labour; importantly, work is recognized as the basis of the acquisition of right to property. Given the individual has the right intention to work is also considered as a part of worship as well. It is therefore a duty and obligation upon all individuals. Gaining instantaneous property rights without working to earn them is forbidden, save for lawful transfer. Example of gaining property rights without working includes gambling, theft, earning interest on money lent, bribery etc.

1.3.3 Contracts and trust

In order to fully understand how the Islamic worldview translates into a functioning economic and business system, one must understand the role and place of contracts and trust in Islam. The concept

40 Islam has five pillars, namely: professing one’s belief (shahada), establishing prayer, paying Zakah, fasting the month of Ramadan, and performing the Hajj or pilgrimage for the able ones.
of contract and contractual arrangement or obligation is at the heart of Islam. In fact, the whole concept of Islam and Shari’ah Law is contractual in its conceptualization, content, and application (Mirakhor 2010, p9). It relates not only to economic aspects but rather it forms initial, primordial covenant between the Creator and humans. Honouring a contract is part of one’s religious duty.

Achieving this objective of justice, as a key goal of Islam, requires rule-compliance as a form of demonstration of faithfulness to the terms of the primordial covenant. Honouring the primordial contractual foundation is not only with respect to the Creator but is also toward other humans (Iqbal and Mirakhor 2011). Moreover, Islam specifies that not only performance of contractual obligation matters but also the essential attributes of intention with which a party enters into a contract such as sincerity, truthfulness, and the strength of loyalty to an obligation an individual is intending to enter.

Trust is yet another result of the Islamic worldview. It is the outcome of the value system Islam espouses and a beginning and basis of a contractual relationship. There is an organic relationship between contract and trust. Trust is the foundation for contractual arrangements and the degree of trust is in direct relationship with the cost of monitoring and enforcing contracts.

Lack of trust results in difficulties in negotiation of contracts and therefore increases the cost of its monitoring and subsequent enforcement. Even worse, Sheng (2009), reminds that if property rights are poorly defined the problem of expensive monitoring and enforcement is even more exacerbated. It is then only expected that lack of trust can easily transform into decrease in trade, less market participants, less investments, lower productivity and consequently lower economic growth. Clearly this is all due to increased transactions costs as a result of lack of trust.

Neoclassical theory of competitive equilibrium discusses the role of complete contracts (Arrow 1972). According to this theory, a concept of complete contract fully specifies all future contingencies relevant to the exchange. Incomplete contracts would also be those where informational asymmetry persists, (Spier 1992). However, complete contracts are available only in theory, in reality majority of contracts are incomplete. Certainly all future contingencies are not known and therefore it is impossible to write a complete contract. Moreover, even if these contingencies are known it would be practically impossible to accommodate them in a single contract. In contrast to this rather theoretical exposition of complete contracts consider the situation where parties trust each other. In such a case they can actually enter into a simple contract and agree to revise its terms in case of any new contingencies.

Fulfilment of contract is strictly ordered in the Qur’an. Fulfilment of all obligations is considered as one of most serious requirements to the extent that any obligations left unfulfilled will be settled in the Hereafter.
“And come not nigh to the orphan’s property, except to improve it, until he attain the age of full strength; give measure and weight with (full) justice;— no burden do We place on any soul, but that which it can bear;— whenever ye speak, speak justly, even if a near relative is concerned; and fulfil the covenant of Allah. Thus doth He command you, that ye may remember.” (Qur’an 6:152)

Furthermore, Qur’an states again in clear terms the requirement of fulfilment of all obligations.

“O ye who believe! Fulfil (all) obligations. Lawful unto you (for food) are all four-footed animals, with the exceptions named: But animals of the chase are forbidden while ye are in the sacred precincts or in pilgrim garb: for Allah doth command according to His will and plan.” (Qur’an 5:1)

1.3.4 Markets

Trading and the existence of markets as physical trading places has been the case since the time immemorial. With passage of time there was a growing need to supervise and establish specific rules for specific markets. The meaning and importance of markets cannot be overemphasized. Given its importance, Samad (2008) points out that cannot be a value-free institution as social and economic conducts and its interactions must reflect moral and ethical order. Markets encapsulate and reflect at the same time a multitude of functions. As Hasan (2008) highlights, over time markets were gradually seen as social institutions that allow exchange of goods, services and information between buyers and sellers. Importantly, the existence of markets formalizes and facilitates transfers of ownership rights in goods and services. In addition, free markets are considered a necessary ingredient of civil society and political freedom. From an economic point of view, markets are important for their price discovery mechanisms. Importantly, free markets facilitate decision-making upwards from the grassroot by consumers sending price signals to producers that leads to efficient allocation of scarce resources.
Profits accrued are only normal and, therefore, legitimate resulting in minimal social costs. Each factor of production gets its fair compensation commensurate to its contribution to total output. Hassan (2008) observes that any form of state intervention like taxes, tariffs and subsidies lead to costly distortions tempting participants to waste and misuse scarce resources. The conventional economics wisdom is that the invisible hand of self-interest is believed to be the best regulator of markets keeping individual and social interests in harmony.

Importantly, the conventional view on the function and importance of markets rests on the premise that competition is and remains perfect. Perfect competition assumes homogenous products, a large number of buyers and sellers so that none can influence the market price, factors of production are easily transferable between alternative uses and each one has complete information of the market. As Hassan (2008) elaborates, the critique of such a view of markets and competition is that, following this line of thinking, perfect competition must tend to destroy itself because if firms could sell at a market price without any limit, some of them would sooner than later acquire monopoly power making competition imperfect.

Clearly, markets play a pivotal role in any economic system. Islamic values and rules are also embedded in the market places. Samad (2008) surveys the contribution of early Muslim scholars, such as Abu Yusuf, Al Ghazali, Ibn Taymiyah, and Ibn Khaldun, and concludes that from Islamic perspective market is a value-based sacred institution. For example, Islam gives a lot emphasis to honest traders as one of the cornerstone principles is the protection of consumers. While conventional theory and practice does accord a great deal of importance to consumer protection, Islamic economics considers ethical trading and values a part of its system. In fact, moral norms are no part of mainstream economic theory.

Islam is very particular about measurements, quality of goods, prices and disclosure of information by sellers. ‘Woe to those who deal in fraud, those who when they have to receive by measure from me take full measure but when they have to give by measure or weight to men give less than that’ (Qur’an, 83: 1-3). This verse clearly stresses necessity of giving the right measure. Scales symbolize justice (Qur’an 27: 25) and giving exact weights is part and parcel of Islamic ethics.

Only ethical and honest behaviour warrants respect in Islamic markets. This may be related to contracts and the issue of trust earlier discussed. It is hard to imagine how trust in the market can be established if traders are not honest, withhold valuable information and/or promote informational asymmetries as a source of their profits. Importantly, Islamic values require traders to internalize these values and not only to honour them because of external enforcement/regulation. The obligation to provide full disclosure of all features of object of sale, its merits and shortcomings, is entirely placed on seller. In terms of pricing, Islamic ethics strictly forbids any attempts at raising prices via hoarding or creation of artificial scarcity.
In fact, Islahi (2005) provides detailed account of classical Islamic scholars supporting the free market price formation. However, as Zarqa (1982, p. 49) highlights, the allocation of resources, distribution, and the rate and direction of growth are aided but not dominated by market forces given that economy should be goal-oriented and not consumption or profit oriented.

1.4 Implementing Islamic economic paradigm – a key challenge

The preceding section sought to present key theoretical foundations of Islamic economics and finance and to discuss some moot points. The consensus views on some of the major issues as a basis for the development of Islamic economics theory and practice were presented. Hence this by and large answers the question we posed at the beginning of the review i.e. what Islamic economics is.

Essentially, the Islamic worldview crafts a different economic strategy for the achievement of broad and comprehensive human well-being. Importantly, the Islamic strategy does not seek to abolish private property, as in the case of Communism, nor does it preclude individuals from serving its self-interest. It provides a pivotal role for the function of markets and competition akin to a conventional or capitalist approach. However, it distinctively considers that markets are not sufficient to safeguard social interest. It promotes a value based system oriented towards achieving more balanced allocation of resources aimed at economic justice. As we have shown, Islamic economics offers a comprehensive value and rule-based system in which the main function is spreading and allocating risk among market participants. This is in contrast to the conventional system that allows the concentration of risk among borrowers.

The consensus of scholars is that the main objective of the Islamic worldview and its translation into an economic system is establishing a framework and rules aimed at achieving and promoting justice. Askari (2013) highlights the famous Arab saying “Authority may survive disbelief but not injustice.” The objective of justice is the cornerstone of the Islamic institutional scaffolding of governance, a structure with full transparency and accountability.

Importantly, the overarching issue is the question of implementation of the Islamic economic paradigm and its strategy. Given that Islamic economics and finance is a nascent industry, the prime challenge for policy makers in Islamic finance is steering out of the ‘path-dependency’ in the financial system (Othman and Mirakhor 2013). The link between Islamic economics and Islamic finance arises from the latter’s support of economic growth and stability. Hence, there is a need to analyse and evaluate the role of the Islamic financial system in facilitating economic growth. The next chapter discusses some of key determinants of the Islamic financial system aspects in relation to economic development and stability.
2. Islamic Economics and Finance in Development: Stability and Growth

Islamic economics is founded on a distinctive worldview based on the Qur’an and Sunnah that creates a radically different economic paradigm. The main feature of this paradigm is the elimination of interest that substantially minimizes the role of debt in the economic system and proposes a largely equity-based system. While the theoretical postulates centre on overall human well-being with rule-based strategies reinforcing the attainment of justice and the Maqāsid Al Shari’ah, one cannot ignore the poor economic performance of Muslim countries.

This raises many questions. Is there a problem with the theory, or its application or perhaps both? To what extent is Islamic economics and finance pro-growth and pro-development? In fact, one may ask how Muslims followed the injunctions of Qur’an throughout the history, given that Islamic economics and finance is rather a new discipline, as we have seen in the previous chapter. In addition to growth and development, an important perspective is that of stability as well. Is the Islamic economic and finance system able to establish and support economic stability or would it introduce new unnecessary shocks and volatility into the economy? This chapter shall seek to answer these questions as we shall attempt to further develop a comprehensive understanding of the theoretical aspects of the Islamic system.

To this end, we shift our attention to the translation of Islamic economic theory and its main principles into a macroeconomic model and the related financial system. We shall also take into consideration the recent Global Financial Crisis (GFC) and relate some of its causes and consequences to the alternative Islamic economics and the financial system.

The discussion in this chapter is divided into three parts. The first section deals with the theoretical framework offered by Islamic economics and finance with respect to risk sharing function of the Islamic economy. The second discusses the Islamic financial system including capital markets and the banking industry. The last section of this chapter addresses the grave consequences of the Global Financial Crisis (GFC) from an Islamic economic perspective. An examination of the application of Islamic finance practices and its assessment against own theoretical models in relation to economic development will be undertaken in Chapter 3.

2.1 Islam and development

We may recall from the previous chapter that Islam certainly does not discourage economic prosperity and growth. In fact, it embraces capitalism with a strong measure of ethics and morality.
An Islamic economic system is a rule-based system. Contrary to a conventional economic system, it treats economic activities together with the set of values. However, there are a number of challenges facing Islamic economics, starting right from its definition to the development of more elaborate economic theories and models. But in spite of various challenges, the Islamic finance industry has left significant imprints in economies of countries belonging to the group of OIC and in the global financial markets. Aksak and Asutay (2011) distinguish two major influences: the addition of novel veins supporting the global financial markets while increasing the potential liquidity pool supporting the system; and, enabling investors and entrepreneurs with the moral and ethical concerns to have an opportunity to provide and maintain a financial resource for their businesses.

It is generally agreed that developments in Islamic finance have positively contributed to a deeper and more inclusive global financial system. Nevertheless, the question to which extent is the Islamic framework supportive of economic development and growth still remains. This is largely due to the poor performance of predominantly Muslim countries. A sensible approach to answering this question may be to evaluate the performance of predominantly Muslim countries. However, Askari and Rehman (2013) make an important point here. The impact of Islam on development and growth can be determined only if countries are first classified by their adoption and adherence to Islamic teachings and only then assessed for the contribution of all factors in the context of a complete (not partial) model, including religion, to their development and growth. Indeed, Pryor (2007) concludes that there is no special Muslim economic system in Muslim countries. Furthermore, he shows that only few economic institutions are uniquely Muslim and that the presence of Islam has relatively little influence on most economic or social performance indicators. As identified in the previous chapter, the most important policy issue is steering away from the ‘path dependency’ of conventional system.

2.2 A risk sharing paradigm

Çizakça (2013) highlights that one of the implications of the prohibition of *riba* (interest) is the problem of combining the factors of production. In other words, if $Q = f(K, L, N, E, \ldots)$ is a simple production function, where $Q$ is production, $K$ is capital, $L$ is labour, $N$ is natural resources, and $E$ is entrepreneurship, then clearly combining these factors is necessary to affect production. However, the challenge is how individual owners of these factors of production will be compensated. The owner of capital, in Islamic economy, cannot be rewarded with interest and his or her capital cannot be transferred to entrepreneur in conventional ways. This is solved by rewarding capitalist with profit similarly to the entrepreneur. In fact, the capitalist and the entrepreneur share profits. Moreover, profit sharing necessitates risk sharing as well. Risk implies the possibility of incurring losses. Therefore, the capitalist
and the entrepreneur in the Islamic economic system share not only profits, but also risks and losses thereby substantially changing the character of the economy.

Hence, the core function of Islamic financial system is to spread and allocate risk among market participants. This is in contrast to the conventional financial system which allows, via debt instruments, risk concentration among the borrowers. The Islamic financial system comprehensively covers a spectrum of financial needs and uses three basic mechanisms for risk allocation/dispersion (Mirakhor and Bao 2013):

(i) **Mu’amalat** (transactions) risk-sharing instruments in the sector,
(ii) Redistributive risk-sharing instruments to less able elements of society, and
(iii) Intergenerational risk sharing with inheritance rules specified in the Qur’an.

The last two mechanisms are normally excluded from the purview of discussions on the issues of Islamic finance but play a central role in establishing a comprehensive risk-sharing system. The redistributive instrument is zakat and is used to redeem the rights of the less able through the income and wealth of the more able members of society (Mirakhor 2013). It reflects equality in access to resources reflecting the concept of Khilafah.

In addition, Islamic inheritance rules ensure that even intergenerational risk sharing takes place with the objective of avoiding the concentration of wealth in the hands of one or a few. Obviously, this approach encourages productivity and acquisition of knowledge and work. However, it is typically **Mu’amalat** financial instruments that are widely debated within the finance framework. The essence of such financial instruments is the provision of capital for either trade or production in close alignment with the real economy.

Importantly, as explained previously, trade (Bay’) transactions represent risk sharing as opposed to risk transfers which are represented by interest contracts. Islamic finance as a system, therefore, requires not only avoidance of interest but importantly risk sharing as well. The Islamic finance industry today, however, has lost sight of risk sharing and instead focuses on prohibition of interest through avoidance. The risk-sharing paradigm, being the cornerstone of Islamic economics and finance, is not only embedded in contractual arrangements at the transaction level, but rather the Islamic economic system establishes a clear framework at the macro and institutional level as well. This is in addition to the specific behavioural rules prescribed at the individual level.

Askari and Krichene (2014) remind that the risk-sharing paradigm is actually not a new concept. In fact, enterprises have evolved over the centuries into the modern corporate structures on the foundations of risk sharing. Brouwer (2005) traced the evolution of the modern day corporation in Europe and showed
that the commenda organizations of medieval Italy shared many characteristics with modern start-ups that are financed by venture capital. Importantly, Brouwer argues that equity finance is better equipped to even out unexpected losses and gains that are more inherent to uncertainty than debt finance. Given this background, a brief historical account of the evolution of Islamic finance will provide a suitable overview of the interaction between Islamic and conventional economics.

### 2.3 A historical perspective

Çizakça (2013) provides a useful historical context of Islamic economics and finance. He shows that, contrary to common understanding and in line with intuitive expectations, Islamic finance is as old as Islam itself. Given that the Islamic economic paradigm shares many common features of capitalism, it effectively predated capitalism by the whole millennium. As a consequence, the West adopted many principles and institutions of Islamic capitalism. Moreover, in medieval times interest was ban in Europe until the sixteenth century. The Reformation and then Enlightenment effectively relaxed interest prohibition. Following the prevalent positivist mind at the time, the ethical capitalist was replaced by the rational *homo economicus* (Çizakça 2013). On the other hand, Muslims were not under pressure to discard their basic teachings. Hence, their economic rationale was always based on the classical sources of Islam. Importantly, the Islamic system at the time was implemented using institutions of partnerships and waqfs (charitable foundations). Partnerships were serving as vehicles for very much needed profit and loss sharing whereas waqfs were providing for most public goods in society given modest state revenues.

Muslim trade made considerable impact on post Roman Europe. At the time Europe was demonetized and Muslim trade brought much needed Islamic coinage. Importantly, it seems that the monetization of Europe can be directly related to the ban of *riba al fadl* as mentioned in the hadith referred to in the previous chapter. The effective ban of barter trade as a possible back door to *riba al nasiah* has encouraged monetized trade of Muslims. Given the wide expansion of The Muslim empire at the time, from the Atlantic to the Pacific, it may be concluded that the system of international trade was established as a result of Islamic values. Clearly an important element of the move from barter to monetized trade was the existence of money in the first place. Here was one more notable achievement of Islamic economy at the time. Given that the Islamic empire included Byzantine and the Sassanid, it effectively took over their gold and silver coinage. Recognizing them as a legitimate means of exchange all over the Islamic empire effectively introduced the bimetallic monetary system. In the meantime, the Islamic empire also introduced Islamic coins. Interestingly, given that Byzantine and Sassanid coins were widely circulated and in use throughout the empire, the Islamic state deliberately kept the precious metal content of the new coins lower than the earlier coins. As such bad money drove away the good money and Islamic coins replaced the earlier ones. Muslims seem to have understood what is known today as
Gresham’s Law almost a millennium before Gresham (Çizakça 2013). This has allowed Islamic coinage to spread and dominate the economies of the Middle East, Europe and even India. Some authors even attribute the rebirth of the European banking system to re-monetization as a result of the introduction of Islamic coinage.

However, these were not the only contributions of the Islamic economic system. As the international trade and shipping lines were important, maritime laws played an important enabling role in that trade. This institution was also provided by Muslims. An important part of the maritime law was the law of partnerships, or Mudarabah. Çizakça (1996) provides detailed account of Mudarabah spread to Europe via Italian merchants under the name of commenda where it was considered as one of the important triggers of the commercial revolution. In addition to commenda, medieval Europeans borrowed the institution of waqf from the Muslims. Waqf, being a perpetual charitable endowment, is an important vehicle in the provision of public goods and especially in education and healthcare. A vivid example of importing the institution of waqf is that they constituted the origins of the English trusts. It may somewhat come as a surprise that even the Oxford’s Merton College was founded practically in the form of a waqf or foundation\(^\text{41}\) (Çizakça 2000). Moreover, international trade has indeed necessitated a number of financial instruments such as bills of exchange, letters of credit, promissory notes, checks, and double-entry bookkeeping. There is a general agreement among historians that medieval Europe, again similar to commenda and waqf, borrowed these instruments. Importantly, borrowing implied that subject institutions or instruments were more cost efficient than the ones used, if in existence, by the borrowing nation or the West in this case. Hence, Çizakça (2013, p.140) concludes, ‘it is now well established that all the legal and institutional prerequisites for financing and administering capitalist production and exchange were in place in the Islamic world long before the Europeans started using them’.

2.4 The Islamic financial system

The Islamic financial system is a key enabler of the Islamic economic paradigm. It is the best and most developed component of the Islamic economic paradigm. It encapsulates the prohibition of riba and other aspects of Islamic values in a coherent set of financial products and markets. The two most important elements are capital markets and the Islamic banking system. The next two sections will provide insights into the core function of the Islamic financial system i.e. spread and allocation of risk among market participants.

\(^{41}\) Based on the extensive research conducted by the Jones (1980) and Hodgson (1968) and referred to in Çizakça (2000).
2.4.1 Capital markets

The importance of capital markets in relation to economic development seems to be an issue that does not need a debate. The contribution of financial markets to economic development has been well researched. A number of studies show positive correlation between financial sector growth and real per capital GDP growth (Kind and Levine 1993; Levine and Zervos 1998; Beck et al. 2000).

Developing economies typically have underdeveloped and inefficient capital markets. On the other hand, developed economies are home to capital markets that greatly contribute to their economic development. However, it is now clear that capital markets and the financial sector overall can also increase the vulnerability of the overall economy, regardless of their state of development, (Reinhart and Rogoff 2009; Epstein 2005). In fact, the recent global financial crisis has shown that the bigger the national financial industry the greater the financial instability. Bacha and Mirakhor (2013) highlight that regardless of where crises originate, in developed or in developing countries, they all seem to have a single fundamental cause – debt. Indeed, Reinhart and Rogoff (2010) show that debt was the root cause of financial crises in the last 50 years, including the recent GFC.

Traditionally, four functions have been attributed to capital markets; (i) intermediating between surplus and deficit units; (ii) facilitating the payments system; (iii) enabling inter-temporal transfers; and (iv) serving as a medium for transmitting monetary policy (Iqbal and Mirakhor 2011). In addition, modern capital markets also provide the means and avenue for risk management (derivative markets). An important role is their function in enabling price discovering mechanisms for different instruments. Askari and Krichene (2014) highlight salient features of a stock market being the pooling of savings, relaxing financing constraints for firms, distributing risk among a large number of owners, diversifying risk, and providing liquidity for shareholders.

Efficiency of capital markets is critical for their effectiveness in fulfilling the above mentioned roles and functions. Timely and cost effective way of disseminating market related information is probably one of the most critical enabling functions of markets. Importantly, the efficient allocation of resources within an economy largely depends on capital market efficiency. The importance of properly functioning capital markets, debt, equity and derivative, therefore, cannot be overstated.

2.4.2 Islamic capital markets and risk sharing

Islamic capital markets (ICM) play a key role in the Islamic financial system. The ICM incorporates most of the features and requirements that all properly functioning markets incorporate. This includes the avoidance of corruption such as bribes, the prohibition on gambling (maysir), proscriptions against the
use of poorly defined contracts (gharar), and insistence on the enforceability of contracts. Clearly, these are features of well-functioning conventional capital markets as well which indicates that Islamic and conventional markets do have many functions in common.

But the distinct feature of an ICM is the insistence on risk-sharing contracts/transactions. In turn, this also implies avoidance of debt or interest (riba). The importance of the risk sharing requirement cannot be over emphasized. An ICM would be a market where risk sharing is the predominant type of contract, if not the only one.

Therefore, a particularly important function of the stock market, from the Islamic economics objectives, is its risk sharing function. For example, a project can be financed via risk transfer – from depositor to the borrower, risk shifting – in case of insurance, or risk sharing – in case of equity markets. Importantly, as Bacha and Mirakhor (2013) assert, the 2007–09 crisis demonstrated how risk transfer can quickly convert to risk shifting and then to ex post forced risk sharing through government bail outs. Given that eventually risk was shared between the general public and ailing financial institutions, such as during the recent GFC, one may, in fact, ask why it is an issue if the risk was shared ex post, especially if risk sharing terms and conditions were determine following various regulatory approvals. The key difference in these two approaches is in alignment of incentives. If the risk is shared ex-post, it is likely that only losses will be passed on to the public just like in the case of recent high profile bail outs. Hence, profits and benefits are privatized while losses are socialized. This is due to a host of asymmetries arising in debt-based contracts.

Stock markets play a particularly important role in risk sharing given its direct connection to the real economy, the production of goods and services. Hence, financial institutions are able to participate directly in real economy activities. It also enables better sharing of the benefits of economic growth as well as financial system stability. In contrast, risk transfer through debt instruments along with high leverage weakens the link between the financial and real sectors, thus posing a threat to financial sector stability. Moreover, the development of debt- based financial instruments, as demonstrated in the recent GFC, will likely results in these instruments outgrowing the real sector giving rise to a phenomenon of decoupling as well as to financialization whereby finance is no longer anchored in the real sector, (Menkhoff and Tolksdorf 2001; Epstein 2005).

The chief reason that stock markets are an effective instrument for risk sharing is that each share represents a contingent residual equity claim. As Askari and Krichene (2014) stress, stock markets that are well organized, regulated and supervised are efficient from an economic point of view because they allocate risks according to the risk-bearing ability of the participants. Importantly, the stock market, being a market-based risk-sharing mechanism, allocates economic risks among participants in accordance to
their respective degrees of risk tolerance. This is also the essence of the Arrow-Debreu model of competitive equilibrium which discusses the problem of how best to allocate risks in an economy.

However, it needs to be highlighted that the importance of a stock market is dependent on many factors, including the general business climate and the quality of institutions, size of the economy, the number of listed firms, etc.

2.4.3 Islamic equity market and stability

Islamic stock markets are free from two major sources of instability, namely interest rates and un-backed money creation. Instability in the stock markets has negative and costly effects on the larger financial system. Significant resources need to hedge various risks while they prevent savers, especially smaller savers, from participating in the market. Hence, the Islamic stock market is, in theory, not only more stable than the conventional one but it also promotes increased liquidity and pooling of resources via equity markets. Hence, a high degree of stability will encourage savers and enable stock markets to achieve maximum efficiency in financial intermediation, reduce trading costs and increase levels of participation.

Given that, at least in theory, the Islamic financial system is mostly debt free, equity prices tend to show less volatility as the instruments contributing to increased speculation in the market are curtailed. Demand and supply for shares would reflect the real economic activities, their risk without leverage inflators. Demand would basically be driven by dividends and real savings. On the other hand, supply would largely be determined by the initial public offerings. Thus, both supply and demand would be driven by the stable variables in the absence of interest rates and debt, and equity prices would tend to display a stationary pattern. Extending this line of thinking further, one would expect that the likelihood of speculative bubbles emerging would be minimal. Askari and Krichene (2014) point out important implications of the Islamic stock market on portfolio management, risk and returns; asset prices in Islamic finance would feature low correlation with the market portfolio and would be more influenced by idiosyncratic risks.

*Other Benefits of the Islamic Equity Market*

More stable equity markets and the undistorted link to the real economy are key features of Islamic capital markets. In addition, it is expected that a deeper and wider stock market would have a number of positive economy-wide effects, including improved resource allocation, reduced vulnerability, avoidance of financialization, value preservation, etc.
As mentioned earlier, given that the Islamic stock market has a strong and undistorted link to the real economy with asset pricing reflective of their actual business risk, resource allocation would improve as well. Asset allocation would, consequently, be performed purely based on risk–return criteria. Importantly, leverage would not distort the incentive system and would not shift resources to a suboptimal uses.

Given the structural set up of Islamic financial markets, an important outcome would also be reduced vulnerability. Debt instruments enable multiple times leverage which is additionally detrimental as it is coupled with implicit or explicit guarantees. In that case, speculative play becomes not only highly profitable but has a minimal downside risk. The recent GFC is the case in point. Many financial institutions have speculated and eventually had to be bailed out with public funds. Krugman (1998) terms this as a Pangloss value. Similarly, such Pangloss value may also result from capital budgeting in which discount factors are used that are lower than they should be. For example, this may be the case where the cost of capital used is lower than it should be because of heavy reliance on debt in capital structure; debt can reduce overall cost of capital. As a result, projects that are marginal and which in normal circumstances would be rejected are accepted, leading to what Krugman calls “overinvestment.” Thus, risk-sharing reduces the moral hazard that leads to destructive risk-taking behaviour.

An additional benefit and important feature of the well-functioning equity markets and, in fact, of an equity based system is the avoidance of financialization and, by extension, the creation of asset bubbles (Mirakhor 2010). Financialization refers to instruments detached from the real sector. Moreover, the impact on portfolios and diversification of Islamic capital markets is likely to have positive effects. In the case of diversification within a domestic market, it can be argued that the residual risk that remains even with full diversification, also known as systematic risk, ought to be lower in a risk-sharing context. In today’s equity markets, where debt is seen as an attractive financing choice by shareholders and where businesses see leveraging as a competitive edge, a domestic portfolio, even a fully diversified one, will have high betas due to the inherent leverage. Hence, due to inherent stability of equity markets in the Islamic economic paradigm, as explained above, it is foreseeable that equity risks could be lower in risk-shared capital markets. As interest rates are an economy-wide variable and therefore systematic, their risk does not get diversified away like other idiosyncratic risks of a stock would, thus the higher portfolio beta. An important consequence of lower riskiness is the reduction in risk premiums and therefore, the required returns for stocks would also be lower. The reduced riskiness of stocks should also make it better suited for a wider investor base i.e. small savers would be able to participate in equity markets.

---

42 Paul Krugman (1998) in ‘What Happened to Asia?’ - the values that variables would take on if it turns out that we live in what is (from their point of view) the best of all possible worlds.
Given the above benefits, it becomes clear that the stability in equity markets resulting from the avoidance of interest and establishment of risk sharing has positive effects across the economy, including investors, financial institutions, small investors and government. A very important consequence of debt free capital markets is that they effectively reduce the economy’s susceptibility to speculative flows, thereby improving overall stability. Also, having equity asset returns firmly anchored to real sector returns, a domestic economy would become more attractive to foreign equity capital in search of diversification.

2.4.4 Islamic banking

The structure of Islamic banking in the risk sharing paradigm

The most prominent manifestation of Islamic economics and its rule based system thus far is Islamic banking. Islamic finance initially appeared in modern economies in the form of Islamic banking and has made major inroads in terms of markets and institutional development. However, Islamic banking has received a lot of criticism as well. In this chapter we shall limit the discussion to the theoretical elements of the Islamic banking. More detailed and critical analysis of current practices will be conducted in the next chapter.

The banking industry plays important role in conventional economies. It provides instruments to both savers and users of surplus capital and importantly performs a critical monetary function in the economy. The key enabler for credit expansion in conventional economies is the banks’ ability to contract debt and extend credit. This is based on the concept of fractional reserve banking. Murray (1995) highlights inherent vulnerabilities of fractional reserve banking system and the role of institution of deposit insurance to further destabilize the system. In contrast, Islamic banks do not extend credit and hence their function and role is substantially different. As there is no credit expansion or contraction, there is no fixing or targeting of interest rates by the state, and no conflict between borrowers and creditors. Many authors contrast the two systems to show various similarities but systemic differences as well (Ryu et al. 2012; Beck et al. 2013; Hasan and Dridi 2010).

Many authors discuss the structure of Islamic banking system and salient features (Ahmed 2002; Beck et al. 2013; El Hawari et. al. 2004, 2007; Iqbal and Mirakhor 2011; Siddiqi 2006). Essentially, Islamic finance can be defined as a two-tier financial system, (i) it is a 100 per cent reserve depository and safekeeping banking system enabling domestic and international payments for those not willing to place money at risk, and (ii) for those willing to take risks it is a profit-loss sharing investment banking system that places real savings (domestic or foreign) directly in private or public projects (domestic or foreign) or indirectly via the stock market for domestic or foreign shareholders (Askari and Krichene 2014). In
fact, it may be argued that Islamic banking does not correspond to conventional banking per se due to this structure. Hence the first function is equated to 100 per cent reserve banking while the second one to the investment banking. It should be noted that prohibition of giving and receiving interest makes additional substantive differences between Islamic banking and 100 per cent reserve and investment banking.

Given that the Islamic bank, in theory, is not able to extend credit on its asset side, it is not able to provide returns to its depositors on the liability side unless depositors are willing to take the risks of investments on the asset side. This effectively implies that those depositors with Islamic banks wishing to maintain their account for safe keeping would essentially be guaranteed their money by the bank but also, in turn, would be charged fees for such service. The payment of fees will induce depositors to hold financial and real assets instead of keeping idle deposits. On the other hand, depositors willing to take investment risks would be able then to participate in profit-sharing investment contracts the bank undertakes on their behalf. As a result, these type of depositors in Islamic bank become investors rather than depositors in the conventional sense. This function of Islamic bank is more akin to investment banking than commercial banking activities in the conventional system. As such, Islamic banks have no monetary role and no impact on money aggregates.

Investors receive transferable or marketable shares that enable them to liquidate their investment if they chose to do so on secondary markets. The nominal value of equity shares is not guaranteed. Depositors share in profits and losses as well as in capital gains and losses. Islamic capital markets only intermediate between savings units and investing units (domestic and foreign) in a way that precludes interest. They do not issue money or debt. They include investment banking, stock markets, mutual funds, exchange-traded funds, and other forms of intermediary risks sharing institutions.

In contrast to this approach, credit in conventional finance plays a major role in commerce, production and investment. Importantly, given that bank finance is involved at every stage during the production process requiring borrowers at each step to pay off their debt regardless of the outcome of their business activities, credit is then defined as self-liquidating. In Islamic finance, this type of self-liquidating credit chain cannot exist. No money is exchanged against money plus interest. It is replaced by the Islamic financing modes of bai salam, istisna, murabaha, mudaraba, or risk-sharing financing. There is cash-in-advance at the beginning of each step and delivery of a commodity at the end of the step.

43 In practice, many Islamic banks use products such as Tawarruk to extend credit or provide liquidity to a customer. Without dwelling into details of permissibility of the Tawarruk, given its debt creation feature, suffice to say that most scholars are in agreement that Tawarruk should be allowed only on a case by case basis.
Earlier we explained that in a risk-sharing system, the bank and businesses are partners in a risk-sharing venture. For example, farmers own land and labour and the bank owns the working capital. Farmers owe no debt to the banks, they share risks – profit and losses in the venture. Clearly, in Islamic finance, money cannot be expanded through credit. As mentioned, the depositors in the investment banking sector have the role of investors as they share state-contingent profits or losses. Their deposits are not secured in nominal terms and are marked-to-market. Redemption of their investments is per agreed maturity or they may be liquidated in a secondary market in case they are in the form of tradable securities, i.e. equity shares, *sukuk*, or shares in funds.

Notably, as there is no credit expansion similar to the fractional depository system implies that there is no over-and-under production. The basic pillars of Islamic finance are actually not a novelty. Garcia et al. (2004) remind that the authors of the Chicago Plan in 1933 proposed a ‘narrow banking’, a 100 per cent reserve banking system, so that nothing would be circulated but ‘pure assets’ and ‘pure money’, rather than ‘near moneys’ and other forms of short-term instruments that were causes of financial crises and system instability.

### 2.5 The Global Financial Crisis and Islamic finance

Following the discussion on Islamic financial system and its salient properties that, among other objectives, achieve the one of stability of the economic and financial system we shall now look at the Global Financial Crisis. This is the case at hand exemplifying major instability in global financial industry and world economies reflecting negative consequences of leverage and inability of regulators to keep in-check and contain its harmful effects.

Since the early 1980’s, the financial markets have experienced increasing globalization as a result of the paradigm and policy shift from tight financial regulation to deregulated neoliberal capitalism. Ever increasing innovation and financialization of the financial industry has played a major role in shaping the current global financial architecture. Crotty (2009) terms the combination of modern financial markets and light government regulation as New Financial Architecture (NFA). Flawed institutions and practices have caused recurrence of financial crises. This time the crisis came bigger, deeper and wider, with unprecedented costs and policy and bailout interventions, on a global scale. The severity of the global financial crisis demonstrates the sheer bankruptcy of the deregulated global neoliberal financial system and perhaps more importantly the economic worldview it reflects.
The relationship to Islamic economics and finance is obvious. The Islamic economic paradigm seem to offer solutions to current global challenges. Understanding the root causes and possible remedies for the crisis will highlight the importance of some solutions proposed by the Islamic economic paradigm. Earlier we have concluded that one of the key challenges facing Islamic economics and finance is the lack of empirical evidences and applications for evaluation and assessment. This shortfall of evidences allows critics of Islamic finance to raise a number of questions that impedes the acceptability of Islamic economic and finance solutions. However Islamic economics and finance has an opportunity to prove some of its concepts by documenting negative empirical evidences of what happens when Islamic economic principles are not upheld.

Several decades of deregulation and innovation grossly inflated the size of financial markets relative to the real economy. Crotty (2009) provides important statistics. The value of all financial assets in the US grew from four times GDP in 1980 to ten times GDP in 2007. In 1981 household debt was 48per cent of GDP, while in 2007 it was 100per cent. Private sector debt was 123per cent of GDP in 1981 and 290per cent by late 2008. The financial sector has been in a leveraging frenzy: its debt rose from 22per cent of GDP in 1981 to 117per cent in late 2008. The share of corporate profits generated in the financial sector rose from 10per cent in the early 1980s to 40per cent in 2006, while its share of the stock market’s value grew from 6per cent to 23per cent.

Hence, as this crisis hit the world economy and brought the most significant economic recession, the estimated cost of various bailouts and liquidity injections already amounts to about US$ 11 trillion of public funds.

2.5.1 Origins of the crisis and challenges

We shall not restate the evolution of the GFC. We shall rather focus on the possible explanations of the root causes as seen by the mainstream scholars. Due to its proportions the crisis spared no one. Hence, the aftermath of the crisis seemed to be more of a blame-game. Fingers were pointed to virtually all the players in the market; institutions, regulators, credit rating agencies, saving institutions, instruments, economists and even academic institutions. Notably, human greed was also commonly cited as a common reason for the crisis. This clearly points to substantial architectural flaws of the system itself.

The crisis originated in the US and through it, the globalized financial system has spread internationally. Another dimension was its transformation from a financial to an economic crisis. A series of unprecedented national and international measures were taken to curb its negative effects to contain its downward spiral. A combination of many factors contributed to the crisis. We shall highlight some of the important ones. Stiglitz (2009) distinguishes two main sources of the crisis; incentive problems in the
market including executive compensation systems, securitization, rating agency incentives, the repeal of Glass Steagall, the Bernanke-Greenspan put and moral hazard, incentives for fraud; *modelling problems* spanning failing to understand diversification, intellectual incoherence and ability to detect Ponzi schemes. We shall not go into details explaining and defining each of the problems though some of them may not be intuitive. Later we shall revert to some of them.

In addition, Crotty (2009) emphases that the New Financial Architecture is indeed built on a very weak theoretical foundation and needs to be overhauled. It has widespread incentives that create excessive risk, exacerbate booms and generate crises. At the same time, innovation created important financial products so complex and opaque they could not be priced correctly nor could they be properly risk managed. Consequently, they lost liquidity when the crisis started. The claim that commercial banks distributed almost all risky assets to capital markets and hedged whatever risk remained was false. Regulators also played important role in the crisis. They have allowed banks to hold assets off balance sheet with no capital required to support them and moreover have allowed banks to measure their own risk and set their own capital requirements. Again, as an example of perverse incentives, this inevitably led to excessive risk-taking. Finally, important conclusion is that the NFA facilitated the growth of detrimentally high system-wide leverage.

As a result of all of the above structural weaknesses and systemic flaws, the GFC was the largest financial crisis since the Great Depression. Financialization of global markets as a result of debt contracts, as explained earlier, created financial assets that are substantially bigger than the global economy. Clearly, this is not sustainable as the real economy cannot consistently generate the cash flows required to sustain such inflated financial claims. Hence, Stiglitz makes the important remark that, going forward, governments face a daunting challenge: they need to stop the financial collapse in the short run to prevent a global depression, while orchestrating a major overhaul and contraction of financial markets over the longer run.

### 2.5.2 The Islamic finance perspective

While the crisis has been discussed from virtually any angle and reforms were proposed for almost all areas of activity related to the financial system, it seems however that a discussion on priorities was largely left out from the purview.

Islamic perspective necessitates deeper discussion on the role of debt. Financial system in Islam, as explained, proposes equity based system and envisions minimal role, if any, for debt. Indeed, the negative systemic consequences of debt are confirmed by the GFC as well. When analysing the role of
debt, we need to take into account three perspectives, namely, consumer debt, corporate debt and public debt.

The Islamic financial system calls for a system in which economic agents, individuals and corporations alike, should ‘live within one’s means’ and basically stay away from debt. In contrast, some conventional theories show that incurring debt to build an asset base at early age with the view of repaying in later years may have some benefits. Assets built through such leveraging allows a smoother consumption pattern including in post-retirement period (Friedman 1957). Borrowing early on, building an asset base and later paying back the loan clearly may have benefits for the individual, but only if the individual actually is able to adhere to this rule and in the meantime the risks taken do not bring undesired instability. In fact, availability of cheap credit and the emergence of credit cards has led to sharp increases in the ‘consumer leverage ratio’ which is the amount of debt outstanding versus the consumer’s disposable income. For example, this ratio has jumped by 20-25 per cent in developed economies, including the UK and the US, in the past 10 years alone. Importantly, most of the consumer debt can actually be avoided as it mostly relates to spending on satisfaction of wants in contrast to satisfaction of needs, which in the Islamic worldview take precedence.

In respect to corporate debt, an important starting point is the famous Modigliani-Miller Theorem (MMT). This theorem states that a firm’s value is independent of how it is financed as it only determines the distribution of expected cash flow streams from operations among creditors and owners. While the theory itself is inconclusive, it is commonly accepted that corporate debt being cheaper than equity in addition to being subsidized by the government via tax shelters, provides a convenient tool for corporate finance and expansion; but, up to a threshold that increases the firm’s riskiness.

The third type of debt deserving our attention is the one that may have the largest systemic consequences, that is public or government debt. Resting on the premises of the Keynesian theory of aggregate demand, governments borrow due to purported growth boosting potential of debt. According to the theory, governments can use fiscal policies (budget deficits) as well as monetary policies (lowering the interest rates) during depressions to boost aggregate consumer and investment demand which will in turn increase employment and national income.

Hence, we can clearly see that conventional economic paradigm places great emphasis on debt and indeed its features, in first instance, do seem attractive. Hence we shall look into and compare and contrast the salient features of debt and equity in order to understand the differences in the foundation of Islamic financial system relative to the conventional one.
2.5.3 Equity vs debt

Earlier we highlighted asymmetry of incentives in case of debt instruments. The issue of incentives, as shown above, is one of the root causes of the GFC as agreed by most of scholars, if not all. We have also stressed that while, both, lender and borrower may find it beneficial to engage in debt contracts it is ultimately the tax payers who bear and pay the costs of informational asymmetry.

However, that is not the only aspect of debt and equity worth mentioning. Importantly, the government provides subsidies to borrowers to take on debt. The subsidy comes via tax shelters. The cost of debt (borrowing) is lower than that of equity. However, the lender is not sharing the underlying business risk which are fully borne by shareholders. Therefore, it can be argued that the benefit from debt to a borrowing company comes from tax arbitrage. Hence it is the government that subsidizes the borrowing.

It is important to note that the lender is also incentivized to extend debt. By virtue of extending debt, the lender is effectively creating a claim on an asset without having to share the risk of the underlying asset/project. In case the company performs well, the lender will be able to collect his money plus interest and in case the company does not perform well, he would crystallize his claim over the asset. Thus, the economics of lending is similar to the call option on the company. These advantages to debtor and lender provided by the leverage appear to be a “win-win” for both parties. However, in case of excessive lending such as during the recent GFC, we actually saw that the society at large ultimately takes the losses.

Bacha and Mirakhor (2013) make important conclusions in this regard. They observe that if there is no subsidy and the attendant tax arbitrage benefit for corporations, the sole benefit of debt—that it is cheaper—may not be sufficient to overcome its many disadvantages. The Modigliani-Miller (MM) world of capital structure irrelevance would prevail in case of no tax shelter, i.e. debt financing has minimal impact on firm value. Under the assumptions of the MM model, firm value remains unchanged regardless of the debt-equity ratio. A quick reflection on Dubai, given that it does not have any taxes and therefore no tax shelters are accorded to borrowing firms, this may have important ramifications for the development of its Islamic finance industry. We shall investigate this aspect in Chapter 7.

Trying to understand the issue of subsidy from an Islamic perspective, one may argue that there is a need and logic to subsidizing basic food staples, enabling redistribution to the poorer segments of society. But subsidizing debt leads to lenders establishing ‘unfair’ advantage. Moreover, this is done without giving up anything in return for this subsidy.
Given that lenders or in the Islamic case financiers share business risk, it is expected that they would likely be more restrictive in extending finance than debt lenders. Also borrowers, or in this case project owners would be more careful when they seek financing as they would need to share all the benefits with financiers as well. Hence, both sides would exercise a higher level of caution and due diligence thus raising the efficiency of resource allocation and economic efficiency. Reduction in overall leverage would also have a positive effect on stability and thereby economic development.

Considering the cost of debt versus the cost of equity as a main attraction of debt, it is to be noted that a firm’s cost of capital will converge to its cost of equity in a risk sharing ecosystem, thereby becoming reflective purely of its business risk. As explained earlier in the chapter, a host of benefits would arise such as corporate earnings and stock returns would be less volatile and priced based on their business risk; the incentive for companies to leverage in order to increase expected earnings/returns will be eliminated; tax arbitrage would be eliminated; on a macro level, a deleveraged economy would reduce economic vulnerability and increase stability.

Therefore, the solution to the root causes of the GFC and its consequences as identified in the preceding section, according to the Islamic economic paradigm, lays in systemic elimination of interest and debt and further by creating a risk sharing system. Such a system would bring a number of benefits including greater financial and economic stability.

2.6 Translating the theory into practice

In this chapter we have focused on the translation of the Islamic economic and finance principles into theories and models relating to macro economy and financial system in order to develop a comprehensive understanding of an applied Islamic economic and financial system. We have shown that an equity based system, its macro properties and financial market, exhibit stronger and fewer distorted links to the real economy and therefore establishes and supports better stability. This stability in turns bring a number of economic benefits including better allocation of resources, lower risks and a wider participation of economic agents. Thus, we have confirmed that the Islamic financial system promotes development and growth while ensuring stability and sustainability of markets and the system overall.

In addition, we have also specifically paid attention to some of the root causes of the GFC and discussed its problems from an Islamic perspective. Contrasting chief features of debt versus equity, we have highlighted the essential incentive problems with debt contracts including government subsidies that further distort incentive systems. Given the recent and growing realization that the global economic and financial system needs systemic improvements, Islamic finance advocates have been propelled to the
limelight. This puts additional pressure on Islamic economic protagonists and practically moves them from being critics of the conventional system complacent with relative successes of the industry into a position where expectations are higher and the solution to economic problems are more thoroughly sought. Therefore the challenge upon the Islamic finance to live up to its promise is further exacerbated.
3 Islamic Finance in Practice – Widening Dichotomy

Islamic finance seems to have a notable role in GCC economies, Malaysia, Sudan, Iran and some others while, in fact, globally it accounts for only about 1 per cent of total financial assets. Still, the practice of Islamic finance has attracted the attention of global regulators, major financial institutions as well as sovereign issuers. The annual growth of approximately 15 per cent since the late nineties implies that this industry may have played an important role in the economies championing the Islamic finance. Likewise, the broad interest from diverse institutions and markets suggest that this industry, perhaps, is yet to have a bigger role in the future development of other countries as well.

The integration into mainstream economic and financial flows is among the industry’s notable achievements, but the increasing criticism for resemblance to conventional counterparts is indicative of formidable challenges the industry is facing. Convergence between the two systems, the conventional and the Islamic, seems to be at the expense of the latter by effectively moving it further away from its theoretical model and original objectives contained in the Maqāsid.

This chapter explores the current practices of Islamic finance and contrasts it against its own theoretical models and the frameworks presented in earlier chapters. We shall elaborate on key perspectives and factors influencing the current practice and the performance of the Islamic financial industry. Understanding factors impacting the development of the industry provides a context for deeper understanding of root causes or points of divergence from the theoretical model.

3.1 The dichotomy of Islamic finance: theory vs practice

Islamic economic theory provides a conceptual framework that reinforces justice, equitable allocation of resources and balanced human-centric economic development. It effectively combines the market orientation with social justice. Being strongly grounded in moral values of homoislamicus (Asutay 2013), the theory has received only limited criticism. The modern practices of Islamic finance, however, have been criticized extensively from various perspectives.

---

44 The recent Islamic bonds, sukūks, issuance of GBP 500 million by the Government of UK and Euro 200 million by the Government of Luxemburg are but the testimony of the success and the appeal of Islamic Finance that goes well beyond the OIC economies and its markets.

45 Kuran and a few others have in fact raised challenging issues in respect to theories of Islamic economics and finance. However, their criticisms were met with strong rebuttal from the mainstream Islamic economists and scholars.
A number of authors, Nienhaus (2013), Rethel (2011), Perry and Rehman (2011), Siddiqi (2006, 2014), Al Jarhi (2012), have highlighted the various discrepancies between the theory and the practice of Islamic finance. The focus is on its increasingly unacceptable resemblance to the conventional financial practices. Many authors are questioning the industry’s distinctiveness and its future developmental role, (Boudjellal 2006; Mirakhor; Asutay 2012). Indeed, following the trend of ‘innovation’, many instruments developed by Islamic banks do resemble conventional products, providing more evidence to the convergence with conventional financial practices, (Beck et al 2010). Worryingly, innovation in Islamic finance may easily lead to financialization\(^{46}\) of the industry, referring to the detachment of the industry away from the real economic needs and serving its own purpose. The financialization is one of the key reasons for the recent Global Financial Crisis, (Asutay 2012). Similarly, comparing indicators of business orientation, cost efficiency, asset quality and stability of conventional and Islamic banks, available research has found little significant differences between the two approaches. Furthermore, the research reveals that Islamic and conventional banks are alike even more than previously thought to the point that (Khan 2010) argues that Islamic banks are actually not Islamic!

Importantly, even beyond the simple resemblance, research indicates only limited, if any, practical impact that Islamic finance is making in local and global economies. For example, Aksak and Asutay (2011) find the impact of Islamic finance on the global financial system and economies to be rather limited, indicating available developmental potential but also a failure of the industry. Hence, many authors recognize the need for substantive changes in the industry. Salah and Ali (2010) summarize the need for a change ‘otherwise we will have a completely established system that will be called Islamic finance, but will have the economics of conventional finance’.

Given that Islamic finance has not been implemented anywhere in entirety, there is a paucity of empirical evidence in support of its theory. Thus, the celebrated convergence with the conventional system has, in fact, amplified the confusion of what Islamic finance is and what it ought to be. Bearing in mind that Islamic finance is as old as Islam itself and that its strong market orientation, as argued by Çizakça (2013), has in fact preceded capitalism by the entire millennium, it is indeed perplexing to understand why Islamic financial intermediation is not able to rise to the challenge faced by modern economies. Therefore it is only pertinent to ask whether it is possible at all to translate the theory of Islamic economics and finance into practice. If yes, what are then the obstacles and challenges in adhering to the objectives of the Islamic economic and financial system more closely? Is Islamic finance in practice able to make a difference in economies where it holds a more meaningful share in financial assets? Put

\(^{46}\) There is no single definition of the term ‘financialization’. Krippner (2004) defines it as a ‘pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production’. For the purpose of this chapter we use simplified definition.
more directly, are Islamic banks only changing the terminology i.e. ‘Islamizing’ the language of finance just to conduct the transactions in a more convoluted and complicated way?

In developing the understanding of the above issues we shall begin with the theoretical microeconomic model of the Islamic financial institution (IFI) and the types of risks IFIs face. Elaborating on various risks IFI’s face will help us understand the distinctiveness of Islamic finance. We shall then contrast the theory to modern practices to identify points of departure. This, in turn, will help us recognize various issues surrounding the industry.

A precise identification of various challenges faced by the Islamic finance industry is important to set a context for better understanding and assessment of Dubai’s model of economic and financial development, its relevance and potential contribution to the industry development. The following chapters of this thesis will, therefore, focus on an in depth examination of Dubai’s model of economic development and seek to provide new impetus to the theory and practice of Islamic economics and finance.

### 3.2 Overview of Islamic financial intermediation: the theoretical model

The core function of financial intermediation in Islam is spreading and allocating risk among market participants as opposed to enabling risk concentration and risk transfers to the borrowers as in conventional finance (Mirakhor 2010). The role of the financial system is to create incentives for efficient allocation of real and financial resources (Iqbal and Mirakhor 2011). To this end, as explained in the Chapter 1, there are two general sets of instruments that ensure risk-sharing takes place in an economy: (i) *mu’amelat instruments* in the financial sector that ensure business transactions are using contracts and financial instruments based on risk sharing, and (ii) *redistributive risk-sharing instruments* in which less able members of the society are sharing their risks with more able members of the population i.e.
Notably, the redistributive instruments such as zakat are not instruments of charity or altruism. They are in fact instruments of redemption of rights and repayment of obligations, as explained in previous chapters. Thus, as a result, between these two general sets of instruments, we have a full spectrum of risk sharing tools available in the economy. It is noteworthy to highlight that even the classification into these two main instrument classes is reflective of a fundamentally different worldview Islamic finance is taking.

Financial intermediation involves a collection of excess savings and then channels them into productive economic activities. Ali (2011) rightly highlights that this is an information intensive activity. Hence, the efficiency of information flows amongst economic subjects in a given economy plays an important enabling role in Islamic economic and financial system. Given the strong emphasis Islamic economics and Finance places on transparency and informed decision making, it may be argued that the availability of institutions and instruments enabling unhindered information flows in the economy is in fact more important within the context of the Islamic economic and financial system. Rocha, Arvai and Farazi (2011) provide elaborate evidence that such enabling infrastructure in MENA region in particular is significantly weaker than in other markets. In addition to informational symmetry or asymmetry for that matter, important perspective of financial intermediation is that of risk. Importantly, information asymmetries and incentive issues go hand in hand, influencing the degree of development of the financial industry including its capital markets which in turn may offer more efficient mechanisms for corporate control (Iqbal 2011).

The theory of Islamic finance does not have any reference to banking as a form of financial intermediation. The theory refers only to contractual arrangements between parties, consisting of four basic principles guiding the conduct of Islamic financial business. These are risk sharing, materiality or being directly or indirectly linked to a real economic transaction, no exploitation, and no financing of sinful activities (El-Hawary, Grais, & Iqbal 2007). Various contracts in compliance with Shari'ah precepts have evolved over time. Lately, these contracts have been standardized, to the extent possible, allowing a wider application of Islamic financial instruments. The main distinction is, however, between two sets of contracts, transactional and intermediation. Transactional contracts play an indispensable role in governing economic transactions between parties while intermediation contracts facilitate and finance transactional contracts.

Transactional contracts are a cornerstone of sale, trade and exchange. As can be seen in Figure 1, they include essential contracts such as murabaha (short term and mainly trade finance instrument), ijara (leasing and medium to long term securitization instrument), istisna (medium to long term manufacturing finance instrument) as well as musharakah (partnership). In addition, a benevolent loan, qard hassan, is also considered a transactional contract. Importantly, all the contracts are directly linked to real
assets, either in production or trade. Instruments such as murabaha, while creating a debt obligation are directly linked to asset ownership that is being financed. Likewise, even qard hassan creates debt obligation but conditioned on no increase in principal amount. Intermediation contracts on the other hand, play an important role of screening, monitoring and capital allocation. These contracts include mudaraba (profit-sharing partnership), kifala (guarantee), amana (trust), takaful (insurance), wikala (agency), and ju’ala. Mudaraba and musharaka are considered a cornerstone of profit sharing instruments due to their risk sharing properties.

Modern IFIs use the above contracts to various degrees. Their use determines not only the types of risks IFI’s are exposed to but also the degree to which IFI’s adhere to the objectives of the Islamic economic worldview. In principal, the greater use of risk sharing instruments the greater the degree of adherence. On the other hand, the widespread use of short term, debt-like instruments contribute to the widening gap between theory and practice. In order to understand more closely the issues at hand we shall first look into the theoretical model of an IFI, or Islamic bank.

3.2.1 Microeconomic model of Islamic bank

Before turning to the practice of the Islamic finance industry we shall look into the set up of Islamic banks and contrast it against the more prevalent conventional counterparts. An IFI will perform the functions of financial intermediation through pooling the resources on the liability side and allocating the same resources on the asset side. Importantly, the IFI performs the same functions as conventional banks, that is administer the economy’s payment system and act as a financial intermediary (Iqbal and Mirakhor 2011). In the case of Islamic banks, however, managing the performance of the assets it finances on behalf of depositors–investors-- is their key feature. The “two-tier mudaraba” and the “two-windows” are the two main models used the in intermediation of IFI’s. Both include the use of mudaraba contracts on both side of the balance sheet. The third model is somewhat less known, the wikala-based model.

The “two-tier mudaraba” model involves mudaraba contract between the investor (depositor) and the bank on one hand, and between the entrepreneur and the bank on the other hand. Hence there are ‘two tiers’ of mudaraba contracts. The mudaraba effectively integrates assets and liabilities. The investor (rabul mal) in the case of the first tier shares in revenues of investments being managed by the bank (mudarib). On the asset side, the bank uses funds from the investor to manage and invest into various projects. Given that the mudaraba deposits are accepted on a profit sharing basis they are not considered strictly as liabilities as their value is not guaranteed given that they may incur losses.

---

47 Islamic Financial Institutions (IFIs) and Islamic Banks (IBs) is used interchangeably in this section
such, they are more akin to a limited term, non-voting equity. However, not all deposits may be earmarked for investments and risk sharing. Those deposits that are not held for investments, yield zero return and are repayable on demand, are then treated as liabilities. Demand deposits in this case are placed on banks’ liability side for safe-keeping, on amanah basis, and are not used to absorb any losses. The implication of this structure is significant. Liabilities in a two tier mudaraba structure do not give rise to any reserve requirements. Another important feature of the two tier mudaraba structure is that both sides -- assets and liabilities -- are not exposing the bank to asset-liability mismatch. Investment deposits on the liability side match placements on the asset side. Asset liability risk is therefore minimized or practically does not exist as the liability side fully adjusts to fluctuations on the asset side; bank solvency is ensured and wider risk sharing is achieved at the economy level. Hence a greater degree of financial and economic stability ensues (Ali 2011). Hence such a risk sharing balance sheet of the bank would effectively insulate the bank from the conventional run on the banks, swings in cost of liabilities, and all other risks contained in asset liability management (ALM).

As mentioned, important feature of this model is high informational requirements for calculation and verification of revenues, costs and hence profit or loss. In cases where inefficiencies in information flows exist i.e. information asymmetry between parties, important hurdles to application of the model in the form of moral hazard and adverse selection may surface (Ali 2011). An alternative to such high informational requirements is the murabaha contract. In this case, the bank buys from the spot market and in its own name, the goods that are to be financed are then sold to the entrepreneur or borrower in conventional terminology on deferred payment with a marked up price. However, the most important feature of this structure is, however, that there is no specific reserve requirements given that investors (depositors) share investment risks while their investments are not guaranteed.

The “two-windows” model has emerged as a result of difficulties in implementing mudarabah on the asset side. It essentially divides bank liabilities into two parts or windows: demand deposits (liabilities in conventional sense) and investment deposits (not liabilities in the conventional sense). Some authors also refer to this system as a one-tier mudarabah, implying that mudarabah is mainly used on the liabilities side. Similar to a two tier mudarabah, investment deposits are used to finance risk-bearing investment projects. Hence, a bank is required to hold a 100 per cent reserve on the demand deposits only as they are guaranteed by the bank while no reserve is required on the investment deposits.

Furthermore, the investment accounts include restricted and unrestricted accounts (Fig. 5) whereas current accounts are based on safe custody and hence are not earning any returns to depositors. They are based on the principle of amana (trust or safekeeping) and repayable in full on demand. Importantly, amana depositors belong to depositors and as such the bank may not use them as the basis for money creation through fractional reserves (Iqbal and Mirakhor 2011). But, typically the largest portion of
liabilities would consist of investment accounts. The returns on this accounts are distributed between depositors and the bank according to a predetermined ratio. For example, a profit sharing ratio between banks and investors (depositors) could be 80:20 in favour of the bank.

The returns on investment accounts are distributed between depositors and the bank according to a predetermined ratio. For example, a profit sharing ratio between banks and investors (depositors) could be 80:20 in favour of the bank.

Figure 5: Islamic bank balance sheet structure, source: (El Hawary et al 2004)

An important feature of investment accounts is also to offer them on a no-comingled basis, i.e. as a restricted investment accounts targeting some specific customers, high net-worth individuals or institutional clients. Unlike the case of two-tier mudaraba model, these funds may not necessarily be invested on the basis of mudaraba only. Depending on a specific assets class or opportunity, a bank may invest these accounts in a plethora of instruments. In this case, there is a close resemblance to conventional investment funds and this represents an instance in which resemblance between Islamic and conventional intermediation is not considered divergence from the Maqāsid. Such restricted investment accounts give a great deal of flexibility to IFI’s in terms of structuring the maturity and distribution of profits on a case by case basis.

The third model of operation of IFI or Islamic bank is that of *wikala*. In this model, IFI acts as a wakil or agent on behalf of investors (depositors) and manages their funds for a fixed fee. Hence, in contrast to mudaraba structures in which IFI raises funds on the liability side as a mudarib or a fund manager, in the case of wikala IFI raises funds to manage them as an agent on behalf of investors (depositors). The asset side of IFI in the case of a wikala model may remain the same as in a two-tier or two-window mudaraba models. Hence, on the liability side, IFI’s relationship with investors may be on the basis of mudarabah, wikala, amana or wadia contracts.
On the asset side, IFI has a greater degree of flexibility given the nature of financing activities then on the liability side. Typical contracts include murabaha, salaam, ijarah, istsina’, mudarabah, musharakah, jo’alah/rahn. This gives flexibility to IFIs to structure their assets based on their preferences for liquidity, risks and returns. At the low risk end of the investment spectrum is primarily a murabaha contract which provides debt-like repayments, short maturities and asset backing. Murabaha is most often used for trade related activities. The next level of risk-return trade-off is typically represented by ijarah and istsina’ contracts. Following this are mudaraba and musharakah contracts or assets that would provide further exposure to higher risk-return assets by effectively resembling to private equity or investment funds contracts.

A critical feature of both models explained is their close adherence to the real economy. There are no contracts that earn returns without being based on economic activity and risk taking. This is the inherent and intrinsic stability feature of Islamic financial system. The two-tier model is more likely representative of an investment intermediary, rather than that of a bank (Ahmed 2002). Hence, the Islamic bank as described above shares features of both, an investment intermediary and a commercial bank. Similar to a conventional bank, depositors in an Islamic bank are not owners of the bank and have no voting rights. However, investment depositors in the Islamic bank do share profits with a bank thereby resembling more of an investment intermediary.

This results in yet another important element of Islamic financial intermediation, that of a market discipline. Chong and Liu (2009) highlight that the profit-and-loss sharing paradigm subjects Islamic banks to greater market discipline given that Islamic banks have more direct exposure to business risks. Therefore, contractual arrangements used in the process of intermediation affirm the general market orientation contained in the principles of Islamic Economics. By the same token, that would imply that any disturbances to such market orientation and ensuing discipline would be disruptive to the Islamic Economic and Financial paradigm. As a result of stronger market discipline or exposure to actual business risks and given that the return on capital and its allocation depend on the productivity and viability of the projects being financed, many authors argue, Islamic finance has intrinsically more efficient allocation of capital (Khan 1986). A brief description of the main islamic financial instruments can be found in Appendix 1.

3.2.2 A risk perspective

Clearly, the theoretical organization of the IFI as elaborated above carries significant differences compared to conventional banks. Depositors the in Islamic structure are, in fact, investors. While this may seem to be a subtle difference it, in fact, makes a fundamental difference in the operational and business models between the two systems to the extent that, for example, the structure of liabilities in
IFIs may not even trigger any reserve requirements given that deposits are not supposed to absorb any losses. In other words, the mismatch between assets and liabilities is eliminated providing stability against economic shocks (El Hawari 2004). This is a significant departure from the conventional banking models. The treatment of depositors as investors implies higher levels of transparency and disclosure as well. Consequently, there is significant impact on the IFI’s risk profile as well. It is only natural that the risk-sharing feature of Islamic banking institutions has a direct consequence on the type of risk IFI’s face. As explained previously, the absence of debt, direct links to the asset based real economy, inability to speculate, etc. should result, in theory, in Islamic banks being more stable than their conventional counterparts.

El Hawary et al (2004) highlights that the risk sharing feature is actually ‘neutralized’ as banks pay competitive ‘market’ returns to their investment account holders regardless of their actual performance and profitability. Neutralization is inevitably done for two reasons, (i) predominance of the conventional system within which Islamic banks operate, and (ii) competition with conventional counterparts forces IFIs to adjust in order to remain relevant. As a result shareholders are effectively displaced as returns to deposit account holders take precedent over dues to shareholders. AAIOFI (1999) relates this risk to the bank’s objective of maintaining its attractiveness to investment account holders at the expense of a deterioration of returns to equity holders. This risk arises in situations where investment returns are not sufficiently high to match conventional rates of returns. Clearly, being pressured by the level of interest rates in conventional banking markets, IFI’s attempt to induce investment account holders not to withdraw their funds to invest them elsewhere. Therefore, it plausible that a bank may forgo all its shareholders’ profits during the financial distress thereby adversely affecting its own capital. 48

The risks faced by the IFIs may be classified within the same framework as conventional financial institutions to cover broad risk categories: transactional, business, treasury, governance, and systemic risks, Figure 6, (El Hawary et al 2004, 2007). Importantly, some of the risks are unique and specific to Islamic financial institutions arising due to the nature of its business and types of financial instruments in use. Such risks include, (a) displacement risk; (b) quality of management; (c) harmonization of the institutional environment; (d) liquidity management, and (e) counter-party risks.

48 An example is the International Islamic Bank for Investment and Development in Egypt, which distributed all of its profits to investment account holders while the shareholders received nothing from the mid to late 1980s, (Warde, 2000)
An important consequence of displacement risk is the need for the IFI to maintain higher levels of reserve capital than would be envisaged under a pure profit and loss sharing regime. In addition, shifts in asset and liabilities instruments away from mudarabas and musharakas further contribute to divergence between the theoretical and real risks faced by Islamic banks. A shift away from profit-sharing instruments may be seen as a result of risks preferences as well as banks' inability to effectively manage medium to long terms risks, hence preference towards more liquid instruments and trade related transactions/instruments.

Ahmed (2002) takes into account the risk perspective in analyzing the microeconomic model of an Islamic bank, i.e. the type of risks IFIs face and ways in which they mitigate those risks. This aspect in particular is important from the regulatory perspective. In the case that Islamic banks are not able to provide sufficient returns that would allow the depositor to preserve real value, net of zakat and other expenses, a possibility of early deposit withdrawals translates into a 'withdrawal risk'. This is another perspective of the displacement risk which is basically the risk of depositors withdrawing their deposits. Hence, the higher the displacement risk, the higher the withdrawal risk.

Given that the depositors are sharing profits with a bank implies that they are sharing their business risks, just like shareholders do (Ahmed 2002). Ahmed further highlights yet another type of risk being a ‘fiduciary risk’ as defined by the AAIOFI. The first one refers to the risk of breaching investment contracts or mismanagement of funds. Fiduciary risks are specific to IFIs as they emerge from the very nature of IFI, i.e. its fiduciary responsibility to manage funds on behalf of its clients.
The theory of Islamic intermediation does not provide for any safety nets for investors on the liability side of Islamic banks. This is one of the principal differences in being a depositor rather than an investor. The implication is therefore that the quality of management and operational processes is of specific importance to IFIs. There were some prominent cases in which funds were misappropriated, a case in point is Dubai Islamic Bank in 1990s, due to poor internal controls and processes. Moreover, Islamic banks need to comply with the Shari'ah supervision which adds one more layer of operational risks. This additionally increases risks relating to internal control processes and hence represents operational risks by exposing IB to potential losses.

3.3 Islamic finance in practice

The previous section used the terms Islamic financial institutions (IFIs) and Islamic banks (IBs) interchangeably. This is due to the fact that more than 80 per cent of total Islamic assets globally are held by Islamic banks, hence a banking model is the predominant form of financial intermediation in Islamic finance. But, in fact, Islamic banking is an oxymoron given that Islamic economic and financial theory has no mention of any banking concepts per se, let alone the one that rests on fractional reserve banking and interest based lending. One issue we shall address in this section is, therefore, that of Islamic finance predominantly taking the form of banking, in contrast to a closer format of venture capital, fund management etc.

As a reflection of this issue is the prevalent use of fixed income instruments such as murabaha, the research conducted by Ali (2011) vividly highlights this problem. Three out of nine Middle East and North Africa (MENA) Islamic financial systems (Kuwait, UAE, Yemen) surveyed utilize more than 90 per cent of murabaha transactions on their asset side, while four other systems (Qatar, Lebanon, Jordan and KSA) have it in excess of 60 per cent. Holding high proportion of murabaha assets reflects Islamic banks’ preference for liquidity, security and essentially risk aversion. This very serious and disheartening reality to the proponents of Islamic finance is a clear symptom of misaligned practices with its core objectives.

3.3.1 Performance and impact

The Islamic finance industry today is a part and parcel of the mainstream financial industry. Only in the last five years, 2009-2014, the growth rate of Islamic finance assets has averaged at the rate of 17.3 per cent to reach US$ 2.1 trillion at the end of 2014. This is undeniably a major achievement positioning the Islamic finance as the fastest growing segment within the financial industry. Geographically, the industry has also spread across continents, major markets and institutions. That is yet another

noteworthy achievement. The major regulators, global rating agencies, leading global corporations and financial houses alike, take into consideration Islamic financing options in their corporate strategies. Importantly, Islamic finance has entered into global education as well getting the attention and necessary space for healthy discussions and debates. All of this is a testimony of Islamic finance transcending the boundaries from the obscure and untested and therefore unaccepted financial practice to reach today’s critical mass.

But it seems that these achievements came at the expense of its own principles as the industry has failed to uphold its very own moral principles and therefore has contributed to economic growth but, in fact, not to economic and social developments. Failing to contribute to economic development implies that the Islamic finance industry has not made significant contributions in the financing of value added creating industries, long-term financing and contributing to social and human development (Asutay 2012). This seems to be the prevalent opinion and consensus of researchers. Moreover, Khan (2010) asserts and reduces Islamic finance only to its distinct terminology for conducting, de facto, conventional financial transactions.

The dichotomy between the achievements of the industry in terms of its own development and the aspirations of the ideals advocated by the Islamic economic and financial theory marks current debates and discussion among the proponents and opponents of its current development stage. But importantly for the future of the industry, as Nagaoka (2007) demonstrates, both groups share common ground for their arguments regarding the definition of riba, thereby affirming the robustness of the fundamental framework of Islamic economics.

However, the severity of the failure of Islamic finance must not go without due attention. The problem is more than serious. Various research documents this in many respects. For example, Asutay (2010c) has shown that Islamic banking institutions did not contribute investments to any field that can bring about economic and social development based on human index development scores. This is despite growing asset bases of the same Islamic banks globally. In addition, many authors, Warde (2000), Jan (2011), provide evidence that Islamic finance did not play the role it is expected, such as providing financing to sectors such as agriculture, industry, and manufacturing.

As a result of the current practices Islamic banking dominates the Islamic finance industry. Investment banks and sukuk assets are estimated to stand at 11per cent each, whereas Islamic funds represent less than 6 per cent of total Islamic financial assets (Ernst & Young 2011). Takaful industry accounts for merely 1 per cent of total assets. In addition, this has to be contrasted to the size of the conventional financial industry. The success story of Islamic finance growth and development in fact stands only about 1per cent of global financial assets.
There are two important conclusions when contrasting the relative sizes of the two industries. The first is that Islamic finance still has a long way to go to be able to make any meaningful impact on the global economy thus putting to rest many debates and criticisms of the impotence of Islamic finance. The second conclusion, and more positive, actually highlights the impressive resilience of the IF’s industry and ability to develop despite such disproportionate and eclipsing of the conventional financial industry, the number of financial markets, and financial instruments – including derivatives and synthetic products. It is, in fact quite a surprise that Islamic finance has managed to develop at all! Moreover, should we add to this the adverse attitudes of financial regulators towards the industry’s development, leads us to think that it would be much easier to explain why the industry did not develop than to rationalize how it actually developed.

In addition, one needs to take into account ‘silent’ factors such as preference of debt over equity, incentive systems favouring debt, taxation hurdles etc. These factors are ‘silent’ in the sense that they are often taken for granted and as a default position hence out of scope of any deeper analysis. This is the straitjacket of neoclassical economic model that many authors acknowledge (Chapra 2000; Asutay 2012). Consequently, the story of the emergence of the Islamic finance and its development into an industry is truly remarkable.

We have mentioned earlier that the core role of the financial system is to create incentives for efficient allocation of real and financial resources while that of financial intermediation, Islamic or otherwise, is to pool resources and allocate them towards a productive utilization (Iqbal and Mirakhor 2011). Clearly, Islamic finance has not fulfilled this role up to its potential.

Keeping in mind the relatively recent and quick rise of the industry, since early 1970s, to reach the critical mass of today, it becomes clear that we need to analyse the industry in a more dynamic fashion. Similar to the ‘flow’ and ‘stock’ concept in accounting, Islamic finance needs to be assessed using the flow approach. In other words, the key to its proper assessment and future policy development is the recognition of its evolution path keeping in mind various hurdles.

Moreover, given the dynamic nature of the practice of Islamic and the conventional finance is yet another factor that warrants the flow approach to the analysis of the industry. Therefore, the industry needs to be assessed from the perspective of opportunities presented inherent in its own theoretical model in response to changing needs of the global economic and financial system. For example, a common explanation for the recent Global Financial Crisis, but rarely heard in modern history of economic development, was the criticism of capitalism for its ‘moral deficiency’ and ‘greed’ of financiers and bankers in particular. Therefore, the financial crisis brought the importance of ‘morals’ into the agenda with the objective of ‘moderating’ the consequences of the ‘capitalist financial system’ (Asutay 2012).
Analysing the industry only from the current vantage point, the stock approach, would highlight only the status quo and may be paralyzing to the future industry's development by the overly inward analysis.

In this context, the functional view of the financial system is of particular importance for the analysis of the Islamic financial system. The core functions of the system include (i) efficient capital mobilization, (ii) efficient risk allocation, (iii) pooling of resources and diversification of ownership, (iv) efficient contracting, (v) transparency and price discovery, (vi) better governance and control, and (vii) operational efficiency (Iqbal and Mirakhor 2011). Even the cursory view of Islamic finance quickly reveals failure of the Islamic financial system to provide its original solutions to the mentioned functions. For example, efficient capital mobilization and risk allocation would imply rising capital across maturities, assets classes and instruments etc. Clearly, with Islamic banking rising as a dominant form of the practice and with the majority of assets placed in short to medium term, murabaha demonstrates failure of the industry. Importantly, this framework allows us not only to diagnose the failure but also to ask the right questions such as what are the missing institutions and instruments to enable long term finance and investments, and what are the available and missing mechanisms available for pooling funds etc.

The next sections will focus on key perspectives and factors influencing the current practice and the performance of the Islamic financial industry touching on the functional aspect of the financial system as well. This will be followed with the discussion of root causes of or the points of divergence from the theoretical model.

### 3.3.2 Development path

In order to address the confusion of what Islamic finance is or what it ought to be, arising from the divergences between theory and practice, initially some more fundamental questions should be addressed. One such question is whether Islam itself bears any significance on economic development in predominantly Islamic countries. It is evident that the majority of Islamic countries are mostly underdeveloped and indeed it may appear that Islam may actually be a hindrance to economic development. While we have shown that Islamic economic theory is in fact strongly pro-growth, with a market-oriented proposition, it may be that empirical research provides contradicting evidence. Hence, the question is whether Islam as a worldview should be viewed as inhibiting economic growth. Such notion is held by Guiso, Sapienza, and Zingales (2002) that Muslims and Islam are among the most 'antimarket' religions. In contrast to this, as we have shown in the second chapter, Islam actually strongly promotes economic development, within the context of Maqāsid Al Shari‘ah. Noland and Pack (2004) also show that research has generally failed to uncover links between Islam and economic performance in the context of conventional growth models. On the contrary, they assert that Islam appears to promote growth based on the results obtained by the examination of large cross-sections of countries over
decades all the way to multi-religious states with a substantial Muslim population. Therefore, Islam has nothing to do with the poor economic performance of Muslim countries, and in fact as Askari and Rehman (2013) argue, it is actually the absence of institutions prescribed by the tenets of Islam that is precisely the reason for the poor economic performance.

Given this backdrop, one needs to look into the development path of the industry in order to get a more complete picture of the direction it is taking. It is worth reminding that the origins of Islamic finance can be traced to the very emergence of Islamic civilization (Çizakça 2013; Asutay 2012). The evolution of contemporary Islamic finance practices could be divided into three distinctive phases characterized by the prime development driver i.e. supply or demand driven stage, size of the industry and nature of growth, main instruments used etc.

The first or introductory phase corresponds to the early days of institutional establishment (Islamic Development Bank, Dubai Islamic Bank, Kuwait Finance House, Tabung Haji) covering the period from mid 1970s to 1990. This is the period in which the first Islamic financial institutions were established and murabaha transactions were predominantly used. The industry made major developments during the period in terms of popularizing Islamic modes of finance, availing Shari’ah compliant transactions to retail and corporate customers as well as establishing the ground for a stronger role in national economic development. Asutay (2012) refers to this stage as the beginning of the financialization of Islamic finance indicating the starting point of divergence between theory and practice. The second stage is the consolidation phase in which established institutions are growing their balance sheets, gaining prominence and getting wider acceptance in local markets. This stage covers the period until early 2000. The first two stages can be described as supply driven. The third, convergence, stage from early 2000 till today has seen strong proliferation and growth of the industry in terms of markets, players and instruments. The growth of sukuk markets has enabled Islamic capital markets to converge with conventional markets, thereby enabling the industry to move to mainstream financial services. While the banking industry dominates Islamic financial services, other markets, players and service providers have also established a foothold.

Given the evolution from the obscure and niche sector to the mainstream one, the fast growth segment of the financial industry has allowed Islamic economics to emerge stronger as an alternative system. Keeping in mind the strong emphasis on equity based financial intermediation, it may appear that Islamic finance is indeed not only growing but also capable of making significant differences in economies where it operates.

50 Asutay (2012) and Mayer (1985) identify establishment of Mith Ghamr Bank in Egypt in 1963 as the beginning of a more distinct phase that preceded the establishment of the IsDB and DIB.
3.3.3 Economic and financial environment

Operations of IFIs are inseparable from the conventional economic and financial environment. In fact, Mirakhor and Bao (2013) assert that conventional finance has given birth to Islamic finance due to the failure of conventional finance to meet the needs of a specific market segment seeking more ethical financial opportunities and options. Consequently, the focus of Islamic finance in practice is the avoidance of *riba* and does not extend to implement risk sharing mechanisms as well. Hence the banking system focuses on low risk, short term instruments persisted by way of replicating conventional financial instruments. As a result Islamic finance has effectively turned into an asset class within the conventional system.

The interest free financial system based on risk sharing is in contrast to the conventional banking which model embodies interest based lending, defines specific roles for depositors and borrowers including contractual terms that reflect acquisition of property rights by the lender over the borrowers’ assets. The interest based debt finance forms the foundation of financial transactions in conventional finance. This system, perpetuated by fractional reserve banking, government deposit insurance, and the potential for high leverage, is prone to instability (Othman and Mirakhor 2013, p. 330). As explained, the microeconomic structure of Islamic banking markedly differs from such conventional framework. Yet, Islamic financial institutions have adopted the conventional modus operandi to accommodate existing regulation and competition. Hence, it is only expected that fitting Islamic financial intermediation into a different format, fundamentally different, is poised to produce suboptimal outcomes and criticisms.

Moreover, as a result of being inevitably integrated into the existing economic and monetary system, IFIs are affected by business cycles of the economies in which they operate (Asutay 2012). It is therefore expected that the fate of IFIs is by and large similar to that of conventional banks. Perhaps it is the magnitude of the severity of business cycle challenges that IFIs are different from conventional banks. Earlier we have highlighted the importance of competition and the size of the conventional financial industry in shaping the asset/liability mix and nature of instruments developed and used by the IFIs. Yet another important extension of the prevalence of interest based instruments is the expression of risk/return via interbank market. LIBOR\(^{51}\) is the most often used benchmark rate in pricing Islamic financial instruments. While the IFI’s claim that such interest rates are only used for benchmarking purposes and do not reflect contractual arrangements between parties, it is in fact another evidence of how the conventional financial system is incorporated into the Islamic.

---

\(^{51}\) London Interbank Offered Rate (LIBOR)
In addition, there are many other factors related to the general economic and business environment that are of relevance to Islamic economics. As we have shown earlier, Islamic economics encourages market orientation and incentive policies that are essentially pro-market and pro-business as well as those incentive policies that enable job-creation and business opportunities. These various policies may be captured in relation to the level of ease of business conduct.\(^5\) The ‘doing business’ policies have indirect relevance but great importance to Islamic finance. It may be inferred that those economies with incentive policies that promote business formation, provide supporting mechanisms to small and medium enterprises at every stage of their life-cycle will be conducive to creating the demand for financial products that rely more on business cash flows and less on various securities and collaterals. Clearly such financial products would be closer to the spirit of Islamic finance than current highly collateralized financial instruments. In this context, the information infrastructure of an economy is an important enabling factor for the success of Islamic finance. Economies with well-developed policies, institutions and instruments in support of SMEs would typically have well-developed infrastructure relating to information flows. Keeping in mind strong emphasis on full and complete provision of information between buyers and sellers, regardless of the nature of the subject products or services, that the theory of Islamic economics places it is then reasonable to assume that those economies with serious flaws in their information infrastructure would consequently have hindrances to the development of Islamic finance as well.

### 3.3.4 Islamic banking industry – too big to change?

As mentioned, the most important manifestation of Islamic finance is in the form of Islamic banking financial institutions (IBFIs). The credit for the continuous development and integration of Islamic finance into the global financial system certainly goes to IBFIs. In addition, based on Ernst & Young (2013) report, the proliferation of Islamic finance has enabled large numbers of retails customers, circa 38 million globally, to conduct their financial activities in accordance with their beliefs, which is in fact one of the fundamental reasons for the emergence of modern Islamic finance. The IBFIs also perform important payment functions similar to conventional banks, and hence they are an indispensable part of the financial system globally as well in local economies. But, at the systemic level and in contrast to its theoretical precepts, Islamic financial intermediation is struggling to make a difference.

The most flagrant divergence of IBI’s practice from the the spirit of the Maqasid al Shari’ah is reflected in their balance sheet structure. Many authors Aggarwal and Yousef (2000), Nagaoka (2007), Asutay

---

\(^5\) The World Bank conducts annual ranking of world economies ‘measuring the regulations that enhance business activity and those that constrain it. Doing Business presents quantitative indicators on business regulations and the protection of property rights that can be compared across 189 economies’.
(2012) highlight the use of debt-like financing, which has become the dominant structure in the assets of IBFIs. In some instances murabaha financing comprised up to 90 per cent of the assets as in the case of the Bank Islam Malaysia Berhad during the period from 1984-2006. Similarly, Dubai Islamic Bank held an average up to 70 per cent of murabaha assets on its balance sheet in the period from 1988-2006. At the same time, profit sharing instruments such as mudarabah and musharakah remained rather marginal at about 1.7 per cent for the Bank Islam Malaysia Berhad, and 9.3 per cent for Dubai Islamic Bank.

Čihák and Hesse (2008) make important findings in respect to the stability of Islamic banks drawing conclusions that (i) small Islamic banks tend to be financially stronger than small commercial banks, (ii) large commercial banks tend to be financially stronger than large Islamic banks; and (iii) small Islamic banks tend to be financially stronger than large Islamic banks. Given that this study has taken into account differences in variables such as bank size, the structure of the balance sheet, and system-wide variables, these effects reflect characteristics of Islamic banks.

Keeping in mind the limitations Islamic banks have in terms of efficiently managing their balance sheet and risks in terms of availability of various instruments that are at the disposal of conventional banks, it is only intuitive that large commercial banks are financially stronger than large Islamic banks. Hence, the smaller the Islamic bank, the more agile it is as it able to effectively control various risks. However, as the IBFI grows the importance of efficient risk management increases whereas its ability to manage increasingly complex risks becomes more restrained. This results in problems relating to adverse selection and moral hazard becoming more prominent. Also, it is interesting to note that, according to the same study, small Islamic banks are more stable than large Islamic banks. It implies that Islamic banks are less stable when operating on a large scale or perhaps that small banks concentrate on low-risk investments and fee income, while large banks do more PLS business. The study also reveals that the impact of a bigger presence of Islamic banks on the soundness of other banks in a country’s financial system is not significant.

Given the above theoretical background on the translation of Islamic economics and finance theory into modern financial practices, El-Hawary, Grais, & Iqbal (2007) provide further examples of important differences between the actual practice and its theoretical aspirations. Rightly so they highlight differences arising from the (i) IFIs preference and the need for liquidity, (ii) income allocation policies, (iii) implementation of risk sharing principle, and (iv) governance associated with investment account holders. These issues are merely but symptoms and reflective of the underlying causes the Islamic finance industry is facing. Again, all of the points of divergence identified relate to Islamic banks as such. In fact, Asutay (2012) identifies modern Islamic banking to be the source for the social failure and hence a disintermediation of Islamic banking should take place.
On the other hand, there are evidences that suggest that Islamic banking contributed towards deeper and wider financial services as well as improved access to finance. Some research indicates that there is no crowding out effect of conventional banking where those two systems exist in parallel indicating that Islamic banking has its own market base and that the development of Islamic banking in Muslim countries leads to higher banking sector development, as measured by the amount of private credit or bank deposits scaled to GDP (Gheereart, 2014). This study evidences strong and consistent empirical evidence that the Islamic banking sector acts as a complement to the conventional banking in Muslim countries, when both systems co-exist and the Islamic sector reaches a medium penetration in the total banking sector.

### 3.3.5 Islamic capital markets – beyond sukuk

Capital markets in the Islamic financial system play an important role. In fact, Bacha and Mirakhor (2013) argue that a risk sharing framework in Islamic capital markets is the key enabler promoting stronger economic development and stability while conventional capital markets are inherently unstable given their biased nature towards debt and debt-based instruments. They further assert that Islamic capital markets (ICM) would need to (i) embed balance and equity (fairness), (ii) ensure acquisition of property rights in accordance to Islam, as explained in Chapter 2, (iii) enable transparent price discovery mechanisms, (iv) utilize contracts enforcing trust among participants, (v) discourage and disable fixity of returns. In addition, gambling or taking unnecessary/excessive risks (maysir), informational asymmetries or ignorance (jahl) and bribery (riswah) must be avoided and prevented systemically.

Capital markets in OIC countries have not reached the level of development and sophistication of leading conventional markets. However, notable developments in Islamic financial intermediation in the last decade were those of Islamic bonds, or sukuk. Sukuks have played an important role in bringing Islamic finance closer to modern financial practices as well as growing the industry in terms of market size and the number of issuers and investors. According to Thomson Reuters (2015) research, the total global outstanding sukuk issuance amounts to US$241 billion, with US$110 billion sukuk issued only in 2014. It is expected that the global outstanding Sukuk issuance will grow to US$907 billion by 2020. This documents the tremendous popularity of the sukuk market and it has been rightfully hailed as a main driver of growth in Islamic banking and finance in the past 10-15 years. Importantly, sukuk was an instrument used to popularize Islamic banking in conventional markets as well. Its strong similarity to conventional bonds has enabled issuers and investors to price and trade sukuk in the same way as conventional bonds.

But, the proliferation of sukuk issuance and their global spread has resulted in criticism as well. A typical criticism is in relation to the issue of substance and form, that is, whether sukuk is in substance and not
only in form comply with Shari‘ah principles. The overriding concern in inventing or adopting new financial instruments has been meeting Shari‘ah requirements legalistically while the Maqasid al-Shari‘ah have not received due attention. AAIOIFI’s criticism has highlighted essential issues relating to asset ownership, distribution of profits and guarantee of principal in sukuk structures. Indeed the nature of structural issues speaks volumes about the nature and status of the Islamic finance industry today. While certainly, any structure can be approved under the ruling of necessity the question is how much longer we need to resort to necessity and when the industry will make leaps toward its theoretical postulates. Today’s Islamic bankers are not worried about systemic superiority (as were the Islamic economists in the 1970s/1980s) but are content with the legal Shari‘ah compliance of their new techniques and products. Their prime objective is no longer ideology but market performance. Addressing these issues will require different risk/return expectations and in essence, a different approach and structure of financial markets.

3.3.6 Islamic financial instruments – déjà vu?

In direct relation to the development of Islamic capital markets is the evolution of Islamic financial instruments that reflect economic needs on the one hand and investors’ appetite for risk on the other. Naturally, Islamic financial instruments need to satisfy Shari‘ah requirements as well, which is not always the case. Financial engineering in the realm of Islamic finance has prominently taken place in the form of sukuk. Various sukuk structure, ranging from the vanilla ijara structures to more complex combinations of several contracts, have allowed issuers from diverse industries and investors of different risk/return preferences to effectively meet their own objectives.

Financial engineering in conventional finance was often blamed as a root cause of the recent GFC due to complex structuring and detachment from the real economies resulting in ever increasing financialization, agency problems and eventually leading to the build-up of financial crises. However, financial engineering as the development of financial instruments proved to be rewarding for the originators and financial engineers hence the crises did not prevent further evolution of conventional financial instruments.

Given that Islamic finance has the tendency of mimicking conventional finance, the risk for the industry to get even more similar to conventional finance by endogenising the shortcomings of conventional finance into the IBF realm is real (Asutay 2012). In other words, ‘financialization’ of Islamic finance via financial engineering that is not compliant with the spirit of Shari‘ah is highly likely. Clearly, financialization is considered detrimental to a robust Islamic economy. An example of such a controversial Islamic contract is tawarruq and other proposed Islamic derivatives (Siddiqi 2007).
3.3.7 Regulating Islamic financial industry – to lead or to follow?

Islamic economic theory has mainly succeeded in explaining the issue of why Islamic finance should be put to use in the modern economic and financial system. But the issue of how the proposed Islamic system should be implemented seems to bear many questions.

Having in mind that it is less widely understood than conventional finance, Islamic finance generates mixed perceptions on the risks it introduces. In fact, some regulators such as those of Saudi Arabia do not distinguish between conventional and Islamic financial institutions. Moreover, Islamic finance is often considered as a type of financial innovation and therefore generates concerns on its inherent risks. These concerns are augmented by features that are rather specific to Islamic finance, such as the absence of sophisticated risk management tools. There are other features that relate more to the nature of operations of IFIs in the sense that Shari‘ah boards exert a large influence on banks’ businesses. All of these compounded together along with apparent differences between the theory and practice of Islamic finance add to the confusion surrounding not only the future but also the current Islamic finance industry.

As the table below summarizes, legal and regulatory practices differ across jurisdictions. Some governments, such as those of Indonesia, Iran, Malaysia, Pakistan, Sudan, Turkey, U.A.E and Yemen, have in fact enacted specific legislation to cater to Islamic banking. Some others such as for example, governments of Saudi Arabia, Egypt and Bosnia and Herzegovina, regulate the sector without distinguishing it from the conventional industry. Some others regulate the sector not as a part of the banking industry, such as in Kuwait for example, where the sole Islamic bank is licensed and regulated as a finance house and is supervised by the Ministry of Commerce rather than the Central Bank.

<table>
<thead>
<tr>
<th>Country</th>
<th>Banking system</th>
<th>AAOIFI standards</th>
<th>Islamic banking law</th>
<th>Existence of Shari‘ah Supervisory Boards</th>
<th>Supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iran</td>
<td>Islamic</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Jordan</td>
<td>Dual</td>
<td>IAS</td>
<td>Yes</td>
<td>Yes</td>
<td>Consolidated</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Dual</td>
<td>IAS</td>
<td>Considered</td>
<td>Yes</td>
<td>Consolidated</td>
</tr>
<tr>
<td>Sudan</td>
<td>Islamic</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Yemen</td>
<td>Dual</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Dual</td>
<td>IAS</td>
<td>Yes</td>
<td>Yes</td>
<td>Consolidated</td>
</tr>
</tbody>
</table>


*Table 7: Diversity in the legal, regulatory and supervisory arrangements; Source (El Hawary et al 2007)*

Regulation is directly relevant to the integration of IFIs into a single global regulatory system, the ability of state regulators to recognize unique risks Islamic banks face and their need to manage them. This
takes us to the issue of the role of regulators in terms of industry development. Are regulators leading the industry development or are they gatekeepers of the conventional system? Hasan (2010) identifies five different approaches to industry regulation, (i) reactive approach – UK and Turkey, (ii) passive approach – Saudi Arabia, (iii) minimalist approach - GCC countries without Oman and KSA, (iv) proactive approach - Malaysia, and (v) interventionist approach - Pakistan.

The reactive approach is confined to countries with a non-Islamic legal environment such as the United Kingdom and Turkey. Under this approach, regulators do not regulate IFIs separately and intervene only if there are significant issues that affect the industry. Importantly, Islamic banks need to comply with both conventional regulation and satisfy Shari’ah requirements enforced by its own institutions. Interestingly, according to this research, Saudi Arabia practices a ‘passive approach’ to Shari’ah governance by not distinguishing between conventional and Islamic financial institutions. The IFIs in the Kingdom are the result of self-initiative rather than the regulators’ strategy to the development of the financial sector. A minimalist approach on the other hand implies a slight intervention by the regulatory authorities. This model is mainly practiced by the GCC countries with the exception of Oman and Saudi Arabia where the regulators encourage IFIs to have proper Shari’ah governance system but without specifying the requirements in details. Hence, the minimalist approach prefers the market to shape its own Shari’ah governance system. A pro-active approach refers to a model practiced by the Malaysian regulatory authority. This is the case in which the regulator actively uses regulation to develop incentives conducive to the industry development. Indeed, as a result of regulators’ pro-active approach, the Malaysian Islamic finance industry is the most developed IF industry globally in terms of asset size, types of instruments and number of players in the market. While the passive approach is exclusive to Saudi Arabia, the interventionist model is unique to the Shari’ah governance model in Pakistan. In this case a third party institution decides on Shari’ah matters pertaining to Islamic finance i.e the Shari’ah Federal Court is the highest authority in matters involving Islamic finance despite the establishment of the Shari’ah board at the State Bank of Pakistan.

The importance of regulation in this regard cannot be overemphasized. The regulation itself, however, cannot be responsible for the development of the industry given that the regulator-led development of the financial industry, Islamic or otherwise, would be at odds with the principles of protection of the public. Moreover, in the case of Islamic finance, regulation may be also an inhibitor to industry development. In other words the real question is what kind of regulation do IFIs actually need? After all, various evidence suggests that they are no different from conventional banks, hence why should the Islamic finance industry warrant a different type of regulation? This is an important question as it reflects to the current confusion between Islamic practices and conventional ones as well as understanding of the future development of the Islamic finance industry and its vision.
Notably, various debates and discussions pertaining to the regulation of Islamic financial institutions limit the discussion to the regulation of the existing IFIs and creating a more favourable operating environment. There are two important perspectives to observe: (i) given that IF promotes universal principles of equality, social harmony, economic and human development while proposing a comprehensive economic and financial system essentially limiting a discussion at the outset only to IFIs seems suboptimal (ii) this in itself is a reflection of the fact that IFIs do not operate at the level playing field with conventional FIs, and hence they strive to create a more favourable environment.

Bearing in mind the theoretical model of IFIs and current circumstances where the industry is, a plausible strategy for the regulators is to consider a two-pronged strategy: managing the transition, and shaping the vision (El Hawari 2007). In managing the transition, the objective is to ensure and promote stability of existing IFIs. The regulatory framework to be applied should be similar to that of conventional banking given close affinity of current Islamic finance practices to those of conventional banking. Importantly, according to some, the issue of standardization of contracts needs to be taken seriously in order to facilitate growth, ease access to liquidity and enhance risk assessment capabilities. Similarly, the industry needs to make advances in terms of transparency enhancements.

Reflecting the developing nature of the industry, a vision of regulation beyond the transition is required. To this end, a consensus on a vision of the nature of the industry, the role it would play in the development of the communities it serves, and how it would play will be essential for its sustainable development (El Hawari 2007). Considering the theoretical IFI model, one can expect minimal regulation with less emphasis on capital requirements, more on transparency and disclosure, probably more on screening management profile and business line in licensing, and an equivalent in supervision as compared to what applies to conventional banking. There would be also an expectation of larger reliance on direct market discipline and less on "command and control regulation" (Hawari 2007). However, Sheng and Singh (2012) highlight an important perspective that given pronounced moral hazard issues associated with the structure of Islamic banks, either strong ethics or strong regulation or perhaps even both is required for the development of the industry.

3.3.8 Governance of Islamic finance industry: a missing link in practice

The growth of the Islamic finance industry and its potential impact raises public policy concerns. International organizations and industry standard setters, national regulatory authorities, policy makers, and academics are focusing on IFIs’ risk management practices, the broad institutional environment in which they operate, and the regulatory framework that governs them. Institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), and the Islamic Financial Services Board (IFSB), have been established with a view to
provide prudential regulations and standards for the Islamic finance industry. These global standards-setting institutions provide guidance to local regulators that bear responsibility to enforce desired standards in the industry, including those relating to governance.

Similar to conventional business practices, the issues relating to governance play an important role in the management of IFIs. In fact, having in mind that IFIs have an additional layer of compliance in the form of Shari’ah requirements implies that governance issues are even more important in the case of IFIs. But it seems that there are no specific governance and management standards developed on the basis of Islamic values that relate to businesses in general and the financial industry in particular.

The issue of governance and management often relates to the issue of corporate social responsibility (SCR) which, from an Islamic perspective, is a narrower concept than what the Islamic economic worldview warrants. Asutay (2012) stresses that tawhid, adalah, rububiyah, and tazkiyah among others, directly refer to social development, environmental concerns, and human and economic development. Therefore, the CSR in Islamic economic theory is embedded and internalized by the business itself whereas conventional business practices consider CSR as exogenous to its main business objectives. Importantly, given that CSR practices form part and parcel of IFIs business and directly relate to the nature of the industry, the expectations on the industry’s CSR’s performance are high. However, some research finds that their CSR performance has been rather weak and poor. Therefore, while in theory the CSR activities should be completely internalized in any Islamic business, whether financial or not, the activities of Islamic financial institutions according to conventional measures of the CSR are below standard. This is yet another evidence of misaligned practices of Islamic financial institutions.

3.4 Points of departure from the theoretical model

Thus far we have discussed the theoretical model of IFIs and various aspects of its application in practice. Some more obvious and some less apparent issues have been identified. Clearly, the understanding of the root causes facing the industry is paramount for its future development and closer alignment with the objectives and the spirit of the Maqāsid Al Shari‘ah. We have highlighted some important issues in the preceding section.

Given the dichotomy of Islamic finance as explained above, the root causes responsible for the divergence from the theoretical postulates may be identified to include (i) a formalistic development approach as opposed to adherence to the substance of the Maqāsid Al Sharī‘ah, and (ii) lack of industry integration into national economic development objectives. Importantly, these issues or points of departure have origins and reasons for their occurrence. However, for the sake of the industry’s future
development they need to be recognized as some of the key reasons for the industry’s confused state of affairs. We shall explore each one of them in a greater level of detail.

3.4.1 Formalistic development: form versus substance

The fast pace of IF growth across geographies and business lines has resulted in many debates on the issue of ‘form vs substance’ or ‘Sharī‘ah compliant finance vs the Islamic based finance’ or ‘asset based versus asset backed’ finance. This debate indeed highlights the issue of legitimacy of the current practice of Islamic finance in general and Islamic banking in particular.

‘The legalistic-rational method applied by the Sharī‘ah scholars should be considered as an important part of this observed social failure, which by definition ignores the ‘substance’ by prioritizing the ‘form’, (Asutay 2012). Clearly, there are many reasons why the form took precedence over substance in Islamic finance. A credible reason as such is the concept of necessity given the practical inability to go beyond mere satisfaction of the form at the expense of substance must not be forgotten. However, given the notable achievement of the industry and stage of its development, inertia in the form of continuing the formalistic development may have dire and negative consequences for the industry as a whole. A formalistic approach in finance is relegated to the process of constructing a product by ignoring the outcomes of the product.

The debate on ‘form’ versus ‘substance’ is an essential issue, and in order to overcome the observed failures, it is essential that Sharī‘ah scholarship endogenises moral principles into their decision-making process (Asutay 2012). Initially, the formalistic approach gave rise to Islamic banking as a form of Islamic financial intermediation while later the threat of financialization has emerged referring to continuous searching for Islamic financial products that mimic the feature of conventional products, in terms of pricing, trading, maturity profiles etc.

3.4.2 Convergence without integration

As explained, convergence refers to the narrowing gap between Islamic and conventional finance with Islamic finance trailing conventional instruments and practices. On a positive note, convergence has resulted in Islamic finance joining the mainstream finance to expand its reach and markets cover. However, this expansion was at the cost of moving away from its own objectives. Asutay (2012) reminds us that Islamic banking was enabled by the Islamization of the knowledge movement in the late 1960s, which originally aimed at Islamizing the institutions of Western construct without even considering the existential question about whether the concept of commercial banking should be an institution of Islamic construct.
Importantly, given that the impact of Islamic finance still remains rather marginal in terms of its impact on the global and local economies where it operates, with the notable exception of Malaysia, the Islamic finance has not been integrated formally into economic development but rather has been perceived as a business proposition aimed at generating returns to its shareholders. In fact, IBFIs are now delivering the new capitalism in the Muslim world (Asutay 2012).

3.5 Growth vs development

This chapter highlighted a dichotomy between the theory and the practice of Islamic finance. It seems that the divergence of Islamic finance practice away from the theory threatens to undermine its potential and the ambition to provide an alternative model of financial intermediation. Given the dire need to reform the conventional financial system, Islamic finance has an opportunity to offer a model based on more balanced economic development.

Conventional finance has given birth to Islamic finance due to its failure to satisfy the needs of the segment of clients looking for ethical and moral equitable finance (Mirakhor 2013). The convergence with the conventional financial system enabled the industry to be a seamless part of the global financial system. But on the other hand it seriously risks diluting industry’s distinctiveness and puts the issue of the form versus substance at the forefront of the debate in the industry as the race after the ‘efficiency’ and growth of the industry has been at the cost of ‘equity’ (Asutay 2012).

Naturally, the practice of Islamic finance cannot be disassociated from the level of economic development of countries with a majority Muslim population. Therefore, at the outset it is no surprise that the Islamic finance and banking industry face formidable challenges. Relying on existing research we have shown that the industry’s contribution to domestic and global economies is rather marginal, at best.

We have sought to identify and understand gaps between the theory and practice of Islamic finance in order to prioritize developmental needs for this nascent industry. In other words, we looked for the reasons for divergence between the theory and its practice. Despite strong criticism for underperformance, we have argued that given the eclipsing size of the conventional financial industry, prevailing disinterest of major domestic regulators along with strong systemic debt preferences as a result of prevailing incentive policies, the Islamic finance industry has in fact achieved remarkable success by reaching the current level. However, going forward the industry needs to undergo major reforms if it is to deliver its promise.
Our analysis has shown that there are many factors that inhibit the development of Islamic finance including general economic and financial environment in which the Islamic finance industry operates. Given that Islamic finance relies heavily on unhindered information flows between market players, pro-business incentive policies as well as a level playing field between debt and equity, it is easy to realize that the industry faces significant challenges in its development path. In addition, the oversized Islamic banking industry mimicking the conventional banking sector may yet represent the most difficult hurdle to reform. Banking sector disintermediation via development of robust Islamic capital markets should constitute a major policy objectives (Asutay 2012; Mirakhor 2013).

The threat of financialization in an attempt to develop new financial instruments and the role of regulators in the industry development is yet another area of concern. While regulators need to ensure the safeguards of public interest, they also need to take a more proactive stance, similar to the Malaysian model, in promoting institutions and instruments that are directly and positively impacting more sustainable economic development.

Developing effective governance and management standards based on Islamic values and then implementing them widely across sectors as opposed to a narrow focus on Shari’a governance is yet another avenue of development of the Islamic economy and finance industry that is more reflective of its own values, principles and objectives. Internalizing, or endogenising ethics, is the key to successful long term sustainable institutional development. In reorienting towards being more Islamic, the IFIs should not be limited to the contract mechanics through which financial ends are achieved. Sustainability of Islamic institutions comes only as a result of actually being ‘Islamic’ in orientation, operations and impact (Asutay 2012).

Summarizing various challenges the industry is facing, given its developmental path and evolving nature (Chapra 2000, p35) concludes that Islamic finance is essentially put into a straitjacket of conventional or neoclassical economic model. In order to understand the key underlying reasons for the dichotomy, we have identified two points of departure from the spirit and objectives of the Islamic economy. The overly formalistic approach to industry development and the lack of integration into national and global economic development are the two root causes for the state of the industry today. All other issues enlisted previously spring from these two main causes.

53 It is important to note diverse definitions and meanings of the term ‘neoclassical’. Detailed analysis of different meanings was conducted by (Lawson 2013, p.981) concluding that ‘contemporary discipline of economics, most now agree, has lost its way’.
Any reform of the industry must substantively address these two causes in order to ensure a paradigm shift towards a more genuine Islamic finance industry. Such a shift needs to go beyond the mechanistic and legal compliance of the industry to serve the economic development needs and match the aspirations of Islamic economics and finance.

Hence, it is difficult to see how the industry will evolve and grow to its potential unless a major industry wide demand pull or supply push is created while addressing the root causes of the dichotomy. For both of these causes to be addressed, strong leadership will be required. The following chapters will critically assess Dubai’s ability to provide necessary leadership in crafting a new phase of Islamic finance development.
Part 2: Dubai Economic Development Model:
Performance, Distinctive Features and Relevance to Islamic Economic Paradigm
4 Dubai’s Development Model: Success and Limitations

Article 7 of the United Arab Emirates’ Constitution defines that Islam is the official religion of the Union while the Islamic Shari’ah is the main source of legislation in the Union. The source of Islamic economics and UAE legislation is therefore the same. In addition, it seems that Dubai’s has followed an unorthodox model of economic development. These give us a strong reason to assess Dubai’s overall economic model and its ability to support broader and more substantive development of Islamic finance industry. This is the subject of Part 2 of this research.

Our interest is to understand the extent to which Dubai’s economic framework, structures and drivers are supportive of the development of the Islamic economic paradigm and its financial services. For that purpose we shall critically review Dubai’s economic performance and assess its economic strategy. Initially we shall discuss some of its more prominent features and later, in Chapter 5, expand it to include some of the less obvious and infrequently discussed elements.

However, as we shall see the literature on Dubai’s economic model is rather limited. Similarly, there is a paucity in the literature relating Islamic finance development to a broader enabling economic environment. Hence, bearing in mind that an Islamic economy is still an intellectual construct, discussions on advancement of modern Islamic economics and finance are almost exclusively confined within the boundaries of conventional economic frameworks. Therefore, we hope to provide a new perspective on both Dubai’s economic model as well as its relevance to global Islamic economic and financial development in the next two chapters.

4.1 Dubai’s economic model

Dubai attracts businesses, visitors and researches alike with the scale of its development and achievements in a short period of time. But, in sharp contrast to its achievements, there is very little academic research about its development approach. The relevant literature can be reduced to scholarly work in an academic series written by Hvidt and Davidson and a handful of other authors discussing some specific aspects or sectors of its economy (Al-Sayegh 1998; Schiliro 2013).

54 Martin Hvidt, professor at Zayed University, Dubai researched Dubai model in ‘The Dubai Model: An Outline of Key Development – Process Elements in Dubai’, ‘Governance in Dubai: The emergence of political and economic ties between the public and private sector’
55 Christopher M. Davidson is a Lecturer in Middle Eastern Politics at the Institute for Middle Eastern and Islamic Studies at the University of Durham in ‘The Emirates of Abu Dhabi and Dubai: Contrasting Roles in the International System’, ‘Dubai: Foreclosure of a Dream’
Dubai has a small, open and well integrated economy into global economic and financial flows. It appears that the abundant natural resources, oil and gas, available locally and regionally are prime drivers and major contributors to its development and growth. Given its central position in a region well-endowed with hydrocarbon resources it seems that its economic prosperity, almost by default, is ascribed to abundant oil revenues. Perhaps that is the reason why the Dubai model has not received due attention from the academic community despite apparent economic and business success. While at the face of it, the Rentier State Theory (RST), may seemingly be relevant in explaining Dubai’s development drivers, motivations and outcomes, irrespective of its actual relevance, its somewhat deterministic and pejorative nature may have in fact inadvertently contributed to inadequate research of its economic model. Hence, the superficial association of Dubai with the RST has obscured many strengths of its development paradigm. By the same token, Dubai’s economic model has several limitations and various lessons thereof are not researched well enough either.

The role of oil, nevertheless, is undeniably an important factor in shaping the economies of Dubai and other GCC countries. But, in case of Dubai, it is likely to play the role of a catalyst as opposed to being a hindrance as some authors and the RST theory of Resource Curse may suggest. Hence we start with the discussion on whether the RST theory is applicable to Dubai in the first place. In the case that Dubai bases its economic success primarily from distributing oil rents then clearly its model would not be taken seriously not only in the context of Islamic economics and finance but likewise in the conventional sense as well. Hence, it would be nearly impossible to envision Dubai as a significant contributor to the Islamic economic paradigm while being primarily engaged in rent distributions.

4.1.1 Rentier state theory and Dubai

Some literature considers Dubai’s model within the context of the *rentier state theory* (RST)\(^{56}\) and neopartrimonialism. Originally, Mahdavy (1970) attempted to highlight economic challenges faced by the oil exporters and suggested ways for addressing such problems. Closely related to the RST is the theory of the Resource Curse which similarly looks into poor economic performance of resource rich economies. Resource curse theory basically attributes an ‘anomaly’ economy or an economy with adverse socioeconomic consequences to the fact that a substantial portion of national revenue is derived from the oil and energy-related income. Gray (2011) defines the RST as a state-society relationship in which the state generates a large portion of income from rents or externally derived payments, typically that of oil and gas. The theory considers the state to be autonomous from society.

\(^{56}\) The first to define RST was Hussien Mahdavy in 1970 writing about Iran before the revolution. Later Hazem Beblawi and Giacomo Luciany were some of early proponents of this concept.
It assumes that states do not need to impose any taxation as long as they distribute rent income to society. In turn the state does not need to have any development strategy.

In fact, Ruthledge (2014) considers these two theories as two elements of the same paradigm. In this particularly critical account of the RST and Resource Curse theories, she points out the theory of the RST had become more deterministic (and pejorative) in nature in the late 1980s and onwards. Moreover and importantly, the ‘state’ was used in a broader meaning to include the institutions of government, commercial entities and the citizens as a whole.

Gray (2011) discusses the RST theory in a view of economic achievements firstly in Dubai, but also in Abu Dhabi and Qatar, and concludes these states do not fit in the original framework of this theory. Notably, it seems that there is increasing recognition that not only Dubai, but also other Gulf Cooperation Council (GCC) states, deserve more attention in understanding their developmental model and the specific role of oil revenues. El Katiri (2014) aptly describes the strong economic-welfare function as a distinguishing feature of GCC economies in relation to other resource-rich states. She defines the GCC states as a ‘Guardian State’ describing a state in which benevolent state elite aim to maximize social welfare supported by the state autonomy in decision making. The relatively small population sizes, geographical position, and inherited governance mechanisms i.e. tribal societies etc, are some of the key reasons for the apparent divergence from the expected outcomes of the classic RST.57

These are important learning developments. Assuming to the contrary, that a state, in our case Dubai, exhibits all the features of early RST theory and primarily autonomy of state from the society, it would be difficult to envisage how such an economy would be able to play an important role for the development of an Islamic economy given that Islamic worldview is premised on integration of state and society (Chapra 2007). As we shall show, traditionally Dubai’s government has played a key role in the economic development not only in policy making and regulation but also by making direct investments akin to private entrepreneurs. In fact, (Pradhan 2009, p5), refers to it as ‘a best case of the success of state-led Capitalism’.

The theory of a ‘Guardian State’ makes important contributions in explaining development models relevant particularly to GCC economies. It recognizes the resource-led nature of a development model similar to the RST but it highlights its strong economic welfare objective function; hence the term the guardian state. But while the economic successes of guardian states are evident as a result of a strong drive to promote economic growth, the guardian state also illustrates some negative externalities. As it may be expected, in general, negative externalities are associated with resource wealth and include a

---

57 Ibid, page 25
high propensity for waste and systemic dilution of market incentives. As a result, sustainability of economic growth is thereby a key challenge in guardian state economies.

4.2 Key elements of Dubai’s model

Being a small and open economy, Dubai is well integrated into global economic and financial flows. Free movements of factors of production, capital and labour, as well as of trade are a corner stone of its development strategy. Dubai pursues a regime replete with liberal economic policies (Schilirò 2013), and does not impose any taxes\(^{58}\) on capital or labour, or any restrictions on capital inflows and outflows. A diverse corporate sector has developed, led by prominent government related enterprises such as Emirates Group, DP World, and comprising a myriad of global and international firms operating in virtually every sector of the economy. In the first decade of the new millennium, Dubai’s real GDP has almost tripled from AED 113 billion in year 2000 to AED 293 billion in 2010 and AED 335 billion in 2014, as can be seen in the Figure 8. Notably, this period includes the negative effects of the 2008/2009 global financial crisis and Dubai’s debt crisis without which the achievement would have been much more impressive. These negative effects are reflected in negative GDP growth for 2009 (-2.5 per cent).

![Dubai’s Real GDP in Million AED and Growth Rates](image.png)

**Figure 8: Dubai Real GDP and Growth; Source: DSC**

Historically Dubai has played the role of a regional entrepôt. Bearing in mind the demographic diversity of Dubai’s population throughout time as well as the nature of trade business meant that a broad range of economic, institutional, political, and cultural factors have shaped the evolution of Dubai’s economy. Hence, its overall development process has to be seen in the broader context, implying a multi-causal explanation (Hvidt 2009). Hvidt lists nine parameters that, according to him, define Dubai’s model: (i) Government-led development (ruler-led), (ii) Fast decision making and “fast track” development, (iii) Flexible labor force, (iv) Bypass of industrialization—creation of a service economy, (v)

Similarly, Nyarko (2010) discusses elements of UAE’s development strategy which may also broadly apply to Dubai. The key elements are defined as (i) a political system, which has resulted in the perception of stability and minimal political risk, encouraging investment, (ii) oil, (iii) development strategies that have resulted in a very dynamic business environment, (iv) openness to foreign skills and management, (v) labor policies that have enabled the immigration of vast numbers of foreign low-skilled workers. Along similar lines, Davidson (2009, p9) describes ‘Dubai’s new post-oil economy capitalized on its long history of trade, merchant immigration and re-export activity, and its relative openness compared to its Arab peninsular neighbours.’ Indeed Dubai’s demographic circumstances coupled with the geographic position it occupies has underpinned and determined the nature of its development.

It is certainly true that all of the above mentioned factors have played a significant role in shaping the development path and outcomes in Dubai’s economy. However, it has to be noted that some of them are more of an exogenous nature from Dubai’s standpoint given the limited control it has over them while some others are actually the result of a broader principle or a policy. For example, fast decision making is the result of a specific role Dubai’s government plays and its governance approach. Likewise, some policies are decided and set at the federal level such as the labour policy whereby Dubai has limited scope or control. Similarly, Hvidt’s bypass of industrialization and creation of investment opportunities may be considered to be more of an effect than a cause or driver of Dubai’s model. Bypassing industrialization is a natural outcome for Dubai, having in mind rapid and recent accumulation of wealth, limited natural resources and a small domestic population. It is true, however, that bypassing industrialization has led to the development of a service-based economy and the governance mechanism as practiced today. Similarly, the creation of investment opportunities is a consequence of its development and governance approach. Thus, the challenge in defining Dubai’s economic model lies in distinguishing between the sources of its development and the effects of its policies and strategies.

4.2.1 The UAE setting

In order to fully understand Dubai’s development model, its path and strategy, at the outset one needs to distinguish between federal common policies and Dubai’s own strategy. Dubai’s economic autonomy is confined within a broader UAE economic framework. Among the important policies, this framework

---

59 We reviewed UAE related research and drew lessons where such research is reflective of Dubai’s model as well.
includes macroeconomic and labour policy, regulatory frameworks for banking and financial industry, currency peg etc.

Federal policies are the result of a common and shared economic and political dynamic of the seven emirates. Dubai has a strong degree of influence but not decisive over the national or federal policies. However, it has to be noted that, while in general federal policies are reflective of Dubai’s economic circumstances, Dubai often finds itself in the legal loopholes as it manoeuvres around the legal pillars. For example, Davidson (2007) highlights the case of the first residential house sales to expatriates and the creation of free zones as a measure to circumvent the federal restrictions on property ownership by expatriates.

Common federal policies have shaped the macroeconomic setting as well as Dubai’s legal framework. The federal influence involves important areas such as monetary and exchange rate policy, immigration, to some extent fiscal policy – taxation, and ownership policy - Company law. A key federal policy is the UAE dirham peg to the US dollar which implies that a local monetary policy should be aligned with US monetary policy. This also implies that the UAE is basically tracking the US interest rate levels regardless of the phase of its own economic cycle. Immigration policy or labour policy is similarly set at the federal level. UAE labour policy is highly flexible and, along with other federal policies, is one of the key developmental pillars of Dubai economic model.

It could be argued that some federal policies such as monetary policy do not necessarily serve the best interest of Dubai or the UAE at all times. The rigidity of monetary policy due to the dollar peg has greatly contributed to the exacerbation of the business cycle in Dubai in late 2007 /08. As Dubai’s economy was experiencing a broad expansion, the US economy was going through difficulties that led it to run an expansionary monetary policy, i.e. a low interest rate policy, which in Dubai’s case was unfavourable and a pro-cyclical measure.

Thus, UAE macroeconomic policies serve as a framework for Dubai’s developmental strategy; the idiosyncratic features are identified below, reflecting on Dubai’s unique approach to economic development:

4.2.2 Government-led, value-based economic development

In contrast to the RST theory which assumes government’s passive role with respect to economic planning and development, the role of the government in the development of Dubai is critical. This is in line with the ‘Guardian State’ theory which asserts that those states markedly differ from most other economies not only by its resource wealth but also by the ‘guardian’ role the government plays. Its role...
and interaction with the business community as well as a ‘social contract’ with its citizens seems to have a long tradition (Al-Sayegh 1998). Importantly, the relationship between the state and its citizens did not come about as a result of oil revenues and rents distribution but rather vice versa. The specific role Dubai’s government plays is the legacy of a centuries old relationship primarily between Dubai’s rulers and its merchant community. In fact, (El Katri 2014) highlights the pre-existing political and economic structures as a distinctive feature of the Guardian States.

The pre-existing structures include the tribe as the key social unit central to structuring socio-political life. The tribe is further divided into families and headed by the tribal sheikh. The role of the sheikh is that of a leader and guardian of his family members including their socio-economic interests. Developing on its tradition and existing structures Dubai has developed idiosyncratic governance mechanisms that has also oriented the government towards a proactive state entrepreneurship and investment policies focused on diversification. Given its unique governance approach, Dubai’s model is a ‘deviant case’ of economic development (Hvidt 2006). It is not too difficult to realize that such idiosyncratic nature of governance mechanism can be related to prevailing traditions and Islamic values leadership and society has espoused. Hence, even though the purpose of this research is not to determine whether Dubai’s economy is Islamic per se, as highlighted in the next Chapter, it is still important to emphasize the relationship between Islamic values and Dubai’s society and its leadership.

Similar to the rest of the Middle East, Metcalfe and Murfin (2011) highlight the importance of moral codes and ethical conduct and emphasize their radical departure from Western models focusing on leadership in organizations and holistic development of an individual’s intellectual and spiritual identity. In fact, they stress that Islamic philosophy and science must be considered at the very core of leadership roles and relations in the Middle East.

Arguing along the similar lines in the context of the UAE, Suliman (2011) highlights that Islamic culture and values are considered as a way of life and regulate almost all aspects of daily living in the UAE. He further stresses general ethical orientation of the UAE society based on the Islamic teachings and finds that work values in the UAE are influenced by Islamic values, Arabic tradition, contemporary development policies, as well as generational, social class and gender factors. Abdulla, Djebarni and Mellahi (2011) study of Dubai’s labor market and job satisfaction confirm that the social life in the UAE is indeed substantially affected by the values and culture of Islam. Their survey demonstrates that all Emiratis see their religion as an integral part of daily life. Likewise, Simadi’s (2006) study of young adult Emiratis’ values found that religious and cognitive values were the strongest determinants of work values in the UAE.
Importantly, as we reported in Chapter 8, our interviewees have confirmed and clearly identified the role of Islamic values when probed about motivation behind economic development in Dubai. They have defined the role of Islamic values very similarly as referenced researchers above, i.e. as a way of life, and have defined it as a set of values that includes fairness, sharing, competitiveness, self-reliance, hard-work, etc.

This seems to resonate well with Metcalfe and Murfin (2011) definition of leadership in Islam as “a relational social practice, a process of interaction between leaders and followers which should be based on mutual engagement and trust...The principle of maslahah (concern for the public good and welfare) governs actions and behaviours of leaders and followers.” As shown in the later in this Chapter, Dubai’s praiseworthy economic achievements in terms of development and growth as well as employment and opportunities created along with social harmony, safety and security are strongly aligned with the principle of maslahah.

*Dubai’s Governance Model and the Role of Merchants*

Since the turn of the 20th century Dubai was an entrepôt in the Gulf and has derived its prosperity from trade and commerce. Uniquely, it is Dubai’s merchants who have played an important role in shaping Dubai’s economic and political reforms (Al Sayegh 1998). Scarce resources and trade meant that merchants and rulers needed to work together to secure their livelihood. Partnerships, genuine creativity and innovation were used to develop businesses and Dubai’s economy. Dubai’s natural harbour, strategic location and thriving merchant community maintained it as entrepôt for many decades. Contrary to expectations, the merchants’ influence did not slow down with the advent of oil. In fact, it continues till today.

The continuous flow of merchants since the end of the 19th century left imprints in Dubai’s economic structures and decision making process in particular. In fact, merchants were key contributors in implementing economic and political reforms. But admittedly there were some declines in merchants’ influences albeit only temporary in nature. Their role and close relationship with the public sector is evident even today. The government and the merchants throughout the history of Dubai have shared the responsibility to develop and contribute social aspects of their society. Social development was never confined to strictly government affairs. As highlighted by (Al Sayegh 1998), merchants have taken on additional roles as service suppliers, urban planners, culture mediators, and internationalists who represent the Gulf throughout the world. Indeed this is the aspect of governance that is aligned with the Islamic worldview.
Interestingly, in many occasions the ruler’s income was not as high as that of the pearl merchants. In fact, there were many times when the ruler resorted to the merchants for financial assistance. Financial dependency of the ruler on the merchant community and vice versa implied the need to focus on business development. In addition, it allowed merchants to have an upper hand or at least equal influence with the ruler in matters affecting their lives. Since the early 20th century ruler used to appoint merchants to his Majlis\(^6\), or advisory board, majlis was constituted as a consultative body and has effectively become a de facto government led by the ruler and composed of merchants. The relationship between the ruler and Dubai’s merchants remains until today. In fact it became even more complex given the legacy of old relationships. The critical juncture took place in the early twentieth century when the ruler of Dubai persuaded the business community of the Persian city-state Lingah to relocate to Dubai. It instituted the strong private sector and pro-business development path which has characterized Dubai ever since.

As a result, Dubai’s achievements are indeed remarkable and note-worthy not only in terms of its economic performance, but also how that performance was achieved. The cosmopolitan nature of Dubai’s merchants has added an important dimension in the fabric and nature of the business conduct and its economic structure. Given limited natural resources endowments, the small size of the local labor force, the complex political surrounding and challenging global economic environment, this governance model has proved to be particularly resilient.

Especially noteworthy are the achievements in this complex environment in terms of social cohesion, safety and a high standard of living. It is clear that Dubai’s economic and social aspects are often inseparable as religion and culture shape Dubai’s decision making process through its own management and governance styles. Therefore, combining economic as well as social achievements of Dubai’s model in a complex environment with many exogenous economic and social factors point that its success is intrinsically driven.

---

\(^6\) The Majlis was a legislative council considered to be the highest central authority in Dubai. It comprised between 15 and 40 members usually drawn from families with a long tradition of public service. It included merchants and tribal chiefs, each appointed in recognition of his contribution to the welfare state. The Majlis’ function was to provide the ruler with advice and political assistance. Although the Majlis had no binding power, through it the ruler would be warned by his senior advisers if his decisions were proving unacceptable. Without the Majlis’ support it was difficult for the ruler to pass any law. Being the town notables, or A ‘yan, and the main contributors to the state’s treasury, merchants always held a special position in the Majlis (Al Sayegh 1998).
**State Entrepreneurship**

A particularly important aspect of Dubai’s government engagement is that of entrepreneurship. This subject has increasingly been recognized as a successful model that has enabled some state owned enterprises to effectively compete in international markets. Thus the role of state guided entrepreneurship cannot be overemphasized. In fact, (Shome 2009) argues that state entrepreneurship, such as in the case of Singapore, is crucial for small, transitional economies to achieve global competitiveness. Sharing a similar orientation, the state entrepreneurship model seems to be working in the case of Dubai as well.

But, sharing the general scarcity in research, it seems that this aspect of Dubai has largely been overlooked and omitted from the academic literature (Nasra and Dacin 2009). In fact, in the period from the 1990-2006 there was no single article focusing on the examination of entrepreneurship in the Middle East as a whole. Again, a plausible explanation to this phenomenon could be the association and perception of the GCC economies in particular to be rentier economies and hence not deserving the attention of the research community.

Nevertheless, it seems now that it is becoming increasingly recognized that the state can, in fact, actively engage in entrepreneurship (Nasra and Dacin 2009). Again, this is in contrast to what RST posits, i.e. the state is deriving rents from the revenues on the account of natural resources and redistributes them within the economy with the objective of keeping oneself in power. Uniquely, Dubai’s government has undertaken investments and created businesses with private sector management orientation. Such companies, government related entities (GREs) 61, have been used as main investments and development vehicles. Examples include Emirates Group, Emaar, Nakheel, Dubal etc. It is not uncommon to find the definition of GREs as ‘100 per cent government owned, private sector company’. 62 Such an oxymoronic statement reflects both ownership and the intended governance style of Dubai’s

---

61 Some literature refers to GREs as State Owned Enterprises (SOEs)
62 Corporate Brochure - Emcredit, a credit bureau owned 100 per cent by the Department of Economic Development, Government of Dubai.
GREs. While being publicly owned, i.e. government owned, their management and governance orientation is that of private sector entities. Hence, Dubai’s Government has a multiplicity of roles it plays. But whether it plays an active developmental role as a policy maker, regulator and investor the default objective is business expansion and economic development.

Hence, the importance of the role it plays in economic development cannot be overstated. Clearly, as any other government, it impacts the course of development through public policies, regulation, public spending and public services but also through corporate leadership. The governance model of Dubai has essentially contributed to creating well managed state owned enterprises thus contradicting the generally accepted views on inefficiency of SOEs and the poor quality of rentier public sectors as a result of large bureaucracies.

Moreover, it is important to understand the source of SOEs success given the weak traditions of not only corporate practices but also limited experiences relating to statehood and economic development. The circumstances in which Dubai has risen were often stacked against it and hence it would be easier to explain why SOEs would be destined to fail rather than finding their sources of success. Hertog (2010) argues that ‘it is a profit- and market-oriented management that is autonomous in its daily operations, hence insulated against political and bureaucratic predation, and that receives clear incentives from a strictly limited, coherent set of high-level principals in the political regime’. This is enabled firstly by, the absence of a populist-mobilization history of economic development, and second, a substantially decisional autonomy of the regime leadership from interest groups within state and society. However, going beyond the legacies of corporate development and statehood one may contrast this successes to the principles of an Islamic economic paradigm. Similar to strong market orientation espoused in an Islamic economic model, Dubai’s SOEs exhibit the same orientation. This coupled with rational and independent decision making process which is positively adding value to the economic and social fabric may additionally explain the source of SOEs success. As elaborated in the next chapter, the relevance of government entrepreneurship strategies in Dubai’s context is their pro-active role in the establishment and development of Islamic financial services. The government is a majority shareholder in three Islamic banks in Dubai (Dubai Islamic Bank, Emirates Islamic Bank and Noor Islamic Bank). In addition, the recent government plans to develop Dubai into a global hub of Islamic economy is a further testimony of the important role the government plays in economic development in general and in Islamic financial services in particular.

4.2.3 Domestic investments and development orientation

The economic diversification of Dubai is led by heavy investments in infrastructure and real estate. Infrastructure investment along with real estate and construction were the main drivers of Dubai’s
exponential development and growth. Charts below depict the important role infrastructure related sectors play in Dubai’s economy. However, it has to be noted that as an economy is further expanding it is expected that these sectors will play more of an enabling than driving role in Dubai’s economy. Dubai’s physical road infrastructure and global connectivity have placed Dubai in a top class worldwide. Dubai has been developing its physical infrastructure from early days starting with the dredging of the Creek in 1955 and the development of Port Rashid in 1972 to the more recent Maktoum International airport and a vast network of highways. Investment in physical infrastructure has certainly played a critical role not only in generating jobs and creating business opportunities but more importantly as enabling growth across industries.

In addition to infrastructure and real estate, trade and manufacturing have played an important role in the development of Dubai. Trade is one of the traditional pillars of the economy and has been a window through which Dubai has achieved its tremendous openness to the regional and global economies even though it has also amplified its economic exposure to international economic and trade cycles.

As explained, a hallmark feature of Dubai is its significant investment in infrastructure as a result of its strong commitment to development. Unlike other countries with strong oil revenues, Dubai has not shifted from production- state to allocation- state thereby creating a vibrant and dynamic economy. Dubai’s economic sustainability essentially depends on its ability to maintain a production state orientation and avert conversion into allocation-state. It is sheer belief and determination that once an empty desert may become an oasis of business coupled with investment in physical infrastructure, as

---

63 In the ‘allocation’-state the state does not need to tap the domestic economy through an array of fiscal instruments, and as such little emphasis is placed on developing an efficient economic base. The opposite is true in the ‘production’ state. In the oil rich Gulf-states the tremendous income from oil export was accrued to the royal families, which then was charged with the task of distributing the oil wealth in society. Thus in the ‘allocation state’ the population assumes a role of passive recipients of services and benefits and as such the state and the private sector are far less dependent on each other, than in the ‘production’ state (Hvidt 2006)
key enablers of economic development has led to progressive growth and development of the Emirate. Domestic investment orientation is reflected in (i) infrastructure investments and development, (ii) creation of GREs across industries, and (iii) establishment and promotion of a pro-business environment. Thus, Dubai not only actively participates in competitive local and international markets but is also responsible for creating a pro-business enabling environment. Contrary to international trends, instead of nationalizing some trophy state assets such as in the utilities and transportation sectors, Dubai is in fact creating a new state assets. This in turn creates new business and ample investment opportunities for local and foreign private sectors thereby sending a positive signal to markets that the business of Dubai’s public sector is only that: business (Hertog 2010).

In order to put Dubai’s development in perspective, it is worth briefly relating it to the economy of Abu Dhabi, a neighbouring emirate endowed with approximately 10per cent of global oil reserves. While Abu Dhabi significantly contributes to the federal budget as well as positive UAE economic growth rates, Dubai has emerged as a corporate champion and a regional business magnet. Dubai’s economic path highlights the effects of diversification via commitment to development. Clearly this shows that Dubai’s policies of domestic investments, diversification, openness, and liberal economic policies coupled with pragmatic leadership have resulted in a rather unique economic model.

4.2.4 Unhindered access to capital and labour markets

Having in mind that Dubai is not endowed with abundant natural resources and consequently does not have abundant liquidity, access to international capital and banking markets is one of the critical factors that have contributed to accelerated growth and development of the Emirate. Dubai Government and GREs, while not being rated by international rating agencies, have successfully raised funds in international capital markets using, both, conventional and Islamic instruments. GREs financed their growth using a combination of equity and debt. A negative aspect is that access to international capital
markets precipitated Dubai’s Debt Crisis in late 2008. Similarly, the ability to attract and maintain a necessary foreign workforce is yet another sine qua non factor of Dubai’s economic model.

The economic success of Dubai is underpinned by the growth of its population which is essentially driven by the influx of expatriate workers and their families. The strong population growth has induced increased demand for real estate, retail, and tourism and services in general. In turn population growth is supported by a flexible immigration policy, a highly efficient government apparatus and the availability of business and job opportunities.

One of the key characteristics of the UAE is the transient nature of its labour force. About 90 per cent of the population is composed of non-nationals, representing close to 95 per cent of the total workforce. The economic development of Dubai is increasingly linked with its ability to attract and retain skilled workers. Failing to attract such workers will result in lower skills among the labour force which would have negative implications in the long-term for sector structural transformation and growth potential.

Currently, immigrant workers are able to reside in Dubai, as per Federal law, only in case they obtain work permits. No other residence option for expatriates is available. This clearly puts the sustainability of the Dubai’s economic development at risk. The Dubai government has attempted to create more permanent residence opportunities for those who have invested into real estate sector above certain thresholds. However, these programs have not proved to be very successful due to the costs associated with them and the schemes put in place are not widely used.

Figure 12: Aggregate labor productivity and labor force in Dubai; Source: DED and DSC

The economic success of Dubai is underpinned by the growth of its population which is essentially driven by the influx of expatriate workers and their families. The strong population growth has induced increased demand for real estate, retail, and tourism and services in general. In turn population growth is supported by a flexible immigration policy, a highly efficient government apparatus and the availability of business and job opportunities.

One of the key characteristics of the UAE is the transient nature of its labour force. About 90 per cent of the population is composed of non-nationals, representing close to 95 per cent of the total workforce. The economic development of Dubai is increasingly linked with its ability to attract and retain skilled workers. Failing to attract such workers will result in lower skills among the labour force which would have negative implications in the long-term for sector structural transformation and growth potential.

Currently, immigrant workers are able to reside in Dubai, as per Federal law, only in case they obtain work permits. No other residence option for expatriates is available. This clearly puts the sustainability of the Dubai’s economic development at risk. The Dubai government has attempted to create more permanent residence opportunities for those who have invested into real estate sector above certain thresholds. However, these programs have not proved to be very successful due to the costs associated with them and the schemes put in place are not widely used.
Dubai’s development has been driven by labour-intensive sectors that have seen the largest inflows of low-skilled non-national labour (Dubai Economic Council 2011). Data above shows sharp increases in labour inflows in labour intensive sectors. However, large labour inflows have been accompanied by declining labour productivity. Economic growth in the UAE has been indeed outpaced by labour force growth in recent years, leading to declines in labour productivity per capita. Labour force growth was substantial, in particular, prior to the recent crisis – reaching over 10% per cent annually from 2006 to 2008. To improve future sustainability of the existing economic approach, the Government seeks to promote a gradual move towards a knowledge-based economy and an economic policy moving towards encouraging capital investment and promoting growth in higher value-added sectors (Schilirò 2013). The ability to attract and increasingly retain qualified human capital is essential in ensuring that these shifts occur.

Declining labour productivity is a negative spill-over effect as argued by the Guardian State theory. Yet, another important reflection of the Guardian State is the large proportion of the national workforce employment in the public sector. The public sector is an attractive employer, due to various rent streams and contacts, generous retirement packages, job security, favourable working hours and good prospects of promotion with time. Dubai is no exception to this productivity anomaly. In fact, as El Katiri (2013) highlights, the private sector is unable to match the public sector’s high reservation wage. In addition, employment subsidies in the private sector coupled with the nationals’ employment quotas further exacerbate a rent seeking incentive system as a source of economic benefit. Hence, public sector employment policies contribute negatively to labour productivity resulting essentially in a wastage of resources.

4.2.5 Protectionism and legal dichotomy

Dubai’s demographic structure with a small local population is in stark contrast to the size of its economy and the number of foreign workers and businesses. In addition to labour market incentives, subsidies
and quotas, the federal government has developed schemes to protect the economic interest of the local population mainly by mandating Emirati ownership of at least 51 per cent of any business established in Dubai. Exempted from this rule are certain activities such as professional jobs of accountants, lawyers etc. who are allowed to set up 100 per cent foreign-owned businesses. Ownership limitations also extend to property and asset ownership.

Given the limited attractiveness of such restrictive policies to prospective foreign investors, a number of free zones have sprung throughout Dubai. Currently, there are 22 distinct zones targeting different industry clusters and client bases. Hence, Dubai confines liberal economic policies in terms of property and business ownership and business conduct within the special economic free zones. The ever-growing economy has necessitated the establishment of a multiple of such free zones. Outside the free zones, the Company law of the UAE requires only locals to own property and businesses and provides some protection mechanisms, perhaps as a reflection of the rentier orientation in which the state is effectively covering social costs and economic welfare benefits.

Importantly, the purposeful actions of the Dubai government have resulted in the creation of a new institutional framework in the form of specialized free zones. This has in turn allowed Dubai to create and manage international and national legitimacy by way of decoupling new economic structures from traditional national institutions. As such, Dubai was effectively able to become an attractive destination for international investors while keeping its political stability within the Middle East (Nasra and Dacin 2009). A case in point is that of the Dubai International Financial Centre (DIFC), a federal free zone focusing on provision of financial services.

4.2.6 Economic and business diversification

Dubai’s economic development is often mistakenly attributed exclusively to oil incomes. While it is true that oil discovery has played a significant role in early economic development, Dubai’s oil contribution to GDP is currently less than 2 per cent. Oil revenues played a more important role in Dubai’s quest for
development in the early post-discovery years, but recently, the effect has been indirect, through the higher liquidity that the Emirate of Abu Dhabi and other GCC oil exporters have injected in Dubai’s economy.

% OIL CONTRIBUTION TO DUBAI GDP

Figure 14: Oil contribution to Dubai’s GDP; Source: DSC

As a matter of fact, as highlighted by Nyarko (2010), there is evidence that natural resource endowments, such as oil, often lead to slower economic development, the so called Dutch disease phenomenon, and in some cases even to civil strife. But, Dubai has not suffered from the Dutch disease. On the contrary, it has taken advantage of available regional liquidity to jump start economic transformation and achieve diversification. Expectations are that Dubai will soon run out of oil and gas reserves. Diminishing oil production in an ever growing economy results in a progressively smaller contribution of oil to GDP. Therefore, the most notable achievement of Dubai’s economy is its diversification away from oil, as shown in Figure 6.

Hence, one of the most critical achievements of Dubai is its ability to diversify away from the dependence on oil revenues. While the diversification may seem to be closely related to domestic investment and development orientation in fact it comes only as a result of a long term policy of developing and investing into enabling sectors (infrastructure, communication etc.) which has allowed the development of other sectors as well. This came about only as a result of a deliberate strategy to develop and diversify the economy away from oil, otherwise the Resource Curse theory would apply.

---

Nyarko, Oil and utilities accounted for 36 per cent of GDP in 2007, down from the 80 per cent peak of GDP in 1974 at the UAE level.
Thus, the above strategic policies have enabled Dubai to develop a competitive edge resulting in a diversified, open and liberal economy. As Dubai was the first in the region to open up to foreign capital and labour in a significant way, it consequently gained large benefits from the first movers’ advantage. This led to the creation of economic clusters that have gained critical mass and economies of scale with the passage of time. Dubai’s model is closely watched and emulated by the government of Qatar, Abu Dhabi and others as well. Investments into what is now considered excellent physical infrastructure have allowed it to develop first class regional and global connectivity. Attracting and retaining a skilled workforce has also resulted in the accumulation of knowledge and know-how which prepares the ground for less labour intensive economic development. However, many challenges still remain. The recent Dubai debt crisis propped some of them to the attention of the government and business community alike.66

4.3 The stress test: Dubai debt crisis

Following extraordinary economic growth across sectors in the first decade of the millennia, exuberance was felt ‘in the air’. Local credit markets were at the highest levels similar to those of real estate and stock markets. Speculation in the real estate market was the norm rather than the exception, IPO listings

66 The Dubai crisis was partly due to credit extended by the leading global institutions who often relied on inadequate credit assessment and proxy
were hundreds of times oversubscribed, executives were paid seven figure bonuses, and GREs were acquiring high profile international trophy assets.

Hasan (2010) explains the circumstances leading to the recent economic turmoil in Dubai. The crisis peaked at the government announcement of a USD59 billion debt payment standstill on November 26, 2009. Prior to the announcement, the global financial crisis was already in full swing and resulted in virtually shut financial markets and loss of confidence across markets. Owing to its open economy with strong reliance on global trade flows and access to global financial markets, Dubai’s economy experienced major disruptions in activity across sectors while structural vulnerabilities were exposed. Among key weaknesses were pro-cyclical fiscal and monetary policies that are exacerbated by the dirham’s peg to the US dollar. Cevik (2011) provides empirical findings indicating how pro-cyclical fiscal policies prior to the crisis reinforced the financial sector cycle, exacerbated the economic upswing, thereby contributing to the build-up of macro financial vulnerabilities. However, for the purpose of this discussion and strictly speaking from Dubai’s angle, fiscal and monetary pro-cyclical weaknesses are exogenous factors over which Dubai has limited control.

Nassehi (2013) explains Dubai/UAE open capital account policy as an instrument of a liberal environment for foreign capital but also as a factor exacerbating Dubai’s boom-bust cycle. Dubai’s construction boom encouraged the influx of immigrant labour that was instrumental to Dubai’s high economic growth. This boom was funded by a rapid increase in foreign borrowing, mainly short-term. Foreign liabilities held by the banking sector rocketed from AED 35 billion in 2003 to AED 320 billion in 2007, representing 33 percent of GDP in 2007. In addition, Chailloux and Hakura (2009) attribute sharp increases in foreign deposits in the banking industry which rose from AED 47 billion to AED 127 billion in 2007, on the expectations of a dirham revaluation, only to be reversed in mid-2008.

This has posed severe internal liquidity pressures in the economy. Ample liquidity in the banking sector meant cheap money that was lent mainly to GREs. Increased liquidity followed by increased credit and elevated inflation levels were not offset by tightening of monetary policy, given dollar peg restrictions. Contrary to desired monetary policy, the UAE had to follow a low interest rate regime as per US monetary policy which resulted in negative interest rates. Due to the absence of a domestic debt market and the Central Bank’s inability to conduct sterilization, Dubai’s boom cycle was heightened. Further, due to high domestic liquidity and ensuing increased credit levels in the financial system, Dubai’s corporates, mainly GREs, have also raised short term funds in international markets, banking and capital. According to the IMF, at its peak, external debt of the banks and the GREs amounted to 74 percent of GDP. Interestingly, Nassehi (2013) also relates the oil boom of the mid-2000s and the perceived implicit government guarantee for GREs’ debt to the debt overhang. The so called, ‘crony capitalism’
led international banks to provide finance to GREs despite obvious moral hazard risks, which have contributed to a large extent to pro-cyclical credit growth.

One of the prime lessons of Dubai’s debt crisis is the realization of Dubai’s, and of the UAE for that matter, financial markets’ inability, to serve local development needs and the excessive reliance on short term debt accumulated by the majority of Dubai’s GREs. Clearly, not being able to refinance such debt has led Dubai into a tailspin. Dubai’s financial markets are primarily centered on the banking industry which, at the time, was highly exposed to the real estate sector. According to the IMF estimates, commercial banks’ exposure to the real estate amounted to 29 per cent of their total assets in 2010. This exposure took place not only via lending to developers but also through retail mortgage finance, construction finance as well as personal loans that were contracted mainly to finance real estate acquisitions.

Following the Debt Crisis, Dubai’s government took important steps to prevent the repetition of earlier mistakes by bringing about greater discipline in public spending, rationalizations and standardization across the real estate market, greater efficiency in public services etc,

The economy grew in 2011 and 2012 and it is expected that growth will continue at a similar pace in the medium term as well. In spite of persisting global economic challenges and modest global growth, Dubai has shown resilience and a great capacity to bounce back – not withstanding its structural challenges, driven by traditional sectors such as trade, logistics and transportation, and tourism.

Figure 16: Spreads of Selected Dubai Bonds; Source: IMF WP 10/260

“Spread” refers to a price of a credit default swap (CDS) and is denominated in basis points (bp), or one-hundredths of a percentage point. For example, a spread of 200 bp, refers to 2.00%. That means that, to insure $100 of particular issuer’s debt, investor would need to pay $2 per year.
### 4.4 Dubai’s unorthodox approach

This chapter systematically developed an understanding of Dubai’s economy by examining its performance and structures to derive its development model. Rooted in traditional business openness and strongly accelerating in 2000s, Dubai has developed into a vibrant, cosmopolitan business city with diversified drivers of economic growth. It capitalizes on its geo-strategic position, favourable macroeconomic environment, and positive demographic and labour market trends.

But given the uniqueness of Dubai’s economic path and achievements, as explained, Dubai’s economic story has not been adequately researched. An in depth comprehensive analysis of Dubai’s economic trajectory is indeed, a daunting task; official data is scarce and not very reliable, local vs. federal policies are often blurred as Dubai is a city with great autonomy within the UAE, the size of Dubai’s economy is not significant in the global context to attract the attention of researchers and the impact of regional factors such as trade, excess liquidity, among other issues is often overemphasized etc. Given its endowments and size, and impact on international business, its economic achievements, such as financial and trade flows are then even more commendable. While Dubai’s economic performance is typically analysed in isolation from its historical, cultural and religious background we have shown that the success of Dubai is not incidental. It is the result of policies instituted by the founding fathers of the emirate in the early 1900s.

In contrast to prevalent views on various inefficiencies associated with resource rich economies and framed in the RST theory, Dubai’s model of development rests on the (i) government leadership with specific governance and state entrepreneurship models, (ii) domestic investment orientation, (iii) unhindered access to capital and labour markets, (iv) protectionism and legal dichotomy, and (iv) policy of systematic diversification.

The model outlined in Figure 17 below seems to better delineate between causes and effects of Dubai’s economic development approach than some models previously put forward. Other models found in a limited literature do not offer a coherent and internally consistent model that provides a framework to capture various drivers at play. Therefore, these models fail to provide clear explanations of Dubai’s developmental path. Rather such models seem to point to Dubai’s success as a haphazard set of developmental priorities that emerged as an answer to opportunistic circumstances.

Importantly, given Dubai’s developmental model based on traditional governance structure and cosmopolitan demography, it seems that Dubai indeed offers an unorthodox approach to economic development. As elaborated in chapters 1 and 2, path-independence is a critical enabling component
for the development of the Islamic economic model. Dubai offers such a suitable environment but also strong market orientation, pro-business policies and unhindered movement of labour and capital.

Diversified drivers of growth are led with leadership commitment to development, access to labour and capital markets among others. However, a debt crisis in 2008/09 revealed many structural weaknesses. An important lesson was the realization of Dubai’s pro-cyclical macroeconomic policies, structural weaknesses in the real estate market, shallow and underdeveloped financial markets, and weaknesses in public spending policy, and lack of support for development of SMEs, etc.

The next chapter builds on lessons learned thus far and considers other less obvious elements of Dubai’s model. For example, incentive policies are central to any well-functioning economy but are not well researched in the case of Dubai. As a result, these two chapters attempt to synthesize a new model of Dubai’s economic development by relating it to the Islamic economic paradigm and Islamic finance which is the subject matter of this research. Such a newly defined development model will provide better reference and parallels to the development requirements of the Islamic economy and financial system.
5 Dubai’s Development Policies and Incentives

The discussion thus far has focused on key elements of Dubai’s economic development model within the UAE setting which resulted in remarkable diversification achievements but, likewise, have given rise to various challenges, including the propensity to leverage an economy beyond its capacity to repay. We have also ascertained that Dubai is not following a path-dependent economic development model, where path dependency refers to a conventional or neo-classical developmental approach. Rather, owing to a unique set of circumstances as well as a stable and visionary leadership Dubai has developed its own approach that proved to yield multiple benefits, successful diversification being but one.

Aiming to comprehensively understand and define Dubai’s model of relevance to the Islamic perspective, additional elements in relation to its economic development must be considered. The tax-free system being such a key feature. In fact, Dubai’s tax-free regime’s often overlooked and left out from the discussion to the extent that the literature discussing the economic and business environment without fiscal regime is virtually non-existent. The reason may likely be the general understanding that the tax-free regime is an anomaly and reflection of Dubai’s ‘rentier’ economy which with the time, given its maturing economy, should be phased out.

Therefore, the subject of this chapter is analysis of a tax-free environment in view of economic, regulatory, cultural, demographic and other factors at play in Dubai. Highlighting some of its less obvious implications and ensuing policies will enable us to reach a more comprehensive definition of Dubai’s model as a precursor for discussion on the development of Dubai’s Islamic economic and financial paradigm. Importantly, Dubai model is assessed from an Islamic economy development perspective, to show the extent to which it can provide useful framework for the development of the Islamic economic paradigm.

It is worth mentioning that we shall not assess the extent to which Dubai model is Islamic per se, but rather the nature of its relationship to the Islamic economic paradigm and, given Dubai’s unorthodox approach, its plausible support to the development of the Islamic finance industry. Hence, we are concerned only with the consequential relevance of Dubai’s model to the further development of Islamic financial services.

5.1 Government policies: fiscal policy and its implications

It is clear by now that Dubai’s government is the key driver of economic development and growth of the Emirate and that its policies have far reaching effects on all economic agents. We have specifically
highlighted its role, unique governance style along with state entrepreneurship as prominent determinants of its economic development model. We have also identified other salient drivers of Dubai’s economic model such as access to capital and labour markets, domestic investments and developmental orientation, protectionism and legal dichotomy, and economic and business diversification as important elements of its model.

In addition, as mentioned, one of the most prominent characteristics of Dubai’s economic model not taken into consideration thus far is the absence of corporate and individual income taxes. The tax free regime is often associated with the labour market attractiveness in form of higher take-home salaries. While this being true, the tax free environment has other more important implications beyond attractiveness to the labour market and its large expatriate population of Dubai. Yet, another general misconception seems to be relating oil revenues or ‘rents’ as a part of the rentier economy narrative with the tax free regime. Certainly, oil revenues play a defining role in the economic development of oil exporting economies, including that of Dubai, and also as an important enabler of its economic development. But, as explained herein below, it seems that oil rents are not the sole enabling factor behind the tax-free regime.

Clearly, Dubai’s economy at the beginning as well as almost throughout the last century was not as complex as some other regional economies which may justify the ability of the government to function even without taxation as a source of public revenues. Given the advanced stage of Dubai’s development today and in view of its legacy of substantial infrastructure investments, the issue is, therefore, to what extent is the tax-free regime able to serve Dubai’s developmental objectives and expected infrastructure investment requirements. Furthermore, it is also important to consider other economic and business implications of such a system and, perhaps above all, to what extent is a tax free regime, in fact, sustainable? Lastly, our interest in this chapter is also to understand the extent to which the tax free environment along with other structural features of Dubai’s economy is conducive to the development of an Islamic economy. Although the tax regime is such an important topic, surprisingly, it has not attracted any academic research. The rentier economies narrative with which Dubai is associated almost by default is likely the main reason for the paucity in this research.

5.1.1 Fiscal policy without taxation

The Guardian State theory argues that oil rent streams have replaced tax revenues and thereby have formed a key defining feature of the rentier state. According to the theory, this has shaped both the guardian state’s finances and its present-day relationship in its economy more firmly than is the case in most other resource-rich states (El Ketiri 2014). But, while not entirely incorrect, Dubai’s development path seems to differ from this general framework. Given its scarce resources, at the time, and the need
to rely on trade, Dubai has understood that the stability of governance and collaboration between public and private sectors i.e. the ruler and merchants is in fact an indispensable ingredient for sustainable development and growth. As highlighted in the previous chapter, a critical junction in Dubai's development was the attraction of merchants from the Persian port of Lingah in the late 1890s and again in the 1920s, mid 1930s and 1979, (Al Sayegh 1998, pp 74-76). A key proposition of Dubai to merchants looking for relocation was the absence of taxes, along with provision of some other benefits (Davidson 2008; Al Sayegh 1998, pp 87-102). Therefore, crucially, Dubai's tax-free environment did not originate as a result of its ample oil revenues nor is it a recent phenomenon. Rather, much earlier, it was a trigger for the attraction of merchants and a key development enabler reflecting the *laissez-faire or market-based* economic vision of the leadership at-the-time.

Interestingly, as an important requirement for the relocation to Dubai, its rulers demanded merchants not to engage in any politics and instead to focus only on business performance and related issues (Davidson 2008). Hence, it would probably be safe to conclude that these two policies formed early on the basis for a strong and long term pro-business orientation. As such, given the unique development path and a combination of geographic and scarce natural resources and its customary adherence to Islamic business principles and teachings, a distinctive set of development policies has emerged over time along Dubai's developmental path.

Therefore, since the late 1890s and early 1900s the tax free regime underlines the development of a rather distinctive business environment and incentive mechanisms that seem to fit well into Dubai's overall policy of *laissez-faire* trade and business activities (Davidson 2008, p 68). Moreover, the no-tax policy further reinforces the government's leadership role in economic development and its close relationships with the private sector. Given the strong pro-business policies from the early days, Dubai has capitalized on free trade and soon has established itself as a main market in textiles, gold and electronics. The key incentive to this end was the absence of taxes as well as pro-active merchants in materializing business prospects (Davidson 2008, pp 60-70).

Perhaps surprisingly, Dubai is upholding the same tax-free regime from those early days, with the exception of foreign oil companies and foreign banks, and has maintained principally the same relationship between the private and public sectors. Importantly, the interests of Dubai's rulers and merchants were aligned since the very beginning of the 20th century. In fact, the ruler, at the time, was maintained by collecting custom duties but even that was often controlled by the merchants via Majlis

---

66 While no direct evidence can be found to support the claim that Dubai rulers and merchants have purposefully maintained Islamic business practices, given the evidences from the social aspects it is safe to assume that the same is relevant to business and economy alike.
councils (Al Sayegh 1998). The absence of taxation at the corporate or individual levels has a powerful impact on Dubai’s economy via changing roles and practices in (i) public administration and the role of government, (ii) financial industry, and (iii) the labour market. In addition, the effect is felt in general business environment and its incentive mechanisms which are discussed in the next section. As such, the tax-free regime, along with other structural features of Dubai’s economy as explained in previous chapter, form the foundation for a unorthodox development model and the resulting enabling environment.

While other Gulf countries, including Kuwait, Qatar and Kingdom of Saudi Arabia, have similar tax-free regimes, Dubai’s fiscal policy in combination with other structural factors and its minimal reliance of hydrocarbon revenues have resulted in rather unique economic environment. As explained in previous chapter, Dubai’s unique governance mechanism and pro-business and pro-market orientation has enabled developmental successes that are often emulated by other regional economies. In fact, even economies with greater natural endowments and better market predisposition attempt to adopt Dubai model in some of its economic policies and initiatives.

**Public administration and the role of government**

The tax free system in Dubai and the UAE implies that public finances need to be funded, in general, either by revenues from the sale of natural resources or by offering services that are of value to customers and hence paid for. The relatively short period, since 1969, when crude oil was first sold till early 2000s, oil revenues were used as a catalyst to propel Dubai’s diversification objectives by financing infrastructure development as well as international asset acquisitions, (Davidson 2008, p 105). With the objective not to rely on its scarce oil revenues nor taxation system, Dubai has developed a service-oriented system in which the government charges fees for each value adding service it provides. In periods preceding the oil discovery as well as the most recent decade, Dubai’s government revenues

![Figure 18: Dubai revenues break-down; Source: Department of Finance](image)
are substantially reliant on the provision of value added services, the ever growing business community and investment incomes from its own business ventures. As a result, the government budget is mainly funded, about 62per cent as of 2011 (Figure 18), on the account of fees which the government collects for various services provided.

We have shown earlier that Dubai’s economy has diversified away from the oil dependence. In fact oil represents less than 2per cent of Dubai’s GDP. Similar to diminishing importance of oil contribution to overall GDP levels, the contribution of hydrocarbon revenues in the government budget is declining as well, from 53per cent in 2000 to 8per cent in 2011. Importantly, during this period, revenues almost tripled from AED 11 billion to AED 29 billion. As can be seen in the Figure 8, the sharp increases in departmental revenues made up the difference in relative decline in oil revenues’ contribution. Given that there is no outright taxation in the economy, the implication of this phenomenon is profound.

Dubai’s government extends various services primarily on a commercial basis. Each government department is responsible for raising revenues and balancing the need to increase the fee levels against the quality of services it provides. Clearly, the direct connection between the quality of government service provided and fee levels collected, i.e. the commercialization of government services, has important implications on productivity, innovation and the general drive for excellence promoted by the government. However, it has to be noted that as long as such fees reflect actual value delivered to customers, the system is poised to function well given that there is a direct relationship between the quality and value of services and corresponding fees collected, all else equal.69 In case fees charged for the provision of particular services are not reflective of value delivered, the system will be more akin to taxation as fees would be perceived as taxes. A mere perception of taxation in Dubai would likely have a far reaching and detrimental effect, among other things, in terms of general competitiveness by making the business environment less attractive. As it may be expected, therefore, the government needs to maintain agility by continuously balancing the need for increases in revenue and hence fee charges and the type and quality of services it provides.

Financial industry: Debt – Equity Level Playing Field

The conventional financial industry typically operates in an environment in which an elaborate fiscal system exists. Taxation plays a critical role in such a system, not only from the corporate perspective,  

69 The relationship between the services provided, fee levels and its value to customers i.e. business is by no means simple and straightforward. However, for the sake of the argument in this chapter we simplify the relationship in emphasizing the ability of government in long run to provide relevant and competitive services. Otherwise, Dubai as a business destination would lose its appeal and attractiveness to the FDIs. All else equal relates to exogenous factors that are out of government control that yet, on a relative basis, may positively impact perceived value of government services.
but also from the banking and financial markets perspective. For example, as explained in Chapter 2, bank debt receives a tax shelter as an indirect form of government subsidy effectively making debt cheaper than other forms of finance. The extent of such subsidy may reach a staggering 3 per cent of GDP (USD 510 billion) in the case of Europe or 5 per cent of GDP (USD 725 billion) in the case of the America, in 2007 alone, as the Economist (2015) research suggests. Financial markets benefit from large institutional investors, often contractual savings institutions such as pension funds, which are often enabled and supported by favourable fiscal policies. In addition, large government fixed income securities markets are underpinned by the general tax collection ability of the government. These fixed income markets play an important role in adding depth and breadth to the financial industry and markets.

Figure 19: Dubai government revenues and expenditures; Source: DOF, Dubai Govt.

In the case of Dubai, the absence of taxation has precipitated emergence of a business environment in which interest payments on debt do not receive tax shelters and hence place the choice between debt and equity finance more at par. Except for different risk-return profiles debt payments and equity receive the same treatment since there are no taxes to incentivize firms to borrow. Likewise, the absence of taxes also means that the government needs to find genuine and innovative ways of raising revenue in order to maintain target public spending and investment. Clearly that triggers essentially and radically different roles of government and potentially a different development path for the financial industry in a tax-free system from that in conventional systems. The effects of debt neutrality in Dubai’s financial industry will be more elaborated in the next chapter. Suffice it to say for the time being that this in fact gives rise to different incentive mechanisms in the financial industry.
However, given the above structure of Dubai’s revenues several issues may be raised. The key issue would clearly be the level of sustainability of such a model i.e. to what extent would the Government be able to maintain similar fiscal policies and yet maintain or increase public spending requirements and how any budget deficits would be financed? As we shall see later, the tax free regime is at the core of Dubai economic model. The inability to maintain the regime would likely prompt the establishment of a radically different economic and business environment. Our research shows that a set of solutions within the framework of the Islamic economic paradigm would be able to service well the objectives of establishing and promoting Dubai as a centre of Islamic economy regionally and globally while at the same time addressing its essential economic challenges in the long run. The remainder of this chapter focuses on further elaborating the various ramifications of Dubai’s enabling environment and later assessing its alignment with the maxims and objectives of Islamic economics and finance.

5.2 Enabling environment and economic incentives

As explained, a distinct economic model and fundamentally a business proposition that Dubai has to offer the business community includes its zero tax, or more accurately, tax-free environment. In addition to its direct consequences on public revenues, budget allocation, public spending etc., its indirect impact on the economic environment is perhaps even more important than its outright fiscal effect.

The conventional fiscal system is structured around the disclosure of financial statements and various reporting mechanisms to tax authorities. The tax authority’s driven need to ensure full disclosure of all financials has resulted in the development of informational infrastructure that strongly contributes toward the reduction of any informational asymmetries in an economy. It should be recalled that an important condition of a well-established market within the Islamic economic paradigm is to ensure full transparency and disclosure about products and services being offered but likewise about corporates involved in particular activities. This includes the provision of accurate and timely financial information when needed. The institutional informational infrastructure aimed at transparency and disclosure of corporate financial information is used not only to obtain access to capital, but also to obtain trade credit from various trade partners and suppliers. Any informational asymmetries in this regard may have important and primarily negative consequences on corporates looking to obtain credit, and then by extension on the banking and financial industry as well in terms of their portfolio diversification.

Dubai’s economy, being tax-free economy, on the other hand is not structured on the premise of state-required financial information disclosure. Necessary regulatory filings are in place to the extent they are required to license business entities and various activities they plan to engage in. The regulatory oversight and monitoring of the economy is managed by various sector specific regulators ensuring legal compliance of all economic agents. As such, a major consequence of the tax free system is non-
existence of a corporate financial reporting system. In the case of a standard taxation system, normally all licensed firms are required to file their periodic tax returns to the appointed government authority. This triggers the existence of an elaborate accounting and audit system. No taxation implies, therefore, no reporting requirements for corporates other than those listed on stock exchanges or regulated financial institutions. Whilst all businesses are required to maintain ledgers, only stock companies, limited liability companies, branches of foreign companies, and firms operating in free zones are required to draw up and file financial statements with the Federal Ministry of Economy and with the local licensing authority. However, as there are no corporate taxes and therefore filing financial statements does not serve practical purpose beyond information and statistics collection these requirements are not always rigorously applied. In addition, the current prevalent understanding that stringent reporting stifles businesses development and attraction of Dubai as a business destination supports such non-stringent application of reporting requirements. This is yet another dimension of a laissez faire or perhaps better referred as a market-based system in Dubai. It implies lesser government intervention in the economy and smaller distortions in the decision making processes at the corporate and individual levels.

Given the above background, it seems only natural that there are no UAE-wide or Dubai-specific accounting or auditing laws or requirements (except for firms incorporated in the DIFC). In addition, as may be expected, there is no central registers of financial statements as a repository of all financial filings. As a result information flows among economic agents seems to be significantly inhibited as corporate disclosure is mainly guided by their need to access credit. SMEs in particular seem to be vulnerable to such informational asymmetry given their lack of expertise and financial resources to dedicate to the preparation of a quality financial statement. As a result, SMEs often suffer from poor access to finance and high cost of finance when such finance is availed to them.\(^70\) In the case of the financial industry, as it is explained in the next chapter, the implication has bearing on its asset portfolios, access and cost of finance. Only recently, Al Etihad Credit Bureau, a federal agency, was established with the objective of collecting credit profiles of borrowers, individuals and corporates alike. Therefore, the implication of such a lack of accounting and auditing standards at the national level has far-reaching consequences on the informational architecture, incentive system and financial industry in Dubai and the UAE.

Lax financial reporting has allowed the creation of a system that is fundamentally based on essential market principles with minimal government distortion and interference. Financial reporting in Dubai and the UAE is, therefore on a need-to-know basis using standards and practices sufficient only to satisfy institutions to which financials are being submitted, most often banks. Hence, Dubai’s enabling

\(^{70}\) This issue of access to finance in relation to prevailing information asymmetries in the market is explored in greater details in the Chapter 6.
environment allows corporations and individuals to act with the objective of promoting their own economic interest without seeking to make decisions motivated by tax minimization or tax avoidance. Likewise, the taxation incentives are not used to influence the decision-making process to promote desired behaviours by economic agents. Hence the market incentive system becomes an important structural feature of Dubai’s economic environment. But, on the other hand, as it may be expected this model has also resulted in poor information sharing at the firm level and information flows within the economy. Impaired information flows thereby inhibit planning and longer term commitments at all levels in the economy. This in turn has resulted in inadequate risk allocations and pricings, among other things.

As explained earlier, Dubai’s government provides value added services to its customers, corporations and individuals alike. As a result of such customer orientation, commercialization of Dubai’s services becomes yet another feature that rests on the premise of a ‘market incentive system’ by way of the government refraining to impose any mandated or obligatory payments that are not directly related to the specific service being provided by the government. In fact, to this end, Dubai has recently announced the introduction of the ‘customer satisfaction index’ as a measure of performance of each government department. Therefore, the tax free regime creates essentially a ‘market incentive system’ in which all economic agents act to maximize their own utility function with minimal government intervention. Moreover, the government further reinforces the system by requiring its own departments to be customer or market oriented in provision of its services.

Lastly, the third and essential element of any market based system is the existence of competition. Keeping in mind the absence of reporting requirements and commercialization of government services essentially leads to strong competition in the market. Clearly, private sector engagement is based on competition which in the case of Dubai is with minimal government intervention. Moreover and importantly, given their strong market orientation and general hesitation to resort to regulation, various government entities act very similarly to private sector corporates. In such an environment, the customer is always a winner in a sense that they are able to obtain continuously improved services for any given level of costs.

Similarly within each emirate, a seemingly highly centralized decision making process owing to a monarchy style of governance, is in-fact highly decentralized. There is a high degree of decision making decentralization among various government agencies and departments, free zones etc. with many overlapping authorities in existence therefore developing strong competition. Competition is at the core of Dubai’s model and one of the driving forces behind its development and overall prosperity. Its highly decentralized decision making process and competing institutions have enabled the creation of dynamic and robust government structures and policies that have provided strong support to its development objectives. Competition among government entities, on the other hand, leads to a lack of coordination
and tendency to duplicate and create unnecessary redundancies hence creating pockets of inefficiency in the economy. The relationship between the identified development principle, strategic policy and policy instrument is depicted in Figure 20 below.

The notion that Dubai’s economy is \textit{laissez faire}, as described above and referred by many authors, must be qualified in relation to Islamic economic paradigm. As explained earlier, \textit{laissez fair} system assumes that free markets, i.e. free of government intervention, are the best facilitators for resource allocation decision. On the other hand, Islamic economic framework as a value and rule based system seems at odds with free markets concept. However, as explained in Chapter 1, free markets play a pivotal role in Islamic economic paradigm. It is worth reminding that, according to early Muslim scholars, such as Abu Yusuf, AL Ghazali, Ibn Taymiyah, and Ibn Khaldun, market is a value-based sacred institution. Hence, market forces within Islamic framework indeed are akin to those in \textit{laissez faire} system albeit within the framework of Islamic values. Therefore, it is argued that Dubai’s \textit{laissez faire} or more aptly termed \textit{market-based} approach is not dissonant with Islamic economic paradigm once it is contextualized within Dubai’s development path where Islamic values, as explained in previous chapter, play pivotal role.

![Figure 20: Laissez faire, market-based dev principle and market incentive system; Author’s own analysis](image)

5.3 Resulting development paradigm: A synthesis

Making sense of Dubai’s economic development is a challenging task. The lack of supporting information and data, the unorthodox approach to development in a stereotypical regional economic
environment, and the changing global economic landscape places any analysis at risk of not recognizing the relative importance of various relevant factors to Dubai’s economic development. Hence, a robust logical framework will not only be able to provide the right context for the discussion in relation to Dubai’s approach and the potential for the development of Islamic economics and finance but may also be useful in investigating some other economic strategies applied in Dubai.

Dubai’s model is designed with a vision to develop an open and internationally competitive city. Figure 21 summarises the preceding discussion, in Chapter 4 and herein, on Dubai’s economic model. It shows the interrelation between Dubai’s development path, key development principles and ensuing long-term strategic policies that are either explicitly or implicitly embedded in Dubai’s economic structure. It also delineates long term principles that are developed as a result of the government’s commitment to development and adherence to Islamic values. Combining the above historical background, development principles and strategies, as well as major development drivers within given economic circumstances, a rather unique proposition or outcome has emerged. Figure 21 also highlights key distinctive outcomes resulting from the interplay between strategies and policies explained previously. In order to facilitate a clear understanding of development objectives and main drivers, Figure 21 divides the model into essentially three building blocks. The first building block, Dubai’s development path is defined and anchored by key determinants which form the bedrock of its development and hence are not subject to change. The key determinants include (i) scarce natural resources, (ii) partnership between ruling and merchant families, and (iii) Islamic teachings and value based business practices.

---

71 Some of leading economies in the region, such as of Saudi Arabia, are more representative of rentier type of economies, i.e. state allocates rents from natural resources to society at large. General perception of resource rich environment may obscure Dubai’s development paradigm and economic strategy without deeper analysis.
The next level building block includes those developmental principles in which Dubai’s leadership essentially had a choice. For example, the early rulers of Dubai may have opted to follow regional trends and not embrace the openness or perhaps succumb to dominance of bigger and economically stronger neighbouring states. Instead, Dubai chose to be and eventually became a model of (i) government led economic development, (ii) liberal, market-based or laissez faire business and trade.

The third element of Dubai’s development model includes key strategies used to achieve objectives of development and growth. They reflect the commitment of the government emanating from its development path and principles mentioned above. They include, as explained earlier, (i) domestic investment and development orientation, (ii) nurturing pro-business environment, (iii) protectionism and establishment of free zones, (iv) economic and business diversification, and (v) access to capital and labour markets.

The outcomes of these policies and strategies are often confused to be factors or drivers of Dubai’s economic development. The zero tax environment along with the culture of competition in which financial reporting is sporadic has essentially contributed to a strong culture of entrepreneurship. In the case of a local Emirati population, such a culture is further supported by protectionist policies in the form of agency laws which ensure that rights to the local population are not diluted within a large expatriate workforce. On the other hand, the expatriate population is incentivized to conduct business through quick and inexpensive company formation procedures, access to markets, availability of alternative financing channels etc. Therefore, combining Dubai’s economic development path, protectionist measures and lax reporting requirements has essentially created a culture of entrepreneurship and instilled a ‘can do’ attitude within Dubai’s population.

5.4 Dubai model: consistency with Islamic principles

An assessment of Dubai’s model from an Islamic perspective requires primarily an evaluation of the role government plays in its development including its policies and outcomes. Given the theoretical foundations of the Islamic economic paradigm, as explained in the Chapter 1, it seems that there is a general agreement that the economic function of the state is to ensure general welfare for its citizens and to strongly promote economic development and growth. In addition, (Kahf n.d.; Chapra 1979) assert that the government should also be responsible for economic equilibrium.

The welfare nature of the state stems out from the very concept of Maqāsid Al Shari’ah as explained earlier in Chapter 1. Among other objectives, economic goals include ensuring comprehensive human
development by eradicating poverty and fostering conditions for full employment, preserving and promoting the real value of money, and providing social security and fostering equitable distribution of income and wealth. Given the small local population, as may be expected and quite apparent, Dubai’s economic model has worked very well in terms of creating wealth for its citizens.

Figure 22 below contrasts the GDP per citizen in relation to GDP per resident (includes expatriates living in Dubai) and clearly shows that Dubai has achieved a high level of welfare for its nationals. Dubai’s government has not only created general opportunities for employment of locals but qualitatively has enabled the locals to work and gain experiences at some of the best international firms. Emiratization ensures the private sector prioritizes employment of nationals for which governments provide a level of subsidies. In addition, locals enjoy free basic telecommunication services, support in obtaining housing loans and land for development, procurement allocation via SME development mechanisms, entrepreneurship support and funding, educational support etc. Therefore, as a result of such a patrimonial approach and in line with Guardian State theory, the state is considered benevolent with respect to ensuring the general welfare of its citizens as well as residents. Moreover, this highlights that the guardian state has more to offer than a typical rentier state given its custodian and entrepreneurial role (El Katiri 2013, p 30). Notably, Islam unequivocally supports the welfare state and in fact in one of the hadith the Prophet states that ‘Any ruler who is responsible for the affairs of Muslims but does not strive sincerely for their wellbeing will not enter Paradise with them’, (Sahih Muslim).

The concept of a welfare state is closely related to the second important function, which is the role the state should play to be in alignment with the Islamic worldview. That is the condition of being a developmental state. The nature and function of the state has to be oriented toward economic development and growth. This is in stark contradiction to some authors, as discussed in previous chapters, who question whether the Islamic economic paradigm promotes economic development. In fact, a key function of the state in Islam is to promote and foster economic development. Being
established around a small harbour with limited natural resources, Dubai had to engage in pro-active economic development in order to be in a position to provide for its citizens. Therefore, over time, the government's custodianship over the economy has in parallel ensured economic and state development. The argument that Dubai is in fact a shining example of a developmental state does not need significant elaboration.

The third function of government is responsible for economic equilibrium. A specifically relevant aspect of economic equilibrium is that of fiscal policy. The government has the right to raise taxes, as per the Islamic worldview, is the general consensus of scholars. Chapra (1979, p 21), highlights that it is only a just tax system that is in harmony with the spirit in Islam. However, the tax system, according to Chapra, should aim to enable the government to discharge its function as a welfare state. In other words, the prime objective of tax collection is to achieve the general welfare of its citizens. In the case of Dubai, it may be argued that unsustainability of government revenues may jeopardize the infrastructure and other developmental objectives, hence a taxation should be introduce to smoothen the revenue flow and ensure finances in the long term. However, in contrast to this generally favoured conventional approach, the tax free regime being at the centre of Dubai’s economic development model, as explained earlier, would certainly introduce another instability into a well-functioning system. The instability relates to essentially a new role and function the government should play with the new system. Given the availability of substantial financial resources locally and regionally alike it seems as a more prudent strategy to create appropriate financial instruments and markets that would allow the surplus fund to be channelled into productive use and to those where there is a deficit in financial resources. In addition, improving some of its structural weaknesses that would improve efficiency of financial markets and financial industry in general would go a long way in creating more robust financial industry able to cater to developmental needs of the emirate. It seems reasonable to assess that until all these avenues for development are fully utilized any introduction of taxation would be premature and would likely lead to significant negative consequences, both short and long term.

Therefore, it is clear from the previous discussion that the Dubai government is effectively, at least in general terms, aligned with Islamic economic principles at the macro and strategic level. Given the relatively small population of local citizens which stands in stark contrast to the size of its economy, the government effectively ensured the high level of economic welfare to its citizens. Dubai’s relentless, long term and continuous drive for economic development and prosperity is indeed one of the hallmark features of Dubai’s model. However, it has to be highlighted that one cannot find evidence that such a model was based on Islamic economic principles per se. As seen in some other cases relating to social issues where merchants have chosen to preserve their religious identity to move for example from Lingah to Dubai, one may expect that such adherence to religious principles would be applied in business practices as well. Hence, it may be safe to conclude that Dubai traditionally held respect and
In high esteem Islamic business practices and would resort to available alternatives before applying something that may be outright prohibited by Islam.

In addition, we have also mentioned in chapter 1 that one of the major contributions of the Islamic economic paradigm is a multidisciplinary dynamic approach or a comprehensive measure of well-being that takes into account moral, psychological, social, political, demographic, historical and other factors that impact well-being in this broad sense. This view recognizes the fact that economic well-being is inseparable from social and other factors that interplay in the development of economic variables and outcomes. Interestingly, Shaikh Mohamed Al Maktoum, the current ruler of Dubai recently declared that “The UAE was founded on the principle of doing good. Its leaders have always been passionate about helping people. We expect nothing in return for we are driven and guided by the principles of Islam and our Emirati national values”.

In contrast to the above achievements that are aligned with the economic objectives of an Islamic worldview, it may be argued that on the other hand, conventional banking practices are widespread, and many products and services offered in Dubai may not be conform with Shari’ah etc. Clearly, the purpose of this research is not to claim that Dubai’s economy is founded in accordance with the Islamic economic paradigm in its entirety but rather to explore the extent to which Dubai’s model may be utilized for the further development of the Islamic economic and finance industry. While not investigating the motivations behind the various choices and alternatives along Dubai’s development path, a pragmatic and visionary leadership has in fact created, within the practical limits and circumstances, a model of development that on many accounts is aligned with an Islamic economy and importantly has created a favourable environment for its further development.

5.4.1 Islamic finance advantage: organic development

As explained, it seems that development principles and strategic policies encapsulated in Dubai’s economic model offer a conducive environment for the development of Islamic finance. The Dubai model, as presented above, may have a profound impact on the development of Islamic financial services given that the Islamic financial system rests on risk sharing, promotion of entrepreneurship, discouragement of speculative behaviour, and emphasis of sanctity of contracts (Iqbal 1997, pp 42-45). The Dubai model describes the interplay between various factors, exogenous and endogenous, which

72 Official Twitter account of Sheikh Mohammad Al Maktum on 8th April 2015. Original Arabic text: "دولة الإمارات تأسست على الخير، ويقودها رجال يحبون الخير، ولا ننتظر عوائدا ولن نطلب مصالحا بل هي مبادئ إسلامية وقيم وطنية تأسست عليها الدولة"
resulted in the creation of an ecosystem that essentially positively relates to Islamic economics in general and Islamic financial services in particular through its market based incentive system, risk sharing environment and no fiscal impediments.

The importance and relevance of Dubai’s development model to the development of the Islamic economic paradigm may easily be grasped by contrasting it to the prevailing efforts of leading Islamic finance centres. Being widely recognized as global Islamic finance hubs, London and Kuala Lumpur are setting standards in promoting and developing the industry. Malaysia has succeeded in creating a dual system conventional and parallel or Islamic, thereby emerging as a major market for Islamic retail, corporate, investment and wealth management instruments and institutions. Malaysia has exceptionally promoted Islamic finance through legislation, tax breaks and indirect subsidies (Wilson 2009). In fact, various tax incentives to promote development for the Islamic finance industry is one of its key developmental instruments of the Malaysian government. For example, tax breaks were highly effective in promoting the development of sukuk markets, where issuers found it cheaper to issue sukuk than comparable straight conventional bonds. Creating a necessary critical mass in Islamic fixed markets played an important role in developing economies of scale across the Islamic finance industry.

Similarly, the Financial Services Authority in the UK, as a part of it wider public policy, has introduced a series of tax and legislative changes specifically designed to remove obstacles to the development of Islamic finance (Financial Services Authority 2007). Obstacles in this context refer to the double taxation that some Islamic financial instruments are subject to given their sale-based nature. In addition to removing fiscal disincentives, the UK FSA is attempting to attract the critical mass of Islamic financial institutions and Middle Eastern investor base with excess liquidity primarily focusing on the availability of markets and a skills base, the presence of other Islamic finance windows as favourable public policy and taxation, and the fact that the FSA is the single regulator in UK financial markets.

Therefore, unless used as a policy instrument to promote industry development, the fiscal system poses a hurdle to the development of Islamic finance. The existence of corporate taxes in an economy, therefore, has a detrimental or negative impact on the development of Islamic finance. Islamic finance promotes risk sharing through asset ownership which typically triggers a double taxation issue at some stage of the transaction execution. This is in addition to the accounting effect that essentially renders debt to be cheaper than equity based instruments due to tax shelters. On the other hand fiscal

---

73 According to Malaysia Islamic Financial Centre (MIFC), the cost to issue RM- denominated and multicurrency sukuk can be more efficient for issuers with the various tax incentives available in Malaysia. Tax incentives include tax exemptions and tax deductions for sukuk issuers and investors alike.
incentives, such as in the Malaysian case, may be an important instrument for the promotion of Islamic finance.

This should be contrasted with Dubai, which does not have a taxation system to be utilized as a tool to promote industry development but, more importantly, its absence removes disincentives and major obstacles to industry development. Thus, Dubai’s model essentially provides organic development of Islamic financial services. Organic development implies that genuine market demand drives industry development without the adverse impact and hurdles posed by the complex taxation system which is the hallmark of conventional regimes. But, it also has to be noted that while Dubai’s economic environment does not create any taxation obstacles to the development of Islamic finance it also, by the same token, does not take any benefit of various tax incentives that are typically used to promote desired policy outcomes.

The role of a no-obstacles framework is highly important for the development of Islamic finance. Crucially, Dubai model’s does not only pave the path for the development of Islamic finance but is also in line with its economic development philosophy, as it also positively promotes key determinants of the Islamic financial system i.e. risk sharing. As a matter of fact, the absence of tax obstacles is a strong long term incentive policy in its own right as its neutrality promotes the development of the industry. On the other hand, the lack of tax incentives as an instrument for the advancement of the industry’s development has a negative impact on the industry’s short term development.

The second important implication of the enabling environment stemming again from the tax-free regime is the establishment of a level playing field between debt and equity i.e. debt-equity neutrality. It may be recalled that theory of capital structure argues that leverage increases a firm’s value due to the tax shelter it receives (Modigliani and Miller 1958). Hence, corporate debt is favoured until it starts progressively to increase a firm’s financial risks which eventually causes firm value to start declining. Hence, the conventional economic paradigm with taxation systems in place provide a favourable environment for the development of debt instruments. The development of equity based instruments is disadvantaged at the outset. Thus, Dubai’s economic framework exhibits debt-equity neutrality simply because of the absence of taxes. In such an environment it would be reasonable to expect that risk sharing i.e. equity based instruments would be able to take stronger prominence in the financial sector, including Islamic finance. The relevance of establishing a level playing field between Islamic and conventional finance is of great importance for the development of Islamic financial services. Dubai’s environment not only creates opportunities for Islamic finance but moreover it positively reinforces development of the industry.
The third implication of Dubai’s enabling economic environment directly relates to market based incentive mechanisms as defined in the previous section. A market-based incentive system does not distort the decision making process in the economy and, provided there is no informational asymmetries, positively promotes liberal economic policies which are in line with the Islamic economic paradigm.

Lastly, the fourth, key enabling factor triggering organic industry development is Dubai’s risk taking and risk sharing culture that is effectively embedded in its economic model, and promoted and led by the government. As previously explained, the risk sharing culture is effectively entrenched into Dubai’s development path from its early days. Falling short of taxation incentive mechanisms, the government of Dubai promoted a strategic sector development by taking the riskier route -it established and invested a number of commercial and government related enterprises (GREs). Prominent examples are those of Emirates Airlines, Dubai Aluminium (DUBAL), DP World etc. Hence, government entrepreneurial willingness to take the risk and compete in the market place is a testimony of effective equity culture that reinforces the objectives and essence of the Islamic economic system and that of Islamic finance. In addition, the lack of financial reporting requirements in its positive manifestation, as explained, contributes to an undistorted and rational decision making environment in which all players act in their own best interest with minimal interference from the government. This will be explored in greater detail in the next chapter of this research.

A summary of the implications of economic environment on development of Islamic finance is shown in Figure 23 below.

![Figure 23: Positive impact of Dubai’s economic environment on Islamic Finance; Author’s own analysis](image)
5.5 Dubai vulnerability through Islamic lenses

The theory of finance defines an ‘original sin’ to be the inability of a country to borrow abroad in its own currency (Eichengreen and Hausmann 1999, p3). Dubai’s debt crisis, it may be argued, may not strictly fit the original sin theory due to the dirham’s dollar peg, i.e. borrowing internationally in US dollars is tantamount to borrowing in dirhams. But, the theory defines the original sin as the inability of the country to borrow in its own currency but also to borrow at home markets at long maturities. The theory stipulates that due to this incompleteness, the financial fragility is inevitable as all domestic investments will have either a currency mismatch or a maturity mismatch. In the context of the ability to borrow domestically and market completeness, well-functioning domestic debt capital markets is regarded as a key avenue. Hence, the inability of Dubai to borrow domestically not only in the long term but in the short term as well reveals the nascent nature and incompleteness of Dubai’s financial markets. Dubai has committed the ‘original sin’ not only by borrowing internationally but also because borrowing was mostly short term.

This pertinent issue to be raised is, it seems, why Dubai had to borrow in the first place, given the levels of available liquidity in local and regional markets, and more importantly what are the structural elements that have contributed towards creation of debt? We have previously highlighted several explanations that are put forward in an attempt to describe the main reasons behind the crisis including rationalizing it on the account of declining fundamentals and weaknesses in the banking system, speculation in the real estate market, a liberal environment for foreign capital, pro-cyclical credit growth and/or simply financial panic and self-fulfilling expectations (Nassehi 2013; Chailloux and Hakura 2009; Hasan 2010; Zaki et.al 2012). But, in the context of Dubai’s economic model, our interest is to understand its relevance in relation to the crisis and with respect to the Islamic economic paradigm.

The Islamic economic paradigm is clear that any type of interest based borrowing is not only discouraged but also strictly prohibited. The borrowing that is allowed is that of qard-al-hassan which as a benevolent loan does not stipulate interest payments. All other instruments of borrowing must be structured as asset based contracts. Clearly, over leveraged GREs in Dubai point to the fact that Dubai has not developed mechanisms that would allow its corporate sector and government alike to access available domestic liquidity, neither conventionally nor Islamically. Importantly, the crisis has therefore revealed multiple shortcomings of Dubai’s developmental model that are not necessarily related solely to financial markets completeness.

While Dubai’s enabling environment provides a supportive framework for the development of Islamic finance, it also includes important structural weaknesses that inhibit its economic development and growth. Earlier we highlighted Dubai’s market-based approach to economic development as reflected in the lax reporting requirements and competition in markets to be some of the key strengths of its
development paradigm. However, the evolving nature of Dubai’s economy and gaps in informational infrastructure as well as weak corporate governance in the public and quasi-public sector were key contributing factors to international borrowing.

Among the main attractions of the Dubai for businesses is the ease with which businesses can be set up, and the business-friendly regulatory and legal environment as a result of a tax-free regime. The government is trying to stay away from creating too many hurdles and entry barriers for businesses. On the other hand, as explained, this business-friendly culture includes a lack of financial reporting requirements on the part of business enterprises. For those entities that do prepare financial statements, there is no disclosure requirement, and audit standards are considered deficient. Inadequate informational infrastructure includes, for example, the absence of a central register in Dubai that collects and pools loans and other credit exposure data of a particular SME borrower across all banks under the CBUAE’s jurisdiction.74 In addition, there is a lack of financial statement information for non-incorporated SMEs but also there are several concerns with respect to the reliability of financial statements in those cases where they do exist. Moreover, Dubai’s legal infrastructure with respect to collateral laws and bankruptcy laws, includes a lack of central assets and/or collateral registry and discourages financial institutions to provide financing to smaller and newer enterprises. Insufficient transparency and disclosure about ownership structures and groups of related companies is yet another reflection of evolving informational infrastructure. Therefore, Dubai’s zero tax environment and absence of information sharing infrastructure in the form of accounting laws and regulations75, and lack of credit agencies leads to informational asymmetry in markets. Such asymmetry results in lower access to credit by SMEs and eventually saturates banks’ risk exposure to GRE clients. Effectively, due to inadequately diversified portfolios and existing large exposure to GREs banking industry, it was not able to provide the required funding for GREs. Given that local debt markets are not available while public equity markets are without required depth and width, the banking industry being over exposed to GRE risk, the large corporates had no choice but to utilize its access to international finance and to borrow internationally. It is interesting to note that international financial institutions had an appetite for Dubai’s risks despite various structural weaknesses including an unclear legal position of GREs and not-particularly strong business cases or rationale for funding. The exuberance in the local economy and financial markets, it seems, has transferred to international financial institutions and markets as well.

74 Only recently Al Etihad Credit Bureau was established to collect liability financial information from the financial industry and private sector.
75 Companies listed on the stock exchange have to abide by stock exchange transparency and disclosure requirements. Similarly, banks need to prepare financial statements in accordance with CB regulations.
In addition to gaps in informational infrastructure negatively affecting the banking industry portfolio diversification, which curbed their ability to extend finance to GREs, poor corporate governance practices fuelled by relentless competition in the market has further put pressure on corporate leaders to develop often unrealistic projects and seek for their funding. In addition, structural weaknesses in terms of a lack of debt management instruments and institutions along with competition and a decentralized decision making process results in poor coordination among various government and quasi-government entities, duplication of efforts and eventually resulted in an accumulation of debt at unsustainable levels.

5.6 Avoiding vulnerability through Islamic based model

Dubai’s instability came as a result of a leveraged position that was unwarranted by individually unsustainable business models. The instability was not only a reflection of an evolving financial industry that was unable to serve the needs of Dubai’s economic development but more importantly it also reflected some of the structural weaknesses of Dubai’s economic model. Drawing lessons from the theory of Islamic economics and finance, as explained in the first three chapters, an Islamic finance model is inherently more stable than a conventional one given avoidance of debt and its direct relation to the real economy. Moreover, an Islamic economic model calls for the establishment of a sustainable economic model with transparent and information efficient markets, risk sharing financial instruments, markets closely related to the real economy, and sound corporate governance practices.

It seems that Dubai needs to adopt two-pronged approaches to economic development. The first and more obvious one is to develop a robust financial sector, based on Islamic principles that would include the development of financial markets able to serve the needs of future economic development. In addition, and equally important, are improvements in the economic structure in terms of primarily information flows and corporate governance. Critically, all the improvements must be aligned with Dubai’s long term economic policies and inherent strengths which have proved successful so far, but at the same time offer solutions aligned with an Islamic economic vision.

Dubai stands a clear chance to holistically approach its economic development in an original way given its non-path dependency in economic development as explained earlier to avoid structural vulnerabilities by essentially adopting an Islamic economic development approach. As a result, Dubai should be able to harness significant local and regional liquidities by providing financial instruments that would enable efficient management and risk sharing tools to economic agents. Such an approach implies building on Dubai’s traditional openness and market-based economy by further improving information flows among
market participants, developing domestic funding mechanisms for long term infrastructure and other projects, and lastly addressing gaps in corporate governance.

5.7 Dubai’s enabling environment – in sync with Islamic finance

We have attempted to shed further lights on Dubai’s developmental approach in order to arrive to a more comprehensive description of its model and then to discuss the same through the prism of Islamic economics and finance. It is important to remember that Dubai’s development model is a ‘process in progression’ given its evolutionary nature and the many factors influencing it including historical, external, locational/size, cultural, institutional and political factors (Pradhan 2009). Hence, the challenge in comprehensively defining Dubai’s development model is to clearly delineate its key drivers and policies as opposed to circumstantial outcomes.

We have shown that Dubai’s non-path dependant development model provides a conducive environment for a long term and robust development of Islamic financial services. In contrast to some other financial centres, Dubai’s enabling environment is conducive for the organic development of an Islamic economic paradigm.

In summary, Dubai’s location and lack of natural resources coupled with its developmental desire and pragmatic action by early rulers has shaped its developmental path. Building partnerships with merchant families and the development of trading have conditioned the pro-business environment which has remained a symbol of modern Dubai. Starting from humble beginnings and supported by a close relationship with the business community, Dubai has developed its business practices on the basis of Islamic principles and traditions. These three key determinants of Dubai’s developmental path i.e. (i) scarce natural resources (ii) partnership between ruling and merchant families, and (iii) Islamic tradition and business practices76 have remained encapsulated in Dubai’s business and economic strategy. The long term tradition of openess, tolerance and placement of business objectives at the forefront is what Dubai’s model has preserved from early days. Attracting regional merchants to establish business in Dubai has allowed the development of a thriving entrepreneurial environment that has been sustained for more than 100 years.

One of the hallmark elements of Dubai’s model is the absence of taxation, at the corporate and individual levels. While not being sufficiently researched, the tax free regime has a major implication on Dubai’s

---

76 Davidson (2008) cites refusal of permission to bury their dead as per local customs of Arabs populating Persian islands of Lingah and Qishm as well as requirement to stop covering faces for wives of merchants’ registering their boats by the Nasser Al-Din Shah Qajar government in Teheran as one of important social reasons to emigrate to Dubai.
economic model and by the same token prospectively on the development of Islamic economics and finance. We have shown that Dubai has developed a public administration and governance model which is not based on taxation, but on a market oriented provision of value-added services. In fact, it seems that Dubai’s role of government is well aligned with the feature of effective government. (Osborne 1993) determines that entrepreneurial governments are catalytic, competitive, mission driven, results oriented, customer driven, and enterprising. The leadership style of Dubai’s government seems to have encapsulated Osborne’s observation. Centered on a tax-free regime, Dubai’s government is evidence of an alternative system to conventional taxation and public administration that may successfully exist in the modern economic system.

We have also concluded that Dubai’s enabling environment not only offers various advantages to Islamic finance development but also weaknesses are negatively influencing the industry’s development. Hence, given the success of Dubai’s development model as well as structural vulnerabilities exposed by the recent debt crisis, a two pronged approach for the development of the economy and Islamic finance seems as a reasonable development agenda. The first is further development of a robust financial sector, based on Islamic principles that would include the development of financial markets capable of serving the needs of future economic development. Robust and dynamic local financial markets closely linked to the real economy would lessen the fiscal burden from the government. Secondly, necessary improvements in the economic structure in relation to information flows, related infrastructure, gaps in corporate governance as well as other shortcomings will enable strong and diverse development of the economy across sectors.

Whether Dubai is ready to implement more comprehensive Islamic economic and financial system based on its strengths and weaknesses is addressed in the following chapters.
Part 3 - Islamic Financial Services in Dubai: Prospects and Readiness for More Comprehensive Implementation
6 The State of Development of Islamic Finance Industry in Dubai

The Dubai Debt Crisis is a paradox. The economies of Gulf Cooperation Council (GCC), being net oil exporters, hold substantial financial liquidity that plays an important catalyst role in global financial markets. Dubai’s debt crisis, essentially a liquidity crisis is, therefore, a paradox that encapsulates gaps in the financial industry and exposes vulnerabilities in its economic model.

We have shown earlier that the theory of Islamic finance is a cornerstone of a broader Islamic economic paradigm. We have concluded that one of the key challenges faced by the industry is to be substantially more distinct from its conventional finance counterparts. By the same token, we have established, referring to various research, that in order for the Islamic finance to develop more robustly and meet its very own objectives, the industry would need to break free from the path dependence on the neoclassical and conventional model of economic development.

For that matter we have explored and defined Dubai economic development model in the preceding two chapters and have shown that Dubai, indeed, has the ingredients conducive for more authentic development of Islamic finance. Importantly, we have also highlighted that some of its structural vulnerabilities pose important challenges to the development of the financial industry in general and the Islamic finance in particular. Likewise, if these challenges are not addressed timely and substantively, they may have an adverse impact on Dubai’s overall economic development and performance.

Our analysis of Islamic finance in Dubai is not done in isolation. Given the above context, this chapter critically assesses the stage of development of Dubai’s financial sector and highlights strong integration of the Islamic finance segment into the overall financial industry. Islamic financial services in Dubai share the same enabling environment, infrastructure, and even regulation as the conventional financial industry. Hence, in order to understand gaps and opportunities in Islamic financial services, a thorough understanding of the context within the financial industry is of paramount importance. Our analysis in this chapter, therefore, takes a comprehensive look at the financial industry.

We seek to understand the relationship between Dubai’s economic model and its financial industry. A pertinent issue we attempt to address is the extent to which the Islamic finance has in fact contributed

---

Some analysts suggest that Abu Dhabi Investment Authority (ADIA), a sovereign wealth fund of Abu Dhabi Government, manages assets in excess of USD 1 trillion alone.
to the economic stability and development of Dubai. This assessment will help us identify and understand any opportunities for further industry development.

6.1 Dubai’s financial industry – growth vs. development

Similar to the paucity of research with respect to Dubai’s economic model there is limited data and research in relation to Dubai’s financial sector. Some relevant analysis was done by Al Hassan et al (2010) and research series by Woertz (2008), albeit discussing the regional financial and banking systems. Importantly, there is also limited research concerning Islamic finance in the context of Dubai although a handful of papers are available on the broader regions of the GCC or MENA. Perhaps, one positive consequences of the GFC was increased recognition and awareness of the importance of financial institutions in the GCC and MENA economies and likely differential performance of conventional and Islamic banks. Hence, some research has emerged with a focus on the GCC-wide financial industry with tangents to Islamic finance. For example, Tai (2014) attempted to identify the efficiency levels and sources of banking system performance, including IFIs.

The financial industry in any economy plays an important catalyst role. As Dubai’s economy recorded high growth rates in the last decade, Dubai’s financial sector as a major enabler has evolved in a dynamic and promising way. In general, the growing local demand is a key driver of the sector’s performance. Capitalizing on growth trends, the Dubai International Financial Centre (DIFC) was founded in 2004, thus making Dubai a home for many global and regional financial institutions. This led to the creation of a high-quality and strongly competitive local market environment with improved standards of business dealings as well as competition among the DIFC and the long-established banking system mainly represented by government-related entities (GREs).

But it seems that growth and developments in Dubai’s financial industry, conventional and Islamic, were not sufficient to avert the debt crisis. In fact, it seems pertinent to question why Dubai’s financial industry has not sufficiently developed to a more mature state to provide sufficient development funding locally. Or perhaps the debt crisis was indeed the consequence of the GFC as it may be widely understood. While the GFC had engulfed all the developed financial markets, being originated in one of them (US), the Dubai financial industry, on the other hand, shielded by its relative underdevelopment had to deal only marginally with effects of the crisis. Short-term capital inflows have destabilized Dubai economy by dramatically increasing domestic credit, fuelling property bubble and inflating asset prices in general. Simultaneously, the lack of availability of long-term finance for development purposes has prompted Dubai’s GREs to tap international credit markets and obtain short-term finance for long term development purposes. In fact, its problems were exacerbated and catalysed by the GFC revealing
various structural weaknesses. Therefore, an inadequately developed financial industry, Islamic or otherwise, has significantly contributed to the creation of the crisis and the coincidence of the external shock in the form of a GFC and had therefore resulted in significant negative consequences (Zaki et al. 2012). The root causes of the crisis, however, are the structural weaknesses of Dubai’s economic model including those in its financial industry.

As explained in Chapter 3, Dubai’s financial markets allowed large inflows of foreign short-term loans or ‘hot money’ that has facilitated bubble creation and eventually led to the bust cycle. The capital market liberalization, as championed by the IMF and the World Bank since 1990s, has shown again to be a destabilizing factor on Dubai’s economy (Nassehi 2013). Given the abundant regional liquidity available in general, the crisis, it seems, also highlights the importance of how the oil exporters ‘recycle’ the oil revenues, but not for the purpose of economic development of oil importers, as discussed by Nsouli (2006) but rather for its own economic development. Indeed it seems quite obvious that while the financial industry as a whole, along with its Islamic component, has recorded impressive growth rates, it, in fact, has not developed sufficiently to match the needs of Dubai’s economy, let alone those of the GCC or MENA, as Dubai aspires to be a regional centre (Woertz 2008).

Hence, Dubai’s debt crisis offers an opportunity for the assessment of the role, strengths and weaknesses of the sector as well as an evaluation of its future development needs and prospects. Importantly, the role of Islamic values, traditions and practices, has a place in Dubai’s economic model as shown earlier. Dubai is home to the first Islamic commercial bank in the world and recently it unveiled plans to become a global centre of Islamic economy.

**Sector’s Economic Relevance**

Financial services are an important contributor to the economic performance of Dubai not only functionally, i.e. financial intermediation, but also in terms of economic value added, employment and overall productivity. Hence, the bigger the sector the stronger the contribution to economic value added and overall GDP. As shown in Figure 24, the number of employees of the financial sector and the corresponding share of total employment are relatively low in Dubai’s economy (2006-2009). Compared to 25,000 employees working in 2006, there were more than 47,000 people employed in the sector during the peak times of the global financial crisis in 2009. Interestingly, based on available official statistics, the downturn of the market and the corresponding falling demand in 2009 did not affect the employment capacity of the sector. While the anecdotal evidence may suggest otherwise, as per Dubai Statistics Centre, from 2008 to 2009 the number of employees rather increased by 24 per cent to 2.4
per cent of the total employment in Dubai, which is still relatively low compared to the value added that is created by the sector.

As a consequence, in the finance sector, labour productivity, defined as the value added per employee, is by far the highest in Dubai’s non-oil economy with upper end rates of more than 900,000 AED per employee (2006). But by 2010 the productivity rate decreased by 23 per cent down to 711,000 AED per employee, which is in line with the strong growth of 87 per cent employment during that time and the slight decline in value added. Earlier we have identified, in line with the rentier economies theory that labour productivity in Dubai is in fact in decline given its economic model.

The growth of the financial services sector in Dubai is shown in Figure 25 for the years 2001 to 2011 in terms of value added and total value added share. The value added of the sector has been steadily growing from 2001 to 2004, which has kept up the pace with GDP resulting in a fairly constant share of total value added of about 5 per cent. Starting from 2005, after the Dubai International Financial Centre (DIFC) was established, a rapid growth rally took place until 2008. During the peak times of the sector in 2009 the contribution of the financial services sector to Dubai’s value added was 33.5 billion AED (10.73 per cent total value added share). As one of the few exceptions in Dubai, the data reveals that the impact of the global financial crisis had only a small effect on the sector. The decline of value added (2006 constant prices) amounted to a mere 1 per cent, while the total value added share also remained constant till 2010.
6.2  Salient features of the financial industry in Dubai

The financial services sector of Dubai is an important driver as well as an enabler of economic development and growth. As mentioned, following the GFC, a number of authors (Barakat 2009; Nassehi 2013; Trabelsi and Fadhel 2011; Challoux and Hakira 2009), analysed the sector’s performance preceding and during the recent Dubai liquidity crisis. Dubai’s liquidity crisis has exposed a number of systemic weaknesses and challenges while the industry’s adjustment to new realities as well as support from the UAE Central Bank and the Ministry of Finance, on the other hand, had critically strengthened the financial system and the sector.

Financial services in general is the sector that traditionally offers high productivity gains, while along with other major sectors (trade, transportation, manufacturing, logistics and tourism) significantly contributes to GDP and employment. Access to finance and the cost of finance are also important considerations for economic development and diversification. Additionally, in order for Dubai to seize the opportunity to firmly grow into a regional and global hub offering a comprehensive range of products and services, it must address the challenges that remain in developing the sector into a fully-fledged centrepiece of economic growth that would serve as an enabler of Dubai’s development in the first place.

The prominent four segments of the financial services sector include: (i) commercial banking offering services to retail and corporate clients, (ii) capital markets and investment banking dealing with more institutional clientele with respect to asset management, mergers and acquisitions, advisory etc. (iii) Islamic banking offering Shari’ah compliant financial services to both retail and corporate clients across the plethora of products and services, and (iv) insurance. The mentioned segments constitute main business lines of the financial services sector serving diverse customer bases and needs. In addition, multiple regulators provide legal frameworks, rules and regulations, market oversights and enforcement.
The financial services sector benefited from developments that have basically stimulated demand sophistication. The growing economic activity especially in trade, real estate and construction created financing needs from the local and international companies serving the market. In parallel, the local population has been growing and has become more prosperous. As a consequence, the demand for banking services has increased both in terms of size and quality. This increased demand was matched by a strong inflow of foreign institutions encouraged by the DIFC’s world-class regulatory environment.

Islamic financial services as a segment of the financial industry have, likewise, recorded significant development and growth aligned with the rest of its industry. As an aspiring regional and global player, Dubai has developed the infrastructure which, in some instances, matches that of a developed market while on the other hand, the type of instruments and market depth is in line with a nascent financial system, as elaborated below. The key structural features of the sector include a market and regulatory dichotomy, an opaque information environment, and inadequate business regulation.

---

78 One of challenges in performing aforementioned analysis if distinguishing Dubai financial services from the rest of UAE. Central bank data is provided only at the Federal level without breakdowns for each emirate. The analysis assumes that UAE sector indicators, ratios and trends are reflective of Dubai’s circumstances as well.
6.2.1 Market and regulatory dichotomy

At the outset, it is important to highlight and draw distinction between key aspects of Dubai/UAE legal system and financial system regulators affecting Islamic financial services in Dubai. The regulatory landscape in Dubai is characterized by a multiplicity of regulators and overlapping jurisdictions. Dubai’s financial services have followed dual track development i.e. strong local banking industry developed in response to growing local demand, and a DIFC environment developed in response to growing international attention and attraction to Dubai and UAE’s development needs and increasing regional opportunities. Figure 27 below depicts Dubai’s financial industry and its target markets in relation to regulatory framework and key financial markets and instruments offered.

![Figure 27: Dubai’s financial services development perspective; Author’s own analysis](image)

The legal system in the UAE is based on both civil code principles and on the Islamic Shari’a Law derived from the UAE Constitution, federal laws and regulations, emirate laws and regulations and Islamic Shari’ah. Whilst the constitution provides that Shari’ah is a main source of law, it is not the only source of law and its application is generally limited to (i) being used by courts in cases where there is no express legislation governing a particular question, (ii) religious, family law matters etc, and (iii) Islamic finance and banking transactions.

While the financial industry is regulated by federal bodies, the Central Bank of the UAE and the Emirates Securities and Exchange Authority, Dubai has developed a dynamic and robust international financial services housed within the Dubai International Financial Centre (DIFC). The DIFC, established as a federal financial free zone, has its own legislative infrastructure. The Dubai Financial Services Authority (DFSA) is independent financial regulator modelled against the FSA regulatory standards and has proven to be one of the most important elements in attracting global and international players to Dubai.
We have noted earlier that the CB as a main regulator of the financial sector in UAE does not regulate Islamic finance proactively similar to regulators, for example, in Malaysia. On the other hand, DFSA a regulator within the DIFC does provide for some of the common-law based legislation and regulation that is also suited for the development of the Islamic finance industry. Hence, the dual legal system of civil and Sharia law has been extended even farther to include common law.

Importantly, the DIFC is regarded as a modern, state-of-the-art legal and regulatory system where some of the largest global financial institutions are domiciled. Notably, the DIFC’s Law Regulating Islamic Financial Business stipulates that any firm that offers Islamic financial business must have a special endorsement on its licence. This allows firms to operate as an Islamic firm, or to operate an Islamic window. Moreover, the DFSA specifically draws a distinction between being a *Shari’ah systems regulator* as opposed to a *Shari’ah regulator* that implies that a firm that performs Islamic financial business must put systems in place to ensure that the business is conducted in accordance with Shari’a.

Hence, the dual track development has enabled Dubai to grow into a regional financial services hub in a very short period of time. The dynamic nature of the sector’s development ensured that growing demand was matched with domestic and international service providers. World-class regulation within the DIFC gave the development of the financial services sector a new direction and attracted world class institutions and expertise to Dubai. The number of licensed financial institutions in DIFC at the end of second quarter 2017 was 463 employing total of 21,628 people.\(^79\) Out of 463 financial institutions 23 of them provide Islamic services. A diverse geographical distribution suggests broad appeal of Dubai and the DIFC to international institutions. In addition, an ecosystem of important ancillary services and professional service providers was established enabling DIFC and Dubai to provide a complete set of finance related services and products. Financial institutions contribute about 70 per cent of DIFC’s GDP while the remaining 28 per cent and 2 per cent is contributed by business providers and public administration respectively.

However, the flip side of the model is the resulting split of the industry's developmental focus and a degree of segregation between regulators and financial markets. Consequently, the dichotomy in regulatory, institutional and market frameworks has created industry gaps. Essentially, federal legislation administered by the UAE Central Bank and the Exchange Securities and Commodity Authority has remained rather constant, primarily addressing the need of local financial markets. On the other hand, the DFSA regulations were directed toward attracting regional and global financial institutions by creating world-class regulatory environment as well as relaxing some of banking and

\(^79\) All DIFC related data is provided by the Dubai International Financial Centre Authority (DIFCA)
equity market rules. The two legislative standards were meant to complement each other, but effectively it may be argued that DFSA regulation has not achieved its maximum potential by placing various restrictions\textsuperscript{80} on regulated entities while the Central Bank has remained passive or minimalist in its regulation as described by Hasan (2012).

6.2.2 Opaque information environment

An efficient market economy with deep financial markets is underpinned by informational infrastructure that enables the efficient flow of timely and accurate information and prevents asymmetries in the market. As explained in chapter one, full transparency and informational disclosure are cornerstones of markets in the Islamic economic doctrine.

While Dubai’s tax free regime and absence of reporting requirements should facilitate information sharing and transparency on a voluntary basis, it is evident that the quality of such information provided is often times very questionable. The absence of accounting legislation and accompanying audit standards is yet another reason for information asymmetry in the market. Clearly, large corporate accessing international markets, stock exchange listed firms and banks are not affected with the issue.

As previously identified, the lack of accounting standards and absence of reporting requirements has contributed to a culture of sporadic information sharing and collateral based lending. The quality of information and the transparency of business dealings of SMEs, in particular is inadequate. The issue of financial access (bank finance primarily) is one of the key drivers of economic development and growth affecting the bulk of the corporate population in Dubai. It is a reflection of the systemic economic structure, financial markets infrastructure and nature of doing business practices in Dubai.

Important lessons learned as a result of the recent GFC is that most of the lenders operating in Dubai have a strong bias toward large borrowers and established credits. This has resulted in highly concentrated portfolios mimicking GDP breakdown i.e. large exposure to real estate sector. This has further caused partial neglect of the financial needs of small and medium enterprises (SMEs). Following the GFC, due to sequential de-risking and deleveraging this has further delayed liquidity injections into the backbone of the economy i.e. SMEs. Therefore, highly skewed portfolios toward large corporations, GRES and subsequent portfolio deleveraging have caused protracted economic and financial pressures on the business community and the economy in general.

\textsuperscript{80} These restrictions initially included the prohibition of UAE Dirham transactions, restrictions on doing business outside the DIFC zone, etc. However, following the debt crisis some restrictions were relaxed in order to facilitate the flow of funds in and out of the DIFC.
Consequently, bank credit to the SME sector is under-developed. Currently prevailing practices show that lending is largely collateral-based where tangible assets are available while SMEs with small tangible asset bases available need to provide personal or third party guarantees (Rocha et. al. 2011). The quality and reliability of the financial information provided to banks is poor and commonly banks rely on factors other than financials provided by firms. This has negative consequences on SMEs ability to access funding from banks and other financial institutions and in case they do, the cost of such capital is prohibitively high. Importantly, Rocha et. al. (2011) identify information asymmetries as a result of underdeveloped information infrastructure as one of key impediments not only for financial industry development but also SME industry support and development.

6.2.3 Inadequate business regulation

Rapid economic development and growth of Dubai’s economy in the past decade has resulted in a more advanced and sophisticated economic structure with significant inflows of foreign direct investments (FDI). Such new economic realities have also created a need for the revision, update and creation of a strong legal infrastructure. Moreover, being the economy open to global markets and competing for the attraction of the FDIs, legal underpinnings have been closely scrutinized and analyzed by the local, regional and global business and investment community.

Legal and business regulations vis a vis markets and investor sophistication, higher standards of doing business and investment community needs are a key elements reflected in investors’ confidence in the domestic economy. While business confidence and consumer confidence in Dubai have traditionally recorded strong positive trends as a result of positive economic growth prospects and renewed demand for products and services, unfortunately, investors’ confidence as reflected in financial markets, i.e. stock markets volatilities and levels, is significantly subdued.

Business regulations with respect to investors’ protection, creditors’ protection and corporate governance and transparency are soft issues requiring attention and pro-business orientation in order to be reflected in renewed investors’ confidence (Rocha et al. 2011). In addition, economy wide legislation with respect to closing down business and protecting workers also weigh down on Dubai’s competitiveness and ability not only to attract but to retain large institutional investors. Important cases of inadequacy of existing business regulation were recorded during the debt crisis that necessitated large corporate restructurings of primarily major GREs. Dubai’s insolvency regulation was not able to deal with the various complexities of required restructurings hence the decision was made to pass the jurisdiction to the DIFC courts.
6.3 Structure of financial markets: Uneven developments

While the history of financial and banking transactions in Dubai dates back to the mid-1900, the foundation of the sector was laid in the 1970s and 1980s by the adoption of legal framework for the UAE Central Bank. In 1973 the formation of a currency board tied the Arab Emirates Dirham (AED) to the US dollar. This currency peg was maintained, when the UAE Currency Board (later UAE Central Bank) was established in 1973. While first local financial institutions were established from the 1950s, a significant foray of foreign banks entering the market commenced in the 1990s.

In 1982, the UAE Banks Federation, or Emirates Banks Association as it was known, was established. It represents and promotes interests of all member banks and maintains a regional and international network of information exchange. The membership is voluntary. Currently 50 banks are members of EBA. Changes in regional and federal regulation have opened new horizons for Dubai-based banks, but have also brought them in close competition. Globalization allowed new market opportunities for local banks, but have also brought new international competitors, including 20 foreign banks. As banks and financial institutions adjust to the new rules of competition, new players will emerge to push the industry forward.

Following the gradual development of the banking industry, the establishment of the stock exchange, Dubai Financial Market (DFM), in 2000 has marked a beginning of a new era of development of the sector. The further proliferation of financial services came with the emergence of numerous brokerage houses, investment companies, asset managers etc. As mentioned earlier, a major milestone was the establishment of the DIFC. In addition, the Financial Services Association of the UAE and the Gulf Sukuk and Bonds Association were established in 2012 and 2011 respectively. Their establishment in DIFC further testifies to the growing depth and width of financial services offered in Dubai as well as their regional aspirations of becoming a financial hub.

But being affected by the debt crisis, Dubai’s financial markets lost market capitalization and credit growth decelerated, sovereign risk spreads widened and investors’ confidence dissipated pulling Dubai’s economy into a tailspin. Short term capital inflows on the expectation of currency revaluation were reversed and severe liquidity shortages were exposed in the market. However, the UAE Central Bank provided strong support to the sector by intervening with a set of measures aimed at preserving the stability and restoring liquidity.

81 Source: UAE Central Bank
Chailloux (2007) analyses the UAE CB measures, such as three year guarantee of all bank deposits and further deposit of AED 70 billion in local banks in addition to a AED 50 billion credit facility, concluding that CB proactive measures helped to send strong signals to the markets and hence stabilize the industry. Reflecting system stability and lesser exposure to global foes of the UAE financial services sector, only AED 7.5 billion were actually used. Chailloux further exposes that the lack of a domestic debt capital market is regarded as a structural weakness and its development would provide a mechanism to manage systemic and private sector liquidity more smoothly.

Figure 28: Timeline Development of the Financial Services Sector; Source: DED

In similarity to the wider region, and as shown in Figure 29 below, the banking sector is the strongest driver of the sector’s performance while assets of financial institutions represent the most significant and largest component of the financial sector. While the importance of the banking sector for the economic wellbeing is undisputed, other channels of financial intermediation have not developed to the same extent. Overreliance only on one form of financial engagement i.e. bank credit may lead towards the inability of the sector to fulfil its prime role required for the support of the envisioned development of the economy. Indeed, the lack of developed capital markets has significantly contributed to high pressures arising from increasing levels of international borrowing by Dubai based corporates.
6.3.1 Banking Industry

The banking industry is at the core of Dubai’s economy. Being the host to eight commercial and Islamic banks, including the UAE’s largest bank – Emirates-NBD, Dubai’s financial sector is dominated by the banking industry.\(^82\) The size of the industry by some estimates far exceeds its GDP to account about 147 per cent of GDP (Trabelsi 2010). Benefiting from the strong economic growth in general and driven by the demand for funding in real estate, in particular, and in addition to favourable rises in oil prices, record low interest rates for an extended period of time and large increases in population (mainly expatriates), Dubai banking industry has strongly expanded.\(^83\) As such, the banking industry dominates the financial sector in terms of its size and number of players.

Endogenous and exogenous drivers of growth

The growth in the banking sector of Dubai and the UAE has been mainly in response to strong demand for retail and corporate products on the back of strong economic performance. The increasing demand in banking services has allowed existing local institutions to grow in strength and sophistication. The major contributing factor behind the rapid growth was the real estate boom that took place primarily in Dubai, until mid-2008, but also in the wider GCC region as well. Particularly, it resulted in a significant increase in loan volumes as demand for credits rose substantially. In addition, the banks have benefited from an upward revaluation in property values, which increased non-interest income and book values. Both, the total assets and deposits of UAE banks are characterized by a steady growth since 2000,

\(^82\) Currently there are 52 banks licensed by the UAE Central Bank. In addition, the DIFC hosts a number of international and local financial institutions, including banks

\(^83\) All of UAE licensed financial institutions operate in Dubai and hence for the purpose of the below analysis UAE banking sector as a whole is being considered and analysed. It is assumed that the sector strengths and weaknesses at the UAE level are reflected at the Emirate level as well.
despite the implications of the global financial crisis during the years 2008 to 2010. The banking market reached the asset size of 2.6 trillion AED, representing 8.5 times the growth in the last 15 years alone and more than 50 times the growth since 1980 thereby becoming the second largest in the Middle East, after the Saudi Arabian banking industry. Moreover, when compared to the size of its population of about 2.5 million, Dubai’s banking system is especially large and influential.

In addition to real estate earnings, banks have benefited from the rising and active stock markets through brokerage fees and capital gains on an appreciation of fair values of their investments, albeit this source of income post crisis has drastically declined. As a result, trading income and capital gains have come to represent a significant portion of the banking income at some banks. But, the real estate and capital market-related earnings are both volatile and vulnerable to downward cycles. Any adjustment or market reversal negatively affects banks with high exposure to these revenue streams.

Altogether, banks have coped well with the economic downturn and the increasing risk of a possible default, although profits have been affected due to rising provisions for NPLs. The banking sector (and in particular Dubai’s banks) was affected by the financial crisis and was exposed to the debt restructuring of Dubai’s GREs. While it was estimated that the overall lending to Dubai GREs amounted to 9 per cent of total loans, Dubai banks were even more exposed with up to 16 per cent of total loans to GREs. In the special case of Dubai World (DW), UAE banks held a proportion of 40 per cent of the debt to be restructured, which amounted to USD14.4 billion. However, DW debt was successfully restructured in May 2011 by lowering interest rates and a phased repayment of debt over a period of five to eight years.

---

84 As of February 2017, Central Bank of UAE
85 The UAE market hosted 23 local banks, of which 8 were Islamic Banks, with 681 branches. Moreover, there were 28 foreign banks holding full commercial banking licenses with 117 branches and another 70 institutions licensed to undertake investment banking, financing activities as well as financial advisory work. Finally, foreign banks have 92 representative offices in the UAE.
Banking industry absorbs liquidity but unable to diversify its assets

As mentioned earlier, the last decade was characterized by strong economic development and high growth rates fuelled by high credit growth rates. Given the conducive environment, all Dubai-based banks experienced growth of deposits over the prolonged period of time. The consistent increase in deposits endowed the banking system with the required liquidity. Further, strong demand as a result of abundant liquidity and negative interest rates was a source of growth of Dubai’s economy prior to the GFC.

The period 2008-10 was particularly challenging for the banking industry in terms of managing their assets. At the retail level, clients were facing difficulties to meet their credit payments due to instability in the labour market and, often times, high leverage. On the corporate front, business defaults led to skip-risks\(^{86}\) of expatriates, overexposure of consumers (e.g. credit cards etc.) or lack of securities in times of falling real estate prices. Hence, credit expansion stagnated during the mentioned period after growing sharply in the previous years, due to the continuously increasing liquidity in the market until 2008.

Importantly, the post crisis period is also characterized with solid deposit growth and liquidity position. But this has not resulted in pre-crisis credit growth rates. Although sufficient funds are available, banks are still restraining new credit as a result of deleveraging and de-risking drive. The chief reasons for cautions credit growth lie in (i) uncertainty in global financial and banking markets with pronounced counterparty risks including sovereign and, hence, the need to maintain strong capital and liquidity positions, and (ii) information asymmetry in the domestic corporate market, especially with respect to SMEs, which increases the cost of obtaining information and stifles risk evaluation and assessment.

Information asymmetry impairs asset quality

Though credit growth had been impressive, the quality of credit is still a cause of concern. Directly related to information infrastructure in the economy, banks operating in Dubai and the UAE have difficulties in assessing credit worthiness of the SME sector. In view of establishing better information flow and reducing asymmetrical information, the Central Bank has established Al Etihad Credit Bureau to enhance and centralize liability data collection on all major borrowers and provide a more comprehensive credit profile available for banks. The UAE Central Bank data indicates that between 2005 and 2008 the compounded annual growth rate of property-related loans amounts to 55 per cent, Figure 32.

\(^{86}\) A skip risk is defined as a risk whereby an expatriate not being able to service loan payments simply absconds and leaves the country.
Due to the size of the real estate and construction sector within Dubai’s GDP and substantial slowdown in the sector due to repercussions of GFC, banking sector exposure to these sectors is the prime determinant of asset quality. Asset quality and exposure to the real estate market is also a prime driver of market sentiment and risk perceptions. For example, the credit default swaps (CDS, 1 year) for Dubai Islamic Bank, which traditionally invests a high share of about 30 per cent of its total credits in real estate, fluctuated between 1000 and 2300 basis points, which reflected the extremely high risk perception of being overexposed to this kind of investment.

In retrospect, the asset quality of UAE banks has improved significantly over the past decade. Although the underlying trend is masked by the high credit growth rate during this period, the ratio of nonperforming loans (NPLs)\textsuperscript{87} to total loans declined from a high starting point of more than 14 per cent in 2003 to its lowest level in 2007. In line with loan defaults due to refinancing issues along with the global financial crisis and in particular with the local real estate crisis in Dubai, NPL-ratios began to rise again from 2008. The stock of NPLs started to gradually decline in the last quarter of 2013 for the first time since 2007.

\textit{Banking sector is the main source of development funds}

The banking sector is the main source of domestic funding for corporate and retail customers, Figure 33 below. It provides a strong service network to all clientele in terms of saving and lending products. As such, the health of the banking system is of prime importance for the stability of the financial sector and thereby of critical importance for the economic development of Dubai. As mentioned earlier, the system has been put at a test during the recent GFC and Dubai’s debt restructuring challenges. While the banking system is characterized by strong capitalization, prudent provisioning rules, a constant drive for improved portfolio diversification and a more conservative lending approach, it is important to highlight the pivotal role played by the UAE Central Bank in supporting the system with timely and adequately measured policy responses.

\textsuperscript{87} Defined as loans that are in arrears for more than 90 days to total loans and is calculated on a gross basis.
All UAE banks well exceed the minimum 10 per cent capital-asset ratio (tier 1 capital to assets ratio) in 2008, at the beginning of the GFC. While the Abu Dhabi government subsidized five of the largest banks in the UAE with a total of 4 bn US-Dollars to boost tier 1 capital in early 2009, this measure however was not replicated in Dubai. As at the end of December 2015, UAE local banks capital adequacy ratio has increased to 18.3 per cent, as most of banks, fully or partially, repaid the Ministry of Finance tier 2 capital granted in 2009.

![Figure 32: Excess bank credit growth in the UAE; Source: UAE CB](image)

### 6.3.2 Capital markets

Capital markets provide sources for long-term funds and typically include equity and debt, fixed income, and markets. Stability and predictability of capital markets is important if they are to provide a source of long terms funds that are of dire importance for economic development. Dubai equity markets have recently been categorized as emerging reflecting the increasing level of width and depth of the market. Capital markets add important diversity to funding sources and in the case of Dubai provide an important channel for mobilization of long-term capital resources even for the firm without track record. Capital markets are essential for the attraction of foreign portfolio investment (FPI) in the form of equity and debt as a major source of finance especially for the OIC countries being all developing nations (Hassan 2005). Given Dubai’s open, small economy and heavy reliance on foreign direct investments, stable and deep capital markets would provide an important avenue for strong FPI inflows.

---

88 UAE Banking Association

89 An estimate of excess bank credit in the system is measured by comparing the credit growth rate with that of the GDP. The difference in growth rate is then applied to the loan book at the beginning of the year to estimate excess credit. Excess credit is usually a sign of build-up of vulnerabilities in the system as it is generally associated with an over valuation of assets. (UAE CB)

90 MSCI Emerging Market Index added Dubai Financial Market and Abu Dhabi Exchange into its Frontier Market Index on May 31, 2014
Two equity exchanges but limited depth

Dubai’s two stock exchanges, the Dubai Financial Market (DFM) and the Nasdaq Dubai, regulated by the Emirates Securities and Commodities Authority (ESCA) and the DFSA respectively, while sharing common ownership\(^9\) essentially serve two different market segments. Importantly, the DFM became the first listed stock exchange in the Middle East going public with 20 per cent of its shares, in December 2006. In addition and uniquely, the DFM is Sharī’ah compliant exchange implying that it its operations are in alignment with the requirements of Islamic laws. However, notably, the DFM allows for trading of non-Shari’ah compliant stocks such as financial institutions as well. While the Nasdaq Dubai is regulated separately by the DFSA, the regulation of DFM and ADX are placed under the umbrella of the ESCA. Establishment of Nasdaq Dubai reflects Dubai’s general orientation to continue expanding its financial services by providing a world class regulatory and enabling environment as well as access to regional liquidity.

The majority of listed companies on DFM are UAE-based. Only some exceptions of secondary listings exist, which are companies from GCC states, like Global Investment House from Kuwait and the Al Salam Bank from Bahrain. The DFM has some success in attracting the interest of particularly regional investors. The GCC as well as international investors can trade and own shares, but are limited to not exceed 49 per cent of the company's overall equity. As a result of substantial declines in valuations of companies listed at the DFM, the market has also experienced significant reductions in volumes of traded stocks. This in turn has negatively impacted the brokerage industry forcing a number of players to leave the industry.

Total market capitalization was AED 201 billion in 2010, about 60 percent lower than market capitalization in 2007, while in March 2016 it stood at about AED 308 billion, Figure 34. The financial crisis caused a substantial decrease in the number and the value of traded shares (-64 per cent and -82 per cent) as well as the number of trades (-65 per cent). The stock index declined from an average of 4509 points in 2007 to 1631 in 2010, a decrease of 64 percent. The strong decline was mainly due to the heavy sell off as a result of the impact of GFC on Dubai’s economy and subsequent loss of investors’ confidence. The impact of the GFC was multidimensional affecting companies’ current and prospective earnings as a result of changes in domestic and global demand patterns.

\(^9\) Both the DFM and NASDAQ Dubai are owned by the Borse Dubai, a GRE. The DFM was established by the Government in 2000 as an independent entity. It operates as a secondary market, trading with securities issued by public joint-stock companies, bonds issued by public institutions, investment funds and other local or foreign financial instruments that are conform to its listing requirements.
Nasdaq Dubai (formerly Dubai International Financial Exchange), established in 2005, is housed at the Dubai International Financial Center. While the focus of Nasdaq Dubai is on international company listings, its most important listing is DP World, created in 2005 by a merger of Dubai Ports Authority and Dubai Ports International. The IPO of DP World in 2007 was the largest IPO in the Middle East (5 billion US Dollar). Altogether, only 10 stocks are traded on this stock exchange. Similar to DFM, Nasdaq Dubai also lost more than 60 percent of its value in the crisis but outperformed DFM in recent years.

Distinctively from the DFM, Nasdaq Dubai allows only 25 per cent of company common stock to be floated on the exchange and permits a book building approach to IPO valuation. This is in contrast to DFM which requires ESCA approvals for IPO value which are typically set 1 AED per share.
The comparison of the market capitalization between the DFM and the Nasdaq Dubai shows the vulnerability of the indices to external impacts. While the DFM lost more than 60 per cent of its market capitalization between 2007 and 2010, the Nasdaq Dubai has only suffered 14.7 per cent during the same time. With respect to IPO, local and regional markets have witnessed a sharp decline in a number of issues as a direct consequence of the GFC and local economic challenges. An important enabler for expected increases of local and regional IPOs is a general drive to promote IPOs of family businesses. As such, in 2007 the required minimum of 55 per cent of floated shares has been reduced to 30 per cent allowing family businesses to go public without losing the majority control over the company.

The merger of the DFM and Nasdaq Dubai in July 2010 represents a significant first consolidation step aimed to increase liquidity, market depth and promote new listings. A larger trading volume brings about higher efficiency and deeper liquidity in the market. The opportunity to trade Nasdaq Dubai listed companies through the trading platform of the DFM is a reasonable enhancement in order to improve or renew investors’ trust. However, it is expected that the further consolidation of the stock exchanges in Abu Dhabi and Dubai would contribute to higher trading volumes and would increase the visibility of the UAE market for foreign investors. The objective of further mergers is the creation of a single regional and international trading platform, which would attract the regional liquidity as well as international institutional investors.

Dubai’s Commodity Markets add to diversity but without required depth

The Dubai Gold and Commodities Exchange (DGCX), based in the Dubai Metals and Commodities Centre (DMCC) is the first commodities exchange in the UAE and operated as a financial free zone. Operations began in 2005 and are regulated by the Securities and Commodities Authority (SCA). Traded
products include futures contracts on gold (since December 2005), silver (since 2006), steel, WTI Light Sweet, Brent Crude Oil (since 2007) and fuel oil. The DGCX also offers trade with options on gold futures and Indian Rupee futures.

In 2007 the Dubai Mercantile Exchange (DME) was established within the DIFC. DME also targets the commodities sector. Regulated by the DFSA, the DME was the first exchange in the Middle East to offer sour crude contracts after its launch by the intercontinental exchange in the UK. In contrast to other exchanges like the NYMEX or DGCX, the DME is trading relatively small volumes of oil, although WTI and Brent are no longer an ideal price reference for Asian markets.

With the acquisition of NYMEX, which established the DME jointly with Tatweer, by the CME Group, the trading platform of the DME oil contracts (DME Oman) became accessible along with WTI and Brent. The DME’s development was further boosted when the Dubai Department of Petroleum Affairs announced the adjustment of their pricing formula, binding it to the DME Oman benchmark. The volumes of traded barrels have more than tripled from 2007 to 2010, reaching 744 million barrels in 2010.

Absence of debt capital markets

Dubai’s government and corporates issue conventional bonds and sukuk in international markets normally in USD denomination. Local debt/sukuk markets do not exist. However, Nasdaq Dubai is increasingly popular as a listing destination for local and global sukuk issuers. However, it has to be noted that the practical impact of sukuk issuance is rather limited.

6.4 Financial services: Scope for development

As elaborated in previous sections, while the financial sector has been developing for decades, the past ten years in particular have witnessed the sector growing in terms of new markets being opened and accessed, the emergence of new domestic and international players, sophistication of products and services offered, and enhancement of business and financial regulation etc. In addition to developments in domestic markets, external factors relating to international financial flows and the overall system have seen tremendous changes giving a rise to new challenges and opportunities for Dubai’s growing financial services industry.

As shown, it seems that Dubai’s financial sector has achieved a critical mass in terms of the number and types of institutions in the market. But it seems that the current state of industry development is not at a level that complements economic development requirements, as demonstrated by the debt crisis. While financial sector development is challenged primarily with structural issues as identified earlier, the
sector is also presented with a host of opportunities to further grow into a stronger enabler and driver of Dubai’s economic development. Such opportunities are associated with the growth of internal demand as a result of economic prosperity, increasing population size and growing customer sophistication, but also positive trends in global and regional shifts in wealth and centres of economic growth.

In view of the preceding analysis, a sector assessment of its major strengths and weaknesses with regards to its ability to play an enabling and pivotal role in Dubai’s economic development is performed. Similarly, Thomas et al. (2013) analysis concurs that ‘that while Dubai’s business environment – infrastructure, labour market efficiency, and ease of doing business – ranked favourably, its financial and legal environments need further work in order to allow the UAE as a whole to compete globally’. Hence, our sector assessment comprises the evaluation of the financial services sector based on the identified strengths and weaknesses as well as opportunities and threats derived from the review process. Therefore, results are summarized in the following SWOT-Analysis, Figure 37.

As the analysis has shown, the direct impact of the financial crisis on the banking sector of Dubai has been limited so far. This can also be attributed to the fact that local banks had no extensive investments in international financial markets and particularly did not hold extensively “toxic” assets. Thus, in spite of being part of a highly open economy and sector that is open to international financial flows, the banking sector’s limited international orientation shielded banks from severe problems.

<table>
<thead>
<tr>
<th><strong>Strengths</strong></th>
<th><strong>Weaknesses</strong></th>
<th><strong>Opportunities</strong></th>
<th><strong>Threats</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Stable and strong banking industry</td>
<td>Complex and unclear regulatory regime</td>
<td>Access to regional liquidity</td>
<td>Inability to retain talent and skills</td>
</tr>
<tr>
<td>Liquidity available</td>
<td>Creditor rights</td>
<td>Proximity to new centers of regional and global growth</td>
<td>Inadequate transparency levels</td>
</tr>
<tr>
<td>Physical infrastructure</td>
<td>Investor protection</td>
<td>Islamic banking legacy</td>
<td>Regional competition</td>
</tr>
<tr>
<td>Availability of skills</td>
<td>Incomplete financial markets infrastructure</td>
<td>Aggregated knowledge and expertise</td>
<td>Prolongation of reform programs</td>
</tr>
<tr>
<td>Strong regulatory regime in DIFC</td>
<td>High sector concentrations to single industries and inadequate portfolio diversification</td>
<td></td>
<td>Decreasing domestic infrastructure finance requirements</td>
</tr>
<tr>
<td>Critical mass of support services</td>
<td>Access to capital for SMEs</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equity markets lack critical size</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lack of institutional investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Overbanked and fragmented banking sector</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Figure 36: SWOT-Analysis of the Financial Services Sector*

Availability of significant asset and liquidity pools managed either in the form of SWFs or as part of growing balance sheets of domestic financial institutions as well as increasing wealth of HNWI and the public sector alike, provides a unique opportunity for Dubai to create a mechanism and investment
channels for aggregation, management, distribution and allocation of such resources into domestic, regional and global markets. Moreover, Dubai’s first mover’s advantage resulted in the establishment of a critical mass of industry players and ancillary service providers as well as conducive business practices, financial laws and regulations (either in or out of DIFC) setting Dubai apart from other aspiring financial centres. This gives Dubai a head start in developing into a world-class financial centre with a full suite of competitive products and services (Thomas et al. 2013).

However, volatility in oil prices, a worldwide economic slowdown in line with falling stock markets and pressure on real estate prices pose major challenges for UAE banks, as these drivers are potentially related to a significant slowdown in economic and business growth, deterioration of asset quality and loss of profitability. Hence, risk aversion may quickly set in the banking industry mainly as a consequence of the GFC, subsequent economic crisis and the need to (i) deleverage and de-risk their portfolios, (ii) maintain a strong capital position in the face of global financial uncertainties, and (iii) manage information asymmetries in local market.

While the prime focus of policy measures and projects should be the development of a viable financial sector in respect to local development needs, regional and global prospects must be taken into account. At the regional level, the opportunity of the financial services sector to become a regional player in the future depends on its capability to focus on clear growth drivers while addressing the structural weaknesses identified earlier. Such growth drivers include regional needs for long term finance and financing available to firms across the spectrum of firms’ sizes.

The following chapter will explore the practice of the Islamic finance in Dubai in greater detail with a subsequent evaluation of options available geared to the advancement of the industry aligned with the salient features of Dubai’s economic model.
7  Dubai’s Islamic Financial Services: Viability and Prospects

We have ascertained in chapters 4 and 5 that Dubai indeed possess the necessary ingredients to provide for more organic development of the Islamic finance. However, we have also shown that Dubai’s financial industry overall was a factor of economic instability, given the structural weaknesses identified. Thus, occupying central role in Dubai’s economic development, financial industry that promotes increased stability is of critical importance for city’s growth and sustainability.

As such, we move our research from the industry level to a more practical and empirical assessment of Dubai’s Islamic financial industry. We shall conduct more focused examination of the practice of Islamic banking, due to its importance for the Islamic industry, and its impact on stability. In addition, given that some of Dubai’s large government related entities (GREs) have used *sukuk*, Islamic bonds, to raise funds in international markets prior to the Dubai Debt Crisis, we shall also critically assess the impact of Islamic instruments on the corporate and overall economic stability.

In addition, this chapter gathers the preceding discussions into a framework deliberating prospects for implementation of the Islamic paradigm within the context of Dubai’s economic model. We take into account issues identified earlier affecting the industry globally as well as theoretical framework and objectives of the Islamic paradigm. Given Dubai’s conducive economic framework these are then related to the identified structural vulnerabilities to explore potential to develop the industry more organically.

In order to systematically approach the implementation prospects, we use analytical framework suggested by Ahmed (2009) relating to classification of vulnerabilities and risks of the global financial system. He divides these risks into (i) institutional – referring to legal, regulatory and informational infrastructure in support of the prevention of moral hazard behaviour and the protection of public interest, (ii) organizational – including those referring to firm wide standardization of business activities and process, and (iii) product – risks related to the nature of products and its features. We find this framework pertinent in relation to the dichotomy in Islamic finance as Ahmed asserts these three broad categories of risks and weaknesses in the global system may also potentially trap Islamic finance. It is worth mentioning, this chapter focuses on exploring Islamic finance implementation prospects by addressing Dubai’s macroeconomic and financial industry weaknesses in order to avoid a research trap of remaining abstract and removed from problem solving as highlighted by Farooq (2013).
7.1 Islamic financial services in Dubai: Global pioneer in local market

Globally Islamic banking proved to be one of the fastest growing industries with an average annual growth of 15 per cent. Dubai has led the path to the development of Islamic banking worldwide and created a major driver for growth of the financial services sector with the establishment of the first Islamic bank (Dubai Islamic Bank) in 1975. The DIB is still the key player in Islamic banking in Dubai today. As the demand for Islamic financing products increased heavily after its introduction, further Islamic banks were established in Dubai and the UAE, including some conventional banks offering Islamic banking products. Hence, Islamic finance has been present in Dubai for more than three decades. Since the establishment of Dubai Islamic Bank, Islamic banking and finance has seen strong growth and proliferation across various segments including banking, advisory, education etc. Its establishment marks Dubai’s commitment to promotion and development of the industry.

Reflecting its entrepreneurial character, highlighted in Chapter 5, Dubai’s government has taken the lead and established other Islamic financial institutions, including Emirates Islamic Bank in 2004 as well as Noor Bank in January 2008. Emirates Islamic acquired later Dubai Bank, a conventional bank that converted to Islamic in 2007. Importantly, in addition to its strong presence in the banking industry, Islamic financial services in Dubai have also developed products and services that are not commonly found in other markets and jurisdictions. This includes (i) specialized mortgage providers, eg. Tamweel and Amlak, (ii) saving/investment institutions, eg, National Bonds, (iii) stock exchange, eg. Dubai Financial Markets, (iv) Shari’ah advisory firms such as Dar Al Shari’ah, (v) fund managers, etc. Notably, Dubai’s government either fully or partially owns most of the mentioned institutions across business lines. The elaborate network of different financial institutions is in fact another testimony of the entrepreneurial character of the government.

Figure 37: The Islamic finance development timeline: Author’s own analysis
Therefore, Islamic finance activities in Dubai are not confined to commercial banking alone. A successful business model in investment banking, mortgage finance, insurance, savings and investments, Shari’ah advisory etc. have been established. As such Dubai’s Islamic finance institutions as well as products and services provide a holistic solution to various clientele from retail, corporate and government alike. In addition, the Islamic sukuk market has also witnessed strong emergence and has become a viable alternative to many issuers and investors alike. Nasdaq Dubai is an increasingly popular destination for sukuk listings with a current nominal value of USD 25.7 billion (Nasdaq Dubai 2014). As the Islamic financing sector shows promising growth potential in regard to the development of the region and especially the GCC, other commercial banks have commenced operations with Islamic financing products.

Similar to the GCC wide proliferation of conventional financial services, Islamic banks in Dubai and GCC alike share similar trends and drivers as their conventional counterparts (Loghod 2010). Structurally, IFIs are dominated by the banking industry while capital markets, both equity and sukuk, add to the depth and breadth of sectors’ offering. At a macro level, there is evidence that Islamic Finance may present an opportunity as a specialized niche to offer benefits for the long term sustainable development of the economy. The sheer growth of Islamic banking, the significant potential of the region and Dubai’s position within this sector imply bright prospects for the sector segment. As such, Islamic financial services have taken the opportunity of growing and developing along with the economy and financial sector in general. The demand for Islamic financing products in respect to the forecasted growth and further development of the MENA region and especially the GCC countries supports this expectation. As such, Islamic finance needs further integration into all aspects of financial and business dealings.

Similar to the rest of the financial industry, IFIs are regulated by the UAE Central Bank, ESCA and DFSA. There are no specific regulations or agencies mandated to supervise only Islamic financial institutions. Likewise, the Central Bank does not provide any statistics related to Islamic financial institutions alone. But Ernst & Young (2014) research indicates that current penetration of Islamic banking assets is about 21.4 per cent. According to the same research, Islamic banks are growing at a faster rate compared to conventional banks at 11 per cent and 5 per cent respectively.

7.2 Islamic vs conventional finance: Microeconomic analysis impact on stability

In previous chapters we have highlighted a common economic environment, similar business regulation and shared industry structural elements within the broader financial services. Hence it is only rational to expect that both, conventional and Islamic, components of financial services would have a similar contribution to economic development and stability. It seems that this commonality is not only specific to Dubai but is a rather common feature of other markets as well. In fact, in cases where conventional
market is substantially more developed in terms of products, including derivatives, then we may expect somewhat different drivers and characteristics of the two systems to emerge.

Miniaoui and Gohou (2011) find that prior to the crisis, conventional banks in the UAE performed better than Islamic banks. But, following the crisis, Islamic banks closed the gap for most performance indicators. Al Tamimi (2010) explored the factors influencing the performance of UAE’s conventional and Islamic banks to find that the liquidity available is a key factor for the performance of conventional banks, while in the case of Islamic banks it is the cost and number of branches. Ali (2011) explains better performance of Islamic banks on the account of (i) Islamic banks’ financing activities being more tied to the real economy, (ii) Islamic banks’ avoidance of direct exposure to toxic debt and derivatives, and (iii) significant liquidity available. Beck et al (2013) also add higher capitalization and better asset quality for Islamic banks in general. But Bourkhis and Nabi (2012) highlight that in fact, there is no significant difference in terms of the effect of the financial crisis on the soundness of IBs and CBs.

A cross country analysis of Islamic banks’ impact on financial stability reveals that small IB tend to be financially stronger than small commercial banks while large commercial banks tend to be stronger than large Islamic banks. Likewise, small Islamic banks seem to be stronger than large Islamic banks (Cihak and Hesse 2008). It seems that this conclusion is intuitive to the extent that large Islamic banks do not have all the risk management tools available to match the sophistication of conventional banks while at the same time the issues of monitoring and control of various profit-loss arrangements becomes progressively challenging with the increasing size.

Some research on the subject is available. Using the data on five Islamic banks in the UAE, Ali (2011) compares growth rates of Islamic banks across the region. The analysis performed confirms that in 2008 the financing component of total assets increased faster than portfolio investment while the cash and cash-equivalent component in fact declined; hence expansion in credit and a strained liquidity situation. Importantly, his analysis reveals a dominant role of murabaha financing in Islamic banks asset composition in the UAE.

Figure 38: Composition of financing modes in use in 2008; Source (Ali 2011)
It is therefore difficult to reasonably expect any significant impact of the Islamic banking industry, beyond the provision of finance similar to conventional banking, on the economy of Dubai. Similarly, a conclusion can be made in terms of the Islamic finance’s impact of stability as well. Given this background, for the purpose of this study, it may be concluded that functionally the role of Islamic banks in Dubai is akin to the role of conventional banks.

However, the importance of the network of different Islamic financial institutions must not be underestimated. While collectively, the industry is not making a significant impact in terms of economic development, the ecosystem created in terms of various contractual relationships that are in conformity with Shari’ah principles provides an impetus for further development. Moreover, given the evolving nature of the Islamic finance industry it may be expected that the impetus for further industry development has been established.

### 7.2.1 The role of sukuk in economic development of Dubai

While satisfying Shari’ah principles, Islamic banking does have a similar role to conventional banks given the commonality of regulations and the economic environment. In addition to the banking industry, a sukuk market is yet another important aspect of Dubai’s Islamic financial industry. Dubai has utilized sukuk structures to raise some of the largest and novel structures such as the USD 3.5 billion convertible sukuk used to finance the acquisition of the P&O port operator by Dubai Ports. Later, Nakheel has also used sukuk to raise USD 4 billion for some of its real estate development projects. Infamously, this sukuk came into a limelight once Nakheel requested restructuring of its USD 26 billion debt pile.

On a positive note, using sukuk in such high profile international acquisitions and project development has certainly further propelled sukuk into mainstream finance. International legal firms, major international banks and investors have taken part in developing, arranging, subscribing and investing these sukuk.

However, the Dubai Debt Crisis has in fact revealed weaknesses in sukuk structures as well as in Dubai’s legal system which was not fit for such a large bankruptcy case (Salah 2010). Similar to other sukuk issuances, Nakheel sukuk was asset based as opposed to asset backed (Nakheel 2006). The difference between the asset backed and asset based, while semantically subtle is in fact substantial. Manoeuvring around the Shari’ah requirement of asset ownership prior to sale of the same asset, most of sukuk are structured to transfer beneficial ownership to sukuk holders. These are asset based sukuk. The sale of asset effectively and legally is not completed and in case of any default investors do not have recourse to the underlying asset. Shari’ah condition of sale asset is satisfied only
contractually but not legally as well. On the other hand, a true sale asset is transferred from the books of a seller to a buyer and hence legally binding. This is an asset backed *sukuk* structure.\(^{92}\)

Nakheel *sukuk* issue was an asset based structure and as such did not give recourse to asset to *sukuk* holders. In addition, it seems that even the UAE legal system was not supportive of an asset backed structure. In fact, (Salah 2010) argues that the problem was inherent to the legal system of the UAE as it seems that the *sukuk* structure was not enforceable under UAE laws. In addition, further weaknesses were exposed in the legal system to the extent that existing insolvency laws were inadequate to deal with the large and complex restructurings of domestics companies (Salah 2010). As such, a Decree No. 57 was enacted giving a jurisdiction to DIFC to hear and decide on cases of the Dubai World and its subsidiaries. The DIFC insolvency law is based on the insolvency law of the UK with elements of Australian and American legislation.

Therefore, given this background, it appears that Dubai's capital markets is similar to the banking industry and do not have a substantive and distinctive role beyond satisfying Shari'ah in its form only.

### 7.3 Operationalizing the Islamic economic framework

Many weaknesses in Dubai's economy in general and financial sector in particular have been identified throughout the study. Now, our focus is on implementation alternatives that may align the economic development objectives with the development of the Islamic economic paradigm via developments in Islamic finance, thus positively contributing towards more stable overall economic development.

Following the recent GFC, many researches have highlighted the systemic relevance of Islamic finance to current global economic and financial challenges (Chapra 2009; Askari 2015; Ahmed 2009; Mirakhor 2009). The potential solutions have been widely debated and many proposals were directed toward reforming the industry. Typically, these include a better and more favourable legal framework as well as regulations more aligned with the needs of the banking industry, standardization of contracts, Shari'ah harmonization, innovation of financial products, improvements in risk management etc. This was reflected in our findings from field research as well. But despite all the efforts to implement such recommendations, it seems that the industry has made little progress in substantive improvements towards its own ideals.

---

\(^{92}\) Some estimates indicate that only 2 per cent of all *sukuk* issues are actually backed with real assets. The remaining 98 per cent uses assets for the transaction purposes only as underlying instrument.
It may be recalled, that we have also elaborated and highlighted some key considerations to be taken into account while deliberating implementation alternatives as: (i) the Islamic banking industry might be too big to undergo changes, (ii) Islamic capital markets are narrowly focused on sukuk issuances, (iii) innovation is largely replicating conventional instruments, (iv) regulating the industry to provide an incentive system conducive to industry development, and (v) developing governance in a wider sense, not limiting it to Islamic banking alone.

Importantly, as a consequence of Islamic finance being reduced mostly to Islamic banking, its widely acclaimed risk sharing feature, as a cornerstone of economic stability and equitable allocation of resources, is in fact neutralized by the competitive pressure of the conventional banking industry. Hence, translating the theory of Islamic economics and finance into practice, while keeping in mind the above and given the prevalence of conventional economic and financial practices, is indeed a formidable task.

However, as this research indicates, a non-orthodox economic development approach modelled by Dubai seems to hold promises as a conducive environment for more genuine development of Islamic finance to primarily serve its own development priorities and provide a new impetus for the industry development itself.

7.4 Capitalizing on Dubai’s predisposition to develop the Islamic framework

As we have seen earlier, in Chapter 5, Dubai’s economic model is well aligned with the fundamental principles of the Islamic economic paradigm. In fact, its key features reinforce and allow for the organic development of Islamic finance. But, the challenge is to identify the right areas of intervention that would ensure the above mentioned considerations are taken into account while ensuring deeper and wider impact of the industry.

Clearly, weaknesses identified in Chapters 4 – 6 may provide some guidance in terms of focus areas for the implementation. For example, given the tax free regime and the need to innovatively source funding to meet public spending objectives, one area requiring continuous development would be that of financial instruments that are diverse enough to address various funding requirements, public and private sector alike. An obvious solution would be the adoption of the tax system that would provide surety in funding, close some information flow deficiencies and improve predictability in government fiscal planning. However, as we have seen in Chapter 5, the tax-free regime is one of Dubai’s fundamental development principles on which its laissez-faire system rests including a market based incentive system and therefore, as mentioned, all other alternatives should be exhausted before resorting to taxation. Therefore, any prospective implementation of the Islamic financial paradigm
should be carefully designed to further reinforce the development principles and strategic policies identified earlier in Chapter 5 in order to contribute not only to the Islamic finance growth but more vitally to economic development in general.

Therefore, capitalizing on Dubai’s enabling environment prospective and more comprehensive implementation of the Islamic finance should be based on the following prerogatives or guiding principles. Implementation policies and solutions in relation to Islamic financial services and economic development in Dubai should specifically:

(i) **Aim to reinforce Dubai’s economic development model - development principles and strategic policies**;
(ii) **Provide for better interaction with international business and trade partners**;
(iii) **Ensure inclusiveness and integration of Islamic finance into mainstream economic development and planning**
(iv) **Effectively address the issue of form vs substance in the Islamic finance**
(v) **Be wide in scope and look to impact the Islamic finance beyond Islamic banking**

The earlier mentioned classification of vulnerabilities and risks by Ahmed (2009), institution-organization-product, may provide useful grouping and a point of reference for Dubai and its Islamic finance vulnerabilities, albeit with a somewhat different focus. For example, we have earlier highlighted the issue of informational infrastructure and the paramount importance of information disclosure and transparency. In fact, Islamic finance is premised on transparency and full disclosure of all available information. Any asymmetrical information may give rise to undue advantage to any of the parties involved in the transaction. However, as we have seen earlier, *information asymmetries* adversely affect financial markets and economic development in general and are structurally enabled in Dubai as a result of the absence of reporting requirements. Addressing this important issue and suggested reform would therefore fall under the heading of institutional classification.

**7.4.1 Institutional developments**

As mentioned, institutional challenges normally refer to legal and regulatory issues but also to information infrastructure in a given economy. In relation to Islamic finance, institutional development almost exclusively refers to Islamic banking and related regulations. As it may be expected, similar to conventional finance, sound governance and regulatory system plays an important role not only in respect to its stability and soundness but also in relation to its development. We have earlier explained, in Chapter 3, the role and the need for sound regulation, while in Chapter 5 we highlighted that, because of absence of taxation mechanisms, Islamic finance regulators in UAE are not able to use fiscal tools to
incentivise market development in a particular way. But, on the other hand, we have also highlighted that Dubai’s economic structure provides suitable framework for more organic development of the Islamic finance industry, banking and non-banking alike. It may also be recalled that we explained, in Chapter 6, the multiplicity in regulation of Dubai’s and UAE’s financial industry. Such multiplicity directly poses developmental challenge for the financial industry, including Islamic finance. We have also cited the case of Nakheel’s sukuk and inadequacy of UAE legislation to manage the resolution with investors, which in turn also highlights the need for the legal system developments. Therefore, while the regulation has apparent room for development in terms of harmonisation, the legal system likewise needs to follow such developments in order to provide robust development framework.

The need for sound Shari’ah governance is particularly important. Evolutionary nature of Islamic financial institutions and instruments warrants continuous improvements in terms of transparency and disclosure, Shari’ah board structure and its competency, etc. However, in their exploratory study of UAE banks, Gebba and Aboelmaged (2015) report that all banks in the UAE, whether Islamic or otherwise, have similar corporate governance structures where all banks have a board of directors, an auditor and an audit committee. The only difference is the existence of Shari’a Supervisory Board (SSB), which is exclusive to Islamic banks. While describing the UAE regulator, i.e. the UAE Central Bank, as minimalistic, Hasan (2012), particularly highlighted the need for the adoption of the AAIOIFI standards and IFSB’s guiding principles. In this context, the DFSA’s efforts to raise governance and regulation standards in Islamic financial services seem particularly important. Its Shari’ah systems model obliges authorized firms to implement adequate systems, controls and processes to ensure compliance with Shari’ah. Implementation of AAIOIFI accounting standards is mandatory in DIFC, along with enhanced disclosure in respect of Shari’ah oversight.

It is clear that particularity of Islamic financial institutions, banking and non-banking, should be in first place recognized. Its regulation along with highest governance standards should be geared to address specific nature and risk profiles of the IFIs. Given inconsistencies in application of federal Islamic banking law, the need to harmonize regulation among various Dubai and UAE regulators in Islamic financial industry is necessary requirement for the industry development and growth.

In addition, the need to standardize is often regarded as the necessity for the industry more rapid development and acceptability in mainstream finance. However, the challenge is standardizing various rules and interpretations of Shari’ah that are often relevant only in particular context. But, while it may not be possible to standardise fatwas, it may be possible to standardise common elements of structures which have been agreed by the majority of scholars. This may provide strong basis upon which Islamic and conventional financial institutions may utilize Shari’ah compliant structures with greater certainty and better speed of execution.
Therefore, in case of Dubai, developing a robust regulatory framework in general and sound Sharī‘ah governance regime in particular seems to be evident and important recommendation. However, within Dubai’s context, in addition to governance and regulation improvements the other two important institutional gaps mentioned in our preceding analysis need to be addressed: (i) poor information infrastructure, and the (ii) lack of institutional investors in the financial industry, including in the Islamic finance.

7.4.1.1. Implementation priorities: Solving information asymmetry

As explained, among the main attractions of Dubai is the ease with which businesses can be set up, and the business-friendly regulatory and legal environment. The Dubai Government is trying to stay away from creating too many hurdles and entry barriers for businesses. On the other hand, this business-friendly culture includes a lack of financial reporting requirement on the part of business enterprises. For those entities that do prepare financial statements, there is no disclosure standard, and audit standards are considered deficient.

Given the strong emphasis Islamic economics and finance places on transparency and informed decision making, it may be argued that the availability of institutions and instruments enabling unhindered information flows in the economy is in fact more important within the context of the Islamic economic and financial system than in the conventional system. However, conventional economies do not face issues similar to that of Dubai. Rocha et. al. (2011) provide elaborate evidence that such an enabling infrastructure in the MENA region in particular is significantly weaker than in other markets. In addition to information asymmetry, an important perspective of financial intermediation is that of risk. Information asymmetries and incentive issues go hand in hand. They influence the degree of development of the financial industry including its capital markets which in turn may offer more efficient mechanisms for corporate control (Iqbal 2011).

As a consequence, information asymmetry negatively impacts financial industry development and diversification, SMEs access and cost of capital, and consequently overall economic stability and development. The tendency of financial institutions, Islamic or otherwise, to extend finance to larger entities leads to asset concentration on the banks’ balance sheets as well as suboptimal and imbalanced economic development and growth. Clearly, financial institutions are not able to properly assess the credit risk of borrowing entities given the poor information quality of businesses seeking finance. Information provided to financial institutions, almost as a rule, is unreliable, inaccurate and not timely. Hence, as previously shown credit flows to the SME sector is under-developed. Being a backbone of any economy, SMEs in Dubai therefore suffer from low access to capital and when available
such capital is often prohibitively expensive. SMEs account for approximately 40 per cent of Dubai’s GDP, and about 42 per cent of Dubai’s employment.93

While the negative consequences of an underdeveloped information infrastructure affect the economy in general and the financial and banking sector in particular, there are serious consequences to Islamic finance given the paradigm that essentially rests on risk sharing. Risk sharing implies the ability of financiers to assess comprehensively the merits of a business/project being financed given its risk sharing proposition. But in an opaque information environment, where full disclosure and information sharing is scarce the intermediation function of the IFIs is significantly distorted while risk sharing in an environment of great uncertainty due to information asymmetries may even amount to gambling. Hence this information asymmetry hurdle, removes IFIs further away from their theoretical equity based and risk sharing practices. Therefore, being the critical enabling factor for further Islamic finance industry development, removing this obstacle effectively becomes a priority area for the reform.

Given Dubai’s market-based approach to economic development and a market based incentive system, the question arises as to what might be done to address this issue. In addition, as we would like to reinforce market based incentive system, mandating regular reporting by the licensed firm to a government entity is not the best option since any mandatory reporting may be perceived by businesses as encroachment of their business liberties. Clearly, in Dubai’s context this would stand a chance of being seen as detrimental to Dubai’s attractiveness as a business destination and consequently may pose a threat to its competitiveness.

Given the importance of uninhibited information flow and the host of benefits that may be derived for each group of stakeholders --i.e. SMEs, financial institutions and the government-- it seems that an SME credit rating agency would be able to close various information gaps. Importantly, given the absence of other reporting mechanisms, such an agency would effectively play a different role than in other economies. In fact, it would become an indispensable part of its economic infrastructure and significantly contribute towards improving access to credit as well as reducing the cost of credit. Both of these perspectives are critical for economic sustainability and the well-functioning of financial markets. Therefore, the rating agency model geared primarily to support the SME sector seems as a particularly suitable model for Dubai’s economy. Importantly, such institution would be able to apply qualitative rating standards that are based on Islamic values as explained below.

93 Source: Dubai SME Development Agency
Developing demand side for wider and deeper Islamic capital markets is a key enabler, as identified in Chapter 6, necessary for economic stability and sustainability. This is especially true for long term funds that are primarily used for infrastructure development. Considering Dubai’s Debt Crisis, it seems that investor’s appetite for such long term funds is very limited. As explained earlier, Dubai’s long term real estate infrastructure developments had to be financed on a short term basis hoping that refinancing in international markets would be always be available. But the GFC has brought international capital markets to a standstill and essentially deprived Dubai from the opportunity to refinance its short term infrastructure borrowings. The Debt Crisis ensued as a result. Should Dubai have been able in the first place to raise long term funds, 10 years and above, then it is likely that the crisis would have been substantially avoided. Given the preceding analysis it should be noted that a particularly weak aspect of Dubai’s financial industry is that of institutional investors.

Developing institutional investors to bring the needed economies of scale to Dubai’s financial markets seems as important implementation priority. Considering large Dubai’s large expatriate population which is typically not covered by pension plans suggests that an opportunity to provide retirement scheme as the UAE government does not mandate the provision of retirement or pension benefits for expatriates. However, Federal Law mandates a payment of End-of –Service- Benefits (EOSB) to all expatriate workers (UAE Labour Law 1980). The nature of Dubai and the UAE labour market is largely reflective of GCC trends and practices. Under current legislation, expatriate workers are entitled to receive an EOSB once their employment contract is terminated. The benefit amount received depends on the
length of time they were employed and their salary levels. The maximum benefit that can be provided is equal to two years of salary for each year of service.

As previously explained, one of the key drivers of Dubai’s economic development and growth is the liberal regime of expatriate labour inflows. Almost 98 per cent of workers in Dubai in the private sector are expatriates whereas their share in the public sector is significantly lower. Given that the immigration laws in the UAE restrict foreigners’ residence to the lengths of their jobs the expatriate workforce in Dubai is transient in nature. Therefore, the labour market plays an important role in maintaining Dubai’s competitiveness and economic development.

Importantly, cases of employers’ non-compliance in paying the EOSB were recorded especially in circumstances of business and financial difficulties. This poses difficulties for the expatriate workers who rely on this income and it decreases the attractiveness of Dubai as a potential work destination. The pro-cyclical nature of the existing EOSB system exacerbates the negative effects of the economic/financial crises exposing workers to increased risks during already challenging economic environment. Therefore, reforms should be aimed to improve the shortcomings of the present EOSB, increase the welfare of expatriate workers while providing opportunities for national economic development (Insight 2011).

In line with extensive literature, such as Holzmann (2012), relating retirement saving and capital market development as well as fully funded retirement benefits and individual savings, the introduction of a portable defined contribution (DC) retirement saving scheme would go a long way in ensuring expatriate workers rights are protected providing them with a necessary mechanism to efficiently plan for their future. This would mean that the UAE labour market would become even more attractive, where not only workers’ rights are protected efficiently, but also employers are able to manage their human resources better, which would likely increase employees’ job satisfaction and productivity. On the other hand, the government would stand to benefit by having a contractual savings institution capable of making strong contributions toward economic development. Clearly, dynamic and well-functioning labour markets coupled with institutional development would form a cornerstone of Dubai’s competitiveness and economic performance that should meet the objectives of economic development.

In relation to Islamic finance, given the functional role institutional investors play, the proposed scheme would play an even more important role than if it were run as a conventional scheme. We have concluded earlier that Islamic finance needs to create demand side, economies of scale, for long term funds in order to start developing as an industry more authentically and decisively. We have also emphasised earlier that being driven by Islamic banking the industry has lost sight of risk sharing and instead focuses on the prohibition of interest through avoidance. This is evidenced by having Shari’ah
conscious investors typically entrusting their funds to Islamic banks thus leaving the Islamic banking institutions with more than 80 per cent of all the Sharī'ah compliant assets. It has to be noted that the risk profile of a typical bank, whether Islamic or conventional, is adjusted to suit the needs of their asset – liability management objectives. This objective restricts banks to invest their funds into long term instruments. These are typically available in capital markets or from mentioned institutional investors.

Hence, while Islamic banking has certainly contributed to the development of the industry overall as well as Sharī'ah compliant investment and saving solutions to Muslims across the world, the banking sector contribution to economic development is incomplete without institutional investors promoting long term investments and sustainable development. Notably, investment banks and sukuk assets are estimated to stand at 11 per cent each, whereas Islamic funds represent less than 6 per cent of total Islamic finance assets (Ernst & Young 2011). In addition, the takaful industry accounts for merely 1 per cent of total assets. An analysis of the Islamic funds industry indicates that there were only 750 funds with an estimated value of USD 58 billion in 2010 whereas the number of funds in 2014, as per Thomson Reuters (2015), grew to 1,181 with the total AUM of USD 60.65 billion. Contrasting this to the size of the conventional fund management industry of an estimated 68,000 funds with assets of USD 25 trillion indicates (i) the size disparity between the two markets, (ii) the limited role Islamic finance plays in economic development, and (iii) the direction for future development of Islamic financial services as an industry.

Considering the fact that not all institutional funds are invested in funds per se, it is likely that the size of the Islamic institutional market is somewhat bigger. Therefore, in order to avail long-term funds for economic development and provide demand-pull for Islamic financial services, large institutional investors with economies of scale should be established, integrating economic development objectives with Islamic economic and financial principles.

A Shari‘ah compliant contractual savings institution with sizable long term investable funds seeking investment opportunities would represent a major driver for Islamic finance industry development. The fund of this nature would almost instantly create demand for new Shari‘ah compliant products, across maturities on one hand, while on the other hand, it would avail the necessary funds needed for long term infrastructure development of Dubai and the region. Certainly, this would substantially reduce reliance on bank finance locally as well as international capital markets, thereby bringing highly needed stability and reduced uncertainty in financial markets and economic development in general. In addition, its essentially conservative investment policies without sovereign guarantees would essentially further reinforce, both, Dubai’s distinctive macroeconomic features as mentioned earlier.
In terms of investments, accumulated funds should be invested following the principles of diversification, security and stability of investment returns, and conservative risk profiles. Therefore, a carefully planned and communicated retirement scheme should bring benefits to all stakeholders. In addition, a gradual implementation of the scheme over the medium to longer term will ensure a smooth transition, allowing all stakeholders to derive the maximum benefit for their employees and businesses. An expatriate retirement saving scheme as described above practically encapsulates the need for integration of Islamic finance with economic development objectives while inherently serving the Maqāsid-al-Shari‘ah.

Therefore, summarizing the investment opportunities in strictly speaking Shari‘ah compatible instruments may prove difficult for large institutional investors in terms of achieving diversification, liquidity and risk return objectives. However, it is clear that (i) the precedents in developing required investment vehicles and structures in compliance with Shari‘ah, as well as (ii) the current size of the market provides sufficient scope for institutional investors to begin operations. With time and economies of scale, a demand pull would result in the expansion of investment universe in terms of markets, asset classes, financial instruments and therefore a myriad of risk-return profiles allowing sophisticated institutional investors to manage their risks effectively and efficiently.

However, the question may be asked to what extent large aggregated funds may be invested efficiently, in a Shari‘ah compatible manner, serving the investment policies and strategies for which it was established in first place. In other words, would a large Dubai or UAE expatriate retirement fund be able to achieve diversification, and risk and return objectives that would meet the requirements of security, stability and required returns? To contextualize this issue, let us understand the size of, for example, OIC94 financial markets. Total market capitalization of OIC stock markets at the end of June 2010 was USD 1,860 billion with 6,655 listed companies (Dinar Standard 2010). For comparison purposes, NYSE Euronext market cap stood at USD 12,250 billion.

This obvious disparity between a single exchange and 27 active OIC exchanges95 just confirms the state of the underdevelopment of financial markets in OIC countries and the corresponding corporate sector. Clearly, it is to be noted that not all OIC stock markets are Shari‘ah compatible and therefore would not represent the right investment universe for a Shari‘ah compliant retirement fund. However, if we assume that predominantly Muslim countries i.e. OIC members should be the ones promoting, supporting and developing Islamic finance, then it is understandable why Islamic finance and Islamic asset management has not developed to its full potential. In terms of returns, institutional investors, given their economies

94 Organization of Islamic Cooperation (OIC) has 57 member countries
95 Largest 10 exchanges in OIC include KSA, Malaysia, Indonesia, Istanbul, Doha, Kuwait, Egypt, Morocco, Abu Dhabi and Iran. Collectively, these exchanges comprise 84.53 per cent of total market capitalization in OIC.
of scale and expected strong management and deal negotiation position, should be able to add value to investment partners while ensuring an optimum risk return trade-off for its beneficiaries.

7.4.2 Organizational developments

‘Capitalism is under siege’ summarizes challenges facing the conventional economic and financial system (Porter and Kramer 2011, p.48). Porter and Kramer argue that the prevailing conventional system is missing shared values focusing on the connections between societal and economic progress. This paradigm in conventional economic thought emerged post GFC, as a result of the fundamental problems facing the modern economies. The authors have rightly identified a seeming trade-off between economic efficiency and social progress which has been institutionalized in decades of policy choices. Importantly, authors argue that a Corporate Social Responsibility (CSR) is not sufficient to address the societal objectives as it is not at the core of the business but rather peripheral. These developments in the economic and business ideas are in fact in line with Colander et al. (2004, p.485) who argues ‘that economics is moving away from a strict adherence to the holy trinity—rationality, selfishness, and equilibrium—to a more eclectic position of purposeful behaviour, enlightened self-interest and sustainability’.

Interestingly, in line with this thinking, the Islamic economic paradigm set out objectives and rules, including those contained in Islamic finance, that aim to achieve exactly what Porter and Kramer argue. Hence while the Islamic economic paradigm exhibits a dichotomy between theory and practice and struggles to get out of the neo-classical straitjacket, conventional economics has empirically reached to the conclusions already contained in the Islamic economic paradigm. Importantly, the Islamic economic model does not only set unified objectives of economic and social progress but it also establishes rules and institutions necessary to achieve the same. However, it seems that the decoupling of social and economic objectives at the business level is not only characteristic of conventional business but has also been transferred to the Islamic business realm as well. Hence, IFIs receive strong criticism for underperformance in respect to its own goals.

The dichotomy between Islamic economics and finance theory has been thoroughly elaborated throughout this research. Reasons for such a dichotomy are many; some of them are endogenous to the Islamic finance industry while some are exogenous, relating to competitive pressures. We have earlier concluded that Islamic economics and finance is primarily a value driven economic worldview that seeks to combine economic with social developments. This feature sets it apart from conventional economic model which primarily focus on profit maximization. Hence, addressing this challenge is an important objective. This amalgamation of the two objectives is at the core of the Islamic economic system which, as explained in Chapter 1, promotes justice and equality while pursuing the objective of
comprehensive human development. Therefore, it seems that a common solution for the problem identified by Porter and Kramer as well as the challenges facing the Islamic financial services lay in the adoption of value-based management standards that would place social objectives at the core of business activities.

*Organizational development from within: Translating values into actions*

Earlier in Chapter 4 we have identified that governance in Islamic finance is an important component of its paradigm. In addition to governance, Shari’ah compliance is the key qualifying criteria that determines whether a product or an institution would be regarded as Islamic. However, going beyond governance and mere Shari’ah compliance, an often neglected aspect is that of management. Implementing values across organizations and not only satisfying Shari’ah requirements insofar that products and services are concerned seems to be a missing link in developing organizations that are Islamic not only in form but also in substance.

In fact, while the Islamic economic paradigm comprehensively addresses the issue of economic development not only using income and wealth criteria but also overall human-centric development, Islamic financial institutions have been increasingly blamed for mimicking and following conventional business models. Notably, conventional financial institutions have been severely criticized during the recent GFC for being devoid of any moral scruple. On the other hand it has been widely documented that value driven organizations outperform their competitors (Collins and Porras 2011).

However, the practical challenge thus far was translating noble objectives of the Islamic economic system into practice. The first step in addressing this important issue starts with the realization that Islamic finance, at this stage of its development, faces more acutely qualitative challenges than quantitative ones. The industry has grown robustly for the past 20 years and has become an important element to various domestic financial systems and by extension, the global system as well. However, in order to more closely reflect its own values and fundamental principles and promises, qualitative development will have to be more fundamentally addressed.

The Islamic economic system, being a values based system, may relate to value-driven organizations and the increasingly popular for-benefit organizations. A for benefit organization is the term entrepreneurs use to describe organizations that generate earned income but give top priority to an explicit social mission (Heerad 2011).

However, issues of managing IFIs typically relate only to governance aspects dealing with issues of decision making and control in a firm. Indeed being an important element of organizational soundness,
several institutions, such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Dubai based Hawkamah, have published Islamic governance codes and standards. But, these Islamic governance standards are focused only on Islamic financial institutions (IFIs) and are sparingly used by the industry.

The challenge with the above infrastructure is twofold. Qualitative issues in Islamic finance are being dealt with only within the finance industry. It has to be noted that (Porter and Kramer 2011) speak about business and corporation in general. Hence there is a need to address the wider issue than that of financial institutions. Secondly, where standards are set by institutions such as AAIOFI or IFSB, there are no clear implementation mechanisms or benefits to implementing institutions. Hence those recommendations remain as such, only recommendations.

Being primarily a value based system, Islamic finance needs a standard that, again given the set of circumstances accorded by Dubai’s economic development approach, should contain a set of management and governance criteria on the basis of Islamic values. Therefore, there is an increased need for having an excellence model based on Islamic values in order to extend Islamic business practices beyond Islamic banking and provide companies with the necessary tools to translate Islamic values into practice, thereby creating a greater benefit for stakeholders. Hence shared values should be translated into a practice.

Importantly, the standards would help achieve unity of purpose, unifying thereby the dunia (worldly) purpose with the A’khira (hereafter) purpose and personal values with organizational values. Such a model should be able to provide guidelines for organizations to implement effective governance in order to create added value or benefit for all stakeholders. In addition to implementing best governance practices and being Sharī’ah compliant, Islamic institutions should ensure the translation of Islamic values at the management level. A success of any organization therefore, should not be measured only using financial metrics but also by its ability to provide benefits to its stakeholders.

Notably, the aspect of benefits is particularly important from the point of view of corporate objectives. Creating benefit for the creatures of Allah, that include all stakeholders, is highly emphasized in the teachings of Islam. Allah (swt) said: “…Thus Allah presents [the example of] truth and falsehood. As for the foam, it vanishes, [being] cast off; but as for that which benefits the people, it remains on the earth. Thus does Allah present examples.” (Qur’an 13:17). Prophet Muhammad (pbuh) also said: “creatures are Allah’s dependents. The most favoured to Him is he who is most beneficial to them”, Albani (1988, 96 Translation by Sahih International)
hadith 3289). This saying of the Prophet Muhammad indicates that the best people are the most beneficial to the creatures of Allah, hence Islamic firms should be comprehensively beneficial to all their stakeholders.

As mentioned, presently Islamic governance standards are mostly focused on solutions for Islamic financial institutions (IFIs) which are, for a number of reasons, selectively being used by the industry. On the other hand, there is a plethora of standards and recommendations on corporate governance and management by various international bodies with respect to conventional practices. It may be envisioned that a specialized institution or an agency should be mandated to develop corporate governance and management standards that are enshrined in Shari’ah laws, to promote and implement universal management values and practices across Dubai’s economy. In fact, such an institution should also be able to offer services to a global Islamic economic market.

Therefore, key features of such excellence model would include (i) value based criteria as evidenced in Qur’an and Sunnah; (ii) not prescriptive, to allow firms to adapt the model to their business objectives and needs - guidance is provided with respect to values and instruments for their identification and translation into action; (iii) applicable not only to Shari’ah compliant firms. Those who would like to apply Shari’ah screens should be able to receive Shari’ah compliance certification as well.

Thus, addressing this implementation priority is aimed at supporting long term sustainability and improved performance of Dubai’s economy while substantively contributing to the development of Islamic financial services and the Islamic economy in general. It effectively implies that it would not be sufficient for an organization, or a bank for that purpose, just to have products and funding in compliance with Shari’ah. More importantly, organizations should adhere to Islamic values from within, in terms of their management and governance.

7.4.3 Product developments

Thus far we have discussed and addressed some structural challenges facing Dubai’s economy and therefore affecting the development of its Islamic financial services. While not addressing the above and previously elaborated challenges may lead to severe underdevelopment of the industry, on the other hand the same challenges represent unique opportunities for the Islamic economic champions to fill the void and provide solutions that, at the same time, would be geared towards more decisive development of the Islamic finance in Dubai. Hence, Dubai stands to capitalize on its organic growth and enabling environment as well as the fact that Dubai’s government is holding both the demand and supply of products.
But, a critical challenge for the government will be to ensure smooth funding of its public expenditure. Given the absence of a taxation system is a hallmark feature of Dubai’s model triggering a myriad of other benefits and challenges, access to efficient and inexpensive finance by the government should also become one of priorities for policy makers. Moreover, improving access to capital not only to the public sector but also to the private and quasi-public (semi-government) sector would significantly contribute to the economic stability and less pronounced economic cycles due to external shocks.

Again, recognizing the need to develop viable alternatives to ubiquitous banks while capitalizing on the opportunities accorded by the economic structure should be directly taken as an opportunity. We have already highlighted in Chapter 3 the difference between debt and equity in terms of a level playing field between the two instrument classes. It should be recalled that debt is more attractive than equity primarily due to the cost advantages but also due to the dilution of control associated with equity. Dubai improves the relative attractiveness of equity by virtue of removing debt’s tax shelters or implicit government subsidy. Hence, coupled with other infrastructure elements, this should be a sufficient impetus to create demand for equity and risk sharing products.

Bacha and Mirakhor (2014) provide an important framework that seems particularly pertinent to Dubai’s situation. They propose the use of innovative sukuk structures that avoid problems with debt but also, importantly, stay away from interest rates as pricing benchmarks. Developing product structures should cater to different type of users, including corporate and government. Importantly their proposal takes into account debt-equity relationships and builds a consistent value proposition that utilizes the advantages of both, debt and equity. As such, the instruments would be attractive to the corporates and should embed the following features, (i) provide advantages of debt but without leverage, (ii) must be cost effective, (iii) should be attractive to both, ‘borrowers’ and financiers, (iv) must be functional and simple, (v) preferably be able to trade in the market, and lastly (vi) comply with Shari’ah requirements.

The nature of government public finance is to provide funding for revenue generating and non-revenue generating projects. Obviously, revenue generating projects would be easier to finance, probably through a combination of mudarabah and wakalah contracts linking financer to the source of revenues. The instrument can be envisioned, as elaborated by Bacha and Mirakhor (2014), with fixed tenor, without claims on the asset, and share of risk and returns. Importantly, in the case of funding non-revenue generating projects, in order to avoid fixed returns, a benchmark such as GDP of the average industry ROA could be used. It would be expected, in the case of Dubai, given strong average performance for a longer period of time that the GDP benchmark would be welcomed by investors. Notably, using these kind of benchmarks yet another problem prevalent in Islamic finance would be avoided. That is the use of LIBOR benchmarks which further converges the Islamic finance with the conventional finance.
Keeping in mind the expected need of the government to mobilize resources for various projects, revenue and non-revenue generating, as well as a vibrant corporate sector either seeking funding or financing opportunities, a systematic development of financial instruments aligned with government and market needs could be adopted. In order to establish a focus in addressing the issue of product development, a clear mandate from the government would be needed. One may envisage a specialized body with the mandate to work with financial regulators, major market players as well as key government entities to develop such instruments.

All the above suggestions are individually and collectively internally consistent and coherent with the objectives set out at the beginning of this chapter. Given Dubai’s unorthodox development approach that is fundamentally path-independent as per the requirement of more authentic industry development would essentially set a strong foundation for organic industry development. Such development, it is hoped, would be more genuine and closer to the spirit of the Islamic economic paradigm.
8 Narrowing the Dichotomy: Dubai’s Readiness and Global Prospects

Starting off with an in-depth analysis of the theory of Islamic economics and finance highlighting its developmental nature we have earlier pointed to various divergences in practical implementation of Islamic paradigm. We have closely analysed and defined Dubai’s economic model and its financial industry, including Islamic finance, emphasising its structural predisposition to provide a fundamentally different economic environment suitable to develop Islamic economic paradigm.

While Dubai possess the necessary ingredients for the industry development, we now broaden our discussion to include insights from Dubai’s chief architects of Islamic financial services obtained in a series of one-on-one, in-depth, semi-structured interviews to highlight some of the pitfalls of the current practices. These interviews not only provide good insights into current state of affairs of the Islamic finance industry, but importantly they are also a gauge of industry’s future developmental prospects. This chapter, therefore, addresses our last research question i.e. the readiness of Dubai to implement Islamic financial paradigm. As highlighted throughout the research such implementation needs to be more substantive in order to move the industry closer to its theoretical ideals.

Following the analysis of empirical results of Dubai’s case, we shall also attempt to derive some insights for reforming global Islamic finance for growth and sustainability.

8.1 Field data – methodology and results

In order to empirically assess the role and prospects of Islamic finance in Dubai’s economic development, we have conducted empirical data collection in the form of semi structured interviews with some key policy makers and businessmen in Dubai. The select group of interviewees included twelve (12) prominent individuals holding key positions in the public and private sectors relevant to, both, Islamic finance and the economic development of Dubai. Importantly, most leaders interviewed hold multiple positions and are widely regarded as insiders closely related to the economic development of Dubai and its Islamic financial services.

The following is a brief summary of each interviewed individuals highlighting their relevance for this research:
- **Mr. Sami Al Qamzi** is the current Director General of the Department of Economic Development in the Government of Dubai as well as the Deputy Chairman of the Dubai Islamic Economy Development Centre (DIECD). In addition, he is also Deputy Chairman and Managing Director of Dubai Media Incorporated (DMI), a government media arm. Being a Member of Dubai’s Executive Council, he is one of the most influential decision makers as far as economic development is concerned. In addition, he is a board member at the Dubai Economic Council, Dubai Real Estate Corporation, Zayed University, and Hamdan Bin Mohammed Smart University;

- **Mr. Essa Kazem** is the Governor of the Dubai International Financial Centre (DIFC) and the Chairman at the Borse Dubai, a holding company of the Dubai Financial Market (DFM) and Nasdaq Dubai. As such he is probably the most prominent decision and policy maker in the financial industry. In addition, Mr. Essa is the Deputy Chairman of Supreme Legislation Committee in Dubai and a member in Dubai’s Supreme Fiscal Committee. Lastly, he is the Secretary General of the Dubai Islamic Economy Development Centre., and the Chairman of the DIFC Investments Board of Directors, Board Member of the Dubai Economic Council, and board member of Noor Bank;

- **Mr. Abdulla Al Awar** is the CEO of the Dubai Islamic Economic Development Center and the former CEO of the Dubai International Financial Centre. During his period at the DIFC, the centre has achieved significant growth in terms of a number of new financial institutions.

- **Mr. Abdul Majeed Al Fahim** is the Chairman of Dubai Pearl, a USD 2.4 billion real estate development in Dubai. A member of a prominent Abu Dhabi family he was the executive director of the private office of a member of Abu Dhabi’s ruling family. In addition he also held several key positions at leading financial institutions in the region including the National Bank of Abu Dhabi, and as a vice-chairman at Bahrain’s Islamic Financial Consultancy;

- **Mr. Mohammed Al Shehhi** is the Deputy Director General at the Department of Finance, in the Government of Dubai. In addition he is a board member at the Emirates NBD Asset Management and the Secretary to the Supreme Fiscal Committee (SFC), and member at the Economic Development Committee –Sectorial Committees at the Executive Board at The Executive Council;

- **Dr. Mohamed Lahouel** is the Chief Economist at the Department of Economic Development, Government of Dubai. A Harvard graduate and formerly Professor of Economics and Associate Dean for Academic Affairs at the Dubai School of Government, the Professor of Economics and
Associate Dean at the University of Tunis, Al Manar, and Visiting Professor at Sorbonne University and Nice Sophia-Antipolis University in France.

- **Mr. Jamal Saeed Bin Ghalaita** is the CEO of Emirates Islamic Bank and a prominent local banker who held a number of senior appointments at Emirates NBD Bank prior to his position at the EIB;

- **Mr. Mohamed Qasim** is the CEO of National Bonds. The National Bonds is the only Shari’ah compliant savings and investment institution that functions on the principle of mudaraba.

- Mr. Amjad Naser, is the Head of Shari’ah at Noor Bank. Noor Bank is an important institution in Dubai’s Government Islamic finance portfolio.

- **Dr. Nasser Saidi**; President, Nasser Saidi & Associates is the former Chief Economist and Head of External Relations of Dubai International Financial Centre (DIFC) and Executive Director of the Hawkamah-Institute for Corporate Governance and The Mudara Institute of Directors at the DIFC between 2006 and 2012. One of the most prominent economists not only in Dubai and the UAE but in the Arab world as well. Also the former Minister of Economy and Trade and Minister of Industry of Lebanon between 1998 and 2000 and the former Vice-Governor of the Central Bank of Lebanon for two successive mandates, 1993-1998 and 1998-2003.

- **Dr. Ahmad Haddad**; Grand Mufti of Dubai, Islamic Affairs

- **Mr. Saeed Al Marri**; Deputy CEO, SME Development Agency and CEO SME Development Fund

The interview questions, Appendix 1, were designed to assess the opinions and perceptions of the business leaders and policy makers in not only shaping the practice of Islamic finance in Dubai but also reflecting the underlying motivations behind Dubai’s economic model. The guiding questions were designed to primarily assess the following areas:

1. **Theory and Practice of Islamic finance**
   a. Distinctiveness of Islamic economics and finance and its dichotomy between theory and practice

2. **Motivation behind the economic development in Dubai**
   a. Role of Islamic teachings and values in shaping Dubai’s economic model
   b. Motivation to use and develop Islamic Finance

3. **Role of Islamic finance in Dubai**
a. The issue of integration vs convergence between Islamic and conventional economy
b. Past and present role of IF in Dubai’s economy and its main drivers
c. Challenges

4. Development of IF in Dubai, challenges and opportunities
   a. Relation between conventional and Islamic economic and financial system, need to reform
   b. Risk sharing and asset based, equity finance development
   c. Islamic finance development in relation to taxation potential in Dubai
   d. Role of institutional investors

5. Benefits/impact of Islamic financial system
   a. Inclusion
   b. Growth
   c. Corporate governance

6. Dubai’s competitiveness in relation to Islamic finance

8.2 Data collection analysis

As indicated, the interviewees were carefully selected in order to provide practical and relevant inputs to this research. They represent industry leaders across different sectors in relation to the development of Dubai’s economy as well as Islamic finance. The questions were positioned in such a way to enable interviewees to provide their views and speak on the issue at hand as well as on other related issues. Of particular importance for this research is to gain insights into qualitative issues in respect to Dubai’s economic development model, primarily, those that relate to the role of Islamic values and their impact on policy choices along Dubai’s development path as well as leadership awareness of the distinctiveness of Dubai’s economic model.

8.2.1 Theory and practice of Islamic finance

The dichotomy between the theory and practice of Islamic finance is well documented as explained throughout this research. In addition, convergence with conventional finance in practice raises many issues on the purpose of the Islamic industry. Understanding the differences and converging points is important to set the direction of the industry development.

Notably all the participants, without exception, view the theory of Islamic finance to be distinctively different from conventional finance. In addition, they also recognize the dichotomy of Islamic finance in
terms of its theory and practice. Importantly, some interviewees have also related the difference between the two theories to the recent GFC and the need to take Islamic Finance more seriously.

A prominent economist commented, “The question is why the banking sector and financial markets do not in general take Islamic finance more seriously”

8.2.2 Motivation behind economic development in Dubai

This is a particularly important perspective for the purpose of this research. It directly probes the role of Islamic teachings and values in the economic development of Dubai.

It seems that all the interviewees are in agreement that Islamic values did and do play a role in the economic development of Dubai for the simple reason that all of its nationals are Muslims. Consequently, the leadership and merchants alike were observant of those values. Some of the responses include the following:

- “Yes definitely. Islam as a complete way of life is part of our traditions, how we live and do business.”
- “Of course it does as the nature of Islamic economy is inspired from the values that was passed on from our grandfathers such as fairness, sharing, competitiveness, self-reliance and hard work etc...”
- “It is about sharing aspect, what distinguishes Dubai and UAE for that matter, from other countries in the region is that economic prosperity and wealth has been shared with local population. In that sense it is inspired by Islamic values. But given that we have very large expatriate population, you could also say that inspiration from Islamic values is the acceptance of others.”

However, it seems that the respondent group has different views in terms of the extent in which such values have, in fact, played an active role in shaping Dubai’s economy. For example, one of the interviewees commented:

“Perhaps marginally (values played a role). I am not sure really at least in terms of using Islamic economic principles, I am not sure it has had much of an effect concretely on Dubai’s economy. Dubai’s economy has developed largely thru traditional finance and as a matter of fact if you look at Dubai’s debt, almost all of it has been contracted elsewhere and very little of it actually in terms of sukuks, and even if it is sukuks, they are much more in form than in substance. My view is that up until now, Islamic values and traditions have had little impact on Dubai’s economic development.”
Likewise one of the respondents reflected on values in light of the convergence between Islamic and conventional finance saying “I think the Islamic value is getting affected by westernization of the Arab world and the Islamic world. So if you want to strengthen this economy and strengthen Islamic economy we should bring Islamic values. We need stronger Islamic values.”

Therefore, it seems that Islamic values do play a role in the economic development of Dubai but likely to the extent that they can be integrated into development within the existing conventional system.

**8.2.3 Role of Islamic finance in Dubai**

Further to the issue of the role of Islamic values and the motivation behind the development of Dubai, the follow up issue is that of the past role of Islamic finance in the emirate’s development as well as its future plans for Islamic finance development.

The main issue tackled here is that of integration versus convergence between Islamic and the conventional economy i.e. whether the two should integrate or remain distinctively segregated. The interviewees have offered several important insights in this regard. The first one is that all the respondents unanimously agree that an Islamic economic paradigm and Islamic finance need to integrate into the rest of economy rather than stay as a separate economic activity. Importantly, as explained by a leading policy maker, there has to be a distinction between the transformation of Dubai’s economy to an Islamic economy capital and making Dubai as a global hub of Islamic economy. In his words,”…we are not saying, for example, our strategy is transforming to a global capital of Islamic economy, it is making Dubai a global capital of Islamic economy without impacting its position also as a conventional economic ecosystem. If we said that, we are actually discrediting all that and just focusing on the Islamic economy sector, it would be counterproductive.” Therefore, the transformation would connote more radical changes of an existing system, whereas making it implies a gradual move towards the Islamic economic system without disrupting the existing system but rather capitalizing on its strengths.

Likewise, a rather uniform view is that Islamic finance has played a role in the development of Dubai given the number of Islamic financial institutions and various forms of funding extended to the public and private sector. But more importantly, it seems that their views stop short of Islamic finance making a distinctive impact that goes beyond funding which is provided similar to conventional banks.

With respect to the drivers of Islamic finance development in Dubai, it seems that all the interviewees agree that the government via its regulations and investments is the main driver. Some have also
highlighted the role of strong market demand and the fact that IFIs are essentially growing on the back of strong demand. The pressure from international markets seems to have a limited role as a driver of industry development.

The obstacles to the development of Islamic finance in Dubai have been elaborated by a number of interviewees. It seems that the critical obstacles that were repeatedly highlighted include the following:

- Legislation and Regulation: Most interviewees highlighted the need to improve legislation that is geared more specially to the needs of the IFIs. Interestingly, while there is a specific Law on Islamic Banks (1985) some interviewees consider it insufficient:

  “There is only one reference being made to Islamic finance within central bank law in the UAE, highlighting the need to develop the Shari’ah central body. But there is no proper guidelines and regulations for a company that wants to undertake Islamic finance transactions or launch a product. It is up to the Shari’ah board.”

  “There is a need for reform to create proper regulations to govern Shari’ah compliant transactions, for example Central Bank regulations to accept Shari’ah investment structures in substance and forms, including reporting standards (IFRS), that will assist financial institutions which follows the Shari’ah standards to get the benefits in addition to the current liabilities (restrictions) imposed on them.”

- Talent: most Islamic finance professionals are trained conventionally. This represents a problem insofar as the development of new instruments is concerned. Given the conventional background, new instruments tend to resemble conventional instruments.

- Single Shari’ah board – the absence of a single Shari’ah approval authority creates space for Shari’ah arbitrage hence bringing confusion in the market when similar products are compared across institutions.

- Cost issues: Some interviewees expressed that Islamic financial products are more expensive and less competitive due to the lack of economies of scale. “At the current stage the main issue is to have enough size for Shari’ah transactions. This might be a challenge as it may add cost to Dubai in the case of a full Shari’ah compliant economy mainly in securing Shari’ah compliant financing also in regard to investment activities (short to medium term placements). However in the long run that will encourage local and global financial institutions to create products to full fill these needs.”
In addition, complex legal documentation often negatively impacts costs associated with Islamic products. "One drawback also is that complex documentation in Shari’ah increases costs."

8.2.4 Development of Islamic finance in Dubai, challenges and opportunities

In relation to the needs to reform the conventional and Islamic economic and financial system, it seems that interviewees were of the opinion that the Islamic financial system should be taken more seriously. All the respondents recognize the importance of risk sharing as being the cornerstone of Islamic finance. Importantly, in reference to risk sharing and the need to share control, the prevalent opinion was that sharing management and control are, in fact, positive elements as they allow businesses to grow stronger on the assumption of partners’ complementarity.

Importantly, some interviewees relate the issue of control sharing to family business ownership. "These issues need to be more dealt with at the family business level. Risk sharing and management dilution is a cultural issue."

In reference to the relationship between Islamic finance and the impact of any taxation introduced in Dubai, most respondents have not seen a direct relationship between the two. In other words, the introduction of taxation in Dubai would be neutral to Islamic finance. Interestingly, some prominent policy makers have also exhibited a degree of confusion between taxation and zakat. Zakat, a mandatory transfer of wealth from the well-to-do to the needy, is not an instrument of fiscal policy in a conventional sense. This clearly shows a degree of inadequate awareness on the part of policy makers on the very purpose of some important aspects of the Islamic economic paradigm. In fact, this exemplifies the issue of lack of talent in the industry an important hurdle to its development.

The importance of institutional investors in the financial system of Dubai was recognized by all the participants. Some key decision makers in the industry have highlighted the need for the presence of more institutional investors in the market given high volatility in the stock markets as a result of the prevalence of retail investors.

8.2.5 Benefits/impact of Islamic financial system

All the interviewees were in clear agreement that the Islamic financial system would make a positive contribution to increasing financial inclusion. On the issue of inequality a distinction was made between inequality and reducing poverty, which is expected to be positively impacted. Likewise, it seems that all the respondents were in agreement that an Islamic financial system would contribute to stronger growth
given the integration of the economy. In relation to corporate governance, most interviewees were of the opinion that current practices are in line with Shari’ah principles. But, some further work would need to be done to improve levels of transparency as well as raise the quality of board members through trainings and education.

8.2.6 Dubai’s competitiveness in relation to Islamic finance

Given Dubai’s positive experiences in developing a dynamic economy within a volatile region, provides ample reasons for the interviewees to agree that Dubai has the necessary ingredients to remain competitive in Islamic finance as well. Some have highlighted the likelihood of Dubai being emulated and followed by other regional players, should Dubai be successful in developing an Islamic economy. Likewise, the role of government leadership was highlighted given the developmental challenge in a sense that the government would need to play an important role model in utilizing the Islamic finance alternative whenever possible in order to create markets and demand for Islamic instruments. Some interviewees also highlighted the need for Dubai to develop a distinctive advantage in Islamic finance thereby differentiating itself from the hubs such as London, New York or Singapore.

“My message to Dubai is that you have to be different from London and New York. You have to be a different hub. So we are always seen as a financial hub so we should be a different financial hub. We should be different but not like London or New York. We should be an Islamic hub for the Islamic world.”

8.3 Pitfalls in the practice of Islamic finance in Dubai

The preceding analysis indicates that Islamic finance in Dubai, while not being distinctively different from conventional finance, nevertheless, holds strong potential for development. Strong government support and leadership coupled with unhindered market orientation gives a reason to believe that the Islamic finance industry is poised to grow. However, our concern is not only the rate of growth but more importantly its quality.

We have shown in previous chapters that Dubai’s economic development model and its enabling environment provides a unique opportunity to develop more authentic Islamic financial services. The above empirical data collected from the decision makers provides very important insights not only into the state of Islamic finance in Dubai but also, more importantly, into its prospects given the views and direction the policy and decision makers are taking.

The interviews conducted are certainly not exhaustive in terms of the number of key decision makers relevant to this study nor in terms of number issues that could be possibly discussed in relation to Islamic
economic and financial paradigm. The design of the interview cantered around most important themes in respect to our research question. The following are major aspects where interviewees have exhibited a consensus view that would be favourable for the prospective Islamic finance development:

(i) The theory of Islamic finance is distinct from the theory of conventional finance;
(ii) The practice of Islamic finance shares many similarities with conventional finance;
(iii) Islamic teachings and values play an important role in shaping Dubai’s economic development;
(iv) Islamic economy and finance in Dubai should be integrated with the economic development of the Emirate;
(v) The Dubai Government is one of the key drivers of the industry’s development;
(vi) Challenges facing the industry include legal ones and regulations, scarce talent, Shari’ah harmonization, product standardization;
(vii) Control sharing elements of the risk sharing paradigm is not necessarily a limiting factor in development of the Islamic finance. In fact, it can be advantageous;
(viii) The focus is more on domestic economy and financial industry development;
(ix) Dubai offers an internationally competitive environment for the development of Islamic finance;

The institutional diversification of the Islamic finance is of particular importance. It signifies that the potential to develop the industry in directions other than banking. As we have seen earlier, disintermediation of the banking industry is crucial for the industry’s development. Importantly and similarly to global Islamic financial services, interviewees’ opinions on Dubai’s Islamic finance challenges were aligned with common challenges the global industry faces as elaborated in Chapter 3. This highlights the relevance of Dubai’s Islamic finance development to global industry development efforts.

However, being in direct relation to this research are issues dealing with the relationship between Islamic banking, governance and taxation. These issues were earlier identified as key determinants and factors shaping Dubai’s economic environment thereby providing a conducive framework for its more authentic development. But, it seems that most interviewees do not see a clear link between Dubai’s enabling economic environment and Islamic finance development nor have they identified clearly the distinctive direction for the future industry’s development. This seems to be the key pitfall relevant for the current practice and future development of the industry. Hence it may be questioned to what extent the industry would be able to develop more genuinely.

Islamic finance institutions in Dubai, it seems, do not recognize the strategic and competitive advantages Dubai’s economic system is able to offer. Instead challenges to industry development seem not to be different from the ones identified in other jurisdictions. Certainly, addressing the above mentioned issues
will allow the industry to further grow and to some extent to further develop as well. However, given the absence of potential tax incentives that the government may resort to in order to boost the industry’s development, similar to say the Malaysian government, the impact of reforms to address the above may effectively have a muted effect. Therefore, more substantive reforms would be needed to allow the industry to gain economies of scale, develop more authentically and address economic development needs as opposed to Islamic finance development needs alone, as discussed in the preceding Chapter.

Dubai has embarked on a very ambitious project of becoming a global hub for the Islamic economy. This is certainly a step in the right direction. But this may not be sufficient to bring about the necessary change Islamic economics and finance promises. The chief reason for this is that it seems that Dubai’s government is approaching the development of the Islamic economy from the market demand side. Indeed this is probably the key perspective but as mentioned it may not be sufficient. Dubai’s government is structurally geared to recognize and answer market needs. Indeed that is the source of its competitiveness, it’s exclusively market orientation. Therefore, given the growing importance, in terms of size and institutional network, of the current practices of Dubai’s Islamic finance with promising development potential but based only on market oriented and demand driven industry development, it seems reasonable to have a cautious optimism with respect to development prospects of the Islamic finance industry in Dubai. In fact, this research seems to be more so relevant to the extent it is able to shed light on an important development perspective that should form part and parcel of the industry’s strategy.

8.4 Fostering sustainability and stability through the Islamic framework

At the very outset of this research we have highlighted major challenges facing the industry. The prime challenge in Islamic finance is steering out of the ‘path-dependency’ in the financial system. The path of contemporary finance is anchored in conventional economic and financial thought which is interest based. Secondly, as the industry has mainly developed instruments at the short end of the risk spectrum, i.e. highly liquid and short maturity, for the industry to progress there will be a need to address the absence of longer term profit sharing instruments. Developing such instruments will help address the issue of path dependency. Thirdly, long term and risk sharing instruments would need to satisfy the conditions of financial inclusiveness, offer solutions to the whole spectrum of uses, ranging from SMEs and start-ups, and working capital needs to government needs for monetary and fiscal stability. The case of Dubai is examined in this research with respect to these three challenges.

The implementation prospects discussed in the preceding Chapter are essentially aimed in two directions. The first one is the creation of a plethora of Islamic financial instruments across maturities, including long term, and asset classes. The users should be private and public sectors but also as
savings and investment mechanisms for retail and institutional investors. The substantial reform in this regard may come only if significant funds, enabling economies of scale, create demand for Islamic instruments. This effectively is the logic behind the pension proposal and the establishment of an entity that should be mandated with product development. Disintermediation of banks, the creation of deeper and wider capital markets – equity and *sukuk*, as well as evolution of fund management industry would become hallmark features of such reforms.

The other direction, is to bring about qualitative developments to the Islamic economy and Islamic finance. Clearly, as explained throughout this research, Islamic finance does not need just more of the same i.e. more of the same products as this would risks pushing the industry further away from its theoretical ideals. In addition, but not instead, the industry needs to emphasise qualitative developments. Hence the industry needs to move its objective from being *bigger* to being *better*. Better growth would trigger bigger growth as well. The proposal to establish an Islamic Management Agency and implement Islamic management and governance standards in order to bring the necessary organizational qualitative improvements within Islamic finance is important beyond the industry and aimed in that direction. The SME rating agency, while performing an important function of eliminating asymmetrical information, should become an important vehicle for the implementation of the said Islamic management standards.

Therefore, the operationalization of the Islamic economic framework as described previously is aimed to serve the purpose of bringing the practice of Islamic finance closer to its theoretical model. Closing this gap would allow a more comprehensive application of the Islamic economic paradigm. Importantly, all the proposed reforms would serve the economic development needs of Dubai while strongly reinforcing its key success factors. The set of suggested implementation prospects effectively utilizes tested concepts, institutions, organization, and products that yield fundamentally different outcomes in support of the development of the Islamic financial services in Dubai but also by extension, globally as well.

Importantly, the challenges in Dubai’s economy need to be identified and addressed, either conventionally or within the Islamic economic paradigm. The Islamic finance industry needs to understand the opportunity presented and capitalize on it. The implementation prospectes suggested, taken individually and more so collectively, would significantly contribute to improved stability in financial markets, greater financial inclusiveness, stronger SMEs development, a more attractive labour market, and above all would reinforce Dubai’s development principles and strategic policies.
8.5 Insights for reforming global Islamic finance for growth and sustainability

We have shown that Islamic economics shares significant commonalities with the foundation of modern economics. In theory, the Islamic economic paradigm aims to comprehensively address the development needs of the global economy. This includes not only economic needs but social development as well.

Given that the Islamic economic system has not been implemented anywhere in its totality, the Islamic financial industry has recorded different degrees of success in several jurisdictions. Various studies have examined the need for the reform of the global Islamic finance industry in light of the recent GFC.

But it seems that the single most important risk the industry is facing is that of recycling the pitfalls of the conventional financial and economic system given the tendency of IFIs to mimic and replicate conventional financial instruments, institutions and regulations. Ahmed (2009) argues that Islamic finance is not immune to global financial foes given its close alignment and trailing of conventional finance. Figure 39 below summarizes this argument.

<table>
<thead>
<tr>
<th>Conventional</th>
<th>Islamic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks/financial institutions engaged in</td>
<td>IFIs can be engaged in subprime financing</td>
</tr>
<tr>
<td>subprime lending</td>
<td>with lax risk-management practices</td>
</tr>
<tr>
<td>Loans were packages as MBS/CDO</td>
<td>If financing is ijarah/diminishing musharakah,</td>
</tr>
<tr>
<td></td>
<td>assets can be securitized as sukuk</td>
</tr>
<tr>
<td>Rating agencies failed to understand the risks</td>
<td>Risks of Islamic products are complex and</td>
</tr>
<tr>
<td>and gave positive ratings to these securities</td>
<td>difficult to assess, but can get good ratings</td>
</tr>
<tr>
<td>Investors bought securities</td>
<td>Investors will buy securities</td>
</tr>
<tr>
<td>Credit Default Swaps (CDS) were bought to hedge</td>
<td>Investors can buy return-swaps that</td>
</tr>
<tr>
<td>credit risks</td>
<td>exchange returns of sukuk with return on</td>
</tr>
<tr>
<td></td>
<td>other asset class</td>
</tr>
<tr>
<td>Issuers of CDS took on the risk of default</td>
<td>Issuers of swaps take up the risk of sukuk.</td>
</tr>
</tbody>
</table>

Figure 39: Replication of the Crisis in Islamic Finance; Source: (Ahmed 2009)

Ahmed (2009) rightly points out that "While greed leading to excessive risk-taking was one of the key elements that triggered the crisis, this problem cannot be resolved by preaching morality. The problems related to risks need to be tackled at the level of institutions, organizations and products by creating appropriate laws, rules, support systems and incentive structures".
Therefore, even though Islamic finance is fundamentally distinct from conventional finance and it prevents the establishment of the system that is based on debt and essentially greed, the Islamic system still shares the same problems and challenges similar to the conventional system. Moreover, being integrated with global economic and financial flows, maintaining its authenticity and distinctiveness is yet another challenge upon the Islamic finance industry. Dubai’s case as elaborated earlier provides insights and opportunities to steer the industry in this desired direction.

Hence, in order to provide practical solutions in line with its theory, this research reconfirms that the most critical policy challenge is to navigate the industry out of the straitjacket of the neoclassical economic framework on a more non-dependent development path. Based on this research and the insights offered by Dubai’s model, in order to reform the global Islamic finance industry the following important policy objectives should be taken into account:

(i) *Qualitative developments in Islamic economy should take precedent over quantitative;* The Islamic economy is much broader than Islamic finance and Islamic finance is much broader than Islamic banking. Appropriate incentive systems should be developed to entice corporates, not only IFIs, to improve and then share their best practices in alignment with the Maqāsid Al Sharī‘ah. Proposed Islamic Management Agency may serve this purpose globally.

(ii) *Developing economies of scale outside the Islamic banking system;* Islamic finance does not equate to Islamic banking alone; efforts have to be made to develop other institutions of Islamic finance thus leading to significant disintermediation of the Islamic banking industry; disintermediation needs to result in a new risk and maturity profile of financial instruments and available markets.

(iii) *Gradual integration of the Islamic economic paradigm into economic planning and development will ensure its relevance and meaningful impact of the Islamic finance industry*
9. Conclusion

This research investigated whether Dubai's economic development model has the significant ingredients to offer a suitable framework for a more substantive and authentic development of the Islamic economic paradigm. We have essentially put forward three research issues: is Islamic economic and finance paradigm worth operationalizing; does Dubai have ingredients for more substantial development of the industry; and whether Dubai is ready to implement the Islamic system more substantively.

We have approached the first issue by critically assessing the Islamic economic paradigm and its sources of the widening dichotomy with practice to assess whether it is worth operationalizing in the first place. Then, using a case study approach we have comprehensively analysed whether Dubai has indeed followed an unorthodox development model that has significant ingredients required to steer the economy away from the conventional economic framework and toward more substantive practice of Islamic economics and finance. Lastly, we have attempted to assess Dubai's readiness to actually implement the Islamic paradigm. Given that the potential of the Islamic paradigm to develop closer to its own values largely depends on its ability to narrow the identified dichotomy, we have thereby attempted to tackle one of the most important issues in Islamic finance.

With regards to our first research question, we have ascertained that the Islamic economic paradigm and Islamic finance holds a promise, at least in theory, for greater social and economic justice. However, the ideal Islamic economic system does not exist today in practice, even though some countries have adopted some of its various features. The yawning gap between theory and practice points to serious challenges facing implementation. Increasing convergence with conventional finance reflects, on the one hand, growing relevance of Islamic financial institutions as it gives hope for further systemic integration into economic development. On the other hand, it seems that further convergence is in fact taking Islamic finance further away from its theoretical postulates and original objectives. Hence, most of the criticism of Islamic finance revolves around this paradox and the failure of the paradigm to deliver on its promise. We stressed that the schism between theory and practice combined with the poor performance recorded in many Islamic nations adds to the ambiguous potential of the Islamic economic paradigm and its practical impact. Therefore, its relevance depends not so much on the soundness of its theoretical premises as on the prospects for a comprehensive and more authentic implementation. Otherwise, the Islamic system will remain largely a theoretical and abstract construct.

The explanation for the sporadic and partial implementation of the Islamic economic model is, according to most economists, the dominance of conventional financial markets and of the neoliberal economic
system. In their efforts to remain competitive, Islamic financial institutions resemble and mimic conventional counterparts and in the process lose their authenticity. The answer to this problem, according to Islamic economists, is in the ability of the Islamic finance industry to steer away from the framework and path-dependence of the neoliberal straitjacket.

Focusing on key principles of the Islamic worldview and related economic model, we have shown that the Islamic economic paradigm is pro-development and pro-growth in the wider and more comprehensive sense of seeking to achieve overall human well-being. In sharpening our understanding of the industry’s challenges, we tried to identify the root causes, as opposed to the symptoms, that the Islamic financial paradigm faces, which are primarily: (i) a formalistic approach focused more on interest (riba) avoidance than on developing genuine risk sharing instruments and institutions, and (ii) convergence with conventional finance but without integration into national economic development efforts. Any reforms aimed to address the real challenges should be designed to primarily account for these two causes in a major way.

The second research question was concerned with Dubai’s model, featuring significant ingredients for the development of the Islamic economic and financial paradigm in the context of its unorthodox economic development approach. Based on in depth analysis of the pillars of the Islamic economic and financial system and its promises and challenges, and on thorough analysis of Dubai’s main factors of development, we have reached the conclusion that Dubai’s economic development model indeed provides a conducive environment for more authentic and organic development of the Islamic paradigm.

In developing our understanding of Dubai’s economy, we sought to conduct a deeper analysis of historical, cultural, demographic and economic factors that have shaped its development path. Initially we explored the hypothesis of Dubai being a rentier economy as the region’s economies are often depicted. We concluded that, while indeed it shares some elements of a rentier economy, Dubai would better fit into the guardian state economy’s model. The role of government and its strong economic welfare function are key features in this context. Bearing in mind humble beginnings in late 19th century, its leadership’s firm commitment to development, unique relationship with the merchant community and absence of taxation have resulted in a distinctive model that has remained until today. Synthesizing various other factors at play, we have concluded that, being rooted in Islamic values and traditions, Dubai’s impressive economic growth and success are not accidental but rather the result of long-term, more than a century old, visionary development and commitment.

Following the review of existing models of Dubai’s development, in response to inadequate descriptions of its development drivers and key factors, we have developed a new and more comprehensive development model. This model, based on our own research, provides better insights into its key
development determinants, principles, policies and outcomes. In summary, as shown in the Figure below, we have explained that Dubai’s development path is defined by key determinants that are essentially permanent in nature including (i) scarce natural resources, (ii) partnership between ruling and merchant families, and (iii) Islamic teachings and value-based business practices. Emanating from such determinants, Dubai has applied two key developmental principles, namely (i) government led economic development, (ii) liberal, market-based or laissez faire business and trade. In terms of economic policies to achieve desired growth and development, Dubai has set them as (i) domestic investment and development orientation, (ii) nurturing pro-business environment, (iii) protectionism and establishment of free zones, (iv) economic and business diversification, and (v) access to capital and labour markets. Finally, we have elaborated that the outcomes of these policies and strategies are often confused to be factors or drivers of Dubai’s economic development.

Two commonly overlooked features of Dubai’s model are worth highlighting: (i) Dubai’s diversification away from oil with today’s contribution to GDP of less than 2 per cent, and (ii) a tax-free environment in the quasi-absence of windfall oil revenues – in fact, tax-free policy is more than 100 years old. Furthermore, Dubai’s laissez-faire business and trade development approach, which is also a feature of conventional economic paradigm, has resulted in the creation of a market based incentive system, a debt – equity level playing field, risk sharing environment and absence of fiscal impediments, all of which are identified potentially as keys to foster stronger development of the Islamic economic system. Arguing that these features are due primarily to the absence of taxation, we have highlighted how this system has shaped the contribution of government and its market incentive policies. Therefore, we have shown that Dubai’s developmental model has indeed some of the significant ingredients that are required for a more organic and genuine development of an Islamic economic paradigm in general, and Islamic financial services in particular.
But, the case for Islamic economy and finance and the prospects for its more meaningful development in Dubai is not straightforward. We have also stressed that Dubai’s model of development is not immune from vulnerabilities and structural weaknesses that may seriously hinder the industry’s development. Dubai’s recent debt crisis was, in that respect, the result of financing schemes that are in clear contravention of fundamental principles of Islamic finance. In fact, while reflecting on the causes of this infamous crisis, we stressed that deviation from the Islamic financial doctrine was not helpful, to say the least, and that shifting to an Islamic framework would increase the chances to prevent debt accumulation in the future, which was after all the prime trigger of Dubai’s instability. We have highlighted other structural weaknesses such as an opaque information sharing environment and corporate governance inadequacies that have adversely affected not only the development of Dubai’s Islamic financial industry, but its overall economic development and stability.

Following the analysis of the Islamic economic and financial system in general, and Dubai’s economy and financial system in particular, we have shown that the Islamic economic and finance principles can be operationalized to foster economic stability and sustainability. As the research identified some structural weaknesses, we sought to address them as implementation priorities by operationalizing Islamic economic and finance principles. We have identified opportunities to make a substantive impact on two fronts. The first is to substantially boost the demand side for Islamic products of various maturities, and more especially of the long-term type; the second is to enable significant qualitative developments within the Islamic financial services industry and beyond by translating Islamic values into corporate practices. The two-pronged strategy aims to ensure a qualitative leap of the industry while, through the disintermediation of Islamic banking, boosting its growth through economies of scale. Such strategy would better serve the broader objectives of stability and sustainability.
highlighted the need to develop sound corporate governance and robust regulation as prerequisite for industry development.

Utilizing the institutional-organizational-product framework, we have argued that addressing the information asymmetry hurdle should be one of the top implementation priorities, given the importance of transparency and full information disclosure in the Islamic paradigm and its markets. We have identified that a rating agency focusing on SMEs would enable unhindered information flows, based on market incentives that generate significant benefits for the financial industry, corporate sector in general, and SMEs in particular, fostering thereby overall economic development. Eliminating information asymmetry is the foundation for establishing a risk-sharing paradigm, which is the cornerstone of the Islamic financial system.

In addition, responding to the need for long-term funds for development while addressing some important structural issues in the domestic labour market, we have identified the need to establish a contractual savings institution that would essentially provide long term saving benefits to Dubai’s large expatriate population. A large saving scheme compliant with Shari‘ah would strongly ‘jump start’ the development of the Islamic financial industry and contribute toward the disintermediation of the Islamic banking industry.

Addressing the issue of form versus substance and recognizing the importance of shared values and their critical role in the Islamic economic paradigm highlights the need to develop strategies to implement it in the corporate setting. Developing management standards based on Islamic values and then institutionalizing its implementation should essentially align societal and economic progress. Such standards would not only ensure that Islamic principles are compliant with in form but more importantly in substance. In addition, Islamic management standards would be relevant not only to Islamic financial institutions but also to any firm wishing to move towards a more holistic Islamic economic model. Hence, such focus would ensure broadening the realm of an Islamic economy, which is more substantive and inclusive, thus increasing the demand for Islamic finance products as well. Moreover, we suggested that the application of these standards to the assessment of risk management would ensure that such values are effectively applied across various sectors of the economy.

Lastly, recognizing the continuous challenge to ensure unhindered access to finance of both the public and private sectors, we have identified an opportunity to establishment a dedicated agency or an institution entrusted with the responsibility to develop innovative financial instruments. Financial instruments similar to those suggested by Bacha and Mirakhor would align with economic development needs and in compliance with Shari‘ah.
The third research question dealt with Dubai’s readiness to implement Islamic system more comprehensively and substantively. Here we have conducted a series of elite semi-structured interviews with some of key decision makers with deep insights into the working of Dubai’s economy and future plans. These interviews were particularly revealing. Through a series of questions, we probed the direction of the industry’s development and its leadership understanding of key development drivers, as well as challenges and opportunities the industry is facing. We have also tested and assessed the leadership views on key strengths and weaknesses of Dubai’s model that our research has identified, namely the benefits arising from the tax-free environment and various structural gaps. Based on responses received, it seems that some of key decision makers, or at least those interviewed for the purpose of this research, are not aware of the mechanisms through which the Islamic system should be implemented, or of the extent to which it could be beneficial to Dubai’s economy beyond the provision of financial liquidity. Hence, some of Dubai’s key business architects and policy makers seem to focus more on meeting market demand for Islamic financial services than on comprehensively capitalizing on the environment to advance the industry’s development needs and thereby serve its own economic development objectives. While focusing on market needs alone is undeniably a necessary condition for industry growth, it may not be sufficient to overcome the various obstacles that inhibit the industry’s development and enable it to move closer to its theoretical postulates. This essentially encapsulates a key challenge of developing the industry while reducing the schism between theory and practice. Arguably, this makes our research even more relevant to the extent it is able to provide a new perspective for both academia and policy makers. Therefore, based on our empirical research on Dubai’s readiness to implement the Islamic system more comprehensively has yielded mixed results.

Based on Dubai’s experience and prospects as well as on a diagnostics of the industry’s challenges and opportunities, we have derived insights for reforming the global Islamic finance in the pursuit of more authentic implementation supporting economic growth and sustainability. The main insights are that (i) the qualitative development in an Islamic economy should take precedence over quantitative development; (ii) developing economies of scale should take place outside the Islamic banking system; and (iii) the Islamic economic paradigm should be gradually integrated into economic planning and development. Our analysis has shown in that respect that there are many factors that inhibit the development of Islamic finance, including the general economic and financial environment in which it operates. Given that Islamic finance relies heavily on full transparency and disclosure, pro-business incentive policies as well as a level playing field between debt and equity, it is easy to realize that the industry faces today significant challenges in its development path. In addition, the fact that the oversized Islamic banking industry mimics conventional banking may yet represent the most difficult hurdle to reforms. Banking sector disintermediation via the development of robust Islamic capital markets should constitute a major policy objective. The previously mentioned reform recommendations in Dubai should help address the global industry challenges as well.
Finally, it is worth to emphasize that our research faced challenges, primarily at two levels. The first involves the paucity of empirical evidence on the Islamic economic and financial paradigm in general and the perplexity in understanding its role, potential and development path, because of the schism between the theory and the practice. The second relates to Dubai’s model being insufficiently researched and the paucity of quality literature. The novelty of our work lies in highlighting the interaction between Dubai economic model and the Islamic economic paradigm as a potential impetus for a more organic and authentic development of the industry. The findings could be highly relevant not only to academia but to policy makers and practitioners, as we have had the ambition to provide a perspective on economic development through the lenses of Islamic finance while providing new insights on Dubai’s economic model.
Appendix

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Murābahah</strong></td>
<td>A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.</td>
</tr>
<tr>
<td><strong>Mushārakah</strong></td>
<td>A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the Musharakah agreement, while losses are shared in proportion to each partner's share of capital.</td>
</tr>
<tr>
<td><strong>Diminishing Mushārakah</strong></td>
<td>A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or the price agreed upon at the time of entering into the contract. The 'buying and selling' is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.</td>
</tr>
<tr>
<td><strong>Ijara</strong></td>
<td>An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An Ijara contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijara contract.</td>
</tr>
<tr>
<td><strong>Ijārah Muntahia Bittamlīk (or Ijara wa lqtina)</strong></td>
<td>A form of lease contract that provides a separate promise of the lessor giving the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value or by means of a Hibah contract.</td>
</tr>
<tr>
<td><strong>Istita•</strong></td>
<td>A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.</td>
</tr>
<tr>
<td><strong>Restricted investment accounts</strong></td>
<td>The account holders authorize the institution offering Islamic financial services to invest their funds based on Mudarabah or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.</td>
</tr>
<tr>
<td><strong>Qard al-Hasan</strong></td>
<td>A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.</td>
</tr>
<tr>
<td><strong>Salam</strong></td>
<td>An agreement to purchase, at a pre-determined price, a specified kind of commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institution offering Islamic financial services as the buyer makes full payment of the purchase price upon conclusion of a Salam contract. The commodity</td>
</tr>
</tbody>
</table>

*Figure 42: Brief Description of Islamic financial instruments; Source: IMF*
Islamic Finance and Economic Development: The Case of Dubai

Interview Topic Guide for Business Leaders and Policy Makers in Dubai

1. Are you directly involved in any Islamic economic or financial activity? Do you deal with any Islamic economic/financial entity?

2. How do you assess your own experience with the Islamic companies/institutions or financial instruments?

3. In theory, do you see Islamic finance to be distinctively different from conventional finance? What about in practice?

4. In your opinion, do Islamic values and teachings espoused by its government and business leaders inspire in any way Dubai’s economic development?

5. Should Islamic economic activities integrate with the mainstream economy in Dubai or it should be treated as a separate economic activity?

6. In your own practice, what are incentives that entice you to use Islamic finance institutions/instruments?

7. Is Islamic finance playing important role in economic development of Dubai?

8. What is driving development of Islamic finance in Dubai?
   a. government led regulations and/or investments
   b. demand by economic actors – companies and households
   c. pressure from international markets

9. What obstacles stand in the way of developing Islamic economy more decisively in Dubai?

10. If all of Dubai’s economy is compliant to Shari’ah principles, how would it affect Dubai’s economic performance?

11. Are you happy with existing financial system or there is a genuine need for reforms and in particular for Islamic based system?

12. What are gaps in financial as well as Islamic financial systems today? What are opportunities to reform?

13. What do you think what would be main advantages or benefits to result from Islamic based financial system?
14. What are factors holding back the development of asset based instruments? Do you think some of main factors can be addressed through Islamic finance, as related to your own activities you are involved as well as in economy in general?

15. In your opinion what is the key impediment to stronger growth of asset based or equity based instruments?

16. Risk sharing within the paradigm of Islamic finance implies sharing control and involvement in management as well. Do you consider control and management dilution as a factor restricting the development of the Islamic finance industry? How manageable and practical is dilution of control? Is it feasible system?

17. In your own case, would you be willing to share both, risks and control over projects seeking for which you are seeking funding?

18. Absence of corporate income taxes removes distortion between debt and equity finance. Do you think that the chances of Islamic finance will diminish if taxation is introduced in the emirate?

19. Do you think that availability of Islamic finance would be an incentive to undertake riskier but higher return project?

20. Do you think that Islamic finance is suitable to finance Dubai’s infrastructure projects? What needs to be done in order to foster the contribution of Islamic finance in infrastructure development?

21. Do you see a role for institutional investors to play in economic development of Dubai?

22. If the Islamic economy expands in Dubai to what extent that would affect corporate governance or do you think there is no inconsistencies between current governance practices and the management principles underlying the Islamic economy?

23. What do you think what would be the impact of Islamic economy on Dubai’s growth prospects?

24. What do you think what would be the impact on economic inclusion and inequalities?

25. Does Dubai have capacity to compete in Islamic finance/economy at the international level and what needs to be done to enhance its competitiveness?
Bibliography


El-Gamal, Mahmoud. n.d. ““Interest” Paradox in Contemporary Islamic Finance.”


Nienhaus, Volker. 2010. Fundamentals of and Islamic Economic System Compared to the Social Market Economy. KAS International Reports.


247


Rosenstein-Rodan. 1943. “Problems of industrialisation of eastern and south-eastern Europe.” *The economic journal* 202-211.


Standard & Poor’s. October 13, 2011. “Will Islamic Finance Play a Key Role in Funding Asia’s Huge Infrastructure Task?” Global Credit Portal-Ratings Direct.


