The Stability of Islamic Finance by Hossein Askari, Zamir Iqbal, Noureddine Krichene and Abbas Mirakhor.

Foreword by Sir Andrew Crockett

Over the past twenty-five years or so, Islamic (Sharia-compliant) finance has made impressive strides. As of 2007, some $600 billion of assets were managed in Sharia compliant accounts around the world. An additional substantial sum is represented by *sukuk,* or Islamic, bonds. Notably too, the development of Islamic finance is not limited to Islamic countries. Global institutions such as HSBC, JPMorgan, and others, have begun to offer sharia-compliant financial services through their world-wide networks.

Moreover, the phenomenon of Islamic finance seems likely to continue to increase in importance. Over recent years, Islamic financial accounts and instruments have been growing twice as fast as conventional finance. Given the size of the untapped market, and the growing wealth of Islamic countries, especially those that are major oil exporters, this trend seems set to continue.

Amid this ferment of practical activity, rigorous studies by well-trained economists have been relatively rare. In this sense, this new book by a group of four western-trained Islamic economists is greatly to be welcomed. It builds on and extends their earlier work on the topic and will become essential reading for all those with an interest in the economic implications of Islamic finance.

The book develops themes that link Islamic finance to existing traditions in economics; that assess the stability properties of Islamic financial instruments, and that explain some of the key Islamic concepts in economists' terms. It will be an invaluable source for those who want to know more about the nature of the financial instruments that go to make up an Islamic financial system, and to understand how an Islamic financial system might work in a twenty-first century context.

Everyone knows that a key concept of Islamic teaching is the avoidance of interest payments that are fixed in advance. (Interestingly, this prohibition is not different from that of other faiths at certain stages of their development.) But much less well-known to non-Muslims are the social teachings that lie behind the prohibition, and the variety of concepts that are permissible in economic transactions among Muslims.

Islamic finance has its roots in the teachings of the prophet Mohammed (himself a merchant) and is grounded in the social, moral and cultural precepts of the Qu'ran. Much has been written about the relationship of Islamic finance to Qu'ranic teachings; but much less, until very recently, about how Islamic finance is related to traditional economic doctrines, and how Islamic finance might perform in a turbulent and unstable time like the present. This volume therefore fills an important gap.

The book begins with an overview of classical capital theory, pointing out its consistency with many of the concepts and limitations of Islamic finance, once interest (the return to capital) and profit (the return to entrepreneurship) are seen as a *combined* return to the provision of capital resources. Pursuing this theme, the authors analyse capital theory from Adam Smith and David Ricardo, through, Jevons, Karl Marx, Bohm-Bawerk, Wicksell and others.

This sets the scene for developing the central thesis of the book, namely that Islamic finance is potentially a more stable means of financing capital accumulation than one that attempts to separate the functions of providing capital and bearing risk. Since Islamic finance requires a much greater relative role for equity capital, it is, the authors contend, better protected against the instability that can come from excess leverage.

The authors seek to demonstrate how conventional finance can generate cyclical instability in credit creation which in turn leads to economic booms and busts. They describe the process we would now call “procyclicality” in the financial system and relate it to the Minsky hypothesis of endogenous financial instability. During a bubble, many assets become effectively monetized and add to demand, while in a bust, liquidity evaporates and credit shrivels. Central banks, while trying to offset these tendencies, have often added to them.

Focusing on the management of interest rates to manage the real economy, the authors argue, has in practice fuelled speculative booms, and the ensuing busts have proved impossible to prevent. Central to all this is the process of credit creation generated by ability of banks to create money substitutes through issuing interest-bearing liabilities.

An interesting chapter deals with the current financial crisis. The book blames the internationalization of the crisis on excess money creation in reserve centers, and self regarding policies by individual countries. Although not directly related to the theme of Islamic finance, the authors implicitly support the idea of a common reserve currency as the basis of a more stable international financial system.

Since Islamic finance avoids interest and interest-based assets, it is, the authors argue, inherently more stable than conventional finance, and need not inhibit the mobilization of savings and the efficient allocation of investment. Islamic financial instruments are more directly linked to the productivity of the real investments they finance, and therefore not only promote the social objective of “sharing” risks and rewards, but cushion financial intermediation against the inherent risks of excess, both in booms and slumps.

Doubtless, defenders of conventional financial systems will say that better regulation and risk management can also protect financial stability, and that a wider range of permitted financial contracts can better achieve the completeness of markets. It is not my purpose here to defend the specific claims made by the authors of the book. Overall, however, it is a provocative and insightful assessment of the economic properties of Islamic finance that deserves to be read and reflected on by Islamic and non-Islamic economists alike.