TOWARDS A MEETING-POINT BETWEEN ISLAMIC FINANCE AND GLOBALISATION

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Abstract: This article focuses on the conditions that should be met for financial globalisation to achieve maximum risk-sharing. The author suggests that the Islamic prohibition of debt-based finance and simultaneous promotion of risk sharing are consistent with the fundamental purpose of Islamic teachings, i.e., the unity of mankind, itself a corollary of the fundamental Islamic axiom of the Unity (*tawhīd*) of the Creator. He then discusses the rules and norms of behaviour prescribed by Islam for individuals and collectivities that meet the conditions for maximum risk-sharing. He also refers to a historical episode of globalisation from the Middle Ages, where trade, finance, investment, and production were based on partnership and equity finance and explains how and why this episode witnessed finance evolve until the dominance of debt-financing which has lasted to the present. Toward the end, the author brings the ideas about the prospect for the convergence of conventional and Islamic finance to conclusion: he argues that their growth could lead to worldwide increase in investment, employment, and economic growth, reduce inequality and poverty, and increase global welfare.

Introduction

Societies face two inter-related problems. Solutions to these problems determine the society's stability and continuity. These are the problems of uncertainty and coordination. The first stems from the fact that the future is unknown. Yet, humans have to make decisions and take actions that affect their future as well as that of others. Making decisions is considered as one of the most fundamental capabilities of humans. It is inexorably bound up with uncertainty. Facing an unknown, and generally unknowable, future, people make decisions and choose among alternative courses of action based on their expectations of future consequences of their actions. These expectations are inevitably subject to uncertainty. Uncertainty, if severe

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enough, can lead to a state of inaction and paralysis both in the case of individuals and their collectivities. The problem becomes more complicated when uncertainty about the future is coupled with ignorance about how other individuals, or their collectivities, behave in response to unknown states of the world. A state of ignorance can take on a variety of forms.

The problem of decision-making under uncertainty is compounded by two additional factors, the competence of the decision-maker and the difficulty of selecting the most preferred among alternative possibilities, especially if there is a once-and-for-all decision since, once made, it destroys the possibility of making that decision again. The gap between competence and difficulty enhances uncertainty leading to errors, surprises and regrets. The level of uncertainty regarding the state of the world, as well as with respect to decision-action of other individuals, makes collective action – necessary if the society is to survive and flourish – a challenge. It then becomes crucial for societies to find ways and means of solving the problem of uncertainty and promoting coordination among individual decision-makers. Because of the interdependence among members of the society, decisions made and actions taken by individuals directly and indirectly affect others.

Given the rapid growth of financial globalisation, on the one hand, and that of Islamic finance, on the other, this article probes whether it is possible that, at some point in the future, conventional and Islamic finance would converge. The underlying justification for this enquiry is that, from a theoretical point of view, the objective of globalisation and Islamic finance is to achieve maximum risk-sharing. The fundamental axiom of Islamic finance is the simultaneous prohibition of debt-based financing and promotion of equity financing: the first reduces risk sharing and the second increases it. Similarly, financial globalisation aims at spreading the investor base, and diversifying and sharing risk globally. This could be done through reliance on the most effective vehicle: equity or equity-like finance. Therefore, at least from a theoretical standpoint, as the conventional and Islamic finance progress through development of sophisticated risk-sharing instruments (including in the field of risk-insurance), it could be expected that they converge, and it is natural that there would be perturbations, missteps, and short-run setbacks. However, in the longer run, they would both expand and their convergence would be feasible. From an empirical point of view, there is tantalising evidence that, particularly in the last decade, the growth of financial globalisation has been accompanied by increasing equity and equity-like cross-border flows. This growth has been faster than debt flows (bonds), especially to emerging markets. On the other hand, the basic Islamic financial transaction modes are increasingly instrumentalised and securitised to enhance their attractiveness to global investors, thus, making convergence between Islamic and conventional finance a distinct possibility. We shall also consider financial globalisation and its progress over the last decade.

Spiritual Foundations for Islamic Finance

After a millennium of atrophy, Muslims have begun a critical re-examination of Islamic thought in all its dimensions in light of the present state of the world. Arguably the first discipline that began this process during the early decades of last century was political philosophy. The re-examination of economics started much later in the second half of the twentieth century and has continued uninterrupted to the present. There is an ongoing constructive debate among scholars on the fundamental question of whether there is a discipline that can be defined unambiguously as Islamic economics and if so what are its distinguishing characteristics. This article is a modest contribution to that debate. It seems reasonable to suggest that any label or prefix that is attached to an economic discipline must bear concrete relationships with the economic system that the discipline serves. Thus, disciplines such as socialist economics, capitalist economics, Buddhist economics, Christian economics, Jewish economics, Gandhian economics and others, relate to an envisioned system defined by its characteristics.

More specifically, Islamic economics can be considered as a discipline concerned with:

- the rules of behaviour (institutions) prescribed by Islam as they relate to resource allocation, production, exchange, distribution and redistribution;
- economic implications of the operations of these rules; and
- policy recommendations for achieving rules compliance that would allow convergence of the actual economy to the ideal economic system envisioned by Islam.

The fountainhead of all Islamic paradigms – including economics – is the Qur’ān. It provides the framework within which all relevant envisioning conceptions of reality find their source. This eternal source specifies rules of behaviour (institutions) applicable to all societies at all times. These rules are immutable temporally and spatially. No one understood the Qur’ān more than the Prophet, appointed to deliver it to mankind. During his life, he was both the spiritual and temporal authority for his followers. The economic system which he established in Medina is the archetype of Islamic economic systems. In this archetype, there is a core of institutional structure which is immutable because it is firmly established based on the Prophet’s authoritative operationalisation of the rules prescribed in the Qur’ān.

The Islamic economic paradigm is a Creator-centred conceptualisation of reality. Its view of man distinguishes between the exterior, physical form (*bashar*) and the non-physical, substantive and internal substance full of potentialities (*insān*). The two concepts roughly parallel Man and Human. In exteriority, they are similar

in appearance, but there are significant differences between the two. The most important difference is an active awareness of the supreme Creator and Cherisher Lord of the Worlds which separates a *bashar* from an *insān*. Both share the same general physical attributes and the same physical needs. What is different is what is inside them. Outwardly they are alike; inwardly, however, the attributes may range from being worse than animals in the sense of non-recognition of their full human potential yet possessing the powers invested in mankind such as cunning, ability to carefully devise and execute premeditated plans that make this creature more dangerous than animals. At the other end of the spectrum, humans may be inwardly so aware of the potentialities of the human state that, by actualising these potentialities, they may surpass even the angelic state.

In more practical terms, while the postulates of self-interest and rationality are crucial in decision-making in both paradigms, they are radically different in their substance. The third postulate of the classical-neoclassical tradition is that of scarcity. In the Islamic paradigm, scarcity takes on three different aspects. First, the Qur'ān repeatedly asserts that from a macro-global standpoint, Allah has created all things in "exact measures" (Qur'ān 49:52) indicating that the Lord Cherisher, Sustainer of all creation provides sufficient sustenance for all in His creation including for mankind. The Qur'ān, however, recognises two other aspects of scarcity. It acknowledges a micro-actual scarcity stemming from maldistribution of resources, and from greed and gluttony. Hence, one encounters in the Qur'ān the overwhelming emphasis on social justice, rules against waste, accumulation of wealth, and extravagance. The third aspect refers to the real scarcity arising from the fact of finite conditions of man on this plane of existence. The physical conditions of man impose a finitude constraint. Becoming aware of these constraints as well as of the potentialities of human state, human consciousness, once awakened, not only allows humans to grasp potentialities but also permits the realisation in them of their ability to transcend the limits of their physical existence to imagine 'what is and what could be'. Humans, thus, realise that their physical existential constraints impose limits on how much of their potentialities they can actualise; they must then 'choose between the alternatives grasped by transcending consciousness'. This aspect of scarcity is addressed in the Qur'ān where there is a constant reminder of limitation of time on this earth and the rapidity of its passage.

Financial Globalisation: Benefits, Costs, and Conditions for Better Risk-Sharing

In recent years, more and more economists have raised serious questions regarding the basic postulates of the classical-neoclassical economic paradigm. Aside from those who have focused their criticism on the separation of economics from ethics,

such as Amartya Sen, others have focused on the postulate of rational self-interest of the paradigm without rejecting its other features. However, even those who advocate reintroduction of ethics into economics decouple ethics from religion to the point of holding an anti-religion attitude. This conflict found its reflection in economic thought.

Neoclassical economics takes as given the classical economists' postulates regarding man, society and their interrelationships. That is, the worldview – or the meta-framework – of the neoclassical economics is that of the classical economics. This value system had its religious roots in Calvinism and Puritan ethics. After the economic success of capitalism and full development of the market economy, this value system was decoupled from its religious moorings and some of its elements, especially asceticism, were either modified or jettisoned altogether. The rest of the elements – accumulation, quantification, labour, individualism, competition, and rational conduct – were preserved.

The institutional framework that supported the classical-neoclassical notion of how the economy works developed in order to allow the flourishing of these values. The most salient features of this institutional framework were:

- the sanctity of private property in order to ensure that accumulation, individualism, and labour would find their unhindered expression;
- free markets organised to allow competition, reward labour, initiative, and innovation;
- consumer sovereignty in order that production finds easy markets;
- sanctity of contracts to reduce uncertainty of future transactions; and
- a legal structure that fully supported these features with enforcement power.

Globalisation is a multifaceted and multidimensional process of growing interconnectedness among peoples and nations. Its main dimensions are cultural, socio-political, and financial. The last dimension is composed of financial globalisation – the cross-border movement of capital – and financial integration – interconnectedness within and among financial markets. The economic and financial globalisation combined refers to growing trade flows and unhindered movement of investment, production, and finance. This is accompanied by standardisation of associated processes, regulations, and institutions, and facilitated by the free flow of information, ideas, and technology. In general, globalisation is the result of reduced costs of information and transportation as well as liberalisation of trade, finance, investment, capital controls, and factor movements.

Since 1990, the world has witnessed a dramatic and rapid change in the structure of financial markets and institutions. Advances in the theory of finance, rapid innovation in the practice of finance, revolution in information technology,

deregulation and liberalisation, and institutional reform have changed the nature of financial relations leading to the emergence of the 'new finance'. As a result, the cost of finance has reduced and investment in many instruments matching different risk-return profiles has been made possible, leading to better risk-sharing among market participants across the world. Financial transactions have become more at arm's length, allowing broader participation in deeper and expanded markets. This, in turn, has expanded the number of participants in financial markets, dispersed ownership and spread risks.¹ Between 1991 and 2000, gross capital flows (the sum of absolute value of capital inflows and outflows) expanded by 300 per cent among industrialised countries alone, the bulk of which was due to the rise in foreign direct investment (FDI) and portfolio equity flows – both rising by 600 per cent – while bond flows over the same period increased by 130 per cent.² Over the same period, both stocks and flows of capital movements have increased substantially, especially in relation to the volume of domestic GDP and the size of financing markets. After the market turbulence in 2000–02, these trends have resumed, with FDI and portfolio equity flows assuming a larger share of the total flow. The largest increase in FDI in 2006 was in the emerging parts of Europe and the Middle East. Empirical evidence suggests that the composition of capital flow matters a great deal. Equity flows (portfolio equity flows + FDI + venture capital) promote better risk-sharing, reduce volatility, and strengthen stability.³ There is a substantial body of evidence to suggest that these flows, especially FDI, are positively associated with economic growth.⁴ FDI is considered an important channel for transfer of technology and organisational knowledge.⁵ Over the past few decades, stock markets too have shown increasing vitality, growing with a rapid surge. The development of the stock markets increases the rate of saving and leads to growth in investment, while enhancing its quality. Stock markets diversify the investor-base while distributing risks across investors, which, in turn, increases the resilience of the economy to shocks. As mentioned earlier, the composition of capital-flows has a significant influence on economies, with FDI and equity flows exerting a great stabilising influence on the economy's vulnerabilities to shocks and financial crises. It has been demonstrated that greater reliance on debt-flows exposes a country to a higher probability of sudden stops of international capital-flows and to financial crises.⁶ A growing body of research has demonstrated the positive impact of stock market development on economic growth.⁷

There is an organic, interactive relationship between financial globalisation and financial integration. On the one hand, the degree of progress of the latter depends on how well developed financial sectors are in countries. On the other hand, financial globalisation plays an important catalytic role in the liberalisation and development of the domestic financial markets.⁸ An important dimension of the process of financial sector development is the expansion and quality improvement in

credit and share markets.⁹ The process of financial development deepens markets and services that channel savings to productive investment and strengthens risk sharing. Liberalisation of stock markets reduces the cost of equity-capital,¹⁰ leading to a surge in the growth of investment and expansion of employment and output. The effect would be stronger when stock market development is accompanied by privatisation as the latter would be a signal of the country's commitment to liberalisation.¹¹ Financial sector development constitutes the most important channel of economic growth, particularly in countries that are finance-constrained.¹² Empirical research over the last two decades, which has established the strong link between financial development and economic growth, has also identified the conduits between the two. These channels include:

- greater involvement of private sector and better risk-sharing;
- reduced risks that lower expected returns, leading to lower cost of capital and resulting in investment in higher-risk, higher-return projects;
- enhancement of competition and innovation;
- improved productivity;
- lower output and income volatility;
- cost-efficiency gains in mobilising resources for public investment;
- financial deepening as financial development leads to greater financial intermediation by banks, capital markets, and non-bank financial institutions; and
- reduced income inequality and poverty.¹³

The benefits listed above will accrue if legal and institutional developments accompany financial development. The most important dimensions of the former are legal protection of creditor, investor, and property rights as well as contract enforcement.¹⁴ Good governance, transparency, and accountability are the important institutional aspects that support financial development.¹⁵ It is considered that, once a threshold level of availability of these legal and institutional developments is surpassed, the beneficial effects will accrue.¹⁶ Empirical evidence suggests that countries with weak governance and low transparency receive less FDI and equity flows and have to resort to debt financing through bank loans that, as mentioned earlier, expose them to vulnerabilities and volatilities, leading to financial crises.¹⁷ Another factor that could exacerbate these problems is economic instability with research suggesting macroeconomic policies as an important determinant of the composition of capital flows. On the other hand, better legal institutions and improved governance and transparency reduce informational problems (adverse selection and moral hazard) and market frictions.¹⁸ This, in turn, will assist in the process of integration and deepening in the financial sector, which, in turn, will allow emergence of active and liquid equity markets, reduced cost of capital, and

improved credit rating.¹⁹ As a result, more investment projects become viable leading to greater risk-sharing. More active equity markets are also associated with reduced volatility, again suggesting improved risk-sharing. On the other hand, equity market opening against a backdrop of weak financial sector, inadequate institutional and legal development, and unstable macro-economy “may not reduce variability at all and may even increase it”.²⁰ Research suggests that an interactive relationship exists between financial sector liberalisation and development of an active equity market when a country achieves a threshold-level of higher bureaucratic quality, lower level of corruption, and strengthened legal institutions.²¹ Stulz²² states that “financial systems with a higher degree of legal and institutional development that support finance increase stock market trading volumes and enhance the effect of financial openness”. In short, financial sector development – which is accompanied by legal and institutional developments that protect investor, creditor, property rights, enforce contracts, improve transparency, and lower corruption – promotes an equity market that, in turn, increases risk sharing.²³

Domestic financial sector development allows integration with the global market as it increases diversification opportunities and expands the set of financial instruments available for risk sharing. Economies that are open to two-way investments – domestic investors can invest in foreign assets and foreign investors in domestic assets – are said to be globally integrated. Financial integration, in turn, becomes an important channel of global risk-sharing. There appears to be a symbiotic and interactive relationship between domestic financial development, financial integration, and financial globalisation. Importantly, there is empirical evidence that financial development and integration reduce poverty through increased investment, employment, income, and reduced income inequality. Recent research has found that

- the impact of financial development on poverty exerts two independent influences with half of the impact on economic growth and the other through reduction in income inequality;
- financial development leads to considerable deceleration in rate of growth of income inequality; and
- as the process of financial development gathers momentum, the rate of reduction in the proportion of population living in poverty accelerates.²⁴ In sum, there appears to be considerable benefit to financial sector development and financial integration which is increased and accelerated as globalisation of finance positively impacts and interacts with these two processes.

On the assumption that significant informational problems and transactions costs are absent, theory suggests that integration and globalisation of finance allow

portfolios to be well diversified internationally and that capital flows into markets with the most favourable risk-return profiles. Thus, as risk-sharing expands globally capital is allocated more efficiently and welfare increases. Empirical evidence, however, suggests that risk sharing within countries and across borders is yet an insignificant fraction of its potential.²⁵ There are important paradoxes contradicting this theory:

- the Lucas paradox
- the home equity bias puzzle
- the equity premium puzzle.

First, Lucas²⁶ argued that this theory suggests that capital-scarce countries have high rates of return to capital and should be able to attract investment from rich countries. The available data, however, did not show large flows of capital from the latter to the former. Indeed, most of the international capital flows, especially FDI and portfolio equity flows, took place among rich countries.²⁷ Also, even then, equity flows were much more biased in favour of domestic (rather than international) markets than the theory suggests.²⁸ Research indicates that a very high percentage of aggregate stock market wealth is composed of domestic equity.²⁹ Furthermore, even in domestic markets of rich countries, investment in stock markets is a fraction of what theory suggests, given that the returns to equity are much larger than justified on the basis of aversion to risk.³⁰ Mehra and Prescott³¹ demonstrated that, over many decades, a large differential existed between the real rate of return to equity than to safe assets, i.e., US Treasury bills. They also demonstrated that this differential was too large to be explained by existing theories of rational investor behaviour. The implication presents a puzzle as to why rational investors, noting the differential, would not invest in equities up to the point where the remaining differential could be explained as the risk premium on equities. While Mehra and Prescott focused on US data in their 1985 paper, subsequent research emphasised that a paradox existed in a number of countries, including India.³² Recent research has shown the global character of this puzzle and has attributed a significant part of it to institutional factors.³³ Interestingly, in one of his recent papers, Mehra³⁴ reports that the real worth of one dollar invested in equity in 1802 would have been worth nearly US\$560,000 in 1997, whereas the real worth of the same US\$1 invested in Treasury bills in 1802 would have been only US\$276 over the same period.

There is validity in the critics' arguments on globalisation that – despite the fact that globalisation was expected to help the poor – poverty has not been reduced and that measures of inequality reveal that it has not decreased.³⁵ Moreover, there is empirical evidence of increased risks of volatility and financial crises.³⁶ In answer, researchers argue that the process of globalisation is far from complete and that, at

present, global economy and finance are undergoing major structural changes that create a situation of ‘fluidity’. These have changed the usual ‘determinants of market valuation, volatility, leverage, velocity, and liquidation’. Each of these changes is significant on its own and in the way it interacts.³⁷

Researchers suggest that, while the benefits of globalisation have not been fully forthcoming with the scope and magnitude expected, the problem has not been the process of globalisation, but rather the way in which it has proceeded, where the playing field has not been quite levelled and where many financial markets have a long way to develop to allow meaningful integration of wider and deeper risk-sharing. Financial globalisation does not automatically provide the benefits expected for many countries unless they have attained threshold levels of legal and institutional developments mentioned earlier.³⁸

Evidence suggests that countries that attain the threshold level of good legal and institutional development are likely to attract more FDI and portfolio equity flows. In one such study, Faria and Mauro³⁹ measured institutional quality as the average of six indicators – voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption – and found that countries that ranked higher on these indicators attracted more equity-like flows. Wei⁴⁰ found evidence from a study on mutual funds that countries with a high degree of government and corporate transparency attract more equity investment because, as explained in a joint study by Erbas and myself,⁴¹ transparency reduces adverse incentive and ambiguity effects. There is mounting evidence to suggest that in the last decade many developing countries have implemented reforms that promoted legal and institutional developments. They have improved governance, transparency and accountability and have adopted regulatory, supervisory, standards of best international practice in accounting and data reporting. They have also stabilised their economies with sound macro policies and debt management. Some have even borrowed or rented additional credibility by cross-listing their domestic corporate shares in more advanced markets.⁴² As a result, they have received increased capital inflows, with FDI and portfolio equity flows constituting a major portion of these flows.⁴³

The data on the composition of households’ financial assets in Europe, the United States, and Japan between 1995 and 2003 demonstrate that in the Euro area, the European Union, and the United States, households allocated a larger portion of their portfolio to risk-sharing instruments. While comparable figures are not available in other areas, similar behaviour could be expected as policy, institutional, legal, and financial development progress in developing countries. Considering the Lucas paradox, scholars concluded that “institutional quality is the leading causal variable” in explaining the paradox based on their empirical study.⁴⁴

Recent empirical evidence also suggests that, since 2001, there has been a systematic decline in home bias, at least in US equity investments.⁴⁵ There has been also some empirical evidence that social capital,⁴⁶ especially trust, institutional and legal developments as well as greater transparency and availability of information may, at least tentatively, explain the equity premium puzzle. The last decade has witnessed a growing body of empirical research demonstrating that finance – particularly risk-sharing instruments like equity – is trust-intensive and, therefore, in societies where the level of trust was high, financial sectors were deeper and more developed. In particular, this literature indicates that there is a high correlation between trust and development of the financial sector.⁴⁷ Importantly, if the level of trust is high, more reliance is placed on risky assets, such as equity. People invest a larger portion of their wealth in stocks, use more checks, and have access to greater amount of credit than in low-trust societies. Over the last decade, a number of researchers have demonstrated the impact of trust on economic performance.⁴⁸ Arrow had suggested in 1975 that trust “is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people’s word.”⁴⁹ Fukuyama⁵⁰ asserts that the general level of trust, an important component of social capital,⁵¹ was a strong explanatory factor in the economic performance of industrial countries; the high level of trust was reinforced in these societies by strong institutions. A recent empirical paper⁵² demonstrates low trust as a crucial factor in explaining the low level of stock market participation, i.e., the equity premium puzzle. Based on the analysis of cross-country data, the paper suggests that where the level of trust is relatively high, investment in equity, in general, and in the stock market, in particular, are relatively high as well. Moreover, the paper asserts that in low-trust countries, equity participation depends on observance of the rule of law and the existence of legal institutions that protect property, creditor and investor rights, and those that enforce contracts. It suggests that in low-performing economies not only is the level of trust low, but property and investor rights are poorly protected, and legal contract enforcement weak. The policy implication for these economies is to strengthen legal institutions, improve transparency, accountability, and governance – both in private and public sectors – and to provide the public with more information on risk sharing, in general, and equity markets, in particular. The growing body of empirical evidence over the last two decades has focused on the existence (or the lack) of strong institutions as a powerful factor explaining cross-country differences in economic performance. Recent research has underlined that the same legal and institutional factors are responsible for financial sector development and the ability of integrating with the global finance which strengthen economic performance.⁵³

Islamic Finance

The central proposition of Islamic finance is the prohibition of the type of transaction in which a rent is collected as a percentage of an amount of principal loaned for a specific time period without the transfer of the property rights over the money loaned to the borrower, thus shifting the entire risk of the transaction to the borrower. As it prohibits debt-based contracts, the Qur'ān simultaneously recommends an alternative: in consonance with its systemic approach that as something is prohibited, an alternative is simultaneously recommended. The alternative to debt-based contract is *al-bay'*: a mutual exchange in which one bundle of property rights is exchanged for another; consequently, the risk of the transaction is shared. It is clear that the objective is to promote risk sharing. But why? Here, an economic hermeneutic of the relevant verses placed within the systemic context of the Qur'ān strongly suggests that risk sharing, along with other prescribed behaviour rules, e.g., exhortation on cooperation (Qur'ān 5:2), serves to bring humans closer to unity which is itself a corollary of Islam's central axiom: the Unity of the Creation. An Islamic philosophic axiom declares that from *one* Creator only *one* creation can issue. The Qur'ān itself unambiguously declares: "Neither your creation (was) nor your resurrection (will be) other than as one united soul" (31:28). In a series of verses, the Qur'ān exhorts human beings to take individual and collective action to achieve social unity and cohesion and then strive to preserve and protect collectivity from all elements of disunity (e.g., 6:153; 3:103). Unity and social cohesion are so central among the objectives of the Qur'ān for mankind that all conducts prohibited may be regarded as those that cause disunity and, conversely, those prescribed to promote and protect social cohesion. It is a natural consequence of such a system to require risk-sharing as an instrument of social integration. Therefore, promoting maximum risk-sharing is, arguably, the ultimate objective of Islamic finance. It is for this reason that Muslim scholars consider profit-loss sharing and equity participation as first best instruments of risk sharing.⁵⁴ Indeed, there is some evidence that stock market and social interaction are related.⁵⁵

One scholar who has recognised the full potential benefits of risk sharing for mankind is Shiller. He points out that "[m]assive risk-sharing can carry with it benefits far beyond that of reducing poverty and diminishing income inequality. The reduction of risks on a greater scale would provide substantial impetus to human and economic progress."⁵⁶ Arguably, the most meaningful human progress will be achieved when all distinctions among human beings on the basis of race, colour, creed, income, and wealth are obliterated to the point where humanity truly views itself as one. The Qur'ān (4:1 and 49:13) unambiguously calls attention to the fact that, despite all apparent multiplicity, humans are fundamentally of one kind and rejects all bases for distinction between and among them except righteousness. This

axiom applies to all dimensions of human existence on this planet, including in the fields of economics and finance. The objective of the unity of mankind could well be promoted by financial globalisation since it has the potential of being the great equaliser of our time. It has the ability to unwind and unbundle, direct, analyse, and price-risk searching for the highest return. It can explore all risk-return to assets and the real rate of return, leading to greater risk-sharing. It can do so across geographic, racial, national, religious, cultural, language, and time boundaries. In the process, it can level playing fields of finance and help remove barriers among people and nations. The same potential holds for Islamic finance if progress follows the trajectory envisioned by Islam, which specifies preconditions for the successful operation of financial arrangements within its framework firmly anchored on a network of norms and rules of behaviour (institutions) prescribed for individuals and collectivities.⁵⁷ This network includes, but is not limited to, those institutions that modern scholarship considers crucial for financial development, integration, and globalisation.⁵⁸

Among the institutions prescribed by Islam are:

- property rights
- contracts
- trust
- governance.

The word 'property' is defined as a bundle of rights, duties, powers and liabilities with respect to an asset. In the Western concept, private property is considered the right of an individual to use and dispose of a property along with the right to exclude others from the use of that property. Even in the evolution of Western economies this is a rather new conception of property that is thought to have accompanied the emergence of the market economy. Before that, however, while a grant of the property rights in land and other assets was the right to use and enjoy the asset, it did not include the right to dispose of it or exclude others from its use. For example, the right to use the revenues from a parcel of land, a corporate charter, or a monopoly granted by the state did not carry the right of disposing of the property. It is thought that the development of the market economy necessitated a revision of this conception of property since it was thought that the right not to be excluded from the use of assets owned by another individual was not marketable; it was deemed impossible to reconcile this particular right with a market economy. Hence, of the two earlier property rights principles – the right to exclude others and the right not to be excluded by others – the latter was abandoned and the new conception of property rights was narrowed to cover only the right to exclude others. In Islam,

however, this right is retained without diminishing the role of the market as a resource allocation and impulse transmission mechanism within the framework.⁵⁹

The first principle of Islamic property rights is that the Supreme Creator is the ultimate owner of all properties and assets, but in order that humans become materially able to perform duties and obligations prescribed by the Law Giver, they have been granted a conditional right of possession of property; this right is granted to the collectivity of humans. The second principle establishes the right of collectivity to the created resources. The third principle allows individuals to appropriate the products resulting from the combination of their labour of these resources, without the collectivity losing its original rights either to the resources or to the goods and services by individuals. The fourth principle recognises only two ways in which individuals accrue rights to property:

- through their own creative labour and/or
- through transfers – via exchange, contracts, grants, or inheritance – from others who have gained property rights title to a property or an asset through their labour.

Fundamentally, therefore, work is the basis of acquisition of right to property. Work, however, is not only performed for the purpose of satisfaction of wants or needs, it is considered a duty and obligation required from everyone. Similarly, access and use of natural resources for producing goods and services is also everyone's right and obligation. So long as individuals are able, they have both the right and the obligation to apply their creative labour to natural resources to produce goods and services needed in the society. However, *if* individuals lack the ability, they no longer have an obligation to work and produce without losing their original right to resources. Therefore, an important principle called 'immutability or invariance of ownership' constitutes the *fifth* principle of property rights in Islam.⁶⁰ The latter writes the duty of sharing into Islam's principles of property rights and obligations. Before any work is performed in conjunction with natural resources all members of the society have equal rights and opportunities to access these resources. When individuals apply their creative labour to resources, they gain a right of priority in the possession, use or market exchange of the resulting product without nullifying the rights of the needy in the sale proceeds of the product. As a result, the *sixth* principle imposes the duty of sharing the monetary proceeds after the sale of the property. This principle regards private property ownership rights as a trust held to affect sharing. The *seventh* principle imposes limitation on the right of disposing of the property – presumably absolute in the Western conception of property rights. Individuals have a severely mandated obligation not to waste, destroy, squander, or use property for unlawful purposes. Once the specified property obligations

are appropriately discharged, including that of sharing in the prescribed amount and manner, property rights are held inviolate and no one has a right to force appropriation or expropriation. This right is held so sacred that even in relatively modern times a rule had to be developed to accommodate emergency cases (e.g., exercise of an eminent domain for the expropriation of land for public utility development). It was called *ikrāh ḥukmī*, i.e., ‘unpleasant necessity’, a legitimate violation.⁶¹ Even in these unusual cases, action could be undertaken only after adequate compensation was paid to the owner.

The inviolability of appropriately acquired private property rights in Islam deserves emphasis. As observed by Habachy, given the divine origin of Islam,

its institutions, such as individual ownership, private rights, and contractual obligations, share its sacredness. [...] Private ownership and individual rights are gifts from God, and creative labor, inheritance, contract, and other lawful means of acquiring property or entitlement to rights are only channels of God’s bounty and goodness to man. [...] All Muslim schools teach that private property and rights are inviolable in relations between individuals as well as in relations with the state. [...] It is not only by their divine origin that the Muslim institutions of private ownership and right differ from their counterpart in Western system of law; their content and range of application are more far-reaching [...]. If absolutes can be compared, it can be safely said that the right of ownership in Muslim law is more absolute than it is in modern system of law. [...] ⁶²

In a terse, unambiguous verse, the Qur’ān exhorts the believers to be “faithful to contracts” (5:1). This command, buttressed by other verses (2:282, 288; 4:33; 6:15 1–153; 9:4; 16:91–4; 17:34–6; 23:1–8), establishes the observance and faithfulness to the terms of contract as the central anchor of a complex relationship between:

- the Creator and His created order, including humans;
- the Creator and the human collectivities;
- individuals and the state, which represents the collectivity;
- human collectivities, and
- individuals.

The concept of contracts in Islam transcends its usual conception as a legal institution ‘necessary for the satisfaction of legitimate human need’. It is considered that the entire fabric of the Divine Law is contractual in its concept and content.⁶³ Contract binds humans to the Creator, and binds them together. As Habachy suggests:

This is not only true of private law contacts, but also of public law contracts and international law treaties. Every public office in Islam, even the Imamate (temporal and spiritual leadership of the society), is regarded as a contract, an agreement (*‘aqd*) that

defines the rights and obligations of the parties. Every contract entered into by the faithful must include a forthright intention to remain loyal to performing the obligations specified by the terms of contract. The fulfilment of contracts is exalted in the Qur'ān to rank it with the highest achievements and noblest virtues (2:172).⁶⁴

The divinely mandated command of faithfulness to the terms and conditions of contracts and abiding by its obligations is undergirded by the equally strong and divinely originated institution of trust.⁶⁵ There is strong interdependence between contract and trust; without the latter, contracts will be difficult to enter into and costly to monitor and enforce. When and where trust is weak, laws and complex, expensive administrative apparatuses are needed to enforce contracts. Perhaps this is why so much emphasis is placed on trust: to make entering into and enforcing contracts less costly. Accordingly, the Qur'ān, in a number of unambiguous verses (2:58, 283; 7:172; 8:58; 12:52; 16:93, 94; 17:34, 36; 23:1–8; 42:107, 125, 143, 162, 178, 193; 48:10) proclaims trustworthiness as a sign of true belief and insists on remaining fully conscious of the obligation of ensuring that the intention to remain trustworthy in fulfilling the terms and conditions precedes promises or entering into contracts. Moreover, the Qur'ān makes clear that fulfilling the obligations of a contract or a promise is mandatory. In short, the Qur'ān makes trust and trustworthiness, as well as keeping faith with contracts and promises, obligatory and has rendered them inviolable, except in the event of an explicitly permissible justification.⁶⁶ In addition, there are numerous prophetic sayings that supplement the qur'ānic verses on trust. For example, it is reported that the Prophet was asked: "Who is a believer?" He replied: "A believer is a person to whom people can trust their person and possession."⁶⁷ It is also reported that he said: "The person who is not trustworthy has no faith, and the person who breaks his promise has no religion." Also, "Keeping promises is a sign of faith", and "There are three [behavioural traits] if found in a person, then he is a hypocrite even if he fasts, prays, performs big and small pilgrimages, and declares 'I am a Muslim': When he speaks, he lies; when he promises, he breeches; and when trusted, he betrays."⁶⁸

The rule of law governs the behaviour of state rulers no less stringently than those of individuals. As two Western legal experts⁶⁹ observe: "Islam is the direct rule of God. His Law, the Shari' a, is the sole criterion of behavior", and "the authority of the temporal ruler is both derived and defined by this law". Under the rule of law, "the ruler is by no means a free agent in the determination of the public interest", and the decisions that the ruler makes "must not be arbitrary, but rather the result of conscientious reasoning on the basis of the general principles of the Shari' a as enunciated in the authoritative texts".⁷⁰ The same legal experts also assert that, based on their consideration of Islamic legal texts, the commands of faithfully

observing contracts and covenants “apply to the ruler acting in a public capacity” just as severely as to individuals.

Just as the ruler has no special prerogative or exemptions as regards the substantive law, so he has none regarding the application of the law through the courts. Ideally, the jurisdiction of the Qadi [Muslim judge], the only person qualified to apply the Shari’a, is comprehensive and exclusive. The principle that no one can be judge in his own cause is firmly established in the legal texts, and when personally involved, the ruler should submit to the jurisdiction of the ordinary Qadis’ courts. The ruler that breaks faith cannot shelter behind any claim of sovereignty from the dictates of the law.⁷¹

The same principles of governance under which a ruler or a state should function also apply to firms. Iqbal and the present writer, in a joint study,⁷² argue that within the Islamic framework a firm can be viewed as a ‘nexus of contracts’ whose objective is to minimise transaction costs and maximise profits and returns to investors subject to constraints that these objectives do not violate the property rights of any party whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honours all implicit or explicit contractual obligations. Since the firm’s behaviour is shaped by that of its managers, it becomes their fiduciary duty to manage the firm as a trust for all stakeholders in ensuring that the behaviour of the firm conforms to the rules and norms specified by the law.⁷³

Even from the above rather cursory consideration, it should become clear that, once fully implemented, the Islamic institutional framework would support rapid financial development and encourage financial integration and globalisation which, in turn, would promote risk sharing. The institutions ordained by Islam reduce uncertainty and ambiguity to ensure predictable behaviour. Islam also prescribes rules regarding income and wealth sharing to promote income-consumption smoothing. Arguably, sharing of economic risks in the society is of great concern to Islam. This is evidenced by the strong position taken by the Qur’ān on distributive justice through *zakāh*, an obligatory 2.5 per cent of wealth, as well as additional exhortation for voluntary economic assistance to those less able; all of which are insurance against income risk. However, these institutions are exceptional by their absence in many, if not all, Muslim countries.⁷⁴ In the case of the Middle Eastern and North African (MENA) region, for example, Abed and Davoodi⁷⁵ found that the rates of growth since the 1970s have not only been lower than those of developing countries as a whole, but that they have been twice as volatile as the developing countries’ average. They attribute this poor performance to: high population growth and low productivity; lagging political and institutional reforms; large and costly public sectors; inefficient and inequitable educational systems; underdeveloped financial markets; high trade restrictiveness; and inappropriate exchange rate policies. A number of Muslim countries, in and out of the MENA

region, have recently implemented macroeconomic and structural reform policies and have adopted international best-practice standards and codes. As a result, the economic performance of these countries has improved markedly, also helped by an increase in oil revenues. While adoption, implementation, and development of Islamic institutions may be slow, implementation of international best-practice of transparency and accountability plus development of an independent and effective judiciary and the reform of the legal system – to protect property, creditor, and investor rights and enforce contracts – and promotion of financial sector development would increase investment, employment, and income leading to reduction in poverty.

Islamic finance has experienced rapid growth, especially over the last decade. Its growth is astonishing, given that its analytic underpinnings, in modern economic and financial terms, were explained just two decades ago.⁷⁶ There is no accurate estimate of the size of the market at present, but it is certain that it is nowhere near its potential. Just as is the case with financial globalisation, Islamic finance has realised only an insignificant fraction of its risk-sharing capacity; of the 15 basic modes of available transactions, only a few have been used widely and even then only a few instruments have been innovated based on these transaction modes. Nearly three decades ago, beginning with Ross,⁷⁷ theory of finance showed that a basic instrument can be *spanned* into a large number.⁷⁸ The wide range of instrument innovations of the ‘new finance’ since then has demonstrated the validity of this idea. Undoubtedly, the process of instrument design within the field of Islamic finance will gather momentum once it attracts the needed expertise. At the moment, this is the most important challenge of Islamic finance.⁷⁹ The lack of expertise has been the reason why, so far, financial engineering in designing new instruments has focused on fast tracking a reverse-engineering process of redesigning some conventional vehicles. Not only the process of instrument design based on the approved transactions modes has to accelerate, but also inventions of new instruments paralleling Shiller’s⁸⁰ ideas on ‘macro-markets’ should start; and here the potential is great. For example, virtually all government-deficit financing in Muslim countries is debt-based. To remedy this, Nadeem-UI-Haque and the present writer⁸¹ proposed an equity instrument to be sold by governments with its rate of return indexed to the rate of return to domestic, Islamic countries, and international-Islamic equity markets, each with specified weights. The analytic arguments underpinning this proposal were explained by Choudhry and myself.⁸² The reasons governments would want to raise funds are to supply social overhead capital, defence, health, and education. If the private sector was either unwilling or unable, it would fall on governments to undertake the needed investments and cover the related expenditure with usual government revenue. The shortfall would be covered by floating the equity instrument which would be, in essence, an instrument backed by assets represented by either earlier bundles of social overhead capital

already completed or in train, e.g., roads, dams, hospitals, and the like. Since these are lumpy investments and their public goods nature provides a higher social return than investments undertaken by the private sector, the rate of return to be paid must be at least as high as the rate of return to be paid by the private sector when raising equity in the stock market. But, since domestic markets may experience volatilities to which government finance should not be exposed, Nadeem-UI-Haque and myself suggested adding two other markets – the index of returns to all Islamic countries' stock returns and the index of returns to Islamic equity funds in the West – to the index of returns to the domestic equity market. There are obvious advantages to this instrument; one being a vehicle for integration of equity markets across the world while another would be globalisation of this instrument forcing governments to compete for funds domestically, regionally, and globally, leading to efficiency gains.

How likely is it that conventional and Islamic finance converge as they both go through the globalisation process? The answer would be quite likely if global finance would rely more extensively on equity or equity-like flows, on the one hand, and invent/innovate a wider spectrum of risk-sharing instruments, on the other. The same process of innovations in Islamic finance would allow an asymptotic convergence between the two. Five decades ago, Modigliani and Miller⁸³ showed that, in the absence of frictions, firms' financial structure would be indifferent between debt and equity. In the real world, there are a number of frictions that bias financial structures in favour of debt and debt-based contracts. The two most important are tax and information. The tax treatment of equity returns and interest in industrial countries, which dominate the world of finance and the present structure of capital flows, is heavily biased against equities. Informational problems (information asymmetry and the related problems of moral hazard and adverse selection) also bias financial transactions in favour of debt or debt-based contracts. Legal-financial systems in advanced countries are also structured, tilting in favour of debt and debt-based transactions. However, as financial market developments progress, legal and institutional developments across the world accelerate, and information technology advances, the informational problems diminish. Whether tax and legal treatment of equity versus debt will become less biased is a policy question. What is clear is that as informational problems decline, it will become increasingly difficult to maintain legal, institutional, and tax policy impediments to level the playing field between equity and debt. Consequently, it is not unreasonable to expect a process of decreasing dominance of the financial system by debt and debt-based instruments, which has not been without costs, including severe financial crises. This dominance has been a major part of the financial scene globally for so long that it is difficult to note that there was a period in the evolution of finance when equity and partnership were the dominant mode of transaction in the Middle Ages. There has been some recent research suggesting that financial globalisation is not

irreversible. Rajan and Zingales⁸⁴ argue that there have been periods in history, specifically 1870–1913, when the degree of global financial integration was no less than the current degree. Yet, as a result of world wars, stock market crashes, and a worldwide depression, not only the global integration stopped, it did not resume until recently.⁸⁵ Same catastrophic factors can explain an even earlier episode of reversal of financial integration in the Middle Ages.

Before the beginning of the twentieth century, economic historians of the Middle Ages all but ignored the importance of trade and financial relations between Europe and the rest of the world, which were crucial to the economic development of the West before the fifteenth century.⁸⁶ Abu-Lughod⁸⁷ contends that this was due to the belief held by the Eurocentric scholarship that globalised trade became relevant only after the ‘rise of the West’ in the late fifteenth century. According to Abu-Lughod,⁸⁸ an advanced globalised system of trade “already existed by the second half of the thirteenth century, one that included almost all regions (only the ‘New World’ was missing). However, it was a world-system that Europe had only recently joined and in which it played only a peripheral role.” Abu-Lughod maps growing global trade flows between 737 and 1478, demonstrating that trade flows first centred in Mesopotamia and spread rapidly over the next eight centuries throughout the then-known world to become global.⁸⁹ Beginning with Postan,⁹⁰ economic historians have indicated that these trade flows were supported by a financial system sustained by an expanding risk-sharing credit structure based on the *commenda* and *maona* concepts of medieval Europe. *Commenda* is identical to *muḍārabah*, and *maona* partnerships are either *mushārah* or *muḍārabah*, depending on the nature of activity undertaken by the partners.⁹¹ Postan’s paper, based on his investigations in the vast commercial archives of the Middle Ages in England, was path-breaking.

There is little doubt that the institutions of *commenda* and *maona* originated in the Islamic world.⁹² These institutions, along with financial instruments, such as *hawālah*⁹³ and *sufṭajah*,⁹⁴ were transmitted to Europe and to other regions by Jewish scholars and merchants throughout the Jewish Diaspora,⁹⁵ and via Spain through trade and scholastic borrowing from Islamic sources. Professor Goitein (d. 1985) of Princeton University painstakingly researched the documents known as the Geniza⁹⁶ records and reached the following conclusions:⁹⁷

- trade in the Middle Ages was both extensive and intensive, financed by risk-sharing partnerships;
- partnership was used in industrial, commercial, and in public administration projects;
- the Mediterranean and Indian trade, as revealed by the Cairo Geniza, was largely not based on cash benefits or legal guarantees, but on the human qualities of mutual trust and friendship; and

- even a cursory examination of the Geniza material proves that lending money for interest was not only shunned religiously, but was also of limited significance economically.

Studying both the Geniza records as well as sources of Islamic jurisprudence (*fiqh*), Udovitch reaches the following conclusions:

- there is remarkable symmetry between the Hanafite legal formulations of the late eighth century and the documented commercial practices of the eleventh- and twelfth-century Geniza merchants;⁹⁸
- he reaffirms Goitein's conclusion that researching "the extensive commercial records of the Geniza, we found comparatively little evidence of usurious transactions".⁹⁹

Moreover, research by medieval historians demonstrates the extensive use of risk-sharing partnerships.¹⁰⁰ While risk-sharing techniques continued to prevail in Europe until the mid seventeenth century, beginning in the mid sixteenth century, the institution of interest-based debt-financing also began to be used more widely and extensively throughout Europe.¹⁰¹

As mentioned earlier, risk-sharing finance is trust-intensive, and trade financing during the Middle Ages was based on risk sharing which, in turn, was based on mutual trust.¹⁰² Recent research indicates that catastrophic and traumatic experience contributes to the breakdown of trust in a community and among its members.¹⁰³ If so, the Middle Ages certainly witnessed enormous, continuous, and extensive traumas, including four crusades, three Mongol invasions, numerous wars in Europe, which are only a few of the traumatic experiences of the age. In addition to these events was the Bubonic plague of the mid fifteenth century that spread rapidly throughout the then-known world along well-established and intensively travelled trade routes.¹⁰⁴

It is well known that the full-scale adoption of a fixed-interest-based financial system, with a fractional reserve banking sector at its core, has a major deficiency: the system is inherently fragile.¹⁰⁵ Toward the end of the 1970s and early 1980s, the existence of financial intermediaries, in general, and banks, in particular, was justified due to their ability to reduce transaction and monitoring costs as well as to manage risk. However, minimal attention was paid to reasons why banks operated on the basis of fixed, predetermined interest-rate-based contracts, i.e., on a fixed-interest basis, that rendered the system fragile and unstable, requiring a lender of last resort to regulate it. Generally, interest-rate theories explain the rate as an equilibrating mechanism between supply of and demand for finance, which is a rate that prevails in the market as a spot price and not as a price determined ex

ante and fixed, tied to the principal and the period covered by the debt contract. In an important paper, Bhattacharya argued that:

[...] with risk-neutral preferences, when the choice of risk level is unobservable, then any sacrifice of higher mean asset payoff constitutes an inefficient choice. The classical model of intermediaries existing to save on transactions/monitoring costs in asset choice does not explain why their liability structure should not be all equity.¹⁰⁶

The fragility of a financial system operating on the basis of fixed, predetermined interest rate was underlined by Stiglitz¹⁰⁷ who argued that interest rates are not like a conventional price. The findings of the new field of ‘information economics’ strengthened the arguments of Minsky¹⁰⁸ and others that a debt-based financial system with the fractional reserve banking – operating with a fixed, predetermined interest-rate mechanism at its core – is inherently fragile and prone to periodic instability. Stiglitz’s findings underlined Minsky’s arguments that, as returns to banks decline, unable to raise interest rates on their loans, they enter a liability-management mode by increasing interest rates on their deposits. As this vicious circle continues to pick up momentum, the liability management transforms into Ponzi financing and eventually bank runs develop.¹⁰⁹ The last two decades of the twentieth century witnessed a number of global bouts with financial instability and debt crises with devastating consequences for a large segment of humanity, thus raising consciousness regarding vulnerability and fragility of the financial systems which are based, at their core, on fixed-price debt contracts. As previously emphasised, legal and institutional developments, along with good governance and adoption of standards of best practice in transparency and accountability at the level of individuals, firms, and state, buttressed by information technology advances, will mitigate the informational problems leading to lesser reliance on debt-based contracts.

Summary and Conclusions

This article has been written as a theoretical consideration of the Islamic economic paradigm from an institutional perspective. It is important to note that there is in actuality no country in which the institutional structure discussed in this article has been implemented. A major reason is that research needed to specify the nature of the Islamic economics is still in a formative stage. While this article has outlined briefly a possible vision of Islamic economics, it is not a paradigm in the true sense of the term. Consensus has to emerge on a conception and vision of Islamic economics by a critical mass of practitioners before the vision and conception can be called a paradigm. Thereafter, significant investment of capital and effort will

be needed to educate the public in order to reduce the cognitive difference between theory and practice.

This article has also addressed a question regarding the future of financial globalisation, and of Islamic finance: will conventional finance, at the heart of the current financial globalisation, and Islamic finance converge? The article began by considering the recent development and the future of financial globalisation. There is evidence that financial globalisation has not been as helpful as expected, given the potential of its benefits for growth of investment, employment, and income as well as for reduction of income inequality and poverty. The article argues that, ultimately, the success of globalisation will depend on the spread and degree of risk sharing around the world. The greater the momentum, the deeper the markets, and wider the spectrum of risk-sharing instruments, then the greater will be shared ownership and participation by a larger number of people in finance. Faster, deeper, wider financial development has a symbiotic relationship with globalisation as the feedback process between the two strengthens both. Evidence suggests that, thus far, the degree of risk sharing achieved by globalisation is insignificant. The article presented reasons that explain why the degree of risk sharing and expected welfare gains from financial integration have been small:

- as of yet, instruments have not been developed sufficiently to allow greater risk-sharing, and
- many countries still need to achieve threshold levels of financial, legal, and institutional development required to allow greater risk-sharing.

It is believed that the process of liberalisation of economies, adoption of best international standards, development of good legal/institutional framework and practice is gathering momentum in many countries, as is the pace of innovation of financial instruments. The article suggests that parallel progress and challenges also characterise Islamic finance. While it has experienced a phenomenal success in the last two decades, Islamic finance has still a long way to go to achieve its objective of maximum risk-sharing. The article argued that the institutional structures ordained, within which Islamic finance is to operate, are those that promote good state and corporate governance, trust, protection of rights and contract enforcement. It was suggested that, in the case of Islamic finance, the progress achieved to date is a negligible fraction of the potential. The reasons are identical to those offered in financial globalisation. It is suggested that financial, legal, institutional developments, and greater pace of instrumentalisation of basic modes of transactions permitted, would accelerate progress of Islamic finance. As it would appear that Islamic finance and financial globalisation share a common objective of achieving maximum risk-sharing, it is not too unrealistic to expect convergence. It was also

argued that legal and institutional developments as well as further advances in information technology will reduce informational problems and lead to growing trust which is essential for risk sharing. The result will be the dominance of equity in financial structures and relationships. The article presented historical evidence of a globalisation period, in the Middle Ages, when partnerships and equity participation were the dominant mode of finance. The breakdown of trust as a result of repeated wars and catastrophes as well as financial innovations, particularly securitisation of government debt in the late Middle Ages, created the right milieu for the dominance of debt and debt finance which has lasted to the present day. Recent data appear to suggest that global finance may be experiencing early stage of return of dominance of equity and widespread risk-sharing through the growth of Islamic financial techniques as well as greater innovation of equity-based instruments of risk sharing within the conventional finance. And therein lie the seeds of convergence.

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93. Literally, a transfer or change from a locality to another or from a person to another or from a situation to another; legally, a contract through which a debtor is released from a debt by another person who becomes responsible for it.
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