

Fostering Interaction between Real Sector and Financial Sector: The Role of Islamic Finance

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Interaction Between the Real Economy and Finance

Production, Exchange, Markets, and Finance:

(Verse 275 of Chapter 2 of the Quran)

Contract of Exchange vs. Interest Based Debt Contract

Propositions Implied by 275:2 on Pre-requisites for Contracts of Exchange:

- Freedom, within the limits of the Law, to produce and to enter into exchange contracts.
- To freely exchange, parties need a market.

To Operate Successfully a Market Needs Rules to Allow:

- Information to flow unhindered.
- Trust to be established.
- Coordination, cooperation, and competition to take place among market participants.
- Transactions costs and costs to third parties to be minimized.

- Contracts of exchange promote risk sharing.
- Emphasis on risk sharing serves the purpose of bringing people together to promote the unity of mankind (*an important desideratum of an Islamic way of life*).
- Equity participation is the first-best instrument of risk sharing.

An Ideal Islamic financial system is embedded in an ideal economic system which is, in turn, embedded in an overall ideal Islamic system. In such a system all rules of behavior (institutional structure) governing the workings of an overall Islamic system are in place.

- Implementation of an ideal system in turn require:
 - Broad consensus on the institutional structure (rules of behavior) deduced from the Q and the S that defines an Islamic society and economy.
 - Social consensus on implementation.
 - Political will and commitment to implementation.

Second Best Alternative:

- Embark on a well designed program of transition to the ideal system.
- During transition, take steps to strengthen legal/judicial, regulatory/supervisory, and enforcement infrastructure. This is necessary so the result of the financial system's interactions with the real sector of the economy converge to those that would be expected from an ideal Islamic financial system.

This can be done by reducing reliance on interest rate-based debt contracts via:

- Leveling the financial playing field.
- Promoting strong reputational intermediaries and well regulated secondary markets for equities.
- Reviewing, reforming, and strengthening the listing rules of the stock exchanges.
- Strengthening the judicial infrastructure.

- Educating those who invest in equity markets to demand full disclosure of information regarding the firms and their management.
- Investing in human capital by strengthening business and law schools.
- Developing a careful program of gradually moving government finances away from interest rate-based debt financing and toward share-holding participation by the public.