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December 2005

Southeast Asia Strategy

Islamic fundamentalism imported to Southeast Asia is threatening economic gains.

Religious schools, which plug a hole in poor education system, are at risk.

An educate workforce is key to economic development.

Action is needed - now.

Unequal education

In our special report *Islamic Economics - Unequal Wealth (May 2005)*, we demonstrated there are no theoretical obstacles to the efficient functioning of the Islamic economic model. All the elements are there for efficient markets. However, a philosophical gap has opened that makes current Islamic economic philosophy incompatible with the neo-classical, and that relates to rigid interpretation of Scriptures, which is frustrating economic efficiency in Islamic societies

Fundamental obstacles

The single largest impediment to economic efficiency in Islamic societies is their education systems. Educational outputs are not properly aligned to the needs of the state and achievement of Allah's wishes, that is, efficient exploitation of resources. There is an urgent need to overhaul the *madrassah*, how they operate, are staffed, are regulated, and the objectives of curriculum. Failure to do so creates an insurmountable impediment to economic efficiency.




Sound religion

Evidence exists - in southern Thailand, Indonesia and Malaysia - that the power to enhance the lives of their constituents is within reach, but will require strong government leadership and a break with a past of benign neglect. The threat to stability posed by fundamentalist Wahhabism and its seduction of Southeast Asia's increasingly marginalized moderate Islam is real. In secular Thailand, poor allocation of educational resources in the largely Moslem south has encouraged the growth of religious schools, which, in the absence of state-imposed education standards, are a potential drag on their development.

Role of secular government

Reinforcement is required of stated government principles of secularism on the path to more open and efficient economies. Changes will be required, many involving some form of political transition. With appropriate economic incentives, change is far cheaper than fight. Economic underperformance and commensurate poverty breed unrest and discontent, and economic underperformance is a given without change - maintaining the status quo is a recipe for continued underperformance.

Recommendations for action

-  **Overhaul the *madrassah* system, allowing the state to align educational output with broader community needs.**
-  **Encourage an independent judiciary, to ensure the fair and equitable flow of goods and services.**
-  **Enhance capital markets efficiency, to provide security and confidence of investment and enable long-term capital formation.**

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CLSA **Islamic economics**
ASIA-PACIFIC MARKETS Special report

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April 2005

**Southeast Asia
Strategy**

**A fundamental principle
of Islam is the equitable
distribution of wealth.**

This is not happening.

**Is this a failure of
economics?**

**Or does the problem lie
elsewhere?**

Unequal wealth
States influenced by Islamic law have enormous economic potential that has so far gone largely untapped. Is this because Islam and the neoclassical economic model are incompatible? By examining the successful neoclassical model in an Islamic context, we find the problem rests with government and atomised interpretations of the Scriptures. Our analysis shows the workings of an Islamic economic model, and suggests ways to work with restive Muslim communities.

Islam can accommodate neoclassical economics
Malaysia, Turkey and Indonesia are examples of how secular government can create the conditions of the neoclassical economy within a predominantly Muslim state. Islamic banking in those countries is growing in the right direction as it finds innovative ways to offer products that comply with the Scriptures while fulfilling the objectives of equitable wealth distribution.

Isolationism is no panacea
The global economy is an interdependent one. Ownership of resources, trade and services within Islamic economies is complex, but the neoclassical economic world has supplanted the pre-modern, requiring a re-examination of how best to recognize and reward inputs and outputs.

A prevalence of ignorance exists
Global economics requires a compatible set of economic tools, but there is an interpretative gap between the Scriptures and their modern application, which is being exploited by vested interests. Education is being directed towards reinforcement of fundamentalism over adaptation towards realism, and the absence of government in guiding constructive education is often the cause of, not the solution to, economic problems.

Lessons for southern Thailand
Islamic fundamentalism, financed and spread from the Middle East and feeding on poverty and lack of development, threatens to bring instability to Southeast Asia's moderate Muslim communities - not least in largely Buddhist Thailand's increasingly unstable Islamic southern provinces. In this report, we suggest a six-point plan for the Thai government to resolve, in an acceptable manner, its southern problems to the mutual benefit of both Buddhist and Muslim communities. Basic to any resolution must be effective economic stimulus that reinforces a sense of nationalism and hope. This approach has application across Southeast Asia, which has long been a seat of a moderate Islam until now divorced from the problems of its Middle Eastern cousins.

Six-point plan for Thailand

- ☞ Take control under acceptable standards
- ☞ Break the vicious educational cycle
- ☞ Provide economic stimulus to the region
- ☞ Localise institutions and power
- ☞ Reinforce nationalism and create hope
- ☞ Accurately price the future social value of the region

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CLSA regularly monitors Southeast Asia's innovative approach to blending Islamic thinking with modern economics.

No theoretical obstacles to efficient Islamic economic model

Widening philosophical gap within Islam creating economic incompatibility

Islamic banking is a cloak of shariah compliance . . .

. . . that endorses neo-classical economics

Madrasah hijacked by fundamentalist thought

Market principles must prevail over religious dictates . . .

. . . or risk inhibiting development of markets

Unequal education

In our special report *Islamic Economics - Unequal Wealth* (May 2005), we demonstrated there are no theoretical obstacles to the ability of an Islamic economic model to function efficiently. All elements of the neo-classical economic model can be satisfied and operate as efficient markets in accord with neo-classical economic theory.

However, a philosophical gap has been opened that makes current Islamic economic philosophy incompatible with the neo-classical. Much of today's Islamic thought is preoccupied with literal or misinterpretations of Scriptures that reflect Islam's beginnings. This preoccupation is frustrating the development of economic efficiency in Islamic societies.

Islamic banking, which is effectively a cloak of *shariah* compliance, has been laid over market-driven tools, window dressing what are otherwise well-understood and time-tested banking products and principles.

Acceptance of this approach is a *de facto* endorsement by Islamic society of neo-classical economics, and recognition of the importance of a market driven pricing framework. Nevertheless the Theocratic state enshrines the authority and power of non-price driven activity by Islamic governments and ruling families, inhibiting the function of the pricing mechanism and, accordingly, the market-driven, and equitable, distribution of goods and services, which is a core Islamic doctrine.

Religious schools, or *madrasah*, have become the dominant conduit of education, but their curricula has been hijacked by fundamentalist thought, which is largely responsible for producing students bereft of the capacity for individual thought - the rights of the individual have been subjugated to those of the cleric-dominated state.

This will persist until there is segregation of religious fundamentalism from the state, the ascendancy of the voice of the people over that of the clerics, judicial independence and liberation of economies such that market principles - the pricing mechanism - prevail over the dictates of a fundamentalist state.

Failure to achieve a non-fundamentalist state inhibits the development of markets and an enabling legal framework, institutionalises inefficiencies, and ensures structural incompatibility with neo-classical economic thought. Alan Ebstein, in *Hayek's Journey*, quotes Frederick Hayek as saying:

. . . the price system was really an instrument which enabled millions of people to adjust their efforts to events, demands and conditions, of which they had no concrete, direct knowledge . . .

Fundamental obstacles

In the beginning . . .

In Medina of 1,400 years ago, in the time of the Prophet Mohammed, society was relatively primitive, communications a function of the fastest horse, and communities a mixture of rival nomadic tribes following opportunities of food and shelter. At relatively secure locations were more permanent settlements, farming food and trading with the nomads. Towns as we know them were embryonic, as was commerce and the role of money.

Conquest was the method of securing incremental wealth, and was the path chosen by Muhammad to promulgate Islam. It was a combination of military expansion behind the banner of the charismatic Muhammad, who has interpreted the will of Allah as his guiding light. As he converted those he conquered to Islam, he secured access to a greater pool of resources.

There was no risk of a secular state - this was imperialism of a predominantly religious form. As towns developed, resources exploited, and industry harnessed, a predominantly barter economy needed to monetise, but neither the experience nor the tools were on hand for Muhammad - the Koran was as ill-equipped as the Bible for dealing with today's treatment of such phenomenon. An important tenet of Islam is the equitable distribution of resources, though "equitable" is a subjective determination.

Muhammad considered the means by which Islam spread were acceptable for the time. But today's challenges are unlike anything encountered a millennium and a half ago, yet some Islamic teaching still seeks to hold to arcane dictates. Leaders seeking to reconcile Islam with economic development tread a difficult path. The Bangkok Post of 9 November 2005 quotes former Malaysian Prime Minister Mahathir bin Mohammad as saying:

. . . around the 15th Century, the learned in Islam began to curb scientific study. They began to study religion alone, insisting that only those who study religion - particularly Islamic jurisprudence - gain merit in the afterlife. The result was intellectual regression at the very moment that Europe began embracing scientific and mathematical knowledge. ... [But] the Koran is not a talisman to be hung around the neck for protection against evil. Allah helps those who improve their minds.

Relatively primitive society

Wealth accrues through conquest

Religious imperialism, but with goal of 'equitable' resource distribution

Teachings out of step with today's challenges

Satisfaction of Allah's wishes is Islam's goal

Sound religion

As we explained in *Islamic Economics - Unequal Wealth*, Islam's basic objectives, as defined by the Prophet Muhammad and the Scriptures, have both basic needs and a hierarchy of basic needs which man is expected to follow, and behave accordingly. They are drawn from Muhammad's five pillars of faith, daily prayer, fasting, contributions to the poor and pilgrimage, and can be (simply and expediently) defined as:

1. Cater to man's basic needs.
2. Enable man to achieve Moral Ascendancy, Spiritual Ascendancy and Economic Welfare.
3. Provide a satisfactory standard of living.
4. Achieve equitable distribution of wealth amongst individuals and the state.
5. Be bound by the hierarchies of individual virtue - satisfaction of basic needs, first - and social justice - consideration of the needy, second - through work and need.

No conflict with neo-classical economics

We contend that neo-classical economic thought is the best economic model to be followed to achieve Islam's basic objectives, and Allah's wishes. As previously demonstrated, there is nothing apparent in Islam that causes a fundamental issue with the full application of the neo-classical economic model.

Avoidable impediments

There are, however, many avoidable impediments that have been created, that do inhibit the neo-classical model's implementation.

Inefficient resource allocation

Islamic economies cannot allocate resources efficiently under the status quo. As the path to neo-classicalism is truncated, so is the path to efficiency. Neo-classical economic thought does not guarantee efficiency, but it is a precursor to enabling efficiency to be released.

Success a measure of government intervention

The track record for the implementation of truly efficient neo-classical economic system means it is still a utopia. Its limitations lie in government endeavours to determine the extent of its intervention in the economy in an attempt to meet certain constituents' needs. It does this through the provision of "essential public services" and by attempting to rectify market anomalies for things such as public goods. Nevertheless, this particular economic model as it is implemented is the best that the world has practiced. As quoted by Ebstein, Hayek believed its key element is enablement of the pricing mechanism and the subsequent efficient allocation of scarce resources:

. . . the basic function of economics was to explain the process of how human activity adapted itself to data about which it had no information. . . [and] by using prices as a guide, or as signals, we were to serve the demands and enlist the powers and capacities of people of whom we knew nothing. . . . [T]he insight that prices were signals bringing about . . . unforeseen coordination . . . became the leading idea behind my work.

Retreat to fundamentalism negates pricing mechanism

As long as Islam persists with its retreat to fundamentalism, it will not enable the pricing mechanism to function and it will fail in its basic objectives, and it will fail to be consistent with neo-classical economic thought.

Striking the right balance in Bangladesh

In some secular Muslim democratic states it is two steps forward, three steps backwards. Bangladesh's 140 million population, 90% Islamic, has been widely terrorized by those wanting instatement of Islamic Law ahead of the 2007 election and political reform. Bangladesh has been failed by its leadership, which has not fulfilled its obligations to its people. The path to development requires more than a framework; it requires a will to succeed, as instanced by contemporary news reports, such as the Bangkok Post of 5 September 2005:

The opposition Awami League organized major protests after the bombings. They charged Prime Minister Khaleda Zia and her ruling Bangladesh Nationalist Party had contributed to the violence and threats by allying itself with the extremist [banned] Jamat-e-Islami.

Progress in Indonesia, Malaysia

Democracy is but one feature of successful economies. We are seeing the coexistence of Islam with the secular state in Indonesia, where removal of corruption has been made a banner objective, and Malaysia, where failure of decades of affirmative action towards the 70% indigenous population under Mahathir is under review. There are teething problems, but by and large progress is being made, and the consequence of that progress is more rapid and less wasteful economic development.

Role of the madrassah

Our focus here is the role of the *madrassah*, Muslim-faith schools that often serve as the only point of education in impoverished parts of South and Southeast Asia.

Atmosphere of tolerance and understanding

In culturally and ethnically diverse Malaysia in particular, the *madrassah* are relatively open. There are still issues with the powers of the religious police and some fringe *madrassah* encouraging and training for violence - such as in Kelantan. However, there appears to be an atmosphere of tolerance and understanding that the secular state is the most sensible course for the enduring betterment of Malays.

Pakistan seeking to regulate religious schools

In Pakistan, the courts have ruled only graduates of registered *madrassah* will have qualifications formally recognised, to the extent the holding of public office is not permissible by those with "unregistered" qualifications. This is part of an overall crackdown on institutions promoting "fundamentalist tendencies". The danger, however, is that such restrictions may exclude a significant portion of the population from policy determination, and give rise to action outside formal channels, as indicated by *The Times of India* of 2 September 2005:

The apex court decision [that unregistered *madrassah* do not teach a curriculum that can prepare students to face the rigours of modern living] will exclude an influential section of the grass-roots leadership from the political mainstream. This could further alienate them from the democratic process and create parallel power centres.

Role of secular government

Government must recognise equitable allocation of resources

Economic growth involves the triumvirate of institutions, policy and resources. It comes down to the abilities and capabilities of a government to put institutions and policies in place that enable the maximization of the allocation of resources in an efficient manner. As pointed out in *Islamic Economics - Unequal Wealth*, Islam would impose the further condition that the resources are allocated not only efficiently but equitably.

Fundamentalism incompatible with development

The fundamental resources that have to be allocated are a country's natural resources and its current and future capital, financial as well as physical and human. Their release and management requires legal and other enabling institutional infrastructure, sound monetary policy, and human capital that is amenable to resource development and equitable distribution. The *raison d'être* of radical Islamic fundamentalism would seem to be the development of human capital for violence, not prosperity, and the maintenance that violence is a justifiable means.

Education the key . . .

To create the appropriate environment requires Islam to radically rethink the way it teaches, and to radically rethink the way it regulates its teachers. Its curriculum requires major overhaul, as do the issues of transparency and accountability in Islamic education.

. . . to modernisation . . .

With such modernisation will come the opportunity to divorce the control the clergy might exercise over the state, allow empowerment, and enfranchise Islamic peoples at large. This liberation will insist upon equitable access to resources, will encourage the maturing of markets, an independent judiciary, and allow the pricing mechanism to work. With an unregulated, operating pricing system, the flows of goods and services become market-driven, and resources allocate themselves according to the wishes of constituents.

. . . and equitable resource distribution

From the application of such neo-classical principles society avoids the climate of poor investment that exists in many Islamic economies today, and takes the first steps toward achieving Islam's guiding principles of equitable distribution of resources, according to the wishes of the peoples.

Fundamentalism creates gap between neo-classical and Islamic economics

Debate dogged by interest rate red herring

Money is an acceptable means of exchange

But pricing mechanism has its detractors

Tools exist to recognise and reward risk

Sound money

In *Islamic Economics, Unequal Wealth*, we described that, from the basic Islamic principles drawn from Islamic Scriptures, guiding codes of behaviour have been structured. In today's world we find that Islam's guiding laws have the following features.

- ❑ They are based on interpretative Principles.
- ❑ There is selective interpretation of these Principles.
- ❑ Understanding of these Laws is consequently bound in confusion.
- ❑ This in turn inhibits the achievement of Islam's basic objectives.

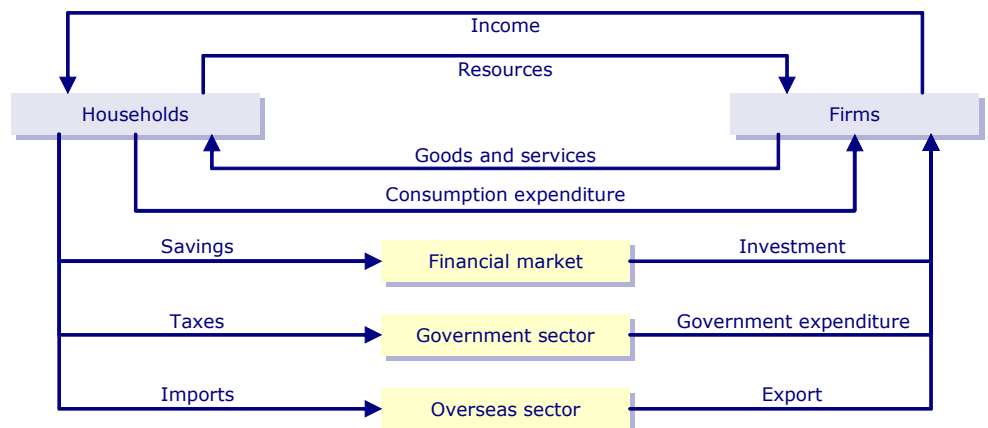
It is on the issue of interpretation that fundamentalists have drawn their line and the consequence is an inherent gap between what could be achieved and what is being achieved, on behalf of their constituents.

Take, for example, the debate on interest and its permissibility in Islamic thought. Usury is clearly prohibited, but if capital is to be allocated efficiently there must be some form of pricing mechanism that enables that allocation. It will not necessarily be efficient, but it must exist.

In all interpretations, fundamentalist and otherwise, there is no issue with money as a medium of exchange, notwithstanding references to the exchanges of certain goods in the Koran. The movement from barter to money to credit is seen as an essential step in the path to better resource exploitation.

Figure 1

Circular flow of income model



Source: CLSA Asia-Pacific Markets

It is when we come to talk about the pricing mechanism as it relates to money that the debate heats up. The fundamentalists insist that interest equates to usury and is therefore prohibited.

If interest rates are not permitted, it is proposed that risk sharing in the form of equity in the exchange of capital, goods and services, be the appropriate vehicle. But what is interest if not the tool that balances the supply of money with its demand, and incorporates the inherent inflation and exchange rate risk in the demand curve. In fact, we know that in today's complex societies, the taking of direct equity includes additional risk - who would disagree that

Direct equity is inefficient

putting one's capital into the stock market is more risky than putting it in the bank. Furthermore, in any economy with inflation, zero interest rates tell individuals and businesses to spend today rather than tomorrow, before the value of your money decreases.

Direct equity - participating in the risk of the venture as a partner - is generally less efficient than bundled transactions under the management of a financial intermediary. Its complex documentation does not benefit from transparent disclosure inherent in the banking sector and public ventures.

A brief history of risk

Cast your mind back 1,500 years when exchange rates were fixed - coin issuers determined precious metal contents and trade patterns determined the liquidity of those different coinages. Those dealing in money took exchange and liquidity, in addition to goods and coinage security, risks in which were embedded demand and supply of money risks. They did not have the advantage of today's flexible exchange rates, sound legal and clearing systems, and the need for a transparent interest rate environment.

Risky business

In the first millennium, the most visible professional money-lending class was the Jews, though this was not an exclusive domain. Whilst Jews were allowed to own land in Medieval Germany, they were effectively prohibited by lack of suitable supply, religious prejudice and the dominance of the land-owning class from so doing, and instead became a merchant class. They initially dealt in and loaned money to expedite trade. The skills acquired developed into the trading of money as a commodity, or money lending. In many cases of ruling-class default, the debtor simply confiscated the money-lender's property, which led to the lender setting a higher rate of interest to seek recovery of losses, and so on. With larger towns, especially in Italy, we saw the Jews displaced by Christian moneylenders, as Richard Ehrenberg explains in *Capital and Finance in the Age of the Renaissance*:

In spite of the ban of the Church interest-bearing loans had at the end of the Middle Ages been for centuries an everyday legal transaction. It was nevertheless regarded as a gross sin. In the Papal indulgences money gained through usury was put on a level with stolen goods.

Ehrenberg continues:

Commerce of course found many ways of getting round the ban on interest. The interest was added directly to the capital, or in what appeared as a bill transaction the interest was smuggled into the price of the bills; or commodities were lent in place of ready money and then charged at a higher rate; or the loan was made in the form of a deposit, which was permissible, and so forth.

The Church and the Law recognized many of these forms, thus opening the door for the evasion of their own bans. The distinctions which were made were, however, so numerous and fine-drawn, and the views of the ecclesiastical and legal experts differed so widely as to what was permissible, that in the centuries between the first lightening of the ban and its removal by legislation commerce was never free from uncertainty.

Same debate now . . .

This is a familiar argument in today's Islamic debate on the permissibility of interest, and the costs of an uncertain commercial operating environment.

. . . as then

The interest debate is not unique to Islam. In Medieval Germany, with the development of towns we see the social and commercial impact of money-lending and usury emerging. Landowners' income streams were in the form of

Shift from barter to money to credit

rent - and it is easy to see why annuities/bonds were some of the earliest securitized and fungible financial products to emerge. Landowners were the rulers - mostly Princes and the like - and the business of commerce was left to others. The church was opposed to the levying of interest, but recognized the value in allowing interest to be applied to expedite commerce. Merchants and moneylenders disguised interest into other forms of finance, which took some centuries to be formalised.

Demand is there, but differences may be illusory

In neo-classical industrial development, economic terms of exchange here were the seeds of a transition from barter to money to credit. Money is the accepted medium of exchange that expedites the underlying exchange of goods and services. By imposing a less efficient pricing mechanism than the interest rate, fundamentalism imposes avoidable inefficiency on the exchange of goods and services, and in turn on the distribution of goods and services, and most particularly on the allocation of capital which leads to growth. The result is not only inefficient, but also likely to be inequitable as constituents are denied equitable access to the pricing mechanism.

Emergence of Islamic banking

Islamic banking is growing - not as rapidly as many would suggest, but nonetheless growing. Examples abound, the most recent being in the predominantly Islamic province of Aceh in northern Sumatra, where post-tsunami reconstruction is well under way. Credit products have been specifically designed for local consumption, and our observations conclude there is a greater propensity by microfinance borrowers for *shariah*-compliant products than mainstream ones.

Sleight of hand

What we have been unable to determine is whether those borrowers understand that the debt and its repayment include charges that reflect the risk and time value of money. The products are structured in such a way that there is no discrete "interest" element advertised in repayment obligations. We suspect they are as unaware of this hidden component as car buyers in western societies - "interest free" auto loans are the producers embedding the cost of the interest into the underlying price of the asset being financed.

Smoke and mirrors

Shariah-compliant banks secure some of their financing from classically *shariah*-compliant depositors, but they are also highly cognisant of the choices facing depositors, and the need to offer competitive rates of return on those deposits. The end result is, not unexpectedly, a table of deposit rates that virtually mirrors those of non-compliant financial intermediaries, where they are disclosed into the three components of fees, principal and interest.

Misdirection

While the specific elements of the products - principal and interest - are not disclosed in *shariah*-compliant products, nor quite often in mainstream products, except where regulators and consumer action groups have petitioned the legal obligation to make such disclosure in order consumers can make more educated choices on what product to choose, their structure virtually mirrors the mainstream products in expected returns to the lender and costs to the borrower.

But finding acceptance

Malaysia has a stated objective to be the world's leading Islamic financing centre, and is home of much academic work on Islamic finance. It has encouraged ringgit-bond issuance with capital gains and income tax exemptions for local and foreign bond holders, and directed local pension funds to invest in domestic issuances. It will see *shariah*-compliant debt issues of MR21.5bn (US\$5.75bn) in 2005, dramatically up on 2004, and comprising more than 80% of total domestic ringgit-debt issuance this year.

<p>Structured Islamic paper</p>	<p>The World Bank and IFC account for 10% of these “structured Islamic papers”, which are asset-backed obligations, the assets rented by the borrower paying a rental stream in lieu of interest, purchasing at maturity.</p>
<p>Semantics?</p>	<p>The point is there is demand from within Islamic communities for <i>Shariah</i>-compliant product. It is up to the issuer to synthesise a debt service scheme that avoids reference to interest, yet delivers a competitively priced product that ensures investors a yield comparable to that from alternative products. A question of semantics? Perhaps.</p>
<p>Islamic retail banking is a reality</p>	<p>In the United Kingdom we have recently seen the formation of the retail Islamic Bank of Britain offering product to the UK’s 2 million Muslims. It will shortly be joined by the European Islamic Investment Bank, a wholesale products bank chaired by the former CEO of Bahrain Islamic Bank, Adnan Ahmed Yousif.</p>
<p>Captive market</p>	<p>Given the apparent comparative advantages of captive Islamic markets, the desirability of the Islamic community to support products that are tailored to their specific, religious needs, and the accumulation of very large surpluses from energy sales by middle-eastern countries in particular, one would expect <i>Shariah</i>-compliant banks to have superior operating performance to those in the mainstream. They do not. Nor are they without compliance concern, as the <i>Daily Mail</i> reported on 30 August 2005:</p> <p style="padding-left: 40px;">United Arab Emirates financial watchdogs have cancelled trading in Dubai Islamic Bank shares worth £1.4bn following accusations of insider dealing.</p>
<p>Early days yet</p>	<p>The argument is hypothesised that it is early days for such institutions, and it will take time for the requisite skills and techniques to develop to required standards. However, in the interim <i>shariah</i>-compliant banking is a less efficient allocation of Allah’s resources - money in many of its forms, from assets to liabilities, as a medium of exchange, and the consequent costs of conducting commerce - than more developed economies adhering to the neo-classical approach.</p>
<p>Attracting mainstream players</p>	<p>An ironic twist to the insistence for a <i>shariah</i>-compliant financial system for Islamic communities is the market-driven response of western financial intermediaries. These firms, spawned and nurtured from the core of neo-classical economic theory, have recognized opportunity and act in a rational way to exploit the opportunity.</p>
<p>Shariah-compliant deposits and investments now worth US\$650bn</p>	<p>They have modified off-the-shelf products to meet <i>Shariah</i>-compliance, ranging from credit cards to mortgages and bonds, installing Islamic scholars on their subsidiary boards to provide the appropriate endorsements. It is estimated <i>shariah</i>-compliant deposits and investments today managed by such intermediaries exceed US\$650bn, and are growing annually at double digit rates. The Institute of Islamic Banking and Insurance in London puts the figure managed by Islamic banks globally at lower but still large US\$260bn. As <i>Newsweek</i> reported in August 2005:</p> <p style="padding-left: 40px;">Giant Western banks - or, rather, their Islamic banking subsidiaries - are leading the market for financing that complies with Qur’anic laws on money lending Citi Islamic . . . now leads the pack with deposits of more than \$6 billion.</p>

Managing change

Investment optimisation

A move to the neo-classical model of economic activity will help improve the resource allocation process. Its insistence on a pricing mechanism and clearly independent legal system will ensure things such as property rights and the enforcement of contracts are taken into account as the determinant of resource allocation. At the same time, social change will occur. The challenge is to achieve this migration without the disruption and violence that persistently accompanies social change. Farish A. Noor wrote in the *Far Eastern Economic Review* in September 2005:

Since medieval times, *madrassahs* have been part of Muslim social life and are found all over the Muslim world. Over the centuries, they evolved into distinct institutions that trained scholars who would later become religious functionaries, bureaucrats, artists and tradesmen. One could compare them to the religious seminaries that produced generations of Jesuits in the West.

Education must be the first step

The first step is to tackle the education system. From the earliest entry into the Islamic education system we see the curriculum dominated by religious thought. Youth taught exclusively from the Koran will be severely hampered, if not barred, from developing the skills to enable future enquiry.

Conflict of interests

There is an indisputable conflict of interest between fundamentalist religious education and training - fundamentalism after all precludes evolution and particularly the right to question - and an education system that prepares the student for the vagaries of our ever-changing world. This is in keeping with Allah's demands that resources be exploited for the benefit of all, and the recognition that the world is not static.

Need for clear and comprehensible laws

Government requires a certain critical mass in order to execute the task of setting the legal framework within which society operates. It is incumbent upon government to set clear and easily comprehensible laws that reflect the mores of society as a whole, and enable commerce to operate with the minimum of "red tape". It is very tempting to those vested with the responsibility to govern to go beyond the setting and enforcement of such laws to meddle with the economy and society. This is sometimes driven by external factors, when it is deemed imperative government act decisively and quickly, as the issues at hand demand immediate response. It may also be permissible when government determines its actions will provide a short cut to achieving certain desirable outcomes for society.

Poor record of government decision-making

However, history shows government has repeatedly made wrong decisions, resulting in the imposition of unnecessary inefficiencies ranging from poor investment to out-and-out crippling of economies. The Asian crisis of 1997 was one outcome of poor government. Controlled exchange rates, consequent poor investment accompanied by an imperfect legal system enabled the disaster, at huge cost to constituents' lives. Government trod where it should not have, and had not fostered development of an independent judiciary and unfettered pricing mechanism.

China's growth is proof of the effectiveness of market forces

China has proved the effectiveness of market forces for economic growth. Under Mao Zedong, the centralised economy was a disaster. Deng Xiaoping's move towards a market economy in 1979 has seen near-constant growth. In the dwindling number of State Owned Enterprises is evidence of the failure of government-directed investment, now eclipsed by entrepreneurs and an increasingly efficient pricing system.

Law enables the pricing mechanism

Law is the constant that enables the pricing mechanism to function, but the law by itself is not enough. It must be transparently and objectively determined, and transparently and independently executed, and be law that is based on common values, not on fundamentalist anomalies, be they political or religious. Legal systems are inadequate in many Islamic societies - women are denied even the most basic rights in Pakistan, commercial law is distorted in Malaysia. Whilst the west is not without fault, the further a society's legal system drifts from an equitable legal base, the less likely that society is to optimize economic development and social harmony.

Islamic law lacking in transparency

There is little transparency in Islamic law, notably in the Middle East, where its application is subjective and at the whim of the ruling families/governments. Claiming such societies do not need a legal system that reflects the ever-changing mores of its societies on the grounds Islamic codes provide sufficient guidelines, ignores inevitable societal unrest.

Creates uncertain investment environment

The consequence is an uncertain investment environment for capital, an uncertain outcome for resource allocation, and inevitable inefficiency in resource allocation. The solution to this inefficiency is a simple one, but the obstacles to its implementation are considerable.

Threat of Wahhabism

Muhammad Ibn-Abd al-Wahhab (1703-92), preaching in the mid-18th Century, sought to "purify" the Sunni sect and return the interpretation and teachings of the Koran to the most fundamental of courses in what he saw as his duty to reverse the decay of Islamic society. He began the process of institutionalizing 'purity' in Islam. His was an absolute belief that did not allow the intrusion or survival of forms of Islam that were not literal in their interpretation of the Koran, and he pursued an idealistic vision and interpretation of the Prophet.

Active proselytism

He managed to convert the Saud tribe, which embarked on a jihad (holy war) against all other forms of Islam, and despite attempts by the moderate Hanafi Sunni of Ottoman Turkey to crush them in the early 19th Century, the Saud managed to conquer Mecca and Medina in 1924 and secure what became Saudi Arabia in 1932. Wahhabi proselytism is active throughout the Moslem world, from India and Sumatra to North Africa, Somalia and the Sudan, and it found loyal followers in the Taliban, which emerged from the Afghan refugee camps in Pakistan. Wahhabism is funded by oil-rich Saudi Arabia.

Symbiotic relationship

A symbiotic relationship evolves. The custodians of Wahhabism ensure religious health, and the rules are guaranteed a trouble-free environment in which to manage. With at least one pilgrimage to Mecca a requirement in the life of a Moslem, the seeds of this fundamentalist school of Islamic thought easily spread, fertilised by well-funded Wahhabist teachers sent out to work in the Islamic constituencies.

Suppresses innovation, economic flexibility

The Wahhab-driven fundamentalist approach has done much to suppress innovation and economic flexibility:

- ❑ Gender inequality, leading to underemployment.
- ❑ A "closed" educational system fostering an environment of complacency.
- ❑ Prohibition of "interest" and consequent financial market inefficiencies.
- ❑ Poorly structured tax systems, and resultant subjective resource collection and reallocation.

Moderate Islam holds sway in SEAsia

- ❑ Constraints on freedom of speech stifling innovation and creativity.
- ❑ No suffrage and consequent unrepresentative and inefficient government.
- ❑ Constraints on an independent legislature, leading to loss of objectivity and trust in the law, hampering optimal allocation of resources.
- ❑ Conformance to backward-looking Islamic morality causing sub-optimization of current economic opportunities and hence poverty.

In parts of Southeast Asia, where a particularly moderate Islam took root from the 13th Century, carried by Arab traders, Wahhabism is spreading among poor and often economically disenfranchised Moslems. In southern Thailand, where Bangkok policy has allowed the development of a "second class" citizenry, Moslems are economically worse off than other Thais. It is much the same in the southern Philippines, compounded by a Catholic/feudal Manila. In northern Malaysia, where Kuala Lumpur has failed to stimulate a predominantly agricultural economy, fundamentalism has free rein. In parts of Indonesia, poverty has generated an increasingly active fundamentalism that the inter-departmental rivalry of the army and police has failed to check. Brunei, however, is slowly emerging from its own Theocracy to which the Sultanate caved some decades ago under the threat of insurgence. It has begun moving towards secularism, restoring elections to the selection of Legislative Council representatives.

Malaysia is an example

Malaysia is as an example of how the state can successfully grow its economic policies in a way that takes note of Islam's particular requirements. Mahathir sought to reconcile the two with his New Economic Policy, launched in the early 1970s, a sort of secular capitalism with Islamic characteristics. The *Bangkok Post* noted on 5 September 2005:

By making Islamists and Islamist sentiments a part of the process of modernization, Malaysia demonstrates that Islamic faith and economic policy can be reconciled if politicians are clever enough not to treat them as contradictions.

Religious strictures lead to inefficient investment

Still, any religious strictures governing resource distribution and investment decision-making can only be less efficient than if the marketplace and the pricing mechanism were left to operate without undue hindrance.

OECD failing to see big picture

A disappointing supporter of much of the status quo is the Organisation for Economic Cooperation and Development (OECD), which is more concerned with short-term stability in energy prices and trade flows than enfranchising Moslems in the Middle East and elsewhere. Potential disruption to more developed economies outweighs the continuing cost of inefficiencies created by strict adherence to Islamic lore, which can only ensure poor investment and a compounding of longer-term costs.

Historical context

It is worth going back to the Prophet Mohammad to consider what might have been. Omar Noman, in *The Profit Motive in Islam: Religion and Economics in the Muslim World*, provides a description of the Prophet's wife and her influence on him as he articulated the five pillars of Islamic thought:

Hazrat Khatija was a property owner, a major trader who hired men to work for her. One of the men she hired - to take a caravan of goods to Syria - was to become her future husband and the Prophet of Islam. Thus market principles, private property, commerce and trade were part of the economy into which Islam was born. It should be noted that interest was not prohibited in the transactions that defined this economy.

Education is a state obligation

The state has an obligation to educate its populace – it is a simple payback to provide the educational tools by which the nation’s latent talent can be developed, and create further wealth for the nation. This is a simple virtuous circle of sound investment by way of education. To ensure the investment is as efficient as possible, the state participates in providing the required infrastructure, training the teachers, structuring the curriculum, ensuring appropriate remuneration to encourage appropriately qualified teachers, and reviewing the performance of the teachers. This is no different to any investment decision, where the ultimate objective is expedited by access to the appropriate resources, and review process. When we come to religious education there is the real risk that the end objectives of that education may run into the objectives of the state and damage the state’s chances of achieving its objectives.

Emergence of madrassah in Thailand a consequence of neglect

The Kingdom of Thailand is a secular state with a significant Islamic population. Education in its southern provinces is handled by a combination of state-regulated and religious-supplemented schools. The growth of *madrassah* - also called *pondok* or *ponoh* - has been encouraged by the under-allocation of educational resources, but they have nonetheless evolved in their own right as a significant medium of religious education for Moslems.

Thailand leaving education in south to chance

Predominantly Buddhist Thailand recognises that diversity of human capital generates incremental wealth for the community. It does not, however, participate in religious education, leaving Buddhism to the monks and Islam to the Imams. As a consequence of an underfunded education system in its southern provinces, curriculum and teachers have been largely left to chance, with the result that many anomalies have arisen in the type of education being given, among them that which is being taught in some *madrassah*. Outputs are being distorted, thwarting the educational objectives of the state.

No state-imposed system

There is no comprehensive, state-imposed education system in Thailand, leaving the *madrassah* outside decisions on school buildings, teachers and curriculum - the three “Ps” of premises, people and product. In economic terms, investment in such education is not subject to expected standards of good governance, and consequently runs the risk of being inefficient.

Output of *madrassah* may run contrary to state objectives

In addition, if the outputs of *madrassah* education are contrary to the state’s objectives, the consequent disruption has a detrimental effect on economic activity. As the Thai economy operates in accord with neo-classical principles, it similarly follows that such *madrassah* outputs are incompatible with neo-classical economic philosophy and as they currently operate are both harmful to the operations of the Thai economy and cannot allow the emergence and development of the south’s latent talent. This in itself contradicts Islam’s fundamental tenet of the obligation to exploit resources to the fullest extent possible and to ensure their equitable distribution.

Want do madrassah teach?

The type of education on offer at some *madrassah* is currently the subject of considerable debate in such “mainstream” Islamic countries as Pakistan but also the secular West. The non-ministerial Office for Standards in Education in the UK inspected Moslem schools in January 2005 and one of its officials, Laura Peek, was quoted in the *Daily Mail* of 30 August 2005 as saying:

. . . inspection teams uncovered evidence the education at many Muslim (sic) faith schools was too ‘narrowly focused’. They need to do more to teach about core British values such as democracy, women’s rights and tolerance of non-traditional families. He (Ofsted head David Bell) called on the government to monitor Muslim faith schools to make sure pupils were being taught about ‘other faiths and the wider tenets of British society’.

The study and understanding of Islam

The schools serve a specific purpose - to study and understand Islam - and are staffed by teachers themselves trained by these schools. Curriculum is internally regulated and not subjected to independent audit. The source material is the Koran, as interpreted by the particular school in question.

Danger of generalisation

There is a danger of generalisation. The majority of *madrassah* are much like the schools funded by Christian churches in that religious education is ostensibly kept separate from the "3Rs". However, the schools can be used as a conduit to move beyond study into a 'reeducation' stream, emphasizing methods deemed to further Islamic ideals in the minds of the students.

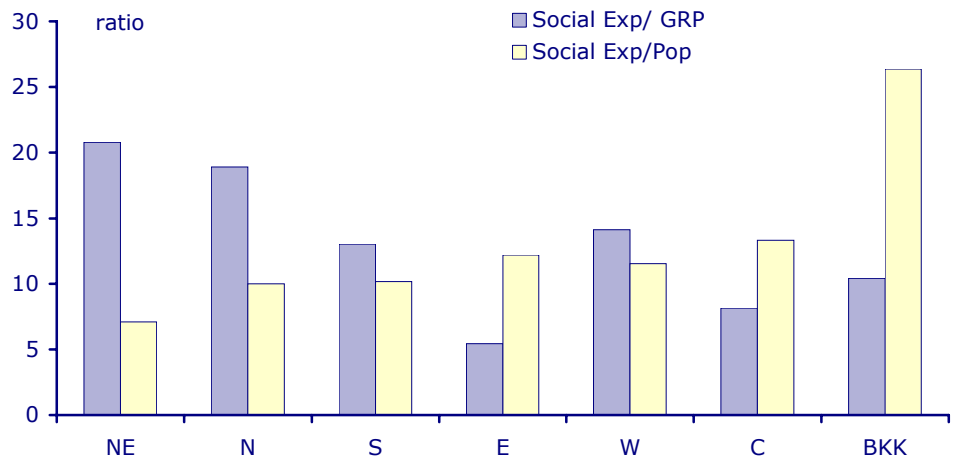
Thailand has wealth . . .

Thailand has a well developed economy that relies on an independent judiciary and the pricing mechanism. Through that economic fundamental it avoids much misallocation of resources, and has demonstrated the capacity for sustained growth. One of the consequences of such growth is the raising of standards of living across its populace. The Thai peoples have become wealthier, healthier and better educated in the process. Resources have been more effectively exploited and distributed. The key enabling factor has been a democratic secular state and an increasingly independent judiciary.

South is disadvantaged in social receipts

Figure 2

Social expenditure by region



Source: NESDB, Thailand

. . . and can accommodate Islam . . .

For all the hyperbole expounded by clerics on the merits of fundamentalist Islam, and its superiority as a medium for achievement of Allah's wishes, the gains achieved by the Thai approach seem to have achieved a better and less painful outcome, and more likely to achieve Allah's core guiding principles.

. . . but only with reconciliation of goals

The solution to efficiency and satisfaction of Allah's wishes lies in Islamic hands. As we have seen, the impediments to efficiency and to reconciliation of economic practice within Islamic societies with the neo-classical economic model are within the grasp of Islamic societies.

Southern Thailand has strong community commitment

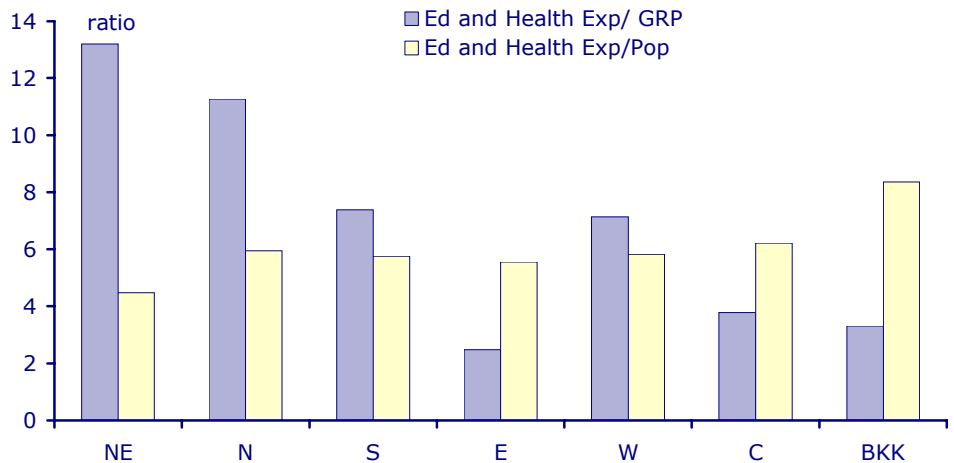
The south has shown community commitment in creating its *madrassah* network, which is in many ways the most democratic region of Thailand. The issue is that the network's outputs are not aligned to the needs of the state, and the link between education and productivity enhancement is being broken by the very tool - the *madrassah* - that the community had hoped would plug the gap created by inadequate state spending on education.

South is not disadvantaged in education and health receipts . . .

This repudiates the two claims the *madrassah* have that their region is being underfunded relative to other Thai regions, and that local autonomy will lead to improved social expenditure. The fact is the south is a net beneficiary, at the expense of Bangkok and the eastern seaboard, through the transfer of wealth into the south.

Figure 3

Health and education expenditure by region

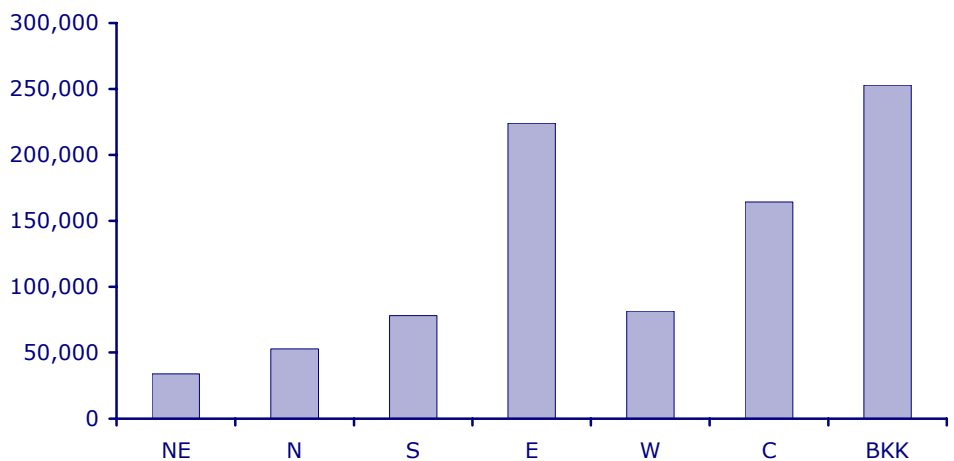


Source: NESDB, Thailand

Budget expenditures are very autonomous, are not subject to close scrutiny, and are clearly not being applied to investment enhancement, particularly to the opportunity of southern people to add dignity to their earning potential. The real question is why the south cannot transfer this advantage into better socio-economic outputs, which brings us back to the question of the role and efficiency of the *madrassah*-based education system.

Figure 4

Per capita gross regional product (GRP) – 2004 (baht)



Source: NESDB, Thailand

. . . but social expenditure is not realised in Southern regional output

Secularism needs to be reinforced in an open and efficient economy

Adaptation more efficient than confrontation

Aligning education with broader needs

Implications for Southeast Asia

To make a start in Southeast Asia, reinforcement of the stated government principles of secularism on the path to more open and efficient economies is required. Changes will be required, many involving some form of political transition. It has been observed that growth cycles occurred in 50% of countries when there was political transition - perhaps a pre-condition in the transformation of Islamic behaviour where focus moves from violence to prosperity.

Without this change it will not be possible to exploit resources optimally (in accordance with Allah's wishes) nor realise Allah's wishes. Change, with appropriate economic incentivisation, is far cheaper than fight. Economic underperformance and commensurate poverty breed unrest and discontent, and economic underperformance is a given without change. The status quo is the recipe for continued underperformance. Noted US economist Larry Summers, giving the 2003 Godkin Lecture to Harvard University's John F. Kennedy School of Government, gave this perspective on neo-classical growth:

[The] rate at which countries grow is substantially determined by three things: their ability to integrate with the global economy through trade and investment; their capacity to maintain sustainable government finances and sound money; and their ability to put in place an institutional environment in which contracts can be enforced and property rights can be established. I would challenge anyone to identify a country that has done all three of these things and has not grown at a substantial rate.

Recommendations for action

The following brief set of recommendations is a good starting point.

1. An overhaul of the *madrassah* educational system

The state has an obligation to its constituents to ensure its education system is aligned with the broader needs of the state. An important element of that system in Islamic communities is the *madrassah*. As things currently stand, the *madrassah* outputs are misaligned, and meet only the narrow needs of The Theocracy at the expense at the state's wider needs. Without educational reform the status quo will persist, the costs to the state will continue (to grow), economic underperformance will persist, and Islamic communities will continue to fail in their attempts to meet Allah's requirements of efficient resource exploitation and equitable distribution. Noor Huda Ismail, a research analyst at Singapore's International Centre for Political Violence and Terrorism, recalls:

We never sang the Indonesian national anthem; the only music we heard at the school was *nasyid*, Arabic religious songs, from loudspeakers in the corners of the school buildings. The wall hangings that adorned our Spartan dormitory have Arabic calligraphies, such as: 'Live as a noble man or die as a martyr'.

Curriculum

An immediate overhaul of curriculum is needed to ensure education provided meets the needs of not only religious study, but more importantly the needs of the wider community, Islamic and non-Islamic. Accompanying texts are also to be included, to encourage consistency across societies.

Teachers

Uniform training, assessment and review of teachers are required. As things stand individual schools, heads and the teachers themselves are lacking consistent guidelines on what their teaching objectives are, and how well they are doing at fulfilling their teaching obligations. They lack reference to the state, and society as a whole.

School environment

The school environment is completely ad hoc, with no common minimum standards for buildings, for hours of operation, for classroom conditions and student conditions.

Accreditation

A proper system of accreditation is lacking at present, for both schools and for graduates. Formalization of minimum standards, assessment of those standards and assessment of graduates' performance post-schooling will raise the overall standard, place some objectivity into the process, and link the performance of schools with the needs of the state. Noor Huda Ismail says:

Like the majority of my fellow alumni, I opted for a successful career in the secular world. In our daily lives, we have to acknowledge a pluralism that is not consistent with a strict interpretation of Islam. In fact, of the 88 percent of Indonesians who are Muslims, most lead secular lives.

Independent judiciary enhances economic performance

2. Development of an independent judiciary

Flowing from reform of the educational system is the role of the judiciary, and its independence. Optimisation of economic performance demands efficiency in the flows of goods and services within and through an economy. Any avoidable impediments to such flows will reduce efficiency. A key element to promote efficiency is an independent judiciary which underwrites access to clear title to the goods and services being exchanged. Such a judiciary stands apart from underlying Theocratic and other interests as an independent judicator, and the comfort such independence accords to the exchanges provides confidence in the durability of future exchanges, and the likelihood of fair settlement in the exchange process. Absence of such a judiciary clearly removes confidence, and commensurate efficiency.

Remove corruption

One of the greatest challenges is to change the prevailing culture of a state. As Indonesia is demonstrating, it is possible to force change to practices that have evolved over years of inefficiency, where payments to expedite inefficiencies become institutionalized, but it requires absolute commitment at all levels, commencing at the top

Enhance training of judiciary

It is one thing to create an appropriate legal environment by the passing of laws, but another to have human resources trained to appropriately implement those laws. This requires the creation of appropriate training at the tertiary level, and a staged working environment where skills can be honed under the tutelage of the more experienced, from within and outside the relevant society.

Competitive, merit-based remuneration

Thailand has learned, as it proceeds to implement its relatively recent bankruptcy laws, that it is important to remunerate competitively if it wants to attract appropriate talent to the judiciary. This means dealing with governmental pay scales, often linked to tenure not performance, and instituting an environment of merit-based pay scales, subject to transparent and timely review.

Make laws relevant

It is one thing to pass laws, but unless those laws reflect the prevailing and desired mores of a pluralist society, any amount of implementation will fail. This starts with education. Failure to ensure the education system produces greater society's graduate outcomes guarantees the judiciary will fail to achieve greater society's desired objectives.

Recognising the role of money as the dominant means of exchange

3. Create efficient capital markets

Flowing from the comfort an independent judiciary applies to the exchange of goods and services is the need to securely and confidently underwrite those exchanges. Money is the medium of exchange, and in the same way goods and services are bid and clear subject to market forces, so does money. Persistence with beliefs that hail from a time of limited involvement of money in the exchange of goods and services (for example, at the time the Koran was written) is a clear abrogation of responsibility if one is to see resources exploited to the maximum extent possible. And to facilitate the clearing process requires greater sophistication, increased simplicity and reduced costs in the clearing process. This is achieved through markets based upon the independence of law, and staffed with appropriately skilled individuals.

Money market

To enable long-term capital formation requires a bond market and bank lending. Persistence in banning interest frustrates the money market's efficiency. But to achieve efficient practices requires the minimum of unnecessary regulation and documentation, and requires minimum standards, benchmarking and transparency.

Currency market

Unless the cross-border exchange of goods and services is expedited by an efficient and open foreign exchange market, inefficiencies which inhibit the full exploitation of resources will exist, and commensurate speculation will lead to destructive, rather than constructive, investment.

Inflation management

Unless an economy's inflation rate is predictable and low, business and individuals cannot make rational economic decisions. Therefore, money supply must be managed to ensure a constant and predictable level of inflation in the economy.

Transparent interest rates

The demand for and supply of money is guided by interest rates, either overtly or covertly, on which are based optimal investment decisions. So interest rates must be transparently set by the market to permit efficient investment decision-making, and the consequent efficient allocation of all resources in the economy.

Market-guided investment

Whether it is an investment in education or a new power plant, it must be an investment in the future, hence it must be guided by what the market needs. Government-led investment must support the basic needs of industry.

Break destructive nexus

For a responsible path toward better achievement of Allah's wishes through efficient capital markets as an efficient resource exploitation vehicle, it is incumbent upon governments to break the destructive nexus of "out-of-control" *madrasah*.