Islamic Finance Project
Harvard Law School
Islamic Legal Studies Program

Harvard Law School Islamic Finance Panel
October 12, 2010

The Impact of Islamic Finance on Economic Development: A Roundtable Discussion

The Islamic Finance Project and Islamic Legal Studies Program of Harvard Law School organized a panel discussion in Austin Hall on October 12, 2010 entitled ""The Impact of Islamic Finance on Economic Development". The overarching goal of the seminar was to promote a more critical and informed discussion on a topic of growing scrutiny and relevance in recent years.

Growing socioeconomic challenges, such as overpopulation and income inequality, threaten to undermine current development efforts and push developing countries, particularly in the Middle East, further behind in their state-building goals. With many losing faith in the efficacy of the conventional financial system, particularly after the recent global economic crisis, the potential role of Islamic Finance in providing a complementary or alternative framework for development efforts has been suggested. The seminar provided a forum to further explore the plausibility and desirability of such a role for Islamic Finance.

The seminar featured a distinguished panel of practitioners from the Islamic Development Bank and academic from Tufts University who provided their insights on the topic, allowing for an appreciation of both the theoretical and functional aspects of the field. Together, the panelists and audience engaged in a rich discussion on the de jure and de facto role of Islamic Finance on economic development.

The session began with a brief overview of the topic and introduction of the panelists by Samuel L. Hayes, III, Jacob H. Schiff Professor of Investment Banking, Emeritus of Harvard Business School. After recognizing the historical importance of economic development to Islam and its importance in the future of development, he provided a history of the Islamic Development Bank (IDB) of Jeddah which is recognized as a premier leader in the field of Islamic Finance.

Ahmed Mohamed Ali, President of the Islamic Development Bank, began the discussion with an overview of the key principles of Islamic Finance that distinguish it from conventional banking and make it particularly competent to promote economic development. He focused on three tenets of Islamic Finance: risk sharing, asset creation, and charitable initiatives. Given the many uncertainties associated with economic development, risk sharing ensures that both parties are impacted to the extent of their investments and no one party is left bearing the brunt. Meanwhile, the requirement that debt creation be tightly linked to asset creation encourages real transactions that imp productivity and thus create wealth. Uncontrolled credit expansion is recognized as a primary cause of economic crashes and bubbles, but Islamic Finance can control credit expansion and thus minimize the frequency and severity of financial crises with such principles. The central role of nonprofit, philanthropic activities in Islamic Finance is also _; economic development cannot be achieved by the market alone, and zakat works as a safety net for those who cannot fulfill their financial obligations. In these ways, Islamic Finance can not only protect the state from financial crises and downturns, but also promote economic development.

The next speaker was Umer Chapra, an adviser to the Islamic Development Bank. Chapra provided further analysis into the unique ways in which Islamic Finance can create a more secure and stable economy. He discussed how excessive and imprudent lending were the primary causes of the financial crisis and bound to occur under the conventional finance system; Islamic Finance, however, injects greater discipline into the financial system and forces banks to be more careful in their lending which ultimately make it more conducive to stability than the conventional system. Nonetheless, financial crises are often inevitable realities and Islamic Finance is not uniquely safe from the effects of such global phenomena.

Ibrahim Warde, Adjunct Professor at Tufts University, was the final panelist speaker. Like Chapra, he warned that it is important to understand that Islamic Finance is not a panacea for all of the financial ills facing the world today. He noted the gap between the de jure principles of Islamic finance and their de facto implementation in Islamic Finance institutions, lack of standards and industry best practices, and association of anything Islamic to terrorism as specific hurdles impeding the progress of Islamic Finance and its potential impact on economic development.

Following the presentation of the panelists, Samuel Hayes opened the floor for questions. He began the Queston & Answer session with three questions of his own. The first was whether Islamic Finance defines economic development any differently than conventional financial systems. Ahmed Mohamad Ali did not find any significant difference in its definition, while Chapra and Warde noted that the attention given by Islamic Finance to the human side of development is unique. Hayes' second question asked about the relationship between the IDB and the least developed countries. In response, Ali and Chapra noted that most Muslim countries are in fact amongst the least developed countries and Islamic Finance gained prominence there. The third question inquired about the direction Islamic Finance, and especially the IDB, is taking economic development. The speakers discussed awqaf and how it has been used to build roads, hospitals, and other infrastructure, as well as grants given to microfinance institutions that have allowed the development of successful businesses.

An audience member also provided a critical assessment of their arguments, noting that the speakers drew on three assumptions which may be flawed: 1) crises emerge from perverse incentives; 2) when banks bear risks, they will lend more responsibly; and 3) greater risk sharing helps the entire industry. She noted that risk was shared widely in the recent financial crisis, yet banks still lent widely, and that much of the cause of the crisis can be attributed to the shadow bank system—namely, the lack of transparency, understanding of risks and financial instruments, and the lack of information about borrowers. Other questions dealt with the topics of corporate social responsibility and institutionalization of the industry. Such engaged debate was indeed a primary goal of the organizers and lent itself to a more robust discussion of the topic.