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GLOBALIZATION OF FINANCIAL MARKETS AND ISLAMIC FINANCIAL INSTITUTIONS*

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In this paper, I reflect on the implications of financial globalization for Islamic financial institutions in terms of coordinates selected from both history and theory. I present in outline the 18th century case for and against commerce, the 19th century case for and against a central institution acting as a lender of last resort, and modern theoretical developments in finance and insurance based on the law of large numbers and centered around the notions of arbitrage, naive and efficient diversification of risk, moral hazard and adverse selection. I argue that an informed understanding of the processes of globalization is a necessary prerequisite for charting out the impact on current financial institutions, and perhaps more importantly, on the development of future institutions based on Islamic values and assumptions. At the same time, I argue that this prerequisite also deepens and enriches our understanding of the values themselves, and thereby, through their derivation, leads to a closer and more-informed reading of the canonical text itself. As such, I question the extent to which the financial aspects can be bracketed, and argue for a lack of closure in what must be a mutually illuminating and necessarily interdisciplinary enquiry.

I. INTRODUCTION

In this paper I deal with the implications of financial globalization on Islamic financial institutions. At a practical level, one can understand financial globalization to be simply the removal of impediments to the international flow of capital, and use one or more currently existing Islamic banking institutions as concrete proxies of an Islamic financial institution. Even if one begins at such a level, the subject inevitably goes beyond a mere cataloguing of the changes in the

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description of day-to-day banking procedures to more fundamental questions concerning commerce, markets, society, governance, risk, and individual motivations. I shall therefore not begin at the level of practical detail, but move directly to the question in its broader philosophical context.

My starting point is simply to view globalization and Islamization as processes that are ongoing; the former encompassing the full range of technological and institutional changes that are occurring in the world today, and the latter drawing its meaning from the adjective Islamic as it pertains both to current institutions as well as to potential ones to be developed. Thus, moving from the practical to the conceptual, I have to develop a framework for the understanding of these processes, and how they impact on each other. Does Islamization lead to globalization or arrest it? How about the other direction? Does globalization lead to Islamization or arrest it.

It is clear that our views on these propositions depend crucially on what we understand by these terms. The question then is how is such an understanding to be obtained. Can financial aspects be bracketed from them and studied in isolation? What range of meanings do they carry with them? And how are they linked to other processes such as modernization, privatization, liberalization, and democratization? Is globalization a positive development? A goal towards which we must strive; or is it negative development? A phenomenon which is destructive and whose destabilizing character must be checked and guarded against. Does it promote welfare? And if so whose? How does it impact on the nation state? And what does one understand by the Islamic ethos? How is it to be formalized and represented? How are abstract principles to be interpreted in terms of concrete details? Have Islamic texts have anything to say about commerce? How can we go about investigating these questions?

In this paper, I offer three complementary approaches to my subject; historical, theoretical and cultural. Under the heading of a historical background, I look at reactions to globalization at two different “points” in time: the differing intellectual response to the effects of commerce in the eighteenth century: and the equally divergent institutional response to capital movements in the nineteenth century. The first involves what has come to be called the Scottish Enlightenment, and the second concerns the debate on the role of central financial institutions as stabilizing and insuring agents. Under the heading of a theoretical background, I look at modern welfare economics, and then at questions of the allocation of risk and risk management as its corollary. The former represents a body of knowledge that deals with a comprehensive and well-articulated model of the allocation of resources generated by decentralized, self-promoting actions of a large group of agents constituting a particular society; while the latter involves asset pricing models and the pooling of risks for a given society. Under the first, I consider problems posed by moral hazard and adverse selection, and under the second, the theoretical distinctions between idiosyncratic and systematic risks, and between naive and efficient diversification. Finally, under the heading a cultural background, I attempt to identify what appears to me to be defining characteristics of an Islamic ethos, particularly as it relates to my subject, and then turn both to the anxiety which Islamic economics and Islamic financial institutions provoke, as well as attempts by particular thinkers to take a more pluralistic and liberal point of view regarding societies whose aspirations take off from different axiomatic conceptions.

Any categorization is suspect. Our approach to historical episodes is colored by the theoretical framework and cultural assumptions that we bring to it. A theory is a stylized attempt to explain an empirical real-world phenomena, and the retrieval of our own past is indispensable when we try to articulate what we see to be our cultural ethos. This paper then is simply an argument for the relevance of my arrangement and choice of material. I bring together what is normally kept separate under different disciplinary boundaries, and use this presentation as a criticism of those boundaries. Arguably, the coherence and novelty of my table of contents is as important as the particular conclusions that I hope to obtain from it. I present a research program of study, and show the type of answers and bases of judgment that it'll allow us to make. I cast my net wide, and make demands on the reader by presenting him/her with necessarily incomplete and fragmentary descriptions of a variety of materials. But once the relevance and coherence of the topics are established, future work can return to each of them with the additional care and detail that they deserve.

II. HISTORICAL BACKGROUND

I begin by going to the past, and, in particular, to two aspects of this past. First, I want to mention how commerce and globalization were conceived in the writings of what is now termed the Scottish Enlightenment. Since this represents the founding moment of modern "economic science", I submit that our understanding of globalization would be seriously incomplete without this background. Second, I turn to the nineteenth century and the debate on the course of action a financial institution should take-more specifically, whether or not the Bank of England should act as a lender of last resort.

1. INTELLECTUAL RESPONSE TO GLOBALIZATION IN THE EIGHTEENTH CENTURY

It was the writers of the eighteenth century England, Scotland and France that first tried to come to terms with the impact of commerce and globalization on the society that they lived in. In the words of Pocock (1975; p. 461), "The Augustan Journalists and critics were the first intellectuals on record to express an entirely secular awareness of social and economic changes going on in their society, and to say specifically that these changes affected both their values and their modes of perceiving social reality." The debate on land, trade and credit, and the subsequent writings of Hume, Tucker, Smith, Rousseau, Condorcet and Burke loom particularly large in this development. I turn to the trajectory of this debate, and begin by placing its key terms in the context in which they ought to be read.

1.1 Languages of Civic Humanism and of Civil Jurisprudence

I begin with a point that hardly needs emphasizing namely, the difficulty - indeed, the indeterminacy - of translation. This pertains as much to two languages at the same point in time as to the same language at two different points in time - the synchronic versus the diachronic. The basic thesis then is that there are two such relevant languages and vocabularies - the language of *civic humanism* and that of *civil jurisprudence* - and both are used to launch attacks on a regime that is committed to commerce and to the free movement of capital. The question is what are these languages and what are their concepts and keywords? How is one to understand these keywords, and what light do our understandings shed on current concerns about globalization

Consider first the vocabulary of *civic humanism* whose crucial terms are *virtue* and *corruption*. The language focuses on the triad *virtues, rights and manners* or alternatively, that of *liberty*, *justice and commerce*, and involves the oppositions: *virtue-fortune*, *virtue-corruption*, *virtue-commerce*. It is important to understand that the term *virtue* does not simply refer to morally desirable practices but to those of *citizenship* in the classical or Graeco-Roman sense of the term. In trying to identify and understand this sense, one has to focus on *polis, respublica, zoon politikon*. These important words have to do with the material and moral preconditions of citizenship. A citizen was virtuous because he was the master of his household, a proprietor of arms, and possessor of property, which would bring *independence* and *leisure* rather than *profit and luxury*. He was *independent* and a direct participant in his government. By delegating these activities to others, he lost his autonomy, and thereby his virtue, and we shall see how this theme is taken up by Rousseau. Property in its *natural* form was represented by land, and it was a precondition for Leisure, citizenship, self-mastery and virtue. Equality between citizens was not mediated by land, and the "prime function of property was political rather than chrematistic". Harrington emphasized "agrarian balance".

On the other side of the scale, it is important to understand that term *corruption* did not primarily have a moral connotation but was engendered by employment of patronage, credit and commerce in the service of parliamentary monarchy. The growth of commerce and culture was a consequence of a *specialization* of functions, which led the warrior-freeman to entrust government and defense to professionals. "Growth of commerce was... associated with the growth of oligarchy, an expansion of dependency long past the point where dependency became corruption." Thus, "history in the civic paradigm was understood... as the struggle of civic institutions of republican self-government to survive the cycle of corruption initiated by the republic meeting its *fortuna*." In such an account, if a society's individuals were suffused with civic virtue, the society as a whole could be virtuous. The social structure as such could be moralized.[1] The crucial characters here are Harrington and the neo-Harringtonians: Henry Neville, Andrew Fletcher of Saltoun.[2]

The writers of the Scottish enlightenment used commerce and the market to over-turn this proposition. By emphasizing unintended consequences of actions, they responded to the claim that division of labor, and the attendant problem of specialization and narrow privatized and conditioned social personalities, led to corruption. This was their crucial motivation, rather than the question of the state regulation of the economy. In their counter-claim, "individuals could be virtuous, but the society as a whole, as the unintended outcomes of discrete acts of self-interest, could not be virtuous." They replaced *polis by politeness*, and *oikos by economy*, and in their vindication of aristocracy in its Whig form, and their defense of a commercial society, inaugurated the founding moment of the "science" of economics. Their move was directed against *ancients* than against Christians, and for them *corruption* of *virtue* explained the decay of the ancient world but was irrelevant to the diagnoses of the modern. Their opposition was to *traditional* and *feudal* rather than to *bourgeois*, and they saw the political a consequence of economic and cultural rather than the other way. They focused on fanaticism, and on the fanaticism of virtue and religion, in particular. What was emphasized was *civility* and *manners*: polite conversation and enlightened taste. Complex exchange relationships led to "softening of manners and refinement of passions. In terms of a schematic treatment, civic → civil; political/military → economic, cultural. Moral - social for short; Fletcherian patriotism → Addisonian politeness; ancient → modern.

[1] See Hont-Ignatieff (1983, p.44).
[2] See the writings of John Pocock.

The defense of commerce in the writings of the Scottish Enlightenment was conceived not only with the instruments furnished by the vocabulary of *civic humanism*, but also with the conceptual vocabulary of the language of *civil Jurisprudence*. A dual conception of property-possession and civic virtue versus exchange and civilization of passions-did not constitute the only "major key to eighteenth century social thought;" the other was provided through the lens of jurisprudence and the language of rights and Justice. This was the tradition of thought that began with Aquinas, and in which the writings of Grotius, Pufendorf and Locke loomed large. The problem was how to reconcile need property claims against need claims.

> If property had to serve the interest of all human beings and not merely the propertied, how were those excluded from the means of subsistence to satisfy their needs? A consistent theorist was required by this question to engage with the legitimacy of the money system in which the subsistence goods of the have-nots were priced. What was the 'just price' at which such goods should exchange in the free market? Hont-Ignatieff (1983: 35).

The key move here was again commerce - a market solution to the problem - one that took the world, in particular the existing distribution of property as is, such a solution insisted that "a world before 'mine and thine' was a distant historical chapter of no direct relevance to the modern world." As I shall mention below, the Arrow-Debreu-McKenzie general equilibrium model - the representation on which the modern defense of globalization and commerce rests - also takes the initial allocation as given. Indeed. Debreu (1969) italicizes and uses the term *a prior* six times in the relevant chapter. In summary, the claims of the propertied and those of the excluded could be achieved by "shifting the terms of analysis from a language of rights to the language of markets."

Having supplied the basic vocabulary of this debate, I now turn to selected and specific conversations.

1.2 Swift, Defoe and the 'Moneyed Interest'

In this section, I turn specifically to the question of finance. In his analysis of the early eighteenth century debate over land, trade and credit, Pocock (1975: 442) writes, "Credit, to observers of the new economics, symbolized and made actual the power of opinion, passion and fantasy in human affairs, where the perception of land (until it too was completely eroded by speculation) might still appear the perception of real property and human relations as they really and naturally were. Credit typifies the instability of secular things, brought about by the interactions of particular human wills, appetites and passions (p. 453)." The point to be noted here is that the *virtue-fortuna* dichotomy now took the form in which credit was seen as a representation of *fortuna.*

Defoe is an interesting writer because he defends what I am broadly calling globalization here, and attempts, in response to Swift, to "show how opinion and passion might be grounded upon experience rather than imagination, and become the means of recognizing the real goods of society and the real sociability of men (p. 459)." However, he is at the same time also well aware of the dangers. To get an idea of this ambivalence, we can look at two passages. First, a definition of credit.

> Money has a younger Sister, a very useful and officious Servant in Trade, which in the absence of her senior Relation, but with her Consent, and on the Supposition of her Confederacy, is very assistant to her; frequently supplies her place for a Time, answers all the ends of Trade perfectly, and to all Intents and Purposes, as well as Money herself: only with one Proviso. That her Sister constantly and punctually relieves her, keeps Time with her, and preserves her good Humour: but if she be never so little disappointed, she grows sullen, sick and ill-natur'd, and will be gone for a great while together: Her Name in our Language is cal'd CREDIT, in some countries Honour, and in others, I know not what.[3]

The crucial point that I wish to emphasize about Defoe's representation is that it sees credit not only as a servant of trade but also as a proxy for honour. The following passage pushes this latter equivalence further.

> "Credit is not dependent on the Person of the Sovereign, upon a Ministry, or upon this or that Management: but upon the Honour of the Public Administration in *General*, and the Justice of *Parliaments in Particular*, in keeping whole the Interest of those that have ventured their estates upon the Public Faith" (p. 455).

In more modern terminology, what is being stated is that the creditworthiness draws from the good governance of that society. If this condition is not satisfied, and there is corruption (now using the term in its more modern sense), the society is in difficulties irrespective of its resource base. To quote Defoe again,

> "Credit is too wary, too Coy a Lady to stay with any People upon such mean Conditions; if you will entertain this Virgin, you must act upon the nice Principles of honour, and Justice; you must preserve Sacred

[3] See Pocock (1975; p. 452).

> all the Foundations, and build regular structures upon them; you must answer all Demands, with a respect to the Solemnity, and value of the Engagement; with respect to Justice, and Honour; and without any respect to parties - if this is not observ'd, Credit will not come; No tho' the Queen should call; tho' the Parliament shou'd call, or tho' the whole nation should call" (p. 455).

The question now reduces to expectations and what is real and what is an illusion - the extent to which an asset's rate of return reflects its contribution to the productivity of the economy rather than the contribution of capital gain (or loss) arising from the opinion in which the asset is held. It is to capture this latter aspect that credit is seen as an "inconstant female figure" and her malignancy and irrationality emphasized.

It was Swift who followed Davenant and expanded on the theme that "corruption took the form of credit." The term "moneyed interest" is his, and it was invariably defined in terms that included merchants but excluded financiers. When credit is characterized as something that "hangs upon opinion and depends upon our passions," what is being asserted is the perception that under globalization,

> "...everything - including the value of land itself - depends upon the rate at which capital can be got; [and] this in turn depends on men's confidence in one another, and that this again, while in the long run it depends upon their perception of moral and material realities, is in the short run determined by opinion and passion, hope and fear, which render it peculiarly exposed to manipulation by corrupt speculators in the paper tokens to which it has been reduced" (p. 451).

Pocock (1975: 457) summarizes this notion of how credit "comes unsought for and goes away without reason. Nor was credit a mere observer and reflector of the universe; she helped to shape it. Given all the resources of a virtuous society credit could coordinate them on a greater scale than ever before in history; but she contributed nothing beyond fantasy, opinion and passion to making society virtuous in the first place. Virtue must involve the cognition of things as they really were; the power of credit was irremediably subjective and it would take all the authority of society to prevent her from breaking loose to submerge the world in a flood of fantasy."

I shall conclude this section by asking how far modern economic science has gone beyond this representation of credit?

1.3 Hume and the Case for Commerce

In terms of a provisional summary, the argument as I have developed it so far, revolves around the basic propositions connecting individual and social virtues and justice and basic needs. The writers of Scottish Enlightenment use the language of civic humanism to emphasize how the individual vice of greed can be used, through the mediation of' commerce and the market, to lead to social virtue. They also use the language of civil jurisprudence to emphasize how commerce and the market can reconcile needs and private property once the status quo is accepted as it is. Arguably, the most crucial in developing both of these arguments was David Hume. Indeed, there is now a veritable cottage industry devoted to Humean studies as they pertain to philosophy, politics, economics and history - in short, to the human sciences as a whole. However, a paper on financial globalization would be seriously incomplete if it not draw attention to his nine essays pertaining to what can now be seen to be economics.

These nine essays have been collected in Rotwein (1955). The essays titled “Of the Balance of Trade” and “Of the Balance of Trade” come closest to the subject of this paper. In current terminology, they deal with the beneficial consequences of unimpeded trade and capital movement, and drew a vigorous response by Josiah Tucker. The essays titled “Of Money” and “Of Interest” delve more deeply monetary considerations, while those titled “Of Taxes” and “Of Public Credit” consider issues arising from the presence of national debt. However the general case for commerce and for luxury - an answer to Harrington and the neo-Harringtonians, if one likes - is made in his essays titled “Of Commerce” and “Of Refinement in the Arts”. The final essay chosen by Rotwein is devoted to population policy, and is titled “Of the Populousness of Ancient Nations.”

I hope to have an opportunity for drawing the implications of these writings from a more detailed and complete reading; the point that I wish to emphasize here is that in their treatment and coverage they already underscore the principle that I am attempting to establish. This is the view that the “material” has to be discussed jointly with the “moral”, and even one holds the view that one cannot proceed with any analysis without limiting the inquiry, the analytical enquiry is seriously incomplete if it is not replaced and read in the larger context from which it was extracted. What Hume showed above all, limited though it was to the Scottish context, that economic development and political institutions belong in the same discussion.

1.4 The Encounter between Rousseau and Smith

Adam Smith as a defender of the market and of commerce well-known even to economist without an interest in the history of their subject. However, I want to introduce him to you opposite Rousseau. This is an encounter between one of capitalist society's most penetrating theorist and one of its most perceptive critics. Both were steeped in the civic humanist and natural jurisprudential traditions and both shared a common view of history; nevertheless, they held two entirely different views of the same reality. Whereas Smith saw commerce and globalization as an answer to the problems of the human condition. Rousseau saw it precisely as one of the problems plaguing it.

I begin with Rousseau:

> "But from the instance in which one man had assistance of another, from the moment he perceived that it could be advantageous to a single person to have provisions for two, equality disappeared, property was introduced, labor became necessary, and the vast forests of nature were changed into agreeable plains, which must be watered with the sweat of mankind, and in which the world beheld slavery and wretchedness begin to grow up and blossom with the harvest."[4]

Smith, on the other hand, gives his view of globalization, and writes in the *Theory of Moral Sentiments*,

> "It is this which has first prompted them to cultivate the ground, to build houses, to found cities and commonwealths, and to invent and improve all the sciences and arts, which ennoble and embellish human life; which have entirely changed the whole face of the globe, have turned the rude forests of nature into agreeable and fertile plains, ad made the trackless and barren ocean a new fund of subsistence, ad the great high road of communication to the different nations of the earth." Smith (1982: 183-184).

Their views on the causes of inequality were also widely different. After the claim that the market has to be supplemented by institutions, and that the "political" cannot be bracketed, Rousseau writes:

> "How many conditions that are difficult to unite does such a government pre-suppose! First, a very small state, where the people can readily be got together and where each citizen can with ease know

[4] See Ignatieff (1985; p. 111).

> all the rest; secondly, great simplicity of manners, to prevent business from multiplying and raising thorny problems (which would have to be resolved by delegation to experts); next a large measure of equality in rank and fortune, without which equality of rights and authority cannot long subsist; lastly little or no luxury - for luxury either comes of riches or makes them necessary; it corrupts at once rich and poor, the rich by possession and the poor by covetousness; it sells country to softness and vanity, and takes away from the State all its citizens, to make them slaves one to another, and one and all to public opinion."[5]

It is of course with Hume that the contrast on luxury is sharpest, the even in Smith's writing, the totally different vision is palpably clear. It is basically a liberal vision from which spring all the modern theorems of welfare economics.

> "The rich only select from the heap what is most precious and agreeable. They consume little more than the poor, and in spite of their natural selfishness and rapacity, though they mean only their own conveniency, though the sole end which they propose from the labors of all the thousands whom they employ, be the gratification of their own vain and insatiable desires, they divide with the poor the produce of all their improvements. They are led by an invisible hand to make nearly the same distribution of the necessities of life, which would have been made, had the earth been divided into equal proportions among all its inhabitants, ad thus without intending it, without knowing it, advance the interest of society, and afford means to the multiplication of the species." Smith (1982: 184-185).

1.5 Burke and the Rehabilitation of Tradition

I conclude my discussion of the intellectual response to globalization in the eighteenth century with Burke. I am interested in him because his writings show in a rather definite way how the major claim of the Scottish Enlightenment was already being overturned by the end of the century. If Hume, Smith and their kin make their case for commerce and globalization as an agent of good governance and of economic development, Burke shows how the latter is a *pre-requisite* for the realization of the beneficial effects of commerce.

To repeat the argument so far, in the classical ideal, independence in arms and land assured a citizen's political virtue, and so the apologists of the commercial order had to develop an alternative ideal. They used political economy as a tool of

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[5] See Ignatieff; *op. cit.,* pp. 115-116).

"ideological defense and moral vindication." I now use Pocock's words to describe this reversal.[6]

> "They did so by characterizing the ancient citizen as an economically under-developed being. Because he lacked the ready credit and cash to pay wage-laborers, he was obliged to exploit the unremunerative labor of slaves and serfs. Because he was not involved in the multifarious social relationships, which only an advancing system of commerce could bring, he could employ his leisure only in active statecraft and war, or in contemplative metaphysics or superstition. His personality lacked the multifaceted refinements ad polishings which arose from encounters with other human beings in a multiplicity of exchange relationships and consumer activities; commerce, it was argued, was the sole agency capable of refining the passions and polishing the manners."

So far, no new ground is covered from what I have been saying. The importance of Burke lies in what follows. I remain with Pocock (1985). "Burke is asserting that commerce is dependent upon manners, and not the other way around; a civilized society is the prerequisite of exchange relations, and the latter alone cannot create the former. The political economists (or 'oeconomical politicians'), the historians of the Scottish school, had ... recognized clerical learning and feudal chivalry as preconditions of the growth of commerce, but Hume, Robertson, Smith, Millar - we may add Gibbons - had all isolated the growth of exchange, production and diversified labor as the motor force which created the growth of manners, culture and enlightenment. Burke characteristically regards this as preposterous, as mistaking the effect for a cause, he insists that commerce can flourish only under the protection of manners, and that manners require the pre-eminence of religion and nobility, the natural protectors of society (p. 199).

"Manners, then offer us a key to his argument, but a strictly progressive theory of manners, such as Burke might have derived from his Scottish acquaintances, presented them as arising, and fulfilling the natural sociability of man, only in the course of the commercialization, refinement and diversification of society. In outlining his differences with 'our oeconomical politicians', Burke declared that manners must precede commerce, rather than the other way round, and that modern European society needed and must not sever its roots in a chivalric and ecclesiastical past" (p. 210).

So we have a complete turnabout here. Burke joins up with Swift writing earlier on in the century and singles out the moneyed interest for condemnation.

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[6] Pocock (1985); pp.195-196.

> "Nations are wading deeper and deeper into an ocean of boundless debt. Public debts, which at first were a security to governments, by interesting any in the public tranquility, are likely in their excess to become the means of their subversion. If governments provide for these debts by heavy impositions, they perish by becoming odious to the people. If they do not provide for them, they will be undone by the efforts of the most dangerous of all parties; I mean an extensive discontented monied interest, injured and not destroyed. The men who compose this interest look for their security, in the first instance, to the fidelity of government; in the second to its power. If they find the old governments effete, worn out, and with their springs relaxed, so as not to be of sufficient vigour for their purposes, they may seek new ones that shall be possessed of more energy, and this energy will be derived, not from an acquisition of resources, but from a contempt of justice."

Indeed, there is now a convergence between the moneyed interest and the *philop-sophe*, and this is hardly accidental - one was anti-nobility and other anti-religious. This is now a very interesting theme, and it constitutes part of the case that Burke was to develop regarding the causes of the French revolution. What is important is to emphasize that the impact of globalization on financial institutions, and on society more generally, is not simply a question that has arisen in our modern present and can be simply answered using the tools and advances of "economic science". Such a treatment gives an appearance and precision to a subject, which it simply does not have. On the contrary, the claim that I hope to keep emphasizing throughout this paper is that my subject can only be studied in the context that involves going back more deeply into what we conceive of as a way of life - what in Arabic is referred to by the term *din*.

2. INSTITUTIONAL RESPONSE TO GLOBALIZATION IN THE NINETEENTH CENTURY

When one discusses Islamic financial institutions, natural questions arise as to whether there should be a lender of last resort for the Islamic community, and whether it should "stand ready, under well-defined circumstances, presumably including but not limited to situations of general credit stringency, to lend freely to private other financial institutions, perhaps suspending the normal standards of credit-worthiness; Solow (1982; p. 237)". Further questions then pertain to what are these "well-defined circumstances", what we mean by "general credit stringency", and to what extent are the "normal standards of creditworthiness" to be suspended.

2.1 Bagehot and the Lender of Last Resort

Capie-Wood (1986: p. 3) quote George Stigler to the effect that "If Adam Smith is the Shakespeare of the economics profession in general. Bagehot is certainly the Shakespeare of the financial system". In this section, I produce some canonical passages from Bagehot's 1873 work *Lombard Street*, and leave a detailed and comprehensive treatment of his writings for later work.

> "In common opinion, there is always great uncertainty about the conduct of the Bank: the Bank has never laid down any clear and sound policy on the subject ... The public is never sure what policy will be adopted at the most important moment ... And until we have on this point a clear understanding with the Bank of England, both our liability to crises and our terror at crises will always be greater than they would otherwise be." Bagehot (1873:101).

In another passage, Bagehot returns to the importance of predictable action by a monetary authority - there must be pre-commitment and no lack of credibility about this pre-commitment.

> "And though the Bank of England certainly do make great advances in time of panic, yet as they do not do so on any distinct principle, they naturally do it hesitatingly, reluctantly, and with misgiving. In 1847, even in 1866 - the latest panic, and the one in which on the whole the Bank acted the best, - there was nevertheless an instant when it was believed that the Bank would not advance on Consuls, or at least hesitated to advance on them. The moment this was reported in the City and telegraphed to the country, it made the panic indefinitely worse. In fact, to make large advances in this faltering way is to incur the evil of making them without obtaining the advantage. Either shut the Bank at once, and say that it will not lend more than it commonly lends, or lend freely, boldly, and so that the public may feel you mean to go on lending. To lend a great deal, and yet not give the public confidence that you will lend sufficiently and effectually, is the worst of all policies" (pp. 64-65).

The next step is the specification of the action itself. Bagehot is clear that the monetary authority should (i) lend freely at penalty rates, (ii) keep collateral requirements in real terms.

> "The amount of the advance is the main consideration for the Bank of England, and not the nature of the security on which the advance is

> made, always assuming the security to be good. An idea prevails (as I believe) at the Bank of England that they ought not to advance during a panic on any kind of security on which they do not commonly advance. But if bankers for the most part do advance on such security in common times, and if that security is indisputably good, the ordinary practice of the Bank of England is immaterial. In ordinary times, the Bank is on1y one of many lenders, whereas in a panic it is the sole lender."

As Rockoff (1986) points out, the problem is that "there are really two Bagehots". Along with the one who tells us to lend freely in a panic. "there is also the Bagehot who tells us to 'protect the reserve' when the market is merely apprehensive."

> Both speak authoritatively, but to whom should we listen? It is here that Bagehot fails us, for nowhere does he supply an explicit guide for recognizing the state of market that calls for one policy rather than the other. Bagehot's schema makes everything depend on the Bank's 'psychoanalysis of the market. "If the bank mistakes apprehension for real panic and lends freely, then the reserve will fall and the level of apprehension will rise. On the other hand, if the Bank mistakes panic (significantly, Bagehot referred to it as a species of 'neuralgia') for mere apprehension. The Bank will starve the market of funds and the panic will intensify.

2.2 Crises versus Pseudo-Crises

The question then is how to distinguish a panic from a situation when the "market is merely apprehensive", - the distinction between what Schwartz (1986) terms a pseudo-crisis from a crisis. As Meltzer (1968) specifies, "the distinction is a reaction against the tendency to dilute the language by using extreme terms to refer to ordinary problems. Financial panics involve the system, not an individual institution. In cases of financial distress, it is in the interests of creditors to palm off the debts of insolvent or illiquid borrowers on the taxpayers by arousing fears of a financial collapse." In the succinct words of Solow (1982),

> "The primary function of the lender of last resort is not to share default risks among private financial institutions. Banking is a business, not a religion; default risk belongs with stockholders just as fashion risk belongs with clothing manufacturers. The job of the lender of last resort is not to preserve individual banks from failure but to preserve the financial system from being forced into undesirable

> deflationary pressure by epidemic loss of confidence in its soundness."

Schwartz (1986) presents two propositions concerning the distinction between real and pseudo-financial crises: (i) insolvency or illiquidity of a bank is neither a necessary nor a sufficient condition for a panic. (ii) failure of the central bank to protect the money stock from a sudden, relatively large decline, unanticipated as to timing and magnitude, is a sufficient condition. As Metzler (1986) emphasizes, "the precipitating cause of the monetary contraction may be a financial failure, but the widespread expectation of a series of failures serves just as well." I would submit that with this description we are essentially back to the eighteenth century's views on credit. There is not much theory to be had on the subject. Schwartz's (1986) conclusions that there was no panic in the UK after 1866, and in the US after 1933 are empirical propositions. We have to go back and study episodes from the past. Why did the collapse of Overand, Gurney and Co. Ltd. in 1866 represent a crisis, and the liquidation of Baring Bros. in 1890 did not? In his study of these two nineteenth century episodes, Batchelor (1986) pushes the language further by asking how a "crisis was prevented from becoming a catastrophe?" For Kindleberger (1978) "manias, panics and crashes are financial crises per se" and he identifies "some three dozen financial crises during the last two and half centuries."

2.3 On Rules and Rule-making

What is important to appreciate here is that in Bagehot's insistence on clear rules, we come up with all the difficulties of what it means to follow a rule. Indeed, Solow quotes him to the effect that "the practical difficulties of life cannot be met by simple rules (p.239)." This is a fascinating topic, which has received extended treatment at the hands of Wittgenstein (1953) and his followers, particularly Cavell (1959) and Kripke (1985). Again, I leave the implications of this work for the future, and simply note that even if the criterion of the applicability of the rule are clearly identified and intelligible, and the community on behalf of which the rule is being applied precisely demarcated, the question of the substance of the rule is itself yet to be specified. One possible rule is not to have any rule!

In the remainder of this section, I list some of the opposing views collected by Solow. Thus, after referring to the Federal Deposit Insurance Act, Friedman writes:

> "A liquidity crisis involving such runs on a widespread scale is now almost inconceivable. The need for rediscounting in order for the Reserve System to serve as a 'lender of last resort' has therefore become obsolete, not because the function has been taken by someone else but because it no longer needs to be performed."

Another view opposed to Bagehot is Harry Johnson's.

> "At least in the presence of a well-developed capital market, and on the assumption of intelligent and responsible monetary management by the central bank, the commercial banks should be able to manage their own reserve positions without the need for a central bank to function as a 'lender of last resort'."

It is this background that I would like you to keep in mind when one reflects on how an Islamic financial institution responds to globalization. I shall conclude this section with a comprehensive summary statement taken from Hicks (1967), leaving you to decide the extent to which economic science is science.

> "Every economy is liable to unexpected shocks. One of the things that we should require of an economic organization is that its institutions should be such that it can stand up to shocks; that it have cushions against them, so that their secondary repercussions are minimized, not intensified by the fears and alarms that they so easily engender. But there are a few cushions that will drop into place automatically; the most that is usually possible is that there should be reserves which can be used, if there are people who have the skill and courage to use them, at the right and not at the wrong time. A developed credit system ... has the advantage over a pure hard money system, in that its reserves are in places where they can be more readily he used, if there is the intelligence and the strength of will to use them. But to fall back on rules, making the monetary system mechanical, is a confession of failure."

2.4 The Problem of Moral Hazard

So far I have not posed the question of moral hazard in my discussion of the appropriate financial institution. In the words of Solow, "Does the existence of a credible commitment by the central bank to lend freely in time of trouble lead to the assumption of excessive risk by private banks in exactly the same way in which a family that is insured against theft may be excessively careless about locking up a house before leaving it? I have already discussed the difficulties in delineating "times of trouble", what I now need to focus on is the meaning of the term "excessively". But this is a theoretical term that has to be evaluated in the context of the general case for commerce: does the market lead to a "good" allocation of resources, and if so, what is the market allocation of risk? Thus, Kindleberger argues for an international lender of last resort "who comes to the rescue and provides the public good of stability that the market is unable to produce for itself".

Schwartz responds with the statement that “I do not subscribe to the notion that only a public authority has in the past filled or can at present fill such a role”. I shall take these questions up in the second substantive part of the paper; my purpose at this stage is simply to introduce the term to you in the practical context of the design of a financial institution.

III. THEORETICAL BACKGROUND

In Part II of this paper, I have tried to give you some idea of the nuanced and sophisticated approach to commerce and globalization in the eighteenth and nineteenth centuries. In this third part of the paper, I turn to modern theory and the lens that it offers for a view of commerce and finance. I begin with welfare economics, and then specialize my discussion to some canonical models of finance.

3. THE ECONOMICS OF WELFARE

The principal difference between current discussions of commerce and trade from those of the eighteenth century lies in the methods that are used - a precise mathematical axiomatic style is substituted for a more literary one. This has given rise to well-posed, and deep, mathematical problems of which the eighteenth century writers were totally unaware. However, this ought not to lead the reader into thinking that the substantive economic issues have of themselves changed, or that they can now be given a more “scientific treatment”. Whether one considers a small closed economy, or a larger provincial conglomeration, or the world as a whole, the basic question remains the same as the one discussed by Hume. Josiah Tucker, Adam Smith and others: do “free markets” fueled by the maximization of self-interest lead to a desirable allocation of resources?

The question then reduces to how modern economic science pose and answer this question? How does it formalize a private ownership economy? How does it conceive of a global world economy? How does it represent the economic actors, and what behavioral motivations does it ascribe to them? What meaning does it give to the phrase “desirable allocation of resources”, and to whose point of view does it privilege when it formalizes “desirable.” If we are to be seriously concerned about globalization, and the institutions that are to respond to it, we certainly cannot avoid an examination of these questions. This is the important subtext that underlines what appear to be more practical and more mundane policy discussions and prescriptions. One of the points that I wish to make in this paper is that we have to be fluent in the vocabulary of this text.

The case for commerce that is “unimpeded” within a country as well as between countries, is made through a branch of the subject that is termed *general* *equilibrium theory and welfare economics*. It is an achievement of modern thought. Over the years, I have presented expositions of the subject in a style that avoids symbolism and mathematics (Khan (1989, 1990)), and here I'll briefly recapitulate its principal features.

The outline of the model in its basic stripped-down version is simple enough. The first step is to define a domain of commodities - these may be "few," (two as in the standard elementary text-book expositions), or "many" (as in more sophisticated versions with an infinity of commodities). The point is that irrespective of the number, the characteristics of the commodities constitute common knowledge for all the agents.

There are two types of agents: consumers and producers. The consumers are characterized by exogenously given preferences over the commodity space, as well as a *priori* given resources of some or all of the commodities. It is after all a *private ownership economy* that is being formalized. The producers are characterized by an exogenously given technology. This is simply the set of production recipes or blueprints that are available to them. The producers own no resources. The agents are independent in that the preferences of a particular consumer depend *only* on his/her consumption; and in that the technological specifications available to a particular producer bear no relation to a particular production plan chosen by any other producer.

It is the behavioral assumptions underlying these representations that are of profound relevance to my inquiry. A free market equilibrium is represented by a price system - one and only one price for each commodity - and each agent maximizes his/her self-interest, as he/she perceives it taking these prices as parameters. There is no conduct *inter homines*, each agent is religiously turned solely towards the price system. Every consumer maximizes his/her preference subject to a budget constraint arising from her initial resources, and every producer maximizes profits. The point is that if these prices are "right," all these independent decisions are consistent in the aggregate. There is no glut or shortfall of commodities - there is equilibrium.

What gives this representation such tremendous power is that this equilibrium has qualities that are "desirable" in a precisely formulated sense. Even though there is no sense of community, and each agent is ruthlessly looking after her own interests, there is social coherence in that the outcomes are technologically efficient, satisfy the equal treatment property, are optimal in the sense that no agent's preference can be increased without diminishing that of another (the Pareto criterion), are group rational. Greed, a private vice, has led to public virtue - and the latter formalized as mathematical theorems.

This vision of commerce carries over in its essentials to the allocation of resources in the world economy. The international commodity space is specified, the agents are individual countries, each of them maximizes their own interests at an internationally given price system. If the prices are right, the international economy is in equilibrium, and the international allocation of resources have all the nice properties that one proves for a small closed economy. We have here the beginning of what is now an imposing edifice of the theory of international trade with "free trade" theorems proving that globalization, and in particular financial globalization, promotes world welfare.

But all of this is too easy. One has a nagging doubt that even if the case for the desirability of competition is plausible for a closed economy, it is somehow stretching it too far by applying it to the global economy. The advantage of the language of modern economic science is that such doubts can be articulated through the theorems themselves. The point I wish to make is that one simply examines the assumptions that underlie the theorems. Any mathematical conclusion is a consequence of the mathematical assumptions, and the reasons for the inapplicability of a particular theorem have to lie in the assumptions used to construct it.

Since the model is an idealized and stylized one, it can only handle a few chosen aspects of reality. A variety of real-world phenomena have of necessity to be excluded from an analytical representation. In this sense a model is necessarily ideological. It is precisely because of this aspect of what a mathematical theory is that one cannot ignore treatments of the subject that employ a purely literary style. Hence, my beginning of this paper with debates on commerce in the eighteenth and nineteenth centuries. In any case, in the remainder of this part of the paper, I shall confine my discussion to three aspects of reality to which I have not drawn attention.

3.1 Externalities and Public Goods

I begin with the assumption of independence. Consider, to begin with, a situation when a particular consumer's preference or welfare depends on the consumption of others; say, the members of his own household. This is enough to destroy the validity of the basic theorems valorizing competitive market outcomes. The point is that the dependence renders the particular consumer, as being manipulable by the others, and as such does nothing to ameliorate the destructive effects of maximization. Household bonding, and more generally community or internationally bonding, arises as a consequence of caring and dependence, and outcomes based on the maximization of individual self-interest, narrowly conceived, fail to take into account all the positive effects that arise from such a bonding.

If I revert to the vocabulary of the welfare theorems, the point is that there are missing markets. The price system does not work because not everything is being priced out. The fact that a parent cares for his child can be viewed as the fact that there is a commodity “parental caring” which, if correctly priced out, will be optimally supplied. Even if such a price could be correctly determined and announced, two important implications follow. The first is the obvious one that the parent as well as the child are independently maximizing their self-interest according to well-defined preferences. Second, this maximization of self-interest does not include an attempt at the manipulation of the price of caring. The commodity is personalized and specific enough that the market for it is necessarily “thin” - there cannot be a non-negligible number of consumers buying the commodity and thereby justifying the price-taking assumption. And so the model falls prey to its own contradiction. We have to rephrase the problem in terms of a bargaining approach. And it is well known that once bargaining is admitted, there is no guarantee of any desirable outcomes.

Strange as it may seem, both fictionalized markets and bargaining solutions have been suggested to the family in the recent literature. But I want to move from this large topic to say something about what I mean by family or community bonding. Stated most simply, I am asking what is it that makes a family a family - or a community a community? Without going into any detail concerning the notion of *social capital*, I shall simply say that any bonding is based on commodities that are commonly enjoyed - commodities for which the notion of aggregation is replaced by that of equality. The amount of radio services enjoyed by one family member leaves an identical amount to be enjoyed by another. The security that a particular member of a particular community enjoys from the services of an insurance company, or from an institution acting as the tender of last resort in that community is identical to that enjoyed by any other. International institutions like WTO or GATT service, presumably equally, all the participants of the world economy.

There is thus an important duality here. For standard commodities, the price is the same but the quantities demanded and supplied are different, and it is their aggregation that is the issue. For *public goods*, the amounts consumed between the agents are all identical and it is the prices - personalized prices or subscription costs or individualized taxes - that are all different, and whose aggregate has to be signaled to the produces. Put simply, institutions for the smooth functioning of commerce, leaving aside for the moment the view one holds of commerce, do not just arise out of a vacuum. They are expensive and have to be provided for, and this provision directly conflicts with the hypothesis of the maximization of self-interest. Since the services of public commodities, by definition, are not amenable to exclusion, there is an incentive for each agent to understate his or her demand for them. Since the others have an equal incentive in the smooth functioning of my family, or of the global economy, maximizing self-interested behavior induces me to leave the task to the others, and then enjoy the fruits of their actions.

And so one has to go back to the drawing board and seek other models and representations in which agent interdependence is explicitly taken into account rather than assumed absent *a priori*. This takes me directly into game theory - what in 1990, I referred to as the shift from the ADMA construction to the CNH construction. I have tried to present an exposition of a small part of this subject in Khan (1998) - at any rate, it is ongoing current research, which quickly takes me outside the scope of this paper (see Khan-Sun (1996a) for an announcement and flavour of some results). Instead, I shall deal with two limited and selected topics.

3.2 Adverse Selection

I began my description of the general equilibrium model by drawing attention to the fact that the characteristics of the commodities constitute common knowledge among all of the agents of the economy. A moment's reflection will enable you to think of a variety of commodities for which this assumption is violated. When we buy a second-hand car, the seller and the buyer have differential information as regards the car. When a national economy obtains credit from an international agency, the borrower and the lender have differential information about the condition of the economy. When I go to a physician to obtain his services, I try to find information about him/her that goes beyond the fact that he has a license to practice medicine - his ability, as summarized by all of his past actions, is relevant. Indeed, it is more of an exception that the rule that all agents have common knowledge regarding what they are buying from the market. Put differently, the price system here is incomplete is another way - now markets are missing for individual characteristics in addition to markets for commodities. These lead to problems that are classified under the label of adverse selection.

Problems of adverse selection prove difficult because they lead to a collapse of markets. Since a bank is not fully aware of the risk classes of the different people it insures, it averages over them, and in so doing, subsidizes the high risk clients at the cost of the low risk ones. In the same way, the price of a used car is an average of the variety of different qualities of cars of that particular vintage, and as such, undervalues the better quality of car. This has a tendency for the lower-risk clients in the first example, and the better quality of car in the second, to drop out of the market. But then the same difficulty repeats itself at the next stage till the market collapses. The problem then is to design incentive schemes, which are cheat-proof and not amenable to strategic misrepresentation. We are now in the field of mechanism and institutional design - how to implement desirable social outcomes as being achieved by maximizing behavior, which explicitly takes the interdependence - a particular game form - into account.

3.3 Moral Hazard Once Again

The first point that I wish to make is that the meaning of moral hazard has to be understood in the context of welfare economics, and that it does not refer to "immoral behavior." In its most basic terms, moral hazard refers to a situation when policies taken to remedy weaknesses of an economy are incorporated into the maximizing calculus of the individual agents and thereby lead to unintended consequences.

Problems of moral hazard are more concretely discussed in the context of insurance. Consider an organization whose mandate is to improve the allocation of resources by pooling risks. In an intertemporal context, it implies shifting resources between different periods of time, and hence acting as a lender of last resort. The point is that the very presence of such an organization will lead agents to take actions that they would not have taken otherwise - the fact that I am insured makes me less risk-averse since the responsibility for my individual actions is being discharged in part by society as a whole. In different words, the existence of the insurance organization lowers the price of risk and thereby encourages a more than optimal share of resources to riskier activities.

Once this principle is grasped, it is easy to find examples of moral hazard in a variety of social phenomena. Subsidized health plans lead to less health care by an individual, car insurance leads to reckless driving; guarantees of government bail-outs for firms or banks lead to riskier ventures and more reckless lending. It is important to understand that in highlighting the problems of moral hazard, one is not taking a position against policy or even against insurance, but simply drawing attention to the fact that there is a feedback effect, which may go against the very reasons why a particular policy was instituted in the first place. Furthermore, not all problems of moral hazard are equally acute - in some situations, individual incentives are strong enough to override any moral hazard problems that may arise.

In concluding this section, I would like to ask what are the particular assumptions behind the standard welfare theorems valorizing perfect competition that rule out problems of moral hazard. At one level, it is clearly the assumption of universality of markets.

However, it is difficult to take this assumption seriously if time and uncertainty are to be taken into account.[7] Thus, alternative institutions have to be designed, but the basic assumption of the general equilibrium model has to hold nevertheless. This is the requirement that the parameters of the model, individual preferences and technologies, are independent of the actions that are taken. In situations of moral hazard, the individual actions affect the probabilities which go toward the specification of preferences, and these consequences are hidden from the market, and therefore cannot be taken into account by the market, and hence exploited by maximizing agents for their own benefit. In summary, we have committed ourselves to the postulate of the maximization of self-interest, and it keeps coming up short even at this abstract idealized level. The postulate has to be supplemented. This is as relevant as in the design of Islamic institutions to respond to globalization, as it is in the design of simply economic policy prescriptions for a small national economy.

4. ARBITRAGE AND THE PRICING OF FINANCIAL ASSETS

So far in this theoretical part, I have blurred the distinction between globalization and financial globalization. I have argued that the latter cannot be understood without a clear view of commerce - how it is represented and evaluated. In this section, I turn to the adjective “financial” and discuss its salient and distinguishing characteristics. I do not do this simply because it is an important subject, and deserves a place in a paper on financial globalization and its impact on Islamic financial institutions, (which it undoubtedly does), but rather because it allows me to underscore what I have been trying to emphasize throughout this paper: the importance of the delineation of the social domain which is to form the context for all economic as well as financial activities. In short, the importance of the designation of the relevant community.

Towards this end, the difference of emphasis between economics and finance should be noted at the outset. The motivation behind general equilibrium theory as well as the theory of international trade is to develop representations and models for discussing the price system. As I had occasion to mention above, the subject “explains” the price system and the consequent allocation of resources as a result of decentralized self-maximizing behavior of individual agents, and “charts out”, the desirable, or undesirable properties of such a system of prices. We thereby obtain a lens for “viewing” commerce. In other field of economics, the particular representations may be different - more partial equilibrium, for example - but the essential thrust of the subject remains the same.

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[7] See the section on “fictional markets” in Khan (1990).

In finance, an equilibrium price system is assumed to be given from the very start, and it is considered to be an equilibrium by virtue of one important property - absence of' arbitrage. The financial assets, and indeed other so-called "non-financial" assets are priced in such a one that there is only a single price for each asset. If this was to be violated, one could gain by buying at the lower price and selling at the higher one. And there would be no limit to these gains. In short, just as water finds its own level, the absence of gains from arbitrage leads to one price. What is then something to be explained in the case of economic theory, becomes the "given" and the data for the case of financial economics.

The question then is what does theory of finance seek to explain? Simply stated, the objective is to use the existing price system and extend it to "price out" other financial assets and instruments for handling risk. In other words, it is to "extend" it to financial assets and projects that are based on the existing menu offered by the financial market. If there are no gains from arbitrage, what is the value of a promise *now* to pay a fixed amount five years from now? Again, assuming the absence of gains from arbitrage, what is the value of *now* of an option to buy or sell at a fixed price a certain stock five years from now?

A crucial term in the vocabulary of financial economics is the notion of diversification. It is a short step from the no-arbitrage assumption to the postulate that the market does not reward gains from diversification, and this insight can be translated into rates of return that an asset or a project ought to earn. The subject is vast, and like much in this paper, needs further exposition and explication. Nevertheless, I shall present two simple canonical models of asset pricing, and show how they formalize and represent different notions of risks - diversifiable, unsystematic, idiosyncratic and inessential - and different notions of diversification - naive and inessential. Despite the simplicity of these representations - they refer only to one-period returns, for example - difficult technical questions are raised which have not yet been settled and constitute topics of current research.

4.1 The Capital Asset Pricing Model

The capital-asset-pricing model (CAPM) of Sharpe (1964) and Lintner (1965) yields the insight that the expected return to any asset is related solely to the non-diversifiable component of its total risk, such a risk is formalized in the model through the concept of a mean-variance efficient portfolio M, and is measured by the beta of the particular asset. If $\mu(t)$ denotes the expected return of a risky asset t chosen from a universe of assets T, x_t its random return, and cov (x_t, M) its covariance with the portfolio M, then its beta β_t is given by cov $(x_t, M)/V(M)$, and the model predicts the simple linear relationship

$$\mu\ (t) = \rho + \beta_t\ (E\ (M) - \rho),$$

where $E(M)$ and $V(M)$ are the expected return and the variance of the portfolio M, and ρ is the riskless interest rate. This formula can be phrased in terms of any mean-variance efficient portfolio, and under strong conditions on investor preferences and/or the process of asset returns, can be rationalized as a market portfolio; see Sharpe (1964: 440-441 and Footnote 26 in particular), and also Markowitz (1952, 1959), Samuelson (1967a) and Tobin (1958). The point to be emphasized is that a mean-variance efficient portfolio is obtained from a solution to an optimization problem, and as such, formalizes the notion of efficient diversification. The CAPM pricing formula has generated extensive empirical work, and has been one of the focal points for finance theory in the last three decades; for an intuitive popular account, see Malkiel (1990: Part 3) and his references.

Thus, the CAPM model shifts attention from variance as a measure of risk to covariance with a single source of risk. The relevant question for my subject is how is this single source to be constructed. In other words, what I am giving emphasis to is the fact that the construction of the CAPM carrier portfolio *M*, and in particular its efficiency property, is relative to the particular finite universe of assets postulated in the model. The question then for an Islamic financial institution, and its response to financial globalization, has to be the relevant formalization of what it conceives to be its "market portfolio". What is its relevant domain of assets? To what extent is this choice a purely financial question and to what extent is it an economic one/More to the point, to what extent is it an ethical question? Given the interdependence of the world economy - whatever globalization may mean, its meaning must at least include this - how can an Islamic financial institution use its investment activities to bring about outcomes that "it" - or more precisely, the community it seeks to represent and serve - consider desirable? To what extent can ethical and moral objectives be bracketed from socio-economic ones? Can one derive "ought" from "is"?

Even in the limited one-period context, the capital asset pricing model does not represent the "whole story." Despite its success in both theoretical and empirical work, the CAPM has had to face criticism for the strong assumptions deriving its pricing formula; see Borch (1969), Feldstein (1969) and Samuelson (1967b, 1970). However, before I consider an alternative model of asset pricing, I must say something, however briefly, about the law of large numbers.

4.2 Pooling of Risks and the Law of large Numbers

In his valuable survey on *Muslim Economic Thinking*, Siddiqi (1981: 28) writes in the section on insurance,

> "Most of the contributors on the subject have been *ulema* who have little knowledge of Economics. As a result there is little economic analysis in most of the works on the subject. Very few have referred to the law of large numbers, which lies at the basis of insurance, and little effort has been made to assess the economic significance of insurance in modern life. Some writers seem to be under the misconception that a comprehensive social security system will do away with the need for insurance. They fail to distinguish between the fulfillment of needs and arrangements designed to increase efficiency and ensure the smooth functioning of large-scale business and industry. They ignore the obvious point that individuals should be encouraged to provide for themselves, as far as they can, and protect themselves against insurable risks, the state should be called in for helping only those who do not have the capacity to do so, or fail to do so."

I cannot do Justice to this complex passage other than to hope that in my discussion of commerce, both historical and theoretical, and its associated problems of moral hazard and adverse selection. I have begun the type of conversation that Professor Siddiqi would like to see initiated. However, I would like to single out from this passage the notion of insurable risks and the closely associated law of large numbers.

In my discussion of the capital asset pricing model, I have already assumed that my reader is familiar with the modern formalization and representation of risk. The foundations of modern probability were laid in the 1930's in Russia and France, and for an illuminating introduction to this fascinating subject, I refer you to the works of Ian Hacking. So I shall assume that you are at ease with the notion of a random variable defined on an abstract measure space[8] and directly consider the adjective "insurable."

The crucial idea in this connection is the notion of "independence".[9] Without going into any technicalities, let me simply say that an event is "independent" of another event if the probability of the occurrence of one does not "add or detract" from the probability of the occurrence of the other. The probability of my falling sick from a particular disease is directly related to that of my neighbor if the community that we are living in is in the throes of an epidemic of that disease. The probability of two communities being hit by an earthquake is not constituted by

[8] For a non-technical and intuitive introduction, see Khan (1998).
[9] See Kac (1964, 1985) for an intuitive and authoritative treatment.

independent events if the communities are situated on the same fault line, and may well be independent if they are not. Once we are at ease with the idea of independent events, we can generalize it to independent "collections" of events, and thereby to independent random variables or risks? The point is that if we take the average of a "large" sample of independent risks, which follow an identical probabilistic law, which is of course to say that they are "identically distributed," the average sample will have the mean of the common distribution. Thus, we cannot say anything about the probability of obtaining a "head" in a toss of a "fair" coin, but the probability of obtaining "heads" in half of a "large" number of tosses is "close" to half. The larger the number of tosses, which is to say, the larger the sample of random variables considered, the closer to half is the proportion of heads in the sequence of outcomes.

The relevance of all of this to the subject of this paper should be evident. Once we consider time and uncertainty, a world of complete markets is simply a fantasy. We have to confront missing markets and face up to shocks. The point is that the risks from these shocks can be pooled. If the shocks are independent, and the society is "large," they can be insured. Taking my cue from the coin-tossing example, suppose that a community is facing two possible outcomes as summarized by gaining or loosing a dollar. Let the probability of each event be half, and let the risk faced by one member of the society be "independent" of that faced by another. In the absence of any institutional arrangement, half of the society will land up with a dollar and half with a loss of a dollar. It is clear that an institutional arrangement can be designed whereby every agent is "insured" for half a dollar by paying a premium of half a dollar. Risk has been pooled and there are thus no losers under this arrangement. Most importantly, since the society is "large", the institution does not loose any resources - the probability of the realizations will be the "objective" ones.

The crux of the matter is that the risks be independent or to use related terminology, that they be "idiosyncratic" or "non-systematic". It is these types of risks that can be insured as opposed to those that cannot. Before I turn to the latter, let me at least mention here two formal treatments of the ideas that I have tried to convey: arguments two examples: (i) the Malinvaud argument for insurance in the context of a general equilibrium model with a "large" number of agents, (ii) the Chamberlain - Rothschild conditions for the existence of a riskless asset in a setting of a market with a "large" number of assets.

4.3 The Arbitrage Pricing Theory

The arbitrage pricing theory (APT), developed in Ross (1976), shifts attention away from the microeconomics of mean-variance efficiency towards the gain from diversification based on portfolio size. Unlike the CAPM, in which a *single* variable (beta) determines the expected return of an asset, the APT allows for a *multiple* number of sources of market-wide risks to capture the intercorrelation among the various assets. This ensemble of market-wide systematic risks is formalized by an *exogenously* given finite number of factors, with each of these factor risks affecting a non-negligible portion of the market. Then the purpose of the theory is to derive the result that the price or expected return of an asset depends only on factor risks and not on the residual unsystematic or idiosyncratic component. Put differently, it is desired that all risk that is not correlated with the factors can be completely diversified away and plays no role in equilibrium asset pricing. The systematic - unsystematic risk decomposition of an asset's unexpected return rests on the claim that even in a financial market with a large number of risk classes, there is only a relatively small number of factors relevant from macroscopic point of view, and that the residual part can be made arbitrarily small when large enough portfolios are taken. Ross' result then rests on three basic ideas: an *exogenously* given factor structure, a large number of assets to formalize the presence of unsystematic risks and to operationalize the notion of large portfolios, and the absence of asymptotic arbitrage in some specific sense. If systematic risks are captured by k exogenous factors $\varphi_n(\cdot)$ defined on some probability space (Ω, A, P) and the random return of asset t is given by

$$x_t(\omega) = \mu(t) + \beta_{t1}\varphi_1(\omega) + \cdots + \beta_{tK}\,\varphi_K(\omega) + e_t(\omega),$$

ω a sample point in Ω, then a suitable version of the absence of arbitrage, and some assumption on the residual process $e_t(\cdot)$ formalizing unsystematic risks, yields the approximate linear equation

$$\mu(t) \simeq \rho + T_1\beta_{t1} + \cdots + T_K\,\beta_{tK}$$

If the β_{tj} are called factor loadings, then the result simply states that an asset's expected return is approximately linearly related to its factor loadings.

If the ensemble of unsystematic risks present in the market is assumed to be constituted by mutually uncorrelated random variables. Ross' theorem follows as a consequence of the law of large numbers and a suitable version of the "no arbitrage" assumption. However, since the law of large numbers is conventionally presented in terms of an asymptotic approximate result for an infinite sequence of random variables, the APT is formulated in the context of an infinite sequence of assets with diversification necessarily incomplete, unsystematic risks only approximately removed, and a pricing formula that can only be expressed in an approximate form. The no arbitrage assumption is, by necessity, also expressed in an asymptotic form; see Ross (1976) and Huberman (1982, 1987). There has been work on the exact version of the APT pricing formula but under additional assumptions: see Chamberlain (1983) and his references. This additional structure is not my concern here. Indeed, given this emphasis on approximation, Chamberlain-Rothschild (1983) present a version of Ross' theorem based only on an approximate factor structure.

4.4 Towards a Synthetic Model

I have put before you two notions of diversification: (i) "efficient diversification" as formalized by the CAPM and resting on the maximization of a programming problem with a finite number of assets, (ii) "naive diversification" as formalized by the APT and resting on the law of large numbers and therefore on a large but finite number of assets.

In my discussion of the CAPM, I have already emphasized the importance and relevance of the market portfolio for Islamic financial institutions - in using it as a benchmark, one has to face the issues that underlie its definition. However, my subsequent discussion of the APT leads to a more concrete form of this question, one that takes its motivation from purely financial considerations. This is simply to ask for a model of asset pricing that synthesizes the ideas of both efficient and naive diversification, and to choose as the market portfolio the single source of risk that emerges from such a synthesis. It is important to note that in my reference to both "large" societies and "large" financial markets, two notions of "negligibility" are coming together here. If you go back to my discussion of the economics of welfare, you'll notice that "numerical negligibility" constitutes one (only?) basis for the price-taking assumption and saving the model from self-contradiction. Indeed, the welfare theorems take their most powerful form in precisely such a context. Moving to finance, and the notion of naive diversification, you'll notice that the law of large numbers assumes its exact form when each shock in the ensemble of the sample of shocks is "numerical negligible." It is only then that *aggregation removes idiosyncratic uncertainty*.

However there are some difficult technical problems in formulating a law of large numbers with a continuum of random variables, and it is only recently that they have been successfully resolved by Sun (1996), based on this technical advance, one can present a model of a financial market in which naive diversification, based simply on portfolio size and obtained as a consequence of the law of large numbers, is distinguished from efficient diversification, based on mean-variance analysis. This distinction yields a valuation formula involving only the *essential* risk embodied in an asset's return, where the overall risk can be decomposed into a *systematic* and an *unsystematic* part, as in the arbitrage pricing theory; and the systematic component further decomposed into an *essential* and an *inessential* part, as in the capital-asset-pricing model. I shall simply refer you to Khan-Sun (1997a, b and c) and move on.

IV. CULTURAL BACKGROUND

I now turn to the explication of the adjective *Islamic* in my title. If you thought that my choice of topics in the first two substantive parts of this paper was already too broad and overly ambitious in scope, you will surely be more critical about this part. How can one represent in a comprehensive way what one understands by an Islamic ethos in the space of one paper? But I am clear that this paper will be seriously deficient without such an attempt. I would like you to see this part simply as tentative notes towards identifying an Islamic ethos and part of research program that really began for me in the beginning of this decade. In Khan (1990), I discussed the commercial vocabulary in the canonical text. In Khan (1991) I emphasized the interdisciplinary nature of the inquiry and drew attention to the relevance of political theory and in Khan (1992), I tried to present a framework for the study of the word *riba*.

I organize this part of the paper in three sections as follows. First, I provide a reading of *surah Takathur* in the light of my previous discussion. Next I consider the anxiety that such an attempt provokes - this hostility extends to the entire enterprise of Islamic economics and ought to be dispassionately understood. Finally, I identify work in other disciplines in the human sciences from which we can learn and draw sustenance.

5. A READING OF *SŪRAH TAKATHUR*

The question of how Islam sits with "capitalism" has been posed and studied by many scholars, most notably by Maxime Rodinson (1966). My purpose in this section is much more defined and concrete. I have identified the Arrow-Debreu-McKenzie model of general economic equilibrium as a viable representation of "free markets" and "perfect competition" and shown how it derives its basic thrust from the postulate of the maximization of individual self-interest. I have also read this model, and this postulate, in the light of valorization of "commerce" in the eighteenth century. I do not want to confront this material to what is Islam - or more precisely, what I consider and understand to be Islam. This is altogether too grand a word and I am hardly sufficient to the task. I simply want to begin a reading of *Sūrah Takathur* in the light of all this material.

Of course, to single out these eight lines from the canonical text already involves a judgment call, and I hope to justify it in future work. I hope that it'll suffice for the moment to quote two authorities. In his summary description of these eight lines, Muhammad Asad writes as follows:

> "This early Meccan is one of the most powerful, prophetic passages of the Qur'ān, illuminating man's unbounded greed in general, and, more particularly, the tendencies which have come to dominate all human societies in our technological age."

Abdullah Yusuf Ali writes as follows:

> "This probably early Makkan *Sūrah* gives a warning against acquisitiveness, i.e. the passion for piling up quantities or numbers, whether in the good things of this world, or in manpower or in other forms of megalomania, which leave no time or opportunity for pursuing the higher things in life."

Thus, I would submit that it is in the light of this *sūrah* that one can begin one's reflection of a system constructed solely, and I emphasize the word "solely", on the postulate of the maximization of self-interest.

I now turn to the question of exegesis of the *sūrah*. In Khan (1992), I have tried to spell out the methodological problems concerning translation, and returned to the issue of how to read a text in Khan (1993a). It is not my intention to go over this ground again. It is clear that one of the contexts for a reading of this *sūrah* must be the entire Qur'an itself - indeed *sūrah Muzzamil* is particularly relevant for such a reading. Maulana Maududi has delineated another context consisting of *sūrahs* 99 to 104. In his discussion of *sūrah Humazah*, Maulana Maududi writes:

> "If this *sūrah* is read in a sequential context that extends from *sūrah Zilzāl* to itself, then one understands very clearly how the principles and social teachings of Islam very firmly imprinted in people's minds."[Author's translation from Maududi (1972, Volume 5, p. 456)].

However, I would again like to emphasize that my purpose here is a much more limited one - it is to read the *sūrah* in the light of the material, particularly the theoretical material that I have laid out above.

Consider the first *ayat* consisting of the two words

alhaa - kum - ut - takāthur.

According to Lane's *Arabic English Lexicon*, the word *takāthur* takes its root from *kathura,* meaning abundant or multiplied, and hence it means, "contending together for superiority in the amount and number of property or children or men." Asad has given a detailed explication of the term *takāthur*.

> "[It] bears the connotation of "greedily striving for an increase"; i.e., in benefits, be they tangible or intangible, real or illusory. In the above context it denotes man's obsessive striving for more and more comforts, more material goods, greater power over his fellow men or over nature, and unceasing technological progress. A passionate pursuit of such endeavors, to the exclusion of everything else, bars man from all spiritual insight and, hence, from the acceptance of any restrictions and inhibitions based on purely *moral* values - with the result that not only individuals but whole societies gradually lose all inner stability and, thus, all chance of happiness."

I wish to emphasize that in this passage, it is Muhammad Asad who is speaking, and that his is one particular interpretation. A veritable variety of words, each with their own shade of meaning, have been used to translate the word. Thus Ahmed Ali represents it as "the avarice of plenitude," Dawood as "taken up with worldly gain;" Pickthall as "rivalry" in worldly increase;" Arberry as "gross rivalry;" Keneth Cragg as "increasing, multiplied wealth [as] your besetting pre-occupation;" Yusuf Ali as "the mutual rivalry for piling up (the good things of this world);" and Irving simply as "competition." In Salah ed-dine Kechrid's French translation, it is rendered as "la proliferation (ou l'amour du plus avoir)."

Next, I turn to the first word of the *ayat*. It has generally been translated by the words "distracted, diverted, occupied, besettingly pre-occupied, obsessed." However, going to the root of the word is most instructive. The root letters are *laam, hah* and *waaw* and the words *yulhi* and *lahu* can be translated as "beguile" and "plaything, toy, amusement and sport", see Nadwi (1983: p. 610). This shade of meaning is borne out when one looks at the use of *wa lahwaa* in 6:32 and in 47:36. I respectively reproduce both for your convenience in terms of the translation of Asad (though if this section has any lesson, it is that you must go to the original yourself).

> And nothing is the life of this world but a play and a passing delight; and the life in the hereafter is by far the better for all who are conscious of God. Will you not, then, use your reason? (6:32)

> The life of this world is but a play and a passing delight; but if you believe (in God) and are conscious of Him, He will grant you your deserts.
>
> And withal, He does not demand of you (to sacrifice in His cause all of) your possessions. (47:36)

As examples of the use of the words *tulhe* and *yulhe*, I respectively offer the following passages.

> Let them eat and enjoy life, and let (false) hope beguile them. They will come to know! (15:3)
> Men whom neither merchandise nor sale beguileth from remembrance of Allah and constancy in prayer and paying to the poor their due; who fear a day when hearts and eyeballs will be overturned. (24:37)

With this background, I can start getting some insight and understanding as to what it is that the *ayat* of two words is drawing attention to. There are nuances and subtleties, which are obvious, even on a first somewhat careful perusal. Indeed Maulana Maududi (1972, Volume 5, p. 442) writes in his explication of this *ayat* that it "Covers such an extensive that an entire piece of writing would hardly be able to render its full meaning." At any rate, let it suffice to say that if we couple it with the next *ayat*, we have what can be seen as an Islamic representation of the life-cycle model of the individual consumer.

But I am still not done, even given the limited nature of my inquiry. The point that I wish to make is that even at the simplest level of interpretation, it is clear that the object is left open. In your maximization of self-interest, as formalized in a model whose unknowns are variables that affect only your individual welfare, what is it that you are diverted or distracted from? The Qur'ān leaves it open. Some commentators have managed to capture this open-endedness, but others have supplied an answer. Thus Kechrid writes "... vous a distraits de vos obligations religieuses);" Yusuf Ali that it "diverts you (From the more serious things.) The translators of Sayyid Qutb answer it by implication in his reference to the "trivialities of this worldly life and its petty concerns"; see Qutb (1979: 271).

The next six *ayats* of the *sūrah* then respond to this representation of an individual, and it is clear that I do not have the time and the space to do justice to its profound complexity. It raises philosophical and grammatical issues, which must await future work. Let me simply point out to the fragility of the meaning if *ayats* 5 and 6 as read together as one sentence, as by Asad, or broken up, as by

Qutb and Maududi. Indeed, Qutb (1979: 270) writes with reference to the fifth *ayah*.

> The conditional sentence is not completed in the text. This is acceptable as a refined form of Arabic. It adds to the feeling of awe generated by the *sūrah*.

6. THE ALLEGED CASE AGAINST ISLAMIC ECONOMICS

In this section, I turn to a consideration of the criticism that has been leveled against the importation of Islamic values and axioms into the human sciences. There seems to be a tremendous anxiety about Islamic economics and how it may have an adverse effect on globalization. Islamic financial institutions have been identified as the institutional vanguard of Islamic economics. I take as my representative text, some selected passages from the recent writings of T. Kuran.

Kuran (1996) begins his article on "The discontents of Islamic morality" with the statement that

> Islamic economics, which is dedicated to restructuring economic thought and practice on the basis of fundamental Islamic teachings, has been criticized extensively for its incoherence, incompleteness, impracticality and irrelevance.

In a subsequent piece, Kuran (1997), examines the "implications of Islamism and economics for a free society."

> One of the most visible triumphs of the ongoing global movement known as Islamic fundamentalism, Islamic revivalism, or Islamism has been the spread of Islamic banks. For many proponents of Islamic banking, its religious rationale is far more important than its economic justification. For them, the overriding objectives are the reassertion of Muslim identity, the reaffirmation of Islam's relevance to the modern world, and the restoration of Islamic authority. Islamic banking defies the separation between economics and religion. It invokes religious authority in a domain that modern civilization has secularized. Moreover, by promoting the distinctness of Islamic economic behavior, it counters the absorption of Islamic civilization into Western civilization.
>
> There is no easy answer ... to the question of what Islamism implies for the future of the global economic order. Like other

> fundamentalisms it is capable of doing economic harm, yet it can also serve as a hidden agent of economic advancement. Remember, too, that some of what passes as Islamic economics, like the establishment of Islamic enterprises, serves to alleviate potentially explosive social problems. How, then, should policymakers committed to a liberal social order respond to the economic activities of Islamists and to their calls for economic reform? What, if anything, should governments, funding agencies, research establishments, educational institutions, and the media be doing to meet the Islamic challenge to prevailing economic ideals, structures, practices and relationships?

In the remainder of his paper, Kuran offers three prescriptions, two of them "confrontational" and the third, "conciliatory." The tough, active responses are to "expose the flaws and limitations of Islamic economics" and to "show that the economic prescriptions of Islamists have considerably less appeal than their leaders tend to claim." These two prescriptions devolve essentially into one; namely, to combat what the author terms "Islamic economics" - one intellectually and the other in more popular way. The third prescription is simply "listen carefully." The fact that Islamists are making some outrageous demands hardly means that their complaints are all unjustified and their suggestions uniformly worthless."

It will take me too far afield to provide a detailed exegesis, and evaluate these passages carefully. Instead, I will use the time and space to give you a flavor of an alternative response from thinkers outside the economics profession.

7. CRITICAL RESPONSIVENESS TO ISLAMIC ASSUMPTIONS

In his 1995 work on *The Ethos of Pluralism*, Connolly writes of

> "an alternative strategy of ethical cultivation, striving to tap into a care for a rich diversity of life that, we hope, already flows through the conventional identities installed upon us. To us, one of the defining characteristics of an ethical orientation is cultivation of a critical responsiveness that can never be automatic, deducible, guaranteed, or commanded by some unquestionable authority" (p. 27).

> "The *initial* need today ... is to detach hegemonic identities to a greater extent from the fixed set of alternatives they already recognize, exciting the experience of discrepancy within established dualities of normality/abnormality, rationality/irrationality, good evil, and sovereignty/anarchy so that alternative experiences of injury and possibility can be cultivated" (p. 26).

In future work, I hope to give a detailed reading of these passages from a context regulated by Islamic assumptions. Such assumptions, of course, begin with an "unquestionable authority" and have their own dualities, but the important point is that these are not closed. For the moment I simply want to draw your attention to Connolly's "critical responsiveness" as a formula for self-ethicization. "A self that works on itself to develop critical responsiveness to that which it is not, to cultivate critical responsiveness to those identities whose very mode of formation may tap into differences within it regulates to be what it is" (p. 70).

The point is that the market has to be supplemented by precisely those aspects that its representations have excised - in particular, by the moral and the ethical. It is the representation of these aspects that presents the serious challenge, and I shall conclude this section by reminding you of the way that two particularly gifted modern theorists view this supplementation.

First, Oakeshott (1991: 66).

> "Politics is the activity of attending to the general arrangements of a collection of people who, in respect of their common recognition of a manner of attending to its arrangements, compose a single community.... This activity then springs neither from instant desires, nor from general principles, but from existing traditions of behavior themselves. And the form it takes, because it can take no other, is the amendments of existing arrangements by exploring and pursuing what is intimated in them."

Similar sentiments are articulated by Rawls (1980).

> "What justifies a conception of justice is not its being true to an order antecedent and given to us, but its congruence with a deeper understanding of ourselves and our aspirations, and our realization that, given our history and the tradition embedded in our public life, it is the most reasonable doctrine for us."

V. TOWARDS AN ARGUMENT

So far in this paper, I have approached the issue of globalization of financial markets and Islamic financial institutions by laying out a grid of inquiry. I have submitted that such a grid simultaneously involves history, theory and culture if the answers that we seek are to have a depth of understanding, which the issues warrant and deserve. By singling out these source materials, and by presenting them in the sequence and order that I have followed, I argue that a historically-and theoretically-informed understanding of the processes of globalization is a necessary prerequisite for charting out the impact on current financial institutions, and perhaps more importantly, on the development of future institutions informed by Islamic values and assumptions. At the same time, I argue that this prerequisite also deepens and enriches our understanding of the values themselves, and thereby, through their derivation, leads to a closer and more-informed reading of the canonical text itself. My principal point has not been to provide answers as to how a particular Islamic financial institution should respond to particular initiatives pertaining to financial globalization, but rather to provide a methodological framework around which and through which such answers can be constructed. Nevertheless, some sharper and more substantive points do emerge from my inquiry; but before I summarize and lay out these propositions, I clear what I consider some possible misconceptions and objections.

The first of these concerns the relevance of history to a fast-moving modern world where ease of communication and the penetration of international boundaries by revolutionary advances of information has rendered the past obsolete and irrelevant. As Vann Woodward (1968: 189) quotes Toynbee,

> ... here we are on top of the world, and we have arrived at this peak to stay there - forever! There is, of course, a thing called history, but history is something unpleasant that happens to other people. We are comfortably outside all that.

This is not a point of view that sits well with a society subscribing to Islamic preconceptions since the canonical text constantly draws on the past to drive its points home. But, of course, whenever one recruits a point in the past, one is using an object that has both similarities and dissimilarities to the present.

Thus the objection can be more sharply, and more fairly, phrased not as a blanket objection to history *per se,* but rather to the particular periods of history that are singled out. What is so special about debates in the 18th - century, or the actions of the Bank of England in the 19th - century, as opposed to say the 7th - century? It is important to be clear that in discussing the historical moments that I do discuss, I do not mean to imply that other historical periods hold no lessons for my inquiry. In my study on the “languages of markets,” (Khan, 1990), I chose backgrounds ranging from Greek antiquity to the abolition of the slave trade at the beginning of the 19th - century to Morocco in the early 20th - century. The point has to be that the historical examples are not totally wanting; in other words, despite the dissimilarities, they give us new insight and understanding.

However, I would go further, I submit that the 18th - century debates on the nature and effects of *commerce* and *financial globalization* laid the foundation stones of modern economic science, and that we cannot make progress without re-opening and re-examining the underlying assumptions and the conclusions that the participants obtained. As you will see from the list of propositions that I present, the propositions that Hume, Smith, Rousseau and others argued over are precisely the propositions that are being argued over today. The anxieties that speculative capital evoked in Swift, Defoe, Hume and Burke; or the 19th - century responses to a financial institution's guarantees as the lender of last resort, all have their counterparts in modern statements by policy-makers and leaders of particular national economies. These historical examples are terribly relevant in forming a reasoned judgment about the implications of financial globalization on Islamic financial institutions.

As I move from history to theory, I have to confront what I consider to be another possible misconception. This leads to an objection that is in some sense dual to that discussed above, and concerns the relevance of purely stylized models that do not do any justice to the complexities of the reality of the world that we live in. The process of abstraction is integral to any theoretical model, which is simply to say that it includes, as well as excludes, features of the reality it seeks to represent. This again leads to the similarity /dissimilarity divide that I mentioned in the case of historical application. To the extent that the model excludes and omits, it misrepresents and hence misleads. This subject, like many others that I have tried to discuss in an hour's paper, deserves more detailed explication. I would simply submit that one cannot do without theory, and the impossibility of a totally a theoretical treatment.

However, as in the case of the objection to history, one can object to the relevance of particular theoretical models - the objection not to assumptions or exclusions *per se*, but to particular assumptions and to particular exclusions. What is so special about the Arrow-Debreu-Mckenzie model of general equilibrium theory, based as it is on a picture of the world where there are no real frictions arising from the complexities of time or uncertainty - the universality of markets assumption? Why should we study the capital asset pricing model in which all agents are identical in a strong sense; or the arbitrage pricing theory with its assumption exogenously given factors and absence of any arbitrage opportunities? Whereas in the case of historical application, the objection is that the past does not do justice to the present because of falling international barriers to capital and information, here the objection is that the real world does not do justice to the model, which assumes no such barriers to begin with!

My answer to this second line of objection remains qualitatively the same as that to the first. Certainly, there are models other than the ones I have discussed in Part II of this paper, which are relevant to my line of inquiry. In my exploratory attempt to understand *riba*, (see Khan, 1991), I singled out other models dealing with time and capital accumulation. But, here again, I would go further. I would submit that the Arrow-Debreu-Mckenzie model of general equilibrium theory is particularly useful in understanding interaction of several agents all pursuing their self-interest at given prices which are immune to their actions. I would submit that both the capital asset pricing model and the arbitrage pricing theory, despite (or because of) their assumptions, are indispensable in grappling with the intricacies of financial diversification. And the understanding of both is necessary if we are to determine the implications of financial globalization on financial institutions.

The third line of objection relates to Part III of my paper, and the concern with the inadvisability - indeed the futility - of appealing to cultural concepts in any serious discussion of finance and commerce. A point of view that insists on bracketing and marking out disciplinary boundaries hardly sits well with a society whose canonical text and teaching constantly emphasizes that it offers guidance to a whole way of life - to what, after Wittgenstein, we can term a language game. My attempt here, after all, is to discuss how financial globalization impacts on financial institutions that are governed by the adjective *Islamic*.

However, it ought to be noted that this objection dovetails into an issue that has engendered much recent debate in the human sciences. This is the dichotomy between "understanding" and "prediction and control." It can be argued, as is done from one side of this debate, that one should concentrate on predicting and constructing the future and on contingency plans that face up to one's representations of it. An implicit imperative behind such an exercise is to avoid religiously "futile philosophical debate" and use categories of thought that are "measureable" and whose measurements are amenable to extrapolation of statistical data. In short, to study the world only as it is rather than as it ought to be. But, of course, this is in itself a philosophical position, which cannot be held, I would say arbitrarily, above contention. In any case, it is beyond the scope of this paper to go into this issue in any detail. I will simply repeat what I stated at the beginning - that *global/globalization* and *Islamic/Islamization* are processes, and as such, we have to rely on all methods at are disposal - statistical *and* historical, theoretical and cultural - to understand and unravel the potentialities of these processes. A robust model or picture of the future cannot be constructed, I would hold, without such an understanding; and furthermore, prediction and control inherently involves a representation. In this paper, I have attempted to highlight a framework of understanding that is not conventional, and whose elements are not typically given prominence in the available literature.

However, at the conclusion of this paper, I invite you to reflect on the validity of the following substantive propositions that can be called from the strands that I have brought together. A methodological framework is only useful to the extent that it allows us to ask, and eventually answer, questions that had not occurred to us before.

1. Commerce is a “civilizing” agent - one that engenders, builds and favorably-modifies both a people and their institutions. In modern terminology, globalization leads to good governance and to the elimination of corruption. In terms of a financial corollary, financial globalization disciplines and thereby leads to financial stability and financial prudence.

2. Commerce is a “disrupting” agent - one that engenders greed, and in the sole pursuit of self-interest, unfavorably - modifies both a people and their institutions. Advantages of commerce accrue once good institutions, in particular, good financial institutions, are already in place. In modern terminology, good governance and absence of corruption checks the potential instabilities and chaos wrought by globalization. A sense of community, and the values, which go with it, is a pre-requisite for enjoying the fruits of commerce.

3. However nuanced and sophisticated one’s views on the effects of commerce and globalization, financial institutions that stabilize risk as a consequence of *diversification* and *aggregation* are indispensable. The indispensability of judicial institutions in ensuring the viability of financial institutions.

4. A specification of the domain, and hence of the society, over which the operations of *diversification* and *aggregation* are conducted. It is this domain over which the jurisdiction of the judicial framework will be primarily exercised, and problems of moral hazard and adverse selection ameliorated. The constitution of such a domain by the Islamic *ummah* and the social and financial implications of such a constitution.

5. The impossibility of bracketing financial institutions from other institutions that govern and regulate the fulfillment of contracts. All of these institutions both draw on, and formalize in concrete terms, the underlying ethos of the society and development of institutions in the light of an Islamic ethos, and the enrichment of the ethos.

6. On the one hand, the overriding importance of societal actions as inputs into individual decision-making, and hence, into the constitution of individual identity; and, on the other hand, the definition and representation of social actions as suitable aggregates of individual actions. The relevance of this for the delineation of individual versus social responsibility, as well as for mechanism design for the provision of public goods or for the amelioration of the problems of moral hazard, adverse selection and other “hidden” actions.

7. The role of globalization on the articulation and definition of the nation state, and the implication of this for a delineation of the societal domain as revolving around the Islamic *ummah*.
8. The articulation of an Islamic ethos and its role in providing restraints against what one sees as the deleterious effects of globalization, particularly financial globalization. At the same time, the role of globalization in providing further insight on Islamic values. The importance of pluralism, and of the realization that there is not one "scientific" way of doing things; but this realization interpreted within the rubric provided the Qur'ān and the Islamic past.

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