Islamic Finance in Multicultural Indonesia

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1. Introduction

In this essay I consider the case for Islamic finance in multicultural Indonesia. I argue that as both a normative good and as a practical matter, the continued development of an Islamic financial system that operates in parallel with the conventional financial system is desirable. While I accept the arguments made by several prominent Muslim critics of Islamic banking, which question philosophical consistency of Islamic finance as practiced in modern economies, I reject their conclusions—that Islamic banking as currently practiced should therefore either be eliminated or dramatically reformed. Rather, I maintain that if their arguments are actually true, then the Indonesian state should continue to provide Islamic financial services for consumers who demand them. That is, if Islamic financial products truly are indistinguishable from conventional financial products, then the only costs in offering them are the costs of financial engineering (which will approach zero over time) and of regulation. Meanwhile, if some pious Muslims in Indonesia demand sharia-compliant products, then offering them allows these consumers to enter the market. Doing so improves the financial market's distributional efficiency, and provides opportunities for these individuals to obtain mortgages, business loans, and other financial products. Indonesia is a country with approximately 200 million Muslim citizens, and while most appear unconcerned with sharia-compliance in their financial products, some are. So long as Islamic finance does not threaten the conventional financial system, the

Indonesian state should continue with the steps that it has taken to accommodate these Islamic finance in the Indonesian economy.

I begin with an analogy. Automobile manufacturers have long recognized that some consumers demand "prestige" goods, goods whose prices are purposefully marked up to reflect the desirability of a particular brand name. In the United States, Ford sells cars under the Mercury brand, inflating the price far beyond that which corresponds with a higher grade of leather or gold plated electronics. They do this because some automobile purchasers wish to buy a prestige brand and are willing to pay these inflated prices.

An Islamic financial market that parallels the conventional financial market is quite similar. Islamic financial engineers produce financial products that are almost identical to conventional financial products, the difference being certain technical details (which I outline below) that are deemed by many Islamic scholars to fulfill Islam's injunction against the collection of interest. Islamic financial products frequently cost the same or perhaps slightly more than conventional products. Yet some Muslims prefer to purchase them because they believe that they are fulfilling a spiritual dictum to avoid prohibited transactions.

No one would impugn an automobile manufacturer for recognizing an opportunity for profit by offering prestige brands. Likewise, I argue, no one should impugn an Islamic financial engineer for recognizing an untapped market segment. Two prominent observers of Islamic economics, Timur Kuran (2004) and Mahmoud El-Gamal (2006), have criticized Islamic finance for violating the social intent of Islamic injunctions against interest. Yet I see this as nothing more than criticizing an automobile manufacturer for taking advantage of the demand for prestige products. We may find their motives odious and exploitative, but there is nothing ethnically improper with matching demand with supply in a voluntary manner. And in fact, I

argue that inasmuch as some pious Indonesian Muslims might actually refuse to participate in the formal economy without the option of purchasing Islamic financial products, it is normatively desirable to make these products available.

In the next section I propose a political lens through which to understand modern banking systems in general, and Islamic banking in particular. I argue that banking systems—both conventional and Islamic—are by necessity centralized and state-controlled political institutions. This creates a tension in countries like Indonesia between the demands of ordinary citizens for specialized, variegated financial products, and the state's need to centralize and regulate a national financial system. I then describe Islamic banking in Indonesia, and detail how Islamic finance differs in a theoretical manner from conventional finance, concluding that there are few differences between Islamic finance and conventional finance. Next, I entertain three objections to Islamic finance, and argue that together they are not sufficient to give the state any reason not to facilitate the development of Islamic finance in Indonesia. Importantly, I support this argument with empirical evidence, introducing results from the first survey ever taken of Indonesian citizens regarding their views of Islamic finance.

2. The State and Finance

There is no aspect of a national financial system where that is independent from political influence. From monetary policy goals to the choice of monetary institutions, political considerations lie at the heart of modern finance (Kirshner 2003). At the center of every modern financial system are a central bank and monetary authorities that give order to what would otherwise be a chaotic system of independent and unregulated private financiers. These organized national financial systems do not arise spontaneously, but rather require a state to enact the legislation that creates them. The laws that allow for the creation of national financial

systems also govern the policy goals and the degree of political autonomy enjoyed by financial policy authorities. As the types of financial transactions that may take place require at least tacit permission from monetary authorities, they depend as well on the state's willingness to tolerate them.

In the same way that national financial systems do not arise absent a state to create them, Islamic financial systems do not emerge spontaneously either. Instead, they require enabling legislation and regulatory institutions, each of which again are necessarily provided by the state. Islamic principles, discussed below, require financial products that do not neatly fit within standard financial regulatory practices (Errico and Farakbash 1998). Banking systems that forbid the collection of interest, for example, may be incompatible with the standard ways that central banks regulate commercial banks—through statutory reserve requirements and interest bearing accounts in the central bank. Without interest, furthermore, it is unclear how banks play their central role in the transmission of monetary policy.

In multicultural countries such as Indonesia, where Islamic banking operates in tandem with a conventional banking system, the fact that national financial systems require centralized institutions and standardized rules creates a singular tension. The state, on one hand, must centralize and regulate financial institutions to ensure their orderly function. The social costs of failing to do so are best illustrated through the breakdown of financial regulation that accompanied the Indonesian economic crisis of the late 1990s. But some citizens may demand different or even preferential financial regulations in line with their beliefs, refusing to participate in financial systems that do not conform to them. To obtain this treatment, they may turn to politics as well. The issue of Islamic finance, then, provides a way to examine broader

tensions between the state and competing identities—in this case example, secular versus pious Muslims—in Indonesia.

With the state playing such a central role in creating and shaping national financial systems, it is no surprise that the rise of Islamic finance is intimately tied with political developments in the Muslim world. Islamic finance comprises only one part of a wider system of Islamic economic thought. Islamic economic thought, in turn, is often considered to have first been articulated in its modern form by Sayyid Abul-Ala Mawdudi, a political activist and economic thinker from modern-day India whose most influential writings date from the 1930s and 1940s (see Kuran 1997). Writing in the context of British decolonization and the debate over Indian partition, Mawdudi argued that Muslims should strive to conceive of Islam as not just a religion, but a way of life in explicit contrast to the secular worldview predominant in Europe and North America. More than simply advocating reform and renewal, however, Mawdudi joined several other scholars in advocating concrete policy reforms to guide such as a society. At the center of these arguments lay an Islamic conception of the economy that held itself to be both modern and a distinct alternative to Western economics. This meant (perhaps confusingly) a return to the society that existed during Islam's Golden Age in the decades following the Prophet Muhammad's death.

Still, even with Mawdudi's promulgation of Islamist economics as a distinct (if contested) economic worldview, it remained several decades before the first Islamic financial institutions were created. Indeed, their creation was far from inevitable. The rise of Islamic finance in its modern form paralleled the global petroleum boom of the 1970s, and its continued growth after the petroleum crunch of the 1980s was part and parcel of other, more liberal, anti-statist economic reforms that targeted unresponsive and interventionist states in the developing

world (Warde 2000). In the 1970s, Muslim countries flush with petroleum revenues were able to establish Islamic financial institutions. In turn, when these petroleum revenues evaporated in the early 1980s, stakeholders in the very financial institutions created by petroleum wealth helped to lead the charge against bloated and unresponsive secular states. No doubt the concomitant rise of global Islamism as a rejection of secular or Western ways of life provided a convenient platform for the development of Islamic finance. In every country that has adopted at least a partially Islamic financial system, political contestation among various societal actors shaped the substantive form of Islamic finance as adopted (see the case studies in Henry and Wilson 2004).

Politics also shaped the spread of Islamic finance to Indonesia. The first Islamic financial institutions arrived somewhat later in Indonesia than they did in other Muslim-majority countries, for under the New Order Islamic finance, like any other conspicuously Islamic behavior, was linked to radicalism and extremism (Venardos 2006: 166). As a consequence, advocates for Islamic finance suffered from the same obstacles that the country's popular Muslim organizations faced under Soeharto's rule. Only in the early 1990s, when Soeharto began to adopt a more conciliatory stance with vis-à-vis Islamists (see Hefner 1999, 2000:128-166), were Islamic financial institutions permitted to organize. This required special legislation, first enacted in 1992 and later amended and extended in 1998, after the New Order's collapse allowed for more inclusive political organizing by all members of Indonesian society. Since 1998, Bank Indonesia has worked along with the National Sharia Board (*Dewan Syariah Nasional*), affiliated with the Indonesian Council of Ulamas (*Majelis Ulama Indonesia*), in order to regulate and clarify the permissibility of various financial products in Indonesia (Bank Indonesia 2007a).

Since Soeharto's decision to allow Islamic banking in Indonesia, Islamic financial institutions—known in Indonesia by the term *perbankan syariah* or "sharia banking"—have gradually gained a foothold (see Timberg n.d.). Most visible in the urban areas of Indonesia is Bank Muamalat, a financial institution that offers a complete array of financial services that parallel those offered by Indonesia's conventional banking system. Two other financial institutions have created sharia-compliant subsidiaries (Bank Syariah Mandiri and Bank Syariah Mega Indonesia). A far larger number of domestic financial institutions have created "sharia windows" within their branches. Rural banks operating under sharia principles (*Bank Perkreditan Rakyat Syariah*) operate on a smaller scale, but they have managed to achieve wider coverage. On a still smaller scale, and targeting the poorest Indonesians, there are thousands of savings and loan institutions known as Bait Maal Wat Tamwil that operate according to Islamic principles. In recent years, foreign banks with a presence in Indonesia (including such established multinational financial institutions as HSBC, Deutsche Bank, and ABN-AMRO) have begun themselves to offer "*syariah*-compliant" financial products. Table 1 summarizes the growth of Islamic financial institutions in Indonesia, using the most recent data available from Bank Indonesia (Indonesia's central bank).

Table 1: *Islamic Financial Institutions in Indonesia*
Source: Bank Indonesia (2008b)

	Dec-03	**Dec-04**	**Dec-05**	**Dec-06**	**Dec-07**	**Apr-08**
Banks with Sharia Units	8	15	19	20	26	28
Branches	45	74	133	163	170	183
Islamic Banks	2	3	3	3	3	3
Branches	189	263	301	346	398	399
Islamic Regional Banks	--	--	--	--	114	118
Branches	--	--	--	--	185	189

Together, these institutions comprise the growing new landscape of Islamic finance in Indonesia. However, from the perspective of the national financial system, Islamic products

remain a small minority of all products sold. While total assets of Islamic financial institutions have nearly quadrupled from Rp. 7.44 trillion in December 2003 to Rp. 26.72 trillion in December 2006, total market share was just 1.69% in March of 2007 (Bank Indonesia 2007b). Seeing an untapped market for Islamic banking products, Bank Indonesia has targeted growth of Islamic finance in Indonesia to achieve a 5% market share by the end of 2008 (Bank Indonesia 2008a).

3. The Mechanics of Islamic Banking

The formation of national financial systems—Islamic and conventional alike—is not the only political component of Islamic finance. Actually defining what comprises "Islamic" finance is far from straightforward. This sets the stage for political interests to play a large role in defining what financial products are and are not "permitted under Islam." A common misconception is that Islamic finance is simply banking without interest (*riba*). This is overly simplistic, for several Hadith refer specifically to issues of speculation and risk and other general ideals that scholars have held as necessary for an Islamic commercial society. For instance, prohibition of *riba* in Islam is accompanied by a less-known prohibition on *gharar*, which might be glossed as "speculative risk," or risk that is not clearly known. Precise distinctions between speculative risk and simple business risk remain unclear, however. Given that simple investment risks are clearly allowable, precisely what *gharar* entails has yet to be defined with any exactitude. Rather than taking a stand on these matters, I follow a number of recent authors by adhering to a more inclusive interpretation. Warde (2000:5) defines Islamic finance as, roughly, all financial practices that "are based, in their objectives and operations, on Koranic principles." This definition is broad, but necessarily so, as it captures the complexity of Islamic finance in the modern world.

It should be recalled before proceeding that the use of spiritual principles to guide financial practice is not unique to Islam. Christian and Jewish holy texts contain numerous prescriptions about usury and business transactions, and these played a large role in theological debates throughout the early modern era (Aggarwal and Yousef 2000:97; Warde 2000:63-68). Christian religious organizations—much like progressive secular organizations—create investment trusts that use non-market principles to guide decisions about portfolio allocation. Islamic finance is just one of many social projects that reimagine the meaning of money to reflect specific, often local, societal conventions and understandings (see Maurer 2005).

While this is not the purpose of this article to delve into the intricacies of Islamic banking, the main points are summarized briefly below. Fuller treatments can be found in El-Gamal (2006), Warde (2000:132-148), Venardos (2006:71-84), and elsewhere. The overwhelming majority of Islamic financial practices mirror conventional practices of providing funds to a customer in order to make a profit. In conventional banking systems, such transactions rely on interest. A bank provides a loan to a entrepreneur for it to purchase a good, such as a factory, and the entrepreneur uses the profits generated through this factory's business activities to pay that loan back in a set of installments. Interest charged on this loan allows the bank to make a profit. In the event that the business fails to be profitable, ownership of the factory reverts to the bank and the entrepreneur suffers. Islamic scholars have interpreted the ban on *riba* to center around the inequality of risk in such transactions: the entrepreneur assumes the business risk, while the lender does not. This motivated the search for distinctly Islamic methods of financing based around contract forms known have to been engaged in either by the Prophet Muhammad or others in his time. The most commonly employed of these contract forms fall

under the rubrics of equity contracts and profit-sharing agreements, each of which allows both the lender and the borrower to share the risk inherent in such transactions.

Equity contracts allow the bank to provide financing to business by reimagining a loan as a type of deferred sale. Under the principle of *murabaha*, the same transaction described above would proceed in the following manner. Instead of lending the entrepreneur a sum of money through which to purchase the factory, the bank purchases a factory itself for the entrepreneur. Then, having previously come to an agreement on the price to be paid for the factory, the bank then resells the factor to the entrepreneur, charging an extra sum of money as profit in exchange for having arranged the sale. A similar principle is *bai bithaman ajil*, which stipulates that the entrepreneur may pay for the factory over a series of installments extending into the future. *Ijara* is another similar arrangement. Instead of reselling the factory to the entrepreneur, under *ijara* financing the bank leases it to entrepreneur, again charging the entrepreneur an extra amount above the cost of the factory to make a profit. There is even an arrangement known as *takjiri* which allows the entrepreneur to purchase the lease agreement upon successful fulfillment of the lease's terms. Such arrangements which allow a bank to make a profit without charging interest by charging "cost-plus" are transparently equivalent to the purpose of interest. In reality, the implied interest rates from such arrangements often very close to those from conventional financing.

Under profit sharing agreements, banks engage in a rather different practice. Instead of purchasing the factory for the entrepreneur, these agreements allow the bank to provide the entrepreneur with money (as with a loan) but stipulate that the bank retains some form of rights over the profits made from any subsequent business activity. Under *mudarabah*, the bank provides capital for the factory, and the entrepreneur in exchange simply agrees to repay the

bank for the cost of the factor along with a share of its profits. This is permissible because the bank bears some risk in this transaction—after all, the entrepreneur may not succeed in his or her business. Relatedly, *musharakah* financing allows both the entrepreneur and the bank to provide cash for purchase of the factory, and the bank shares profits based on the percentage of the purchase that it financed or some other agreed-upon terms. These arrangements are quite similar to venture capital practices in conventional financial systems. In all, there is only a small difference between these and Islamic equity contracts. Write Aggarwal and Yousef (2000:97), "the critical feature of markup [equity] contracts is that the bank retains ownership of the asset and can seize it in cases of default. Under PLS [profit-sharing] contracts, the bank has no such direct claim on the asset as it is in partnership with the entrepreneur. Thus it is the control rights over the asset conferred by markup financing that differentiate it from PLS financing."

There remains a final type of loan that in principle may be conducted under Islamic principles: the benevolent loan (*qardh ul hasan*). These are simply loans with no interest, with the borrower obligated to pay back the loan's principle only. Much of the Islamic literature concentrates on *qardh ul hasan* as a way to achieve the goals of an Islamic economy, but in practice these comprise but a vanishingly small fraction of all financial activities. It is not hard to see why, as the profit-seeking motives of bankers conflict with the benevolent principles which underlie *qardh ul hasan*.

From these simple principles a wide array of financial products have been engineered, including many that at first glance have little resemblance to such premodern contract forms. For example, *wadiah* demand deposit accounts, built on the profit-sharing principle, allow depositors earn "profits" rather than interest on their accounts. The bank is under no strict obligation to distribute such profits, but no Islamic bank that did not distribute them would remain attractive to

depositors for very long. Likewise, there do exist Islamic equity investment opportunities for consumers, as well as Islamic derivatives, bonds, and mutual funds (Warde 2006:138-142). The additional stipulation to these products beyond the Islamic contract forms at their base is normally that Islamic investments must avoid companies that do business in activities considered incompatible with Islamic principles (brewing, gambling) or which hold excessive debts.[1]

Insurance was often considered to be particularly incompatible with Islamic principles, for it is a financial product whose trade relies pricing the often unpredictable risks inherent in everyday life. This would run afoul of the injunction against *gharar* under most interpretations of that term. Accordingly, Islamic scholars and financiers have created a parallel insurance system known as *takaful* based on *mudarabah* and other permissible Islamic agreements. Bank Negara Malaysia, which has played a prominent role in Islamic financial engineering, summarizes *takaful* as an agreement among customers who

> reciprocally guarantee…each other against loss or damage that may befall any one of them. Al-mudharabah is the commercial profit sharing contract between the provider(s) of funds (participants) for a business venture and the entrepreneur who actually conducts the business. Tabarru' is the agreement by a participant to relinquish as tabarru' (to donate, to contribute, to give away), a certain proportion of the takaful contribution that he agrees or undertakes to pay, thus, enabling him to fulfil his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss….The operation of takaful may be envisaged as a profit sharing business venture between the takaful operator and the individual members of a group of participants who desire to reciprocally guarantee each

[1] Note that this is "excessive debts," not "any debts."

> other against a certain loss or damage that any one of them may suffer (Bank Negara Malaysia 1999:257).

It is clear from this description that *takaful* insurance shares many characteristics with group insurance plans in conventional financial systems.

The practice of Islamic financial engineering has made it possible for financial institutions to offer products that parallel every type of conventional transaction but which avoid the collection of interest by a lender for the purpose of profit. The strongest such statement comes from Mahmoud El-Gamal, a financial economist with extensive knowledge of Islamic financial practice who concludes that "beyond doubt…any conventional financial product can be synthesized from premodern contracts" (2006:176). In the financial marketplace, Islamic products are competitive with conventional products, and financial institutions frequently advertise Islamic financial products in parallel with conventional financial products, even specifying the implied interest rate from the Islamic product. With this, it is clear that the prohibition on interest has largely been avoided in name only.

Skepticism about the uniqueness of Islamic finance accordingly abounds. Writes Warde (2000:240), Islamic finance "is…a failure insofar as it did not fulfil its original promise of being and original and innovative system, based on risk sharing, that would bring social and economic benefits to the Islamic world." Kuran (2004:12) adds, "my basic point is simply that the lending practices of the Islamic banks do not conform to the stipulations of Islamic economics." And El-Gamal (2006:2) states that "this 'Islamic' distinction often can be preserved only at a cost, and minimization of that cost—driven by competitive pressures—may render it a distinction of form without substance." Beyond these theoretical critiques, Aggarwal and Yousef (2000) present quantitative evidence that around the world Islamic financial institutions do not engage in

different lending behaviors than conventional banks. Central to each of these critiques is that Islamic finance fails because it is functionally identical to conventional finance.

The reason lying behind this apparent failure of Islamic financial institutions to conform to the social-minded principles emphasized under Islamic economics appears to be the fact that Islamic bankers, like other bankers, respond to the profit motive. Benevolent interest-free loans (*qardh ul hasan*), which seem to represent the heart of Islamic economics, illustrate this well. Benevolent interest-free loans comprised less than 0.33% of all rupiah-denominated loans made by Bank Muamalat in 1998, at the height of the economic crisis in Indonesia (Timberg n.d.: 5). More than any other period in recent history, this should have been the time when such institutions would have been making such loans if benevolent or socially-minded principles lay at the heart of their lending practices. Yet their total value is vanishingly small in this context, which suggests that Bank Muamalat focuses more on protecting its profitability than on socially minded principles.

4. What Is The Harm?

Accordingly, the central question at the heart of the debate over Islamic finance in multicultural Indonesia, given that Islamic finance is nearly indistinguishable from conventional banking, is not one over the substance of the financial services provided by Islamic institutions. Rather, it is about the extent to which the growth of an Islamic financial system in Indonesia is either costly or beneficial to Indonesians, Muslims and non-Muslims alike. In other words, the debate over Islamic banking is neither theological nor technical, it is distributional and political. How should the Indonesian state accommodate the demands of its citizens for financial products deemed to comply with Islamic principles?

Here, I propose that we may judge the development of a parallel Islamic financial system in Indonesia harmful for any of three reasons. (1) If radical elements in Indonesian society demand that an Islamic financial system *replaces* Indonesia's conventional financial system (as in Sudan or Pakistan). (2) If the regulatory burden of maintaining an Islamic financial system in parallel with a conventional financial system is so burdensome that it drains precious resources from the state's coffers or threatens the very viability of the country's financial system. And finally, (3) if Islamic banking is merely a tool for rent-seekers to exploit naïve or unsophisticated consumers with the allure of "religiously pure" banking products.

The first possibility is the most sensationalist in the Indonesian context. It is also probably the least likely to come to pass. There is, as of yet, no organized movement in Indonesia that commands any degree of popular support and which has proposed that Islamic finance should *replace* rather than *supplement* conventional banking. Indeed, there is no organized movement that has placed Islamic banking at anywhere close to the center of their campaign platforms. An economist currently serving as a member of the House of Representatives from Indonesia's Prosperous Justice Party, an Islamist party often labeled as the most conservative of a number of parties who are based on Islam rather than the pluralist ideology of Pancasila, argues that it would be simply impossible to replace conventional banking with Islamic banking in Indonesia (author interview with Zulkieflimansyah, July 4, 2008). However, the views of ordinary Indonesians remain absent in considering this question, so it is difficult to ascertain whether or not a movement to replace conventional banking with Islamic banking could attract popular support.

To gauge the extent to which ordinary Indonesians are sympathetic to the elimination of conventional banking and its replacement by Islamic banking, the Indonesian Survey Institute

(Lembaga Survei Indonesia) recently asked several questions about Islamic banking in a nationally-representative random survey of over 2500 Indonesian citizens. A series of questions were posed to the respondents about their experience with banking practices and their opinions about Islamic banking in particular. Table 2 presents results from an initial question about whether or not charging interest should be forbidden because it conflicts with the teachings of Islam.[2] Respondents were given five choices of responses; the total number of respondents is broken down among those who have used banking services versus those who have not. The figures only include self-identified Muslims, and do not include respondents who either refused or could not answer at least one of the questions.

Table 2: *Opinions about the Forbidding of Bank Interest*

Bank Interest Should be Eliminated	**Have Ever Used Bank Services**		
	No	*Yes*	TOTAL
Strongly disagree	23	10	33
Disagree	468	346	814
No opinion	121	127	248
Agree	506	369	875
Strongly agree	39	16	55
TOTAL	1,157	868	2,025

The results show that fully 41.6% (847/2,025) of respondents either agreed or strongly agreed with the statement that the charging of bank interest should be eliminated because it runs contrary to the principles of Islam. While a minority of respondents, from an absolute perspective this is a surprisingly high number. These figures are remarkably consistent among respondents who have used banking services before and those who have not. Among those who either disagree or strongly disagree with the elimination of interest, 42.0% (356/847) have used

[2] The precise wording of the question is as follows: "Apakah Ibu/Bapak sangat setuju, setuju, tidak punya sikap, tidak setutu, atau sangat tidak setutju dengang pandangan-pandangan di bawah ini? Sebaiknya bunga bank dilarang karena bertentangan dengan ajaran agama Islam."

banking services, while among those who agree or strongly agree with the elimination of interest, the figure is 41.4% (385/930).

While these numbers suggest that at the level of ideal preferences, a substantial minority of Indonesians would support the elimination of bank interest, they probably reflect little more than these idealized preferences. Other evidence suggests that among these respondents, there is very little substantial link between these preferences and the respondents' behaviors as bank customers. The survey described previously also asked respondents to rate the frequency with which they chose sharia-compliant financial products.[3] The results appear in Table 3. Respondents included in Table 3 are only ones that fulfilled the requirements of (1) having used banking services before, (2) being aware that Islamic banking exists in Indonesia, (3) being Muslim, and (4) not refusing or claiming to be unable to answer at least one of the questions.

Table 3: *Opinions about the Forbidding of Bank Interest and Respondents' Banking Choices*

Bank Interest Should be Eliminated	**Use Islamic Financial Products**				
	Never	*Sometimes*	*Usually*	*Always*	TOTAL
Strongly disagree	5	2	0	2	9
Disagree	201	29	6	4	240
No opinion	77	10	5	1	93
Agree	223	33	26	13	295
Strongly agree	9	1	3	0	13
Total	515	75	40	20	650

These results show little substantive link between opinions about bank interest and actual behavior. Indeed, fully 75.3% (232/308) of respondents who claim to agree or strongly agree that bank interest should be eliminated nevertheless *never* use Islamic financial products, compared to 82.7% (206/249) of those who disagree or strongly disagree that bank interest should be eliminated. Moreover, even among those who do use Islamic financial institutions, respondents

[3] The precise wording of the question is as follows: "Apakah selama ini, Ibu/Bapak selalu, cukup sering, kadang-kadang, atau tidak pernah menggunakan jasa-jasa perbankan Islam / perbankan syariah?"

are far more likely to report using Islamic products "sometimes" or "usually" than always. The fact that three-quarters of those who support eliminating bank interest because it runs contrary to Islamic teachings still always choose conventional products should be reassuring for those who believe that political pressure will somehow force Islamic finance to replace conventional finance in Indonesia. A more likely future path is that of Malaysia, where Islamic and conventional financial systems operate in parallel.

The second possibility, that Islamic finance may raise the costs of regulation and actually threaten the viability of Indonesia's financial system, is enticing. El-Gamal (2006) suggests that "shari'a arbitrage"—a term that refers to the practice of using a set of pre-modern but theologically permissible contract forms to synthesize the equivalent of a conventional but forbidden contract—has "a striking resemblance to the 'layering' techniques used in financial crimes" (176). Venardos (2006:100-114) and Errico and Farakbash (1998) detail further areas in regulatory practice where clear parallels between conventional and Islamic regulation remain murky or even absent. This confirms the need for prudential oversight of Islamic financial markets to prevent the types of financial malfeasance that may occur.

So far, there is little evidence that Islamic financial institutions engage in more risky behavior than conventional banks. Table 4 shows the factions of all loans rated as non-performing across domestically-owned Islamic banks and conventional banks, and compares those figures to those from foreign-owned banks. Again, data are the most recently available from Bank Indonesia.

Table 4: *Non-Performing Loans as a Percentage of Total Loans, by Bank Type*
Source: Bank Indonesia (2008b)

	Dec-03	**Dec-04**	**Dec-05**	**Dec-06**	**Dec-07**	**Apr-08**
Islamic	2.34	2.37	2.82	4.75	4.05	4.39
Conventional Domestic	6.78	4.50	7.56	6.07	4.07	3.82

Foreign	11.47	5.99	4.50	3.64	5.23	5.95

These data reveal that Islamic banks (perhaps due to their newness) have not suffered from worse lending practices in the past several years. Figures for non-performing loans are, rather, in the neighborhood of those for conventional banks (both foreign and domestic) today.

From a different perspective, though, the observation that Islamic financial engineering can create products whose risks are unfamiliar to state regulators does not make Islamic finance uniquely too challenging for regulators. Indeed, it shows the deep similarities between Islamic finance and conventional finance. The history of financial engineering in conventional financial systems has been marked by the continued development of new and often confusing financial products, from derivatives to collateralized debt obligations, that present new and unforeseen challenges for regulators. The hallmarks of these new financial products are frequently the repackaging of risk. It is an inherent feature of state financial regulation in market economies that financial engineering requires active oversight by regulatory authorities. There is no *a priori* reason why this should not apply the same for Islamic financial products as it does for conventional financial products.

It is also a peculiar choice to hold Islamic finance to a higher standard than conventional finance. Indonesia's recent history has shown that conventional banking practices are quite capable of producing dramatic economic meltdowns on their own. Islamic finance had already made inroads into the Indonesian economy by this period, but had nothing to do with the economic crisis of the late 1990s. This indicates the general weakness of Indonesian financial regulation is a central problem, but not one that should impugn the viability of Islamic finance. Moreover, it is striking (given Indonesia's history of weak financial oversight) how seriously Bank Indonesia takes its mission of overseeing the development of prudent regulations in Islamic

finance. Its plan for accelerating the growth of Islamic finance, for example, includes detailed lists of regulatory challenges that it will face and steps it will take to meet them (Bank Indonesia 2008a). This should be encouraging for those who fear that Islamic finance may challenge the regulatory capacities of the Indonesian state.

The third possibility—that Islamic finance in Indonesia is merely a tool of rent-seekers to exploit naïve consumers—is profoundly pessimistic. However, it may be an accurate description of reality. It is impossible to prove conclusively that the motives of Islamic bankers are simply greed, although the evidence cited about Bank Muamalat's lending practices at the height of Indonesia's economic crises certainly suggests that profit motivates Indonesia's Islamic bankers. At the same time, my own interviews conducted in June and July of 2008 suggest that a number of mid-level officials from parties across the Indonesian political spectrum remain convinced that Islamic finance offers a "new face" for socially-minded economic development in Indonesia (the identities of these interviewees I keep anonymous).

Rather than take a stand about the social-mindedness of Islamic banking in Indonesia without evidence to support it, I shall instead assume the worst case scenario: that all Islamic bankers, like conventional bankers, search for profits to the exclusion of all other concerns. This, recall, is the basis of the most trenchant economic critiques of Islamic banking. However, the fact that a seller's motivations are profit rather than social welfare should have no bearing upon the normative evaluation of that good. Recognizing this, we can evaluate Islamic banking products in the same fashion that we may evaluate other goods.

As suggested in the introduction, the analogy of automobile brands may help to illustrate this point more clearly. At the basic level there are few substantial differences between the automobiles marketed as "Ford" versus "Mercury" in the United States. The former include an

upgrade in the quality of the electronics and the interior finishing, and may offer some additional improvements to the motor and drive train. But the essence of the difference is one of the automotive consumer's perception of the quality of the automobile, and this is tied deeply to the price that the same manufacturer can charge for essentially the same automobile. Consumers purchase the expensive version of an identical product, in part, precisely *because* it is expensive. In the economics literature, these are called "Veblen effects" after the economist who identified them (and who also coined the term "conspicuous consumption" (Veblen 1899)). Islamic finance is not an exact parallel here: Veblen effects exist because price actually comprises part of what consumers demand, whereas the demand for Islamic financial products is dependent on the theological permissibility of these goods as identified by religious authorities (note also that the prices charged for Islamic financial products are not necessarily higher). Yet the spirit of the consumption is the same. Consumers base their consumption decisions on considerations other than whether or not the price charged reflects an "objective" valuation of the goods that they purchase.

The foundations of economic theory make no claims about the sources of individuals' tastes or preferences over their consumption patterns. We may locate the sources of tastes in the rational utility-maximizing calculations of individuals—people may support Islamic finance because they believe that they will suffer sanctions from their neighbors if they do not—but this does not speak to inherent moral or ethical dimensions of preferences (see the discussion in Stigler and Becker 1977). The implication is that so long as there exists a market for Islamic finance, then the fact that its customers may be sold products that are functionally identical to conventional products by greedy bankers in search of profit has no bearing on our normative valuation of that practice. Islamic finance fulfills a niche in the Indonesian financial marketplace

by allowing consumers to purchase “Islamic” products. There should be no ethical qualm associated with this practice simply because the motives of bankers may be something other than spiritual purity.

In fact, the standards required to maintain bankers’ greed, or functional equivalence between Islamic and conventional products, as objections to Islamic banking are profoundly anti-democratic and anti-pluralist. In essence, it requires insisting that some entity—perhaps the state—has authority to rule on the appropriate values of consumers in the modern economy. The consequences might include regulating the marketing of luxury goods, from Mercury automobiles to Rolex watches. Or of “silly” goods, like green-colored ketchup (once a fad in the United States). Insisting that Muslims eager to enter the financial marketplace not use their own spirituality to guide their consumption patterns reflects the very sort of anti-pluralist sentiment that was prevalent during the worst years of Soeharto’s New Order.

So while it is straightforward to criticize the spiritual consistency of Islamic financial products that are functionally equivalent to conventional products but which have been engineered by combining contract forms from the era of the Prophet Muhammad, this criticism should have no public policy consequences. Instead, the development of a parallel Islamic financial system in Indonesia may be beneficial in the event that calling financial products “Islamic” makes it possible for devout Muslims to purchase them. As yet there are no reliable estimates of the size of this market, but it certainly may capture the ideals of millions of ordinary Indonesian citizens.

5. Conclusion

This essay has argued that it is normatively desirable to encourage the further development of an Islamic financial system in parallel to a conventional financial system in

Indonesia. Its approach to this argument is rather different than most normative defenses of Islamic financial development. Most such defenses of Islamic finance hold that the desirability of Islamic finance stems from Islamic theology, including scriptural injunctions against prohibited transactions and the purity of the society that existed in the years following the death of the Prophet Muhammad. These defenses, however, are deeply vulnerable to simple critiques by skeptics well-versed in Islamic finance as it is currently practiced: that contemporary banking practices reveal that Islamic finance is a distinction in name rather than in substance, that Islamic finance is a particularly modern phenomenon, and that the stakeholders in Islamic financial services are far more concerned with profits than with socially-minded goals.

My defense accepts all of these critiques, yet still maintains that they are not sufficient to undermine the desirability of developing an Islamic financial system in Indonesia that operates in parallel with the country's conventional financial system. The basis of this defense is the recognizance that a substantial number of Indonesians appear truly to desire Islamic financial products, and that the Indonesian state's challenge is to allow these voices in Indonesian society to be heard. I argue that there is no legitimate reason to single out the demand for Islamic finance as normatively undesirable, even allowing there to be selfish motives underlying the providers of Islamic financial services. It is not the state's responsibility to rate some consumer demands as reasonable or otherwise.

Of course, this conclusion is wholly conditional on one point: that Islamic finance does not *replace* conventional finance, rather only parallels it. There is no evidence that a ban on conventional finance is anywhere near the future for Indonesia's economy. Even the most conservative Islamic political parties have not made this anything of a political issue. Even many of Islamic finance's proponents still use conventional financial products themselves. Still, the

accommodation of multiple different ideologies in Indonesia works both ways, protecting both those consumers who demand Islamic financial products and those who demand nothing of the sort. So far, this has been the mission of Indonesia's financial authorities—a concerted effort to bring Islamic finance to those who demand it, while endeavoring to strengthen the regulatory apparatus for Islamic finance, and nevertheless maintaining the country's conventional financial system as the prime player in the country. This leaves me at a rather unusual position of believing that the Indonesian state since 1998 has proceeded quite well in encouraging the development of Islamic financial institutions in Indonesia.

The implications of this essay also make a broader point. The tension between the demands of ordinary citizens and the state's need to centralize and regularize critical state institutions is inherent not only in the state's role in financial regulation, but throughout the negotiations between ordinary citizens and the state in the multiethnic, multicultural, multireligious country of Indonesia. Islamic finance offers a convenient avenue to explore this issue, but throughout the country the dialogue between the centralizing impulses of state authority and the differing voices of Indonesian society may be heard. The challenge for the Indonesian state in the democratic era is to accommodate as many of these voices as possible.

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