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The Role of Islamic Finance in the Development of the IDB Member Countries: A Case Study of the Kyrgyz Republic and Tajikistan

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Finance is expected to play a major role in equitable and sustainable economic development. However, the track record of conventional finance is not encouraging for the task. It has not been very successful in addressing unemployment and poverty. Indeed, the stylized facts show that many countries suffer from increasing income and opportunities inequalities along with economic and financial instabilities. Can Islamic finance offer a solution where conventional finance has failed in the task of equitable socio-economic development? The present paper seeks to explain how promotion of Islamic finance can help in the development of low-income countries.[1] This potential role of Islamic finance is discussed in the context of a case study of Kyrgyz Republic and Tajikistan. Development of Islamic financial sector is high on the agenda of Islamic Development Bank in its efforts to partner in the socio-economic development of its member countries and restoration of human dignity.

The paper notes the achievements as well as identifies some key constraints faced by Kyrgyz Republic and Tajikistan in their aspiration for socio-economic development. These constraints are a combination of financial, governance and

[1] For operational and analytical purposes, the World Bank classifies economies into four groups according to gross national income (GNI) per capita. The groups are: low income, $1,025 or less; lower middle income, $1,026 - $4,035; upper middle income, $4,036 - $12,475; and high income, $12,476 or more.

political factors that are interlinked. Therefore, a broader approach is followed in the present study of highlighting the issues and indicating as how Islamic finance can address them to alleviate some of the identified constraints. It also discusses, as examples, some specific sectors in the countries under study where Islamic finance can make a difference.

Socio-Economic Progress and Challenges

Kyrgyz Republic and Tajikistan have made a considerable progress since their independence given the huge task of socio-economic transformation that they faced. For example, Kyrgyz Republic has been successful in transforming the economy from central control to the market economy and has achieved a great success in economic growth and poverty reduction compared to the early years. Similarly, Tajikistan has been successful in many fronts. It has been recognized as a democratic country internationally. It has focussed its efforts on socio-economic and political reforms, converting a socialist to a market economy, building good relations with other countries for the promotion of trade and creating an investment environment in the country. It has been successful in achieving growth and controlling unemployment.

However, like many other developing countries, due to many internal and external factors the economies in these countries have been vulnerable to shocks and face constraints in sustaining the economic growth. They also face high inflation, high incidence of poverty and worsening income distribution. Kyrgyz Republic registered high unemployment during the last decade, but Tajikistan reduced the unemployment due to the emigration of workers to Russia and other countries and benefitted from the receipt of huge foreign remittances. Both countries are facing high saving-investment gap, declining foreign direct investment (FDI), declining net official assistance and foreign aid, huge trade and current account deficits, increasing fiscal imbalances and increasing burden of external debt.

The financial markets are not sufficiently developed in the whole Central Asian Region. The financial market in Kyrgyz Republic and Tajikistan is shallow as indicated by the M2-GDP ratio. Availability of domestic credit to the private sector is very low along with very high and discouraging lending interest rate. Small firms are getting insignificant finance from the banking system compared to large firms.

Microeconomic risks appear very strong in both Kyrgyz Republic and Tajikistan. Although Kyrgyz Republic has made efforts to create business friendly environment which has improved its doing-business indicators such as starting a business, registering property, protecting investors, but weaknesses remain in getting electricity, paying taxes, trading across border and closing contracts. Business firms consider policy instability, corruption, Government instability, inefficient government bureaucracy and access to finance as the major factors constraining doing business in Kyrgyz Republic. Similarly, firms in Tajikistan are exposed to a very weak business environment and experience constraints on doing business in the area of access to finance, tax rates, tax regulation, corruption, foreign currency regulation and inefficient government bureaucracy. Furthermore, the countries under this study are urged to improve their governance, human development, labour productivity and overall level of development toward industrialization and eventual transition to the knowledge economy. Furthermore, Kyrgyz Republic and Tajikistan are characterised with poor quality of infrastructure, weak quality of institutions and are very weak in terms of global competitiveness.

Binding Constraints

Analysis of these challenges brings out three factors as binding constraints on the sustainable development of Kyrgyz Republic: i) Low level of public investment (about 6 percent per annum during the last decade), ii) declining private investment & FDI and iii) weak software of growth. Low public investment is caused by budget deficit, poor governance, weak institutions and lack of human capital. The private investment has been high compared to public investment. However, it has been declining over the recent years and can be a potential binding constraint in the sustainable development. Similarly FDI is also falling. The low private investment and low FDI inflow are caused by poor physical and human capital, microeconomic risks factors and macroeconomic vulnerabilities including huge deficit in trade and current account, budget deficit, increasing debt services, high unemployment and high lending cost. Overall economic growth is also constrained by the weak software of growth such as weak global competitiveness due to the low expenditures on R&D, low quality of education, low overall level of development towards the knowledge economy and the low labour productivity

In Tajikistan, the binding constraints on sustainable growth are (i) the low level of private investment (4.36 percent per annum during the last decade), (ii) low public investment and (iii) weak software of growth. The low private investment is caused by weak financial sector, low domestic savings, poor intermediation, microeconomic risk factors, and macro risks such as trade and current account deficits, huge budget deficit, low foreign exchange reserves, increasing debt services, and high inflation. Low public investment is affected by budget deficit, poor governance, weak institutions and lack of human capital. Weak software of growth is resulted by weak global competitiveness due to the low R&D expenditures, low quality of education and low level of development toward the knowledge economy and relatively low labour productivity.

Relationship between Finance and Growth

Although economics literature finds positive association between the financial development and economic growth, the traditional finance has failed to prevent crises, encouraged pro-cyclical policy-making and rendered the national financial systems non-transparent and impossible to regulate. It has failed in providing sustainable and equitable growth, reducing unemployment and poverty.

The countries under study have been experiencing a number of constraints as pointed out above. The Islamic finance can play a great role in promoting inclusive growth and enabling the considered countries to follow a more equitable development path with the objectives to achieve high income and social cohesion simultaneously. Since Islamic finance is not currently practiced in these countries, the study also explains the nature of Islamic finance before pointing to the ways in which it can help address the challenge of alleviating the development constraints.

Islamic Finance and Development Constraints

Islamic finance is different from conventional finance in its close attention to all aspects of society’s development. Islamic financial system: (i) help and stimulate economic activity and entrepreneurship, (ii) addresses poverty and inequality, (iii) ensures financial and social stability, and (iv) promotes comprehensive human development and fairness. It links finance with the real economy and maintains that link at each point in time in fair and transparent manner.

How Islamic Finance Can Alleviate the Development Constraints?

The challenges of low public and private investment, gap between savings and investment and declining foreign direct investment can be addressed through measures and incentives that rationalize government borrowing; but increase development expenditures; enhance financial inclusion; and promote entrepreneurship.

Limiting Budget Deficits and Rationalizing Government Borrowing:

High and persistent government budget deficits are usually the result of government assuming too many responsibilities outside its main areas of concern, which necessitates borrowing from public and abroad. The possibilities to borrow on interest and the perceived needs by the government for higher expenditure often reinforce each other to create a spiralling cycle of public sector borrowing and spending, which also contributes to the crowding out of the private sector investment and consequently economic growth.

Prohibition of interest would constraint excessive government borrowing by removing the incentive to lend and by disallowing the rollover of debt. However, the governments will be able to raise finance either for pure public goods and services or for other revenue generating social projects. It will also have other sources of revenue such as taxation and voluntary contributions from the public. *Zakāt* (and *ʿushr*) will be earmarked exclusively for supporting the poor, the needy and for the other prescribed categories. Many social needs will be met through voluntary philanthropy for which the government will only need to provide coordination and encouragement services. Thus Islamic financial system along with abolishment of interest would constraint government borrowing and ensures best use of its internal and external resources in socially and economically useful projects while it frees up resources for investment and economic growth through private sector.

Savings and Investment Gap, High Cost of Finance, Financial Access, and Developing Entrepreneurship:

Islamic finance can foster better financial access and financial inclusion through making finance compatible with the religious and social values of solidarity as exemplified by the profit and loss sharing principle which reduces reliance on collateral. Moreover, by avoiding interest it makes credit tied to economic activity. Islamic financial system, by emphasizing profit and loss sharing, develops healthy risk appetite in the society at all levels. This would develop entrepreneurship and willingness for real investments, which are key drivers for innovation, economic growth and stability. This key advantage when combined with higher financial inclusion leads to faster, diverse and broad-based growth.

Linking Finance to Real Economy:

It is one of the hallmarks of Islamic finance that it always keeps finance linked to the real sector activity. The delink between the real and financial sectors is avoided by prohibiting interest (*ribā*) and the selling of debts and the rolling-over of the unpaid debts as well as the prohibiting of excessive uncertainty or avoidable uncertainty (*gharar*) in contracts, and promoting ethical norms that ensure fairness and transparency. The linkage between finance and real economy ensures that stability and economic progress is not lost by frequent crises.

What Islamic Finance can do in Various Economic Sectors of Countries Understudy?

Cotton Sector:

Cotton is one of the major exports of Tajikistan contributing a substantial portion of its GDP. In the cotton sector, Islamic finance modes such as *salam, murābaḥah* and *ijārah* can be used to provide inputs like seeds, fertilizer, sowing and harvesting machines. At the output harvesting stage Islamic financial modes can be utilized to buy and process cotton. At the export stage, Islamic finance can be used for export financing and pre-shipment financing. It can also be used in creating a mechanism to store, transport and smoothly sell cotton. Islamic finance can also be used as a way to bringing FDI in the yarn manufacturing and weaving sectors to produce high value added products for exports.

All this will add to creating new possibilities and freeing the farmers from the double exploitation of monopoly and monopsony that they currently face. To promote cotton exports at better terms a network of local storage facilities and certification system for the quality and quantity of cotton can be created and institutionalized. Warehouse certificates against these cotton bales can serve as guarantees as well as sale instruments for execution of international trade and trade financing by Islamic financial institutions.

Foreign Direct Investment:

Another avenue is to attract FDI in processing of fine quality yarn and cloth from the raw cotton. This will result not only in high value added goods but a whole line of associated services will also come into play for economic development. However, the business environment and official procedures need to be made investment friendly. By recognizing and institutionalizing Islamic modes of finance and allowing Islamic financial institutions to operate in the countries there is more likelihood that the Gulf capital may flow to the region and contribute in various projects, cotton and cotton related industry being one of them, through FDI. Thus allowing for operations of Islamic financial institutions itself will attract FDI.

Energy Sector:

Kyrgyz Republic and Tajikistan are facing electricity shortages for use in the household and industrial sectors. The problems are not only insufficient production of electricity but also the poor distribution networks. Many electric lines that exist from pre-independence era are such that they now go cross border after the creation of new countries instead of supplying to local consumers. In this context, project financing based on Islamic modes can be utilized for construction of electrical power generation units and creating suitable distribution networks for local use of electricity as well as for exporting it to the neighbouring countries on quid pro quo basis. Islamic project finance will utilize combination of *istiṣnāʿ*, *murābaḥah, ijārah,* and *salam* contracts at various stages of the project to address the economic development needs. Project specific *ṣukūk* are another alternative to raise funds from internal and external sources. These instruments will also be useful in developing a secondary capital market providing additional features of flexibility and liquidity. If these are issued in small denominations they can attract more diversified investors base that include individuals as well as large institutions.

Infrastructure Sector:

Roads are very important for trade and commerce in landlocked countries. Not only new roads for intra- and inter-city transportation are needed but old ones also require maintenance and expansion. Islamic modes of financing such as *istiṣnāʿ* and lease-to-sell (*ijārah muntahi bi-tamlīk*) are some of the suitable modes for this purpose. The financing of toll road projects can also be undertaken through issuance of *ṣukūk*.

Tapping of Remittances and putting them to Productive Use:

Remittances constitute substantial part of the GDP of the countries under study. These are currently being used either for consumption or remain idle as savings outside the formal financial sector. Channelling of these financial resources and remittances into national level investment would first require promoting localized and regional investments. For this the use of appropriate institutions and such financial instruments are needed that enable local investment and build confidence and trust at all levels, individuals, firms and the government. Moving towards national level investments government issued project specific *ṣukūk* for funding of specific projects that pay out from the returns of these projects are likely to develop new avenues of cooperation and trust in the efficiency of the government. The support infrastructure institutions and practices created for such *ṣukūk* will also become useful for the functioning of private sector businesses and reducing the cost of doing business for private firms as well.

Use of Voluntary Sector and Cooperation for Economic Development

Activation of voluntary sector, such as *awqāf* and *Zakāt* institutions, is another source for creation of such support and infrastructure that can improve corporate governance and reduce cost of doing business. Many of the *awqāf* properties are amenable to securitization through issuance of *ṣukūk*. The proceeds can be used to expand the operations and build new social projects. *Awqāf* can be used not only for poverty alleviation through simple transfers but they can be used as a system of social protection and assistance in addition to *Zakāt* and targeted to a wider group than the *Zakāt* recipients. *Awqāf* can even be used to build the missing social and public institutions which the private for-profit-sector may not have incentives to develop but which nevertheless are needed for economic development. For example, institutions for better governance, development of accounting standards, providing education and training, creation of system for property and collateral registration, and institutions to settle minor trade disputes all are possible through *awqāf*.

Obligation of *Zakāt* and encouragement of charity directly addresses the poverty issues and provide mechanisms to bring people in the mainstream economic activity including their access to formal financial sector. There are studies showing that *Zakāt* has the potential to alleviate poverty form Tajikistan by raising the income of the poor who earn below 1.25 dollar a day above this threshold. However, if *Zakāt* is used in more planned manner to enable the poor not only meet their immediate consumption needs but also develop their skills and provide them capital to start their own small businesses and become self-sustained then the impact of *Zakāt* will be higher.

Improving Business Environment and Relations with Neighbouring Countries:

Improving the business environment and managing relations and promoting cooperation with the neighbouring countries is necessary in stimulating private investment and flow of foreign direct investment, and more so in the context of landlocked Central Asian countries. The translation of Islamic teachings of rights and responsibilities, justice and benevolence into economic and financial dimension will enhance efficient enforcement of contracts and rules, protection of rights of both the investors and the workers, and promotion of sale. All of these matter very much for inflow of funds, their investment, and economic growth. Cooperation and harmonization of relationships are fundamental to a healthy society and economic growth. In the countries understudy growth in GDP and social wellbeing requires attention to growth in trade, agriculture, cotton sector, and SMEs as targets for near future. For the longer term development of non-cotton agriculture, power, mining, and human capital will be the key to growth.

Microfinance Institutions:

The efficiency of MFIs depends on their outreach, the available infrastructure and support institutions. Regulatory frameworks for MFIs exist in countries under study and lending and leasing both are already recognized within these frameworks. The need is to add mark-up sale (*murābaḥah*) and partnership opportunities in the allowable transactions and create necessary infrastructure for their use by MFIs. In addition to deposit taking MFIs, cooperative based structures for MFIs are also needed to promote Islamic finance. At present the credit rating institutions and collateral registration institutions are either non-existent or very weak requiring urgent attention. Efficient working of such infrastructure institutions will give a boost to MFIs. To make the micro-finance programs a success social capital formation and cooperation is necessary. In addition to group-based mutual guarantee schemes there is a need to build the cooperation by inculcating Islamic norms of cooperation and mutual help. The smallest unit of social cooperation is family, to which Islam gives more importance. Therefore, the family as a unit should be supported to grow out of poverty and get linked to the chain of mainstream economic activity at the next higher level of scale and scope.

Harnessing the Untapped Opportunities:

The declining FDI can be reversed and the exports can also be diversified by making financial sector laws conducive for Islamic banking and finance. Indeed, Islamic banks and financial institutions from other countries where such finance is more developed would find attractive opportunities to enter the market. Such banks and financial institutions would bring with them expertise of Islamic finance and can help in developing the necessary financial infrastructure and training of human resources. The entry of Islamic financial institutions is also likely to bring in foreign investors interested in other economic sectors and doing business through these financial institutions. However, stable policies, currency convertibility and easy currency transfer policies are also needed for entry of financial firms. Another potential area in exports that can be developed through Islamic finance is *ḥalāl* products of processed and fresh meat, poultry and agricultural commodities that can find a good market in the GCC and other countries.