

Speculation in the Stock Market
From
The Islamic Perspective.

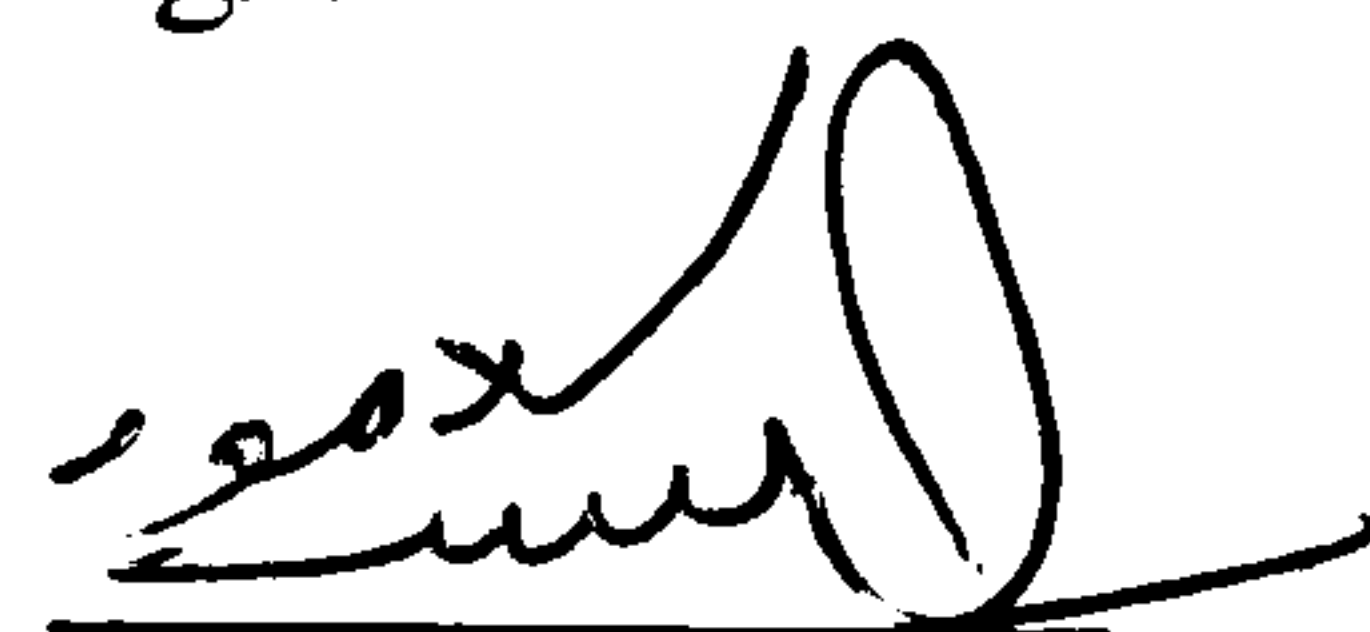
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This thesis is submitted to the University of Wales in fulfilment of the
requirement of the degree of Doctor of Philosophy

1998

DECLARATION

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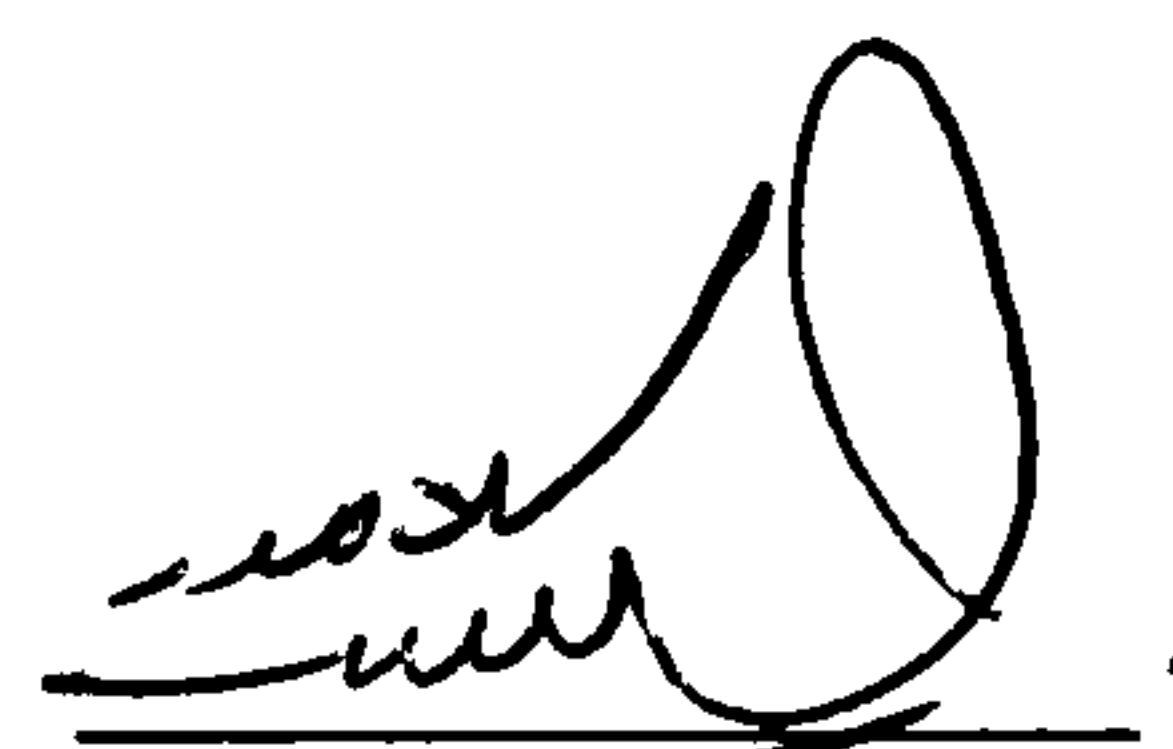
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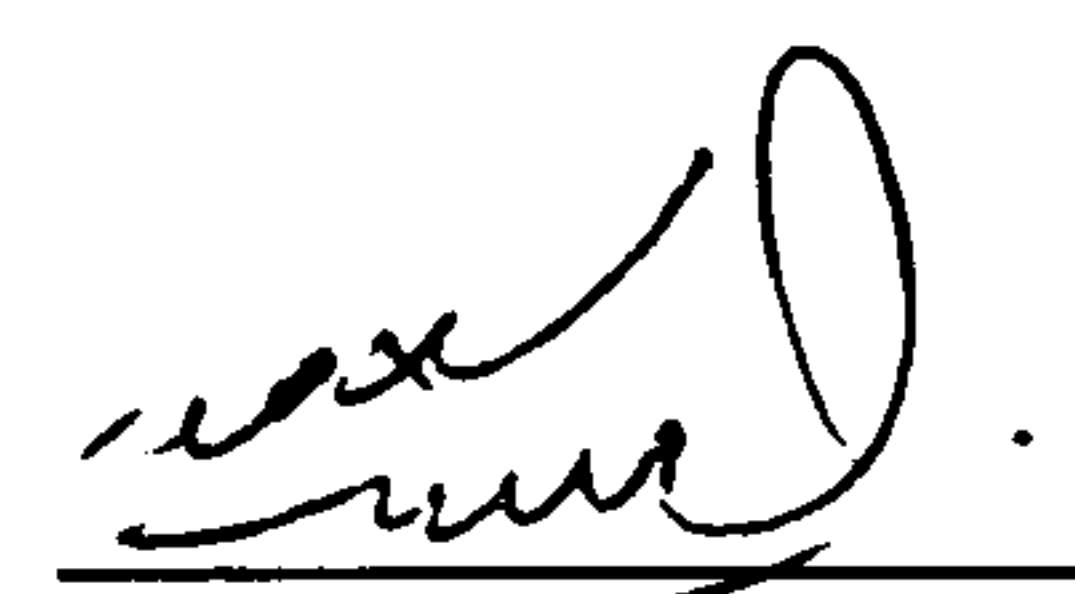
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DEDICATED TO THOSE WHO ARE ISTIQĀMAH
IN ENJOINING PEOPLE TO DO GOOD AND
FORBIDDING PEOPLE FROM DOING EVIL
AND BELIEVING IN ALLĀH

"O YE WHO BELIEVE, IF YE WILL HELP ALLĀH,
HE WILL HELP YOU,
AND PLANT YOUR FEET FIRMLY"

The Qur'ān, 47 : 7

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PREFACE

Notes on Transliteration.

The following system has been followed in transliterating the Arabic words and names used in the text.

| | | | | | |
|---|-----------------------|---|----|---|--|
| ء | a (con.) ¹ | ز | z | ق | q |
| ا | ā (l.v.) ² | س | s | ك | k |
| ب | b | ش | sh | م | m |
| ت | t | ص | ṣ | ن | n |
| ث | th | ض | ḍ | ه | h |
| ج | j | ط | ṭ | و | w |
| ح | ḥ | ظ | ẓ | و | ū (l.v.) |
| خ | kh | ع | ‘ | و | au (d.t.) ³ |
| د | d | غ | gh | ي | ī (l.v.) |
| ذ | dh | ف | f | ي | ai (d.t.) except when doubled which is written ayy. |
| ر | r | ل | l | | |

Note: The Arabic Muslim names have generally been transliterated except for those authors whose untransliterated names have already been used in English literature.

Notes on Referencing.

All direct references, in the form of quotations or paraphrasing, have been acknowledged by mentioning first, the name of the author followed by the title of the book or article, the edition of the publication, the place of publication, the publisher and the year of publication.

¹ Consonant

² Long vowel

³ Diphthong

ABSTRACT

Speculation in the Stock Market from the Islamic Perspective.

In the last few decades of Islamic resurgence, there has been increasing interest by scholars, Muslim and non-Muslim, to study Islam especially on the subject of Islamic Economics. It is believed that the Islamic System of Economics provides practical solutions to existing world economic problems and as an alternative to the present system. One very challenging subject is the question of the stock markets.

Many interesting aspects need to be studied in depth on the subject of stock markets. One interesting subject is the question of speculative transactions. The study is becoming very important and interesting since stock markets are today being widely participated in by Muslims. Furthermore, it is now being 'transferred' into a place of 'playing fortune' and making money in a short time or vice-versa, 'gambling' and losing money every second. This situation is obvious in any stock market in any country regarding the activities of some 'investors' or precisely, speculators, who invest their money with the intention of making profit in a very short time. They are not genuine investors and can not even be called investors at all. To some economists, they are merely 'gamblers' who live on 'unearned income' and make fortunes at the expense of other people. They will not contribute to the development of the economy of a country. Instead, their activities lead to 'silent destruction' of the world economy as testified in the event of the Great Depression of the 1930s.

Since Muslims are bound to the moral and ethical teachings of Islam in everything including business activities, are these types of transactions allowed in Islam? Thus, to study and explore the permissibility of participating in this type of business in the light of Islam is badly needed. Is there any possibility to establish an alternative stock market that detaches itself from speculative activities? These are the two main objectives of this study.

CHAPTER 1

INTRODUCTION

1.1 Introduction.

The Islamic resurgence that has been testified for a few decades can now be witnessed all over the world, even in Europe as well as in the former Communist countries. In the early period of this resurgence, the pioneers faced many dreadful and painful experiences and tribulations to the extent that some of them were *shahīd* (martyred). The wave of Islamic resurgence has continuously spread all over the world even though there has been strong opposition. Today the stream and wave of Islamic resurgence has gained a momentum which seems to be unstoppable not only in the Muslim countries but surprisingly also in the Western ones and in the former Communist countries. There is a demand for 'Islam as a way of life' to be practised in the daily life of Muslims. The demand is being made by Muslims from all walks of life, regardless of their educational background, secular or Islamic. Astonishingly, the ordinary people are also crying for Islam and struggling to practice Islam in their daily life.

The animating of the Islamic resurgence simultaneously has attained a new dimension. The resurgence has led to a deep moral awareness in the life of a Muslim, individually as well as collectively. This awareness has moved them towards practising Islam in all spheres of their life and to view Islam as a capable alternative to the existing systems of life, socially, politically and economically. Hence, any problem they encounter, they will always view it from the Islamic perspective and make an effort to solve it through an Islamic solution. Consequently, in the last few decades the world has witnessed the increasing interest of scholars, Muslim and non-Muslim in studying Islam. The teaching of Islamic Economics is one of the interest areas. This encouraging interest indirectly infers the need for establishing a new system as an alternative to the 'failing' dominating conventional system, one which especially focuses on the question of business ethics. Some aspects of the teaching of Islamic Economics which were initially alien even to Muslims, are gradually being

put into practice. The implementation of these aspects has shown that the system has a great potential to be widely recognised in the future.

Nevertheless, there are many other aspects of Islamic Economics which need to be explored for the benefit of the society. The subject of the stock market from the Islamic perspective is one important area to discover. This is especially true with regard to the speculative transactions of the modern stock markets. This is an important subject to deal with from the point view of Islam, as they are now being excessively participated in by Muslims. Hence, this is the subject of this study, where the present writer is attempting to uncover the view of Islam on speculative transactions in the stock market.

A stock market is a highly organised market place in which securities are traded. These securities include among others, bonds, common and preferred stocks, shares other than bills and similar short-term instruments. The exact date of the first stock exchange established is unknown. The first formally established securities trading centre which used the name (stock exchange), was Sweeting's Alley Stock Exchange. It was named on July 15, 1773¹, and is now known as the London Stock Exchange. The first arranged market place of similar trading was Paris Bourse in 1724². However according to other writers, the first proper stock exchange established was Amsterdam Stock Exchange in 1611, which was trading shares of the Dutch East India Company³. On May 17, 1792, after the Buttonwood Tree Agreement, the New York Stock Exchange was established.

In today's life of the modern world economy, the institution of the stock market has become very vital as it creates a place of secondary market for the public to trade their shares and stocks. There might be no active participation of the investors in the primary market if no active secondary market exists. Through these active activities of buying and selling stocks and shares, new investors are directly invited to

¹ Poley, Arthur P., *The History, Law and Practice of the Stock Exchange* (4th Ed.), London, Sir Isaac Pitman & Sons Ltd., 1926, p. 1.

² Arnold, Henry C.F, "Stock Exchange" in *Encyclopedia of Economics* (Ed. by Douglas Greenwald), New York, Mc Graw-Hill Inc., 1982, p. 896.

³ Isa, Mansur, "Shares and Investment from the Islamic Perspectives", a paper presented in a seminar on Islamic Economics, National Productivity Center Hotel, 26-27 April, 1994, p. 3.

participate in the listed companies and simultaneously they contribute to the economic development of the country.

The stock market also functions as an agent of effective investment of scarce resources accumulated. The capital of the community must be invested in a place of most profitable use⁴. Also, to ensure that the existing assets of a firm are profitably utilised is also a function reasonably expected to be performed by the stock market⁵. Other functions of the stock market are to ensure just and fair dealings in the activities of buying and selling of stocks and shares, to get new investors from the community, to give a chance to the companies listed to increase their performances and to play a role as an agent of social engineering to restructure the society⁶.

These are the various benefits of the stock market to the society and the economy, but what is the stand of Islam on the subject? Since the institution of the stock market is inherited from the conventional system, are the business operations in the stock market in line with the teachings of Islam especially with respect to the speculative transactions which are rampantly practised? Is it possible to re-evaluate or re-structure the existing stock market into an Islamic model to make it participatable in by Muslims who are attaining economic prosperity? All of these questions will be dealt in this research.

1.2 Literature Review.

No book has been written on the specific subject of speculation in the stock market from the Western point of view, though the writings on the topic of stock markets are innumerable. However, writing on the subject of speculation can be found scattered in small sub-topics in chapters of books. There are a few writings in journals, especially on the subject of the effect of speculation on the price and economic stabilities. At the same time short pieces of writing to explain speculation in its general understanding

⁴ Arnold, Henry C.F., "Stock Exchange", op. cit., 898.

⁵ Singh, Ajit, *Take-Over: Their Relevance to the Stock Market and the Theory of the Firm*. Cambridge, The University Press, 1971, p. 2.

⁶ Man, Zakaria, "Management System of Islamic Share Market, Model and its Implementation in Malaysia", a seminar paper presented in the National Conference on Islamic Management at the Universiti Teknologi Malaysia, November 1993, p. 6.

can be found in many books of economics. However this concise writing might only give a little help to the subject of this research.

An interesting chapter on the subject of speculation in the stock market was written by Aubrey, and was published a century ago under the heading 'Stock Exchange Investments: the Theory, Methods, Practice and Results'⁷. Although the focus of the book as a whole is on investment in the stock market with respect to the theory, method, practice and the results expected, the problem of speculation in the stock market is also discussed in two separate chapters.

In the fourth chapter of the book, Aubrey discusses the difference between investment and speculation. It is very difficult to distinguish between them because every investment contains the element of speculation. The border-line between investment and speculation is so dim and vague and almost undetectable because they merge into each other. However, there are a few elements that can explain the slight difference between both⁸.

In chapter five, he discusses the various degrees of speculation involved in any business venture, which he terms as legitimate speculation. The safest investment, that carries the lowest degree of speculation is to invest one's capital into a permanent investment, which is an investment with the largest return and the smallest risk. The second degree of speculation is to invest one's capital in stocks that may be deemed certain to increase in value within a reasonable period. This is what he terms as 'permanent speculation' where a judicious moment must be seized for buying and selling. The third degree of speculation is to be involved in temporary operations, especially in a place of small and quick profits. The process of '*ad infinitum*' is the secret of success⁹.

Another writing that discusses the difference between investment and speculation is the paper written by Hussin Salamon on the topic of 'Speculation in the Share Market

⁷ Aubrey, W.H.S., *Stock Exchange Investments: The Theory, Methods, Practice and Results*. London, Simpkin, Marshall, Hamilton, Kent and Co., Ltd, 1896.

⁸ *Ibid.*, pp. 36-42.

⁹ *Ibid.*, pp. 43-9 and see also pp. 111-5.

from the Islamic Perspective'¹⁰. In his writing, the writer discusses a few differences between investment and speculation, and he suggests that society must invest rather than be involved in speculative activities.

Meanwhile there is some material published in journals focusing on the aspect of the effect of speculation on price stability. The present writer will only review two of those publications. The writing of Baumol entitled 'Speculation, Profitability, and Stability' was published in 'The Review of Economics and Statistics' in 1957¹¹. In this writing, Baumol discusses the influence of profitable speculation on price stability. He tries to refute the established idea that profitable speculation will always exert a stabilising influence in the market. To him, profitable or unprofitable speculation can have a stabilising or destabilising influence on the price in the market.

Another important article on the subject is written by Kaldor entitled 'Speculation and Economic Stability' which appeared in 'The Review of Economic Studies'¹². The discussion in this paper is divided into three parts. The first is the discussion of the conditions under which speculation could emerge. The second is on the effect of speculation on the price stability and in the third, Kaldor discusses the effect of speculation on the economic stability. In the first part, he stresses that two important conditions of speculation, namely the existence of a perfect market or a semi-perfect market, and the low carrying cost. With respect to the influence of speculation on price stability, he argues that speculation can do both, exert a price stabilising as well as price destabilising influence on the market. In concluding the third part of his discussion, Kaldor maintains that speculation has its influence on the economic stability of a country.

As far as the subject of the stock market from the Islamic perspective is concerned up to the present writer's knowledge, no specific book has been written on the subject.

¹⁰ Hussin Salamon, "Speculation in the Share Market from the Islamic Perspective", a paper presented in a seminar, 'Shares and investment in the Stock Exchange: Islamic Evaluation' at the Universiti Teknologi Malaysia, Johor Bahru, Jun 12, 1994.

¹¹ Baumol, W.J., "Speculation, Profitability, and Stability" in *Review of Economics and Statistics*, Vol. 39, August 1957, pp. 263-71.

¹² Kaldor, N., "Speculation and Economic Stability" in *The Review of Economic Studies*, Vol. 7, No. 1, London, 1939, pp. 1-27.

The writings are usually found as a small discussion which is part of a chapter in a book of Islamic Economics. Nevertheless, there are a few articles in journals, especially in the Journal of Islamic Economics on the subject as well. However writing on the subject of speculation in the stock market from the Islamic perspective is very scarce. The discussion on speculation and speculative transactions in the stock market is usually found as a small sub-topic in a discussion of the stock market from the Islamic perspective.

One of these pieces of writing is by Khan in his book of Islamic Economics, 'Issues in Islamic Economics'¹³. Although the writer discusses the issue of the stock market from the Islamic Perspective, it consists of only a small part of the book. Another writer who discussed the subject as part of a chapter in his book is Monzer Kahf who wrote 'Islamic Economics'¹⁴. However as in the first book mentioned, the writing on the subject in this book is done not as a thorough discussion, but as a small part of the discussion on Islamic Economics.

However the most interesting work is in a chapter written by Umer Chapra¹⁵ entitled "A Sane Stock Market" in his book 'Towards a Just Monetary System'. Although the writing is only a sub-topic of a small chapter, he gave a very meaningful critical analysis on the present operation of the stock market, and continued with a few very enlightening suggestions of how the stock market should be operated according to Islamic framework. At the same time he forwarded the problems of speculation in the stock market and some analysis on the problem from an Islamic perspective.

Although articles in journals on the stock market from an Islamic perspective are few in number they give an enlightening discussion on the subject. Furthermore, in their writings they do touch on the aspect of speculation in the stock market and give a concise but meaningful contribution to the subject. One of these articles is written by Khan, entitled 'The Commodity Exchange and Stock Exchange in an Islamic

¹³ Khan, Muhammad Akram, *Issues in Islamic Economics*, Lahore, Islamic Publications Ltd., 1983.

¹⁴ Kahf, Monzer, *Islamic Economics*, Indiana, The Muslims Students Association of the United States and Canada, 1978.

¹⁵ Chapra, Muhammad Umer, *Towards a Just Monetary System*, Leicester, Islamic Foundation, 1985.

Economy'¹⁶. This writing was originally a paper presented at the International Seminar on Islamic Economics held in Kuala Lumpur, July 6-9 1987. This writing focuses on the contemporary practices in the commodity, currency and stock tradings from the perspective of Islam. The discussion on the stock market touches on a few business dealings which are not in line with the teaching of the *sharī'ah*, such as in short selling (purchase or selling securities without physical transfer), options contract and also future trading¹⁷. The writer gives the Islamic alternative to each of the points discussed.

Another article published in a journal is by Elgari entitled 'Towards an Islamic Stock Market'¹⁸. In this writing, the writer concentrates his discussion on the aspect of options trading in the contemporary stock market and scrutinises them from the point of view of the *sharī'ah*. In comparing the option contract in the conventional system with the Islamic alternative, he gives three differences. The first is on the aspect of option cost. Option in the *sharī'ah* is not detached from the actual contract, as usually happens in the conventional system. Secondly, in the *sharī'ah* only tangible items can carry the value for an exchange contract and be priced, and not abstract objects which are nonexistant and thus do not carry any price. Thirdly is concerning the speculative nature of the option transaction in the conventional system which many *sharī'ah* scholars have agreed upon¹⁹. However, in the conclusion, the writer gives his opinion that the door of *sharī'ah* is not totally closed against option trading in the stock market. Before concluding his writing, the writer presents an alternative option trading that is compatible to the *sharī'ah*²⁰.

The writing by Metwally entitled 'The Role of the Stock Exchange in an Islamic Economy'²¹ is another meaningful contribution to the subject of the stock market from the Islamic perspective. This writing focuses on the important functions of the

¹⁶ Khan, M. A., "Commodity Exchange and Stock Exchange in an Islamic Economy" in *Journal of Islamic Economics*, Vol. 1, No. 2, International Islamic University Malaysia, Kulliyah of Economics, July 1988.

¹⁷ *Ibid.*, pp. 48-50.

¹⁸ Elgari, M., "Towards an Islamic Stock Market" in *New Horizon*, UK, October 1994, pp. 4-7.

¹⁹ *Ibid.*, p. 5.

²⁰ *Ibid.*, p. 7.

²¹ Metwally, M.M., "The Role of the Stock Exchange in an Islamic Economy" in *Journal of Research in Islamic Economics*, Vol. 2, No. 1, Islamabad, Summer 1984, pp. 21-30.

stock market in the economy as well as on how the functions should be carried out in an Islamic economy. The criticism on the stock market from the conventional point of view as well as the Islamic criticism are given, and the failure of the system to fulfill its fundamental functions is discussed²². In the final part of his writing, the writer goes to the structure of the stock market in an Islamic economy and follows it by the economic operation of the stock market where all elaborations are done using mathematical equations as well as graphs.

As the present writer stated above, the writing on the subject is very limited, especially when it comes to the specific question of speculation in the stock market from the Islamic perspective. Besides the above mentioned writers who discuss the model of the stock market in Islam and make a short but interesting contribution to the aspect of speculation from the Islamic perspective, other writers only make statements on the problem of speculation in their writing, unfortunately without discussing it²³. These writers might already have made a prior judgement or may hold a prejudiced opinion on the question of speculation because they draw conclusions without presenting their arguments on the subject.

Nonetheless, one attempt has been made by Hussin Salamon in his paper where he discusses the problem of speculation in the stock market and the view of Islam on it. It is clearly discussed in this paper that Islam promotes investment to be participated in by Muslims and discourages Muslims from being involved in the business of speculative transactions. The reason given is that the speculative activities will lead to various unhealthy situations for society. As well as this, the speculative activities, as discussed in the paper, involve in them the problem of *al-maisir* (gambling), *al-gharār* (uncertainty) and a few other malpractices associated with speculative transactions in the stock market.

²² Ibid., p. 22.

²³ See Niazi, Kausar, *Economic Concepts in Islam*, Lahore, Sh. Muhammad Ashraf, 1977, Ṣāliḥ. Nabil, *Unlawful Gain and Legitimate Profit in Islamic Law*, London, Cambridge Press, 1988. Kuran, T., "Economic Justice in Contemporary Islamic Thought", in *Islamic Economics Alternative* (Ed. Jomo K. Sundram), Kuala Lumpur, Ikrq, 1993 and also see Maudūdi, Abū A'lā, "Political Theory of Islam" in *Islam its Meaning and Message*, (ed. Khurshid Aḥmad), Kuala Lumpur, Dewan Pustaka Islam, 1982.

Another significant attempt has been made to provide a model of Islamic stock market in Malaysia by Zakariyya Man²⁴. Although the set-up model is only concerned with the principles that should be adopted by the future Islamic stock market, it provides a clear idea that the existing system must be restructured. The same approach has been discussed by Nik Mustafa, a researcher from the Malaysian Institute of Islamic Understanding (IKIM) in his paper entitled 'The Stock Exchange and the activities of Speculation'²⁵.

Thus, from the above discussion it is clear that there is only limited material available on the subject, especially material that directly relates to the question of speculation in the stock market from the Islamic perspective. The outcome of this present research will hopefully serve greatly to help the future economy of the Islamic *Ummah* (society) as well as the human community as a whole.

1.3 The Rationales and Contribution Expected.

Islamic resurgence, as mentioned above, is a common phenomenon all over the world including that in Malaysia. The majority of Muslims in Malaysia are very eager to practise Islam as their way of life. However, their understanding of some issues is not very clear, particularly in the area of Islamic Economics. Thus, it is timely to give them a clear and correct understanding of this subject from the point of view of Islam, especially on the question of speculative business transactions, which have now become a common practice in the stock markets. Through presenting this research, it is hoped that the understanding gained will consequently help Muslims, especially in Malaysia to carry out the Islamisation process that was launched some decades ago.

The institution of the stock market as mentioned above, is a very important subject to study because it is quite new in the Economic System of Islam. As Islam provides the basic foundation for this system, a concrete contribution to enhance the chance of the system to receive a world wide recognition is needed. Totally rejecting the modern

²⁴Man, Z., "Management System of Islamic Share Market...", Op. Cit.

²⁵Nik Hassan, Nik Mustaffa, "The Stock Exchange and the Problem of Speculation", a paper presented in a 'National Seminar on Science of Mu'āmalah' at the Universiti Teknologi Malaysia, Johor Baharu, April 1-3, 1994.

economic system of the stock market, which is today considered by economists as the core of a modern economy, is indeed not a good move for Muslims. This is because the existence of a stock market in the modern economy is very essential to the extent that 'no modern economy can exist without a well-organised Stock Exchange'²⁶. Thus, it is indeed very important to uncover the real views of Islam on this aspect through thorough study about the present practice of a stock market. This is among the rationale behind choosing this research topic.

One further important point to ponder, is that the business operation scenario of the stock market is now being transformed into a place of making money in a short time, or vice versa losing money every second. This situation is caused by the activities of some investors, or more precisely 'speculators', who use their money with the intention of making a profit in a short time. Since there are Muslims who participate in this business of speculative transaction, the question emerges here on the aspect of its permissibility. As every Muslim is bound to the moral and ethical teachings of Islam regarding business, including these modern and sophisticated types of business transactions, to study and explore the permissibility or rejectability of these activities is very important for Muslims. Hence to reach a sound conclusion on this subject is the foremost rationale behind the topic chosen for this research.

In exploring the understanding of the business of speculative transactions in the stock market, according to the present writer's knowledge no specific work has been done on the subject from the Islamic point of view. There are scattered works on the subject of the stock market from an Islamic perspective but unfortunately the question of speculative transactions is only discussed as a small portion of the writing. In other words, there are a few scattered materials written which are usually only a part of a general discussion. Hence, this is another rationale behind the choice of the topic i.e. the present writer small contributions to this interesting subject in the modern economy.

²⁶Khan, M.A., *Issues in Islamic Economics*, Op. Cit., p. 87.

Thus the contributions expected from the research are as follows ;

- a) To give a clear understanding of the subject from an Islamic perspective to Muslims especially to the Muslims in Malaysia.
- b) To add a small contribution to the subject in English in view of the very limited writing on the subject.
- c) To make a contribution towards achieving the process of Islamisation which has been carried out in a particular by the Government of Malaysia in respect of Islamising its economic activities.
- d) To remove the misunderstandings concerning the permissibility of participating in speculative business in the stock market for Muslims.

1.4 Research Methodology.

In order to achieve the aims of this research, a careful study on the writings of Muslim and non-Muslim scholars is important. As this research work is on the subject of speculative activities in the stock market, which directly includes the question of ethics, hence the question of ethics in the business world shall be discussed. Thus, to study the subject of business ethics in the conventional economic system, the available writings of Western scholars on the subject will be very helpful. The writings of Muslims scholars will be used to study business ethics in Islam. This methodology is also used to understand the institution of the stock market in the modern economy and to discuss the concept of speculation. Hence, library research constitutes the main research methodology used in this research

The writings of Muslims Economists as well as the *fiqh* scholars (scholars of Islamic jurisprudence) on the subject of speculation in business transactions will greatly contribute to the discussion. These will be especially useful when examining few issues in the stock market from the Islamic perspective (chapter 5), the business of speculative transactions and *al-maisir* (gambling) (chapter 8), the business of

speculative transactions and other negative elements (chapter 9) and the Islamic approach towards speculation: a proposal of an alternative model of stock market in Islam (chapter 10). To study their scattered writings on the subject of Islamic economics, as well as *fiqh al-mu'āmalah* (jurisprudence of transaction), is very essential. Hence, library research will again constitute the main methodology for data collection for this research.

Inevitably, the collection of data through field work is also unavoidable. This is especially where the present writer deals with the current general understanding of speculation in business activities and the specific understanding of the business of speculative transactions in the stock market from Islamic perspectives. Hence, the opinions of current Muslim and non-Muslim scholars will be acquired. In acquiring this valuable information, a series of interviews will be carried out with a few scholars of Islamic economics.

In order to place the established ideas of the *fiqh* scholars into a proper context interviews with Muslim Economists are vital. Their views to some extent might be different from those of the *fiqh* scholars. This is only to be expected because, as economists, they are more exposed to the world of the modern economy when compared to the *fiqh* scholars. Hence their opinions do not only depend on the *fiqh* texts per se but are also based on the existing economic system participated in by Muslims.

As well as, those two research methodologies, analytical approach is another research methodology which will be greatly practiced by the present writer in order to reach the aim of this study. It will be carefully done, especially when dealing with opinions and arguments by Muslims Economists and *fiqh* scholars. This careful understanding is very important in order to avoid the present writer being emotionally carried away by their arguments. Thus, the present writer shall carefully scrutinise and analyse all the opinions and ideas or feed back received. This will be the most important part of the research and will be the basis for the outcome of this research.

1.5 Synopsis.

In the first chapter, the present writer will deal with the literature review of the existing writing on the subject. Although, direct writing on the subject is yet to be found, the available writing in general discussions of the topic will be fully used. Following this will be the rationales behind the choice of the topic and the contribution expected. This is to justify the importance of the research to be carried out in the present day. The methodology of the research will then follow and this first chapter will end with the synopsis of the research.

In the second chapter, the present writer shall discuss aspects of ethics in the business world. This chapter will focus on the question of ethics in the Capitalism and Socialism. Do Capitalists give a high regard to the aspect of ethics in their business activity or do they rather concentrate on achieving success, which is usually measured through the profit gained in their business? The emergence of Socialism, as claimed by Socialists resulted from negative aspects and injustices that prevailed in Capitalism, the dominating system of that time. Does the existence of this system give a good alternative to society with respect to the question of ethics in the business world? These questions will be elaborated in this chapter.

In the third chapter, the focal point of the discussion is on business ethics in Islam. Islam regards wealth as an *amānah* (responsibility) and every individual will be asked and held accountable on the day of judgement. To attain the *riḍā* (pleasure) of God is the central objective of every Muslim. The prescription of *al-ḥalāl wa al-ḥarām* (the lawful and unlawful) in Islam is to ensure that human beings carry out their responsibility properly in order to attain God's *riḍā*. Therefore, ethics are an important component when pursuing economic well being in Islam, and this includes the business of the stock market.

In the fourth chapter, the present writer shall focus on a study of the stock market in the modern economy. A brief illustration concerning the history of the development, the management and the business operations, the functions and the importance of the stock market in the modern economy is given here. This chapter serves as a stepping

stone to understanding the stock market, especially concerning the business of speculative transactions in the stock market. This understanding is important because this subject is the centre of this research. These speculative business instruments will be illustrated under the sub-topic of 'the business operation of the stock market'.

In the fifth chapter, the focus of the discussion is on some issues in the stock market from the Islamic perspective. The presentation of these issues, besides the issue of speculative transaction, which is the subject of this research, is to acknowledge that there are other issues that stand as a barrier to Muslims wishing to participate in the business of the stock market. These issues are worth further research and should be resolved from the Islamic perspective in order for the stock market to be fully Islamised. Issues such as the conventional concept of company, flow of investment, capital accumulation, reimbursement of profit and discouragement of speculative loans are discussed in this chapter.

In chapter six, the subject of speculation is discussed in great detail. The definition of the word is carefully illustrated while the existence, the nature and the functions of speculation in the economy are elaborated. More importantly, an historical account of past economic crises caused by speculative excessiveness is briefly given in this chapter. Meanwhile a detailed account of the negative consequences of speculative activities in the crash of the NYSE in 1929, which led to the World Great Depression in 1930s, is also given.

An analytical observation on the negative contributions of speculative excessiveness to economic crises is further carried out in chapter seven. The focus of this analytical observation is on the current crisis in Asia, with special reference to the crisis in Malaysia, one of the 'Asian Tigers'. The contribution of speculative activities in this crisis is manifested, especially in the foreign exchange and the stock market and that this led to the crumbling down of the Malaysian economy. The discussion in this chapter and at the end of chapter six clearly shows that the business of speculative transactions can cause a dreadful economic experience, and shows that even from the conventional economic point of view, the activities are unjustifiable.

In the eighth chapter, the understanding gained as regards speculation from the Islamic perspective is elaborated. In its general application, to indulge in speculative judgement is considered in Islam to be in the nature of human creation. People have been given the faculty of intellect, the main tool used to speculate on future events. However, speculative judgement in the more specific usage of the word, such as in the business of speculative transactions in the stock market, obviously needs moral and religious justification. This is because embodied in the speculative transactions in the stock market are the elements of *al-maisir* (gambling). Hence, the activities seemingly fall into the category of unlawful business activity in Islam.

In chapter nine, other negative elements that prevail in the business of speculative transactions in the stock market are demonstrated. The existence of the element *al-gharār* (uncertainty), malpractices, unethical activity and the question of 'unearned income' in the transaction, further strengthen the above stance of Islam on the illegitimacy of speculative activity in the stock market. Even viewed from the conventional system of economics, the existence of the element of *al-maisir* added to these other elements, means that these activities are morally wrong and unjustifiable.

In chapter ten, the approach of Islam towards the problem of speculation in the stock market is presented. In this chapter, an alternative stock market which conforms to the spirit of Islamic economics is proposed. To maintain the sustainability of the stock market, it must return to its fundamental functions, as a meeting place among the entrepreneurs to discuss their daily business activities and to make genuine transactions on stocks and shares. The existence of speculative transactions in the proposed alternative stock market is to be abolished. Also, the *ribā* (interest bearing loan) is proposed to be discouraged, or more 'radically' to be eradicated in order to suppress speculative activities which usually depend on loans. As proven in the crash of the NYSE, easy availability and access to speculative loans feeds the speculative mania which takes place in the market and which eventually leads to the market crash.

The concluding chapter will provide a summary of the whole discussion on this research.

1.6 Conclusion.

To conclude the introductory chapter of this research, the present writer again stresses that the subject of speculation in the stock market from Islamic perspectives is a very interesting and challenging topic in the modern economy. This topic is directly concerned with the question of ethics in the business of speculative transactions in the stock market. Despite the overwhelming participation among Muslims in these activities no specific study has been made to clarify the status of these business activities from an Islamic point of view. Hence, to thoroughly study and analyse the subject from the Islamic perspective is important because the analysis will be widely read and probably be greatly used by Muslims in their participation in this attractive business transaction. Thus, the questions need to be carefully studied so as to help Muslims in their future involvement in this business activity.

CHAPTER 2

ETHICS IN THE BUSINESS WORLD.

2.1 Introduction.

Ethics, sometimes called moral philosophy, is a subject generally concerned with questions concerning that which is morally good and bad and that which is right and wrong which can be applied to any system or theory regarding moral values and principles¹. As used by Aristotle, the word ethics has acquired "the sense of character and disposition"². In other words, ethics is the science of the ideal in aspects of the human character and human conduct³.

The word ethics in the modern world is often used to indicate a variety of meanings and purposes. Thus professional ethics comprises an ethical code for professional conduct, constructed by an association of professional workers. Ethics is also used to refer to the religious values prescribed by a religion designated by terms such as Christian or Islamic Ethics. To a lesser extent, it has been applied to the ideas of famous or notable and notorious personalities such as Hitler⁴.

It is however, worth noting that there is no standard distinction of meaning between the words ethics and morals. Therefore, it is quite common for some writers to treat the two as interchangeable, the connotation in meaning being the same. The only certain distinction of both words is in their respective origins. While the word ethics originates from Greek, the word morals is of Latin origin⁵. Although the subject matter is human conduct and character, these are not treated as "natural facts", as in the case with history nor as causal connections with other facts. Rather conduct and

¹ "Ethics" in *The New Encyclopædia Britannica*, (15th Ed. by Goetz, Philip W., et al), Micropædia Vol. 4, Chicago, Encyclopedia Britannica Inc., 1991, p. 578.

² Sorley, W.R., "Ethics" in *Dictionary of Philosophy and Psychology*, (Ed. by Baldwin, James M.), Vol. 1, New York, Mac Millan Co., 1925, p. 346.

³ Ibid.

⁴ Ladd, J., "Ethics" in *Encyclopedia of Bioethics*, (Ed. by Warren T. Reich), Vol. 1, New York, The Free Press, 1978, p. 400.

⁵ Ibid., p. 400.

character are seen to possess value because of the positing of a standard or ideal which relates to important elements in human nature itself⁶.

According to Sorley⁷, the question of whether ethics should be regarded as a science or as a branch of philosophy has proved difficult to resolve for two important reasons. Firstly, there is uncertainty as to the distinction between science and philosophy. Secondly, there is uncertainty about the nature of ethical inquiry itself. In this respect therefore, some philosophers use the word ethics, moral science and moral philosophy interchangeably.

He further added that there are two fundamental conceptions of ethics. Firstly the ideal, value, right, virtue or end that is the standard of goodness within the character and shapes human conduct. What is more important is the implied agreement between conduct and the law resulting from the standard prescribed. The second conception relates to the freedom or power of conforming to the law or realising the ideal, a freedom belonging to the human consciousness and manifested in activity, because human beings are not only able to apprehend the moral law or ideal but at the same time to consciously guide themselves by it.

The subject of ethics is generally divided into three major sub disciplines. The first of these is metaethics, which focuses on the nature of moral concepts and judgements. This category is also sometimes called analytical ethics. The second namely normative ethics, is primarily concerned with establishing standards or norms for conduct and is commonly associated with general theories about how one ought to live. The third category is applied ethics, which focuses on the application of normative theories into practical life. The prevailing problems of human rights and justice, within the context of socio-political and economic dimensions need to be tackled through the discussion of applied ethics⁸.

⁶ Muirhead, J.H., "Ethics" in *Encyclopædia of Religion and Ethics*, (Ed. by Hastings J.), Vol. 5. Edinburgh, T&T. Clark, 1912, p. 414.

⁷ Sorley, W.R., "Ethics", *Op. Cit.*, pp. 346-47.

⁸ "Ethics" in *The New Encyclopædia Britannica*, *Op. Cit.*, p. 578-9.

2.2 Ethics in the Business World?

Business, literally mean's activity (busy-ness)⁹, however the term business incorporates several slight variations in meaning. At the most basic level it refers to a person's occupation or employment by which, through his/her labour, he/she attempts to procure an income and maintenance. On the other hand, it also indicates "the legitimate employment of a person's powers, his/her right to act in certain affairs"¹⁰ without interference. Hence business in its widest sense implies systematically focusing attention on those affairs and activities by which men and women can acquire necessities and comforts for their life. According to this understanding, business is something directly related to the field of economic activity incorporating the spheres of production, distribution of wealth, efficient allocation of resources and employment¹¹.

In the modern global economy, the word business is used to denote initiative, as well as routine in the commercial and industrial activity¹². It can take many forms, from the simplest example of sole proprietorship, to larger forms of enterprise such as a partnership, a private limited company or a public limited company as well as public enterprise which is undertaken directly by the state.

One question which has recurrently been asked, especially by the religious person,¹³ is whether, it is possible to establish in the business world an ethical business? This is one of many questions being asked and debated between Christian priests and theologians representing the Church, and merchants, being businessmen. This is something not as strange as it first appears, as some within Christendom believe that

⁹ Seldon, A., and Pennance, F.G., *Everyman's Dictionary of Economics*, London, J.M Dent & Son Ltd., 1975, p. 40.

¹⁰ Smith, G.A., "Business" in *Encyclopædia of Religion and Ethics* (1910), Op. Cit., Vol 3, p. 46.

¹¹ Ibid.

¹² Seldon, A., Pennance, F.G., *Everyman's Dictionary of Economics*, Op. Cit., p. 40.

¹³ What the present writer meant by the religious person is the priests of the Christian belief. This is because as we will see later in the on going discussion, there was a long time debate between the teaching of the Church and the life of a merchant.

those who work to acquire possessions, either by trade or by other honest means, are acting contrary to the spirit of the Gospel and the prohibitions of Jesus Christ¹⁴.

It is important to note that this perceived conflict between living the life of a merchant and at the same time being a good Christian contributed to the separation of business activities from the sphere of religion. The present writer shall return to this point later in the chapter. This development contrasts sharply with the teachings of Islam, where every aspect of life is incorporated into its framework, including the economic aspect of human life. The position of Islam with regard to this topic will be discussed in chapter three.

In analysing the nature of the modern global economic system which is separated from the sphere of religion, one is struck by the levels of hatred, cheating, exploitation, injustice and assorted malpractices. As the purpose of business is to obtain income and wealth in order to fulfil material desires as well as satisfy and maximise wants, competition centres on the world's resources, which are basically and increasingly scarce. Thus, competition to secure economic well-being inevitably leads to a life of selfishness, vested interest and individualism. This unhealthy situation will gradually erode essential elements needed to ensure peace and harmony in society, such as mutual understanding, mutual responsibility, mutual co-operation and sharing. Thus to ask if ethics could possibly exist within the business world, where fulfilling one's own desires is its primary goal, is not simply an abstract discussion, but a question of immediate urgency.

2.3 Ethics and Economics.

Economics can be simply understood as the science of the administration of the household. Aristotle gave a very simple definition which defined it as the management of the household including the treatment of slaves¹⁵. However, in the modern world, the most generally accepted definition of the term economics is given

¹⁴ The saying of Bayle as quoted by Bernard Groethuysen in his book entitled *The Bourgeois: Catholicism verses Capitalism in 18th Century France*, (tr. by Mary Ilford), London, Barrie & Rockliff the Cresset Press, 1968, p. 192.

¹⁵ Turner, Stanley H., "Economics" in *Encyclopædia of Religion and Ethics* (1912), Vol. 5., Op. Cit., p. 145.

by L. Robbins, "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses"¹⁶.

The scope of the above definition includes all human activities to maintain life. Hence, to manage all kinds of scarce resources and possessions, the utilisation of consumer goods, the allocation of labour, the distribution of income and wealth in order to avoid waste and so on are the economic concerns. It also concerns activities in acquiring goods to be consumed and satisfy wants and how goods are being produced and distributed among individuals in a society. Therefore, economics is a social science which is closely related to the socioeconomic life of humankind, because it directly involves the discussion of movement in searching for a comfortable life, it cannot be separated from the question of ethics.

The link between ethics and economics becomes closer when viewed in conjunction with the aspect of applied economics. More specifically the question of the distribution of wealth highlights the question of justice, which has been a long and important debate among economists. Lately however, the question of environmental pollution caused by the intensive processes of economic development and technological advancement has appeared and become the concern of many people, not only among the economists but also the politicians and scientists. There are many clear examples around us of the pollution which occurs in all spheres of economic activity, in the developed as well as the developing countries¹⁷.

The above consequences of development have been caused by the vested interests of those whose only concern is maximising profits without considering the negative effects of their unethical conduct. The private business entrepreneurs or public agencies who are directly involved in these economic activities, and the development process of a country tend to take account only of those costs that effect them in cash form. The atmosphere and other natural bounties "have been treated as free goods for which no price has to be paid"¹⁸. Unbecomingly, societies continue to use and treat

¹⁶ Hanson, J.L., *A Dictionary of Economics and Commerce*, (5th Ed.), Plymouth, MacDonald & Evans Ltd., 1977, p. 147.

¹⁷ Sleeman, John F., *Economics Crisis: A Christian Perspective*, London, SCM Press Ltd., 1976, pp. 131-36.

¹⁸ *Ibid.*, p. 133.

these bounties as if they were limitless and endlessly recurring natural resources¹⁹. Thus, as long as the natural environment remains a residual concern of the business community, pollution will increase.

Thus, it is clear from the above discussion that economics as a social science is related closely to the question of ethics and morality, because it cannot avoid the question of human's attitude towards his daily economic activities. However some have questioned whether ethics and morality belong to the economic sphere, arguing that the very idealism of the former renders it impractical in the economics of the modern world. The question reflects the widespread notion that ethics and morality are subjective matters, and thus, cannot be allowed to disturb the objective existence of economic life²⁰.

2.4 Religion and Economics.

Any discussion of the historical separation between the sphere of religion²¹ and the worldly or 'secular' sphere in the West will bring us back to the history of the later middle ages up to the sixteenth and seventeenth centuries which are considered by many as a critical period²². The separation is not only in the aspect of economics however, it includes all those spheres of worldly activities including social, scientific and even political theory. In fact the most momentous of the intellectual changes which ushered in the modern world was the secularisation of political theory.

"The theological mould which shaped political theory from the middle ages to the seventeenth century is broken; politics becomes a science, ultimately a group of sciences, and theology at best one science among others. Reason takes the place of revelation and the criterion of political

¹⁹ Ausubel, J., "Economics in the Air: An Introduction to Economics Issues of the Atmosphere and Climate" in *Climatic Constraints and Human Activities* (Ed. Jesse Ausubel and Asit K. Biswas) Oxford, Pergamon Press Ltd., 1980, p. 13.

²⁰ Wogaman, J. P., *Christians and the Great Economics Debate*, London, SCM Press Ltd., 1977, p.

²¹ The word 'religion' in this discussion is specifically refers to Christianity as the development of Capitalism, Socialism and Secularism took place in a society whereby Christianity was dominant. A discussion on the relationship between Islam and economic well-being will be dealt in chapter 3.

²² Tawney, R.H., *Religion and the Rise of Capitalism*, Middlesex, Penguin Books Ltd., 1961, pp. 19-20.

institutions is expediency, not religious authority. Religion ceasing to be the master-interest of mankind, dwindles into a department of life with boundaries which it is extravagant to overstep... By the end of seventeenth century the secular state separate from the Churches, which are subordinate to it, has emerged from the theory which had regarded both as dual aspects of a single society. The former pays a shadowy deference to religion; the latter do not meddle with the external fabric of the political and social system, which is the concern of the former. The age of religious struggles virtually ends with the Treaty of Westphalia in 1648"²³.

The same development occurred in the field of science. Although there was an attempt to inject the influence of religion into science, especially in the interpretation of nature, it was doomed, believed to be due to the "fundamental contradictions within the Christian religion itself"²⁴. As a result science forced itself to break loose and developed its own course in the interpretation of the nature of reality in opposition to religion²⁵. Hence science gradually developed its own discipline that parted fundamentally from the Christian religion. This great separation was not surprising as the entire history of science and the Christian religion, is one long catalogue of conflicts. Thus for most, if not all of these conflicts, and for this fateful rift, Christianity was ultimately responsible²⁶.

The separation of the socio-economic sphere from religion received less attention in comparison to the developments in political theories of the state. The separation occurred when the connection between the religious movement and economics was broken by the outburst of economic energy which transformed society in the Netherlands and England. During this time Capitalism developed due to the large economic development and achievement driven by various scientific discoveries and the resulting technological advancements²⁷. However, economic issues become more

²³ Ibid., pp. 19-20.

²⁴ Al-Attas, S.M. Naquib, *Islam; Secularism and the Philosophy of the Future*, London, Mansell Publishing Ltd., 1985, p. xxiii.

²⁵ Ibid., p. xxiii.

²⁶ Jaki, Stanley L., "Science and Religion" in *The Encyclopedia of Religion*, (Ed. by Mircea Eliade et al) Vol. 13, N. York, Mac Millan Publishing Company, 1987, p. 122.

²⁷ Tawney, R.H., *Op. Cit.*, p. x.

widely discussed after the appearance of Machiavelli's idea of emancipating the state from religion. This development took place a century later, when the doctrine of a self-contained department with laws of its own began to be applied in business activities²⁸.

By the middle of the seventeenth century, everything had been changed with a new economic system established, accompanied by a revolution in political thought. The claim that the church could maintain rules of good conscience in economic affairs finally vanished and any attempt to restore the idea that there was a Christian standard of economic conduct seemed to be impossible²⁹. This is due not only to the general opposition to this but also because of the non-existence of a common standard of values that could be enforced³⁰. Although Max Weber believed that the Church still had a grip over humankind's activities, including the sphere of economics through its new forms of control³¹, the reality is that the crisis in the fundamental beliefs of Christianity itself, as pointed out by al-Attas, contributed to this separation³². Hence the separation could not be prevented as it came from the roots of the religion itself.

There has been a long debate as to the proper place of a Christian, and their involvement, in trade activities. Pere Thomassin concluded that every act of accumulating possessions any kind of wealth without end and measure was the greatest of all injustices³³.

On another occasion Bayle said;

"Of all the occupations of life, there is hardly any more blameworthy; judged by the criteria of religion than that which is the most common, namely, that of those who work to acquire possessions, either by trade or by other honest means. The means of gaining wealth which humanly

²⁸ Ibid., p. 21.

²⁹ Ibid., p. 23.

³⁰ Ibid., p. 23.

³¹ Weber, Max, *The Protestant Ethic and the Spirit of Capitalism*, (tr. by Talcott Parsons), London, Unwin University Book, 1974, p. 6.

³² Al-Attas, S.M. Naquib, *Islam; Secularism and...*, Op. Cit., p. xxiii.

³³ His saying has been quoted by Bernard Groethuysen in his book, *The Bourgeois; Catholicism verses Capitalism...*, Op. Cit., p. 191.

speaking are the most legitimate are contrary not only to the spirit of the Gospels, but also to the specific prohibitions of Jesus Christ and of his apostles"³⁴.

This came to characterize the position of the church towards the life of a merchant. Although there were various writings and reinterpretations by theologians designed to naturalise the above view through determining a more just procedure for conducting trade, so as not to have it totally condemned, the prevalent understanding remained the same³⁵. Thus, the question emerges as to how a Christian can be a merchant, since gaining from a business, even through a very legitimate and honest means, is considered contrary to the spirit of the Gospels and the teachings of Jesus Christ and his successors.

There were few Christian theologians who have been trained in the rigorous discipline of economics; and Christian thinking in the field of economics is still in conflict with modern urban civilisation³⁶. One reason is that this thinking was formulated in a time when human relations were far less complex than today. In addition, the principles developed were only in terms of qualitative and not quantitative applicability, the latter being essential in dealing with the problem of economics in the modern world. Thus, the moral principles formulated were not applicable.

"If in the past Christians accepted too easily the perversions of a largely secular civilisation that has departed from its Christian foundations, a large part of the most acute Christian thinking of today could more properly be criticised for failing to appreciate the peculiar contributions that the modern World has made to the human history. This is particularly true in Britain. There has been devoted work by individual priests and ministers; there has been notable experiments in all sorts of fields; but too often, in the economic field, the digging of the foundations to the proper theological depth has

³⁴ Ibid., p. 192.

³⁵ Ibid., p. 192.

³⁶ Munby, D.L., *Christianity and Economic Problems*, London, MacMillan & Co. Ltd., 1956, p. 102.

resulted in a misunderstanding of the economic facts"³⁷.

In short, according to Tawney although the rules of morality as elaborated in Christian teaching were very subtle and sincere, it was as a good seed from the fertile plain dropped and sterilised in a river of ice³⁸.

2.5 The Capitalism.

Capitalism has been variously described as a free enterprise economy, a free market economy and an economic system of *laissez-faire*. Although the word capitalism is usually known and publicised in terms of an economic system, in general applications it is a political as well as a social system. To a large extent property and capital assets are owned and controlled by private owners or individuals and production is guided and income distributed largely through the operation of the free market. As a system in which permission is given to private ownership, people are free to engage in any production to meet the demand of the society. In other words, works are neither undertaken as a customary duty, as in the feudal system, nor as the response to bureaucratic commands, as in the communist system, but rather for individual reward under the system of free contract.

The emergence of capitalism in the western world as we have seen occurred in the sixteenth and seventeenth centuries after the break up of feudalism. However, its roots were already established in the ancient world³⁹. Although there was no specific principle of capitalism in the ancient period, the idea of life depending on purely business activities is in the spirit of capitalism⁴⁰. The capitalist spirit is therefore

³⁷ Ibid., p. 102.

³⁸ Tawney, R. H., *Religion and the Rise of Capitalism*, Op Cit., p. 225.

³⁹ "Capitalism" in *The New Encyclopædia Britannica*(1991), Micropædia Vol. 2, Op. Cit., p. 831. According to Amintore Fanfani, the Catholic ideal of Economic life can be found in the Gospels which were elaborated extensively by St Paul and St Thomas Aquinas, prince of Catholic philosophers, and which are believed to be rooted in the scattered writing from the time of Aristotelianism. See Fanfani, Amintore, *Catholicism, Protestantism and Capitalism*, New York, Sheed & Ward, 1935, p. 119.

⁴⁰ According to Samuel Smiles, Thales the great philosopher of ancient Greek, Solon the second founder of Athens and Hyperates the mathematician, were all traders. And even Plato the well-known Greek philosopher repaid his travelling expenses in Egypt by the profit from the oil which he sold during his journey. See Smiles, Samuel, *Self-Help*, London, John Murray Ltd., 1969, p. 262.

nothing but the prevailing economic spirit of a given period with regard to inner attitude, conscious or subconscious, in which man acts in certain ways in business matters⁴¹. Thus, in one sense one can speak of the conception of capitalism as an actual adaptation of economic action, concerned with income and expenses, regardless of how primitive the form is. Hence according to Weber, it was established in all civilised countries including ancient China, India, Babylon, Egypt and others as well as in modern times⁴².

The pre-capitalist period contributed a lot to the development of the modern capitalist. This influence stretches back to the fourth, and up to the fifteenth century, where during this period capitalists were supposed to repent on their death-beds to reaffirm their belief in Christianity. However, towards the end of the fifteenth century this sense of shame for acting in a capitalist manner had largely disappeared⁴³. During the next two centuries, capitalism developed due to the large economic transformation in the time of the industrial revolution⁴⁴.

In short, we may conclude that if by capitalism we mean the direction of industry as dictated by the pecuniary gain of the capital owner, and the social relations that established themselves between the owner and the worker under capitalist control, then it was established in medieval Italy and medieval Flanders. However, if the understanding of capitalism is referring to the pursuit of profit by every means without any consideration of moral values, then this was established in and familiar to the saints and sages of the Middle Ages. As pointed out by Tawney, this occurred during the economic imperialism of Catholic Portugal and Spain and the achievement of the Protestant powers and colonisation⁴⁵.

However according to Salvioli, as quoted in Fanfani, capitalism is rooted since the time of the Caesars of Rome. See Fanfani, *Catholicism, Protestantism and Capitalism*, Op. Cit., p. 8.

⁴¹ See Fanfani, *Ibid.*, pp. 20-21.

⁴² Weber, M., *The Protestant Ethic and the Spirit of Capitalism*, Op. Cit., p. 19.

⁴³ See Fanfani, *Catholicism, Protestantism and Capitalism*, Op. Cit., pp. 34-36.

⁴⁴ Dobb, Maurice, *Capitalism Yesterday & Today*, London, Lawrence & Wishart Ltd., 1958, p. 19.

⁴⁵ Tawney, R.H., *Religion and the Rise of Capitalism*, Op. Cit., p. 93.

2.5.1 Ethic in Capitalism

The question of ethics in capitalism is important since it accompanied the establishment of the system. With the continued decline of Christianity and the increase in secularization, the ethical aspect has re-emerged in the guise of moral philosophy, which maintains that the Christian moral teaching is still present, but far from being practiced. Thus an attempt is made to find alternatives to restore this moral and ethical teaching into the economic activities of humankind.

It is true that a form of moral teaching regarding capitalism was spread by the writings of Samuel Smiles in 1859 in his book 'Self-Help'. However, it is unreasonable to suppose that this teaching, which was written a long time ago, is relevant and applicable to the present day situation, the period of post-capitalism. Although there may be instances where Samuel's moral teaching is found in modern capitalism, it is purely coincidental and unintended by the capitalists. The reality of today's capitalism suggests that the moral and ethical teachings of Christianity have been left far behind.

Furthermore, in addition to the above, Friedrich Nietzsche said, 'God is dead'⁴⁶ was not found during the time of Smiles. This famous saying which is still ringing in the Western World, is mingled with the crying of 'Christian is dead'. It is this context which forced the theologians to accommodate secularisation and to reinterpret the Gospel and the role of the church, in accordance with the new picture of Western secular man⁴⁷. Inevitably, the acceptance of secularism means that the moral values of Christian belief lose their importance in mankind's worldly life, including the sphere of economics.

In order to know whether the activities of capitalists are in line with the ethical teachings of Christian beliefs or in contradiction to them, it is important to explore the

⁴⁶ Friedrich Nietzsche (1844-1900) is a famous German Philosopher and writer. His famous saying that 'God is dead' is an indication to the flourish process of secularisation which separated the aspect of worldly affairs from any religious belief or in other word it was the triumph of secularisation. See "Nietzsche" in *The New Encyclopædia Britannica*(1991), Macropædia Vol. 24, Op. Cit.,

⁴⁷ See al-Attas, S.M., *Islam, Secularism and...*, Op. Cit., pp. 2-6.

essence or the spirit which embodies capitalism, the same spirit that made it rapidly develop and become dominant during the nineteenth century, "the century of capitalism"⁴⁸. To some extent, the spirit itself reflects the attitude of its adherents which advocates and motivates them towards the separation between economics and religion. As clearly described by Weber, the spirit "has the advantage of being free from all direct relationship to religion"⁴⁹. The following describes the spirits which embodies capitalism. Without them the system could not be called capitalism.

2.5.2 The Spirit of Capitalism.

The above becomes worse when one looks into the spirit of Capitalism, as it encouraged people to be more concerned with their own achievement and economic well-being and to maximize their wants and profits in the context of scarce resources. This spirit is reflected in maxims such as; remember time is money, credit is money, money is of the prolific generating nature, the good pay master is lord of another humankind's purse and others⁵⁰. These ideas clearly reflect the primary objective of making money, putting money as a sole objective in this worldly life and at the same time avoiding spontaneous enjoyment of life, which according to Weber is absolutely irrational⁵¹.

Inevitably, the implication of the above spirit, is that humankind as individuals will concentrate more on achieving their own economic well-being without considering others. Hence, it will put aside the moral aspect in the pursuit of economic well-being. The role of morality in the economic decision making of the capitalists, according to Wogaman, is denied, ironically through the advice of Adam Smith, the father of Capitalism⁵². These principles of selfishness advocated by Smith were then supported by some Christian leaders, even to the extent that some of them asserted

⁴⁸ See Fanfani, *Catholicism, Protestantism and Capitalism*, Op. Cit., p. 19

⁴⁹ Weber, M., *The Protestant Ethic and the Spirit of Capitalism*, Op. Cit., p. 48.

⁵⁰ Ibid., pp. 47-50.

⁵¹ Ibid., p. 53.

⁵² Wogaman, J.P., *Christians and the Great Economics Debate*, Op. Cit., p. 1.

that "Godliness is in league with richness"⁵³. Even Adam Smith believed that economics will work best if fuelled by out-and-out pursuit of self-interest⁵⁴.

2.5.3 Capitalism Vs Moral Values.

It can be deduced from the above discussion that the spirit of capitalism is more concerned with the material achievement of business venture. How profit can be achieved, strictly depends on the personality dealing with it. The welfare of other people is secondary to their vested interest of maximizing profit from the venture that they are involved in. This selfishness of capitalists will be seen more clearly when the following concepts governing their business operation are understood.

2.5.3.1 Profit Motive.

As a matter of fact, in the market economy, to gain or to focus business activities on the aspect of profit is a 'holy target'. Whatever the condition or situation, profit must come before all other considerations. The profit motive is the thing that motivates the capitalists to indulge aggressively in any business activities that they participate in. The above discussion of the capitalist spirit establishes that the capitalist's only concern is of making profit. Inevitably, this will develop the attitude of 'thinking of him/herself' and hence the spirit of selfishness exists.

Inevitably, to a certain extent, consciously or unconsciously, this situation will lead to the denial of moral values and at the same time it will lift up vices to the rank of virtues⁵⁵. This is the concern of many economists and Christian thinkers. Archbishop Camara of Brazil once said to the House of Parliament; "Why do you not denounce, once and for all, the intrinsic selfishness and heartlessness of Capitalism"⁵⁶.

⁵³ Ibid., p. 2.

⁵⁴ Ibid., p. 15.

⁵⁵ Acton H.B., *The Morals of Markets : An Ethical Exploration*, London, Longman, 1971, p. 9.

⁵⁶ As quoted by Antony Flew in his Discussion Paper "The Profit Motive", London, Foundation for Business Responsibilities, 1973, p. 1.

There were writings by Capitalists or even by moral philosophers of capitalism to justify the profit motive as something required in any economic organisation⁵⁷, However, it did not provide any coherent argument on the ethical aspect of the profit motive. In support of their argument, Flew writes that the profit motive existed in almost all aspects of economic activities, including wages and rents that, according to him, result from man's self-interest, hence selfishness⁵⁸.

However the present writer disagrees with regard to the question of self-interest in wages. This is because in the case of wages the level is decided by the employer and not by the employee, hence the possibilities for the employer in capitalism to exploit labour is much greater, while the employees can do nothing. The only chance that they have is through their unions which must be strong enough to be heard by the unscrupulous employers.

The same can be argued in the case of rents. However, in the profit motive, the capitalist can exploit through all the means that they possess in order to maximise profit especially in an area where poverty and illiteracy are very high. Whatever the damage the capitalist does in exploiting the available resources, it will not concern such people in poor circumstances as their primary aim is basic survival, although they are aware that they will be used by the capitalists. In the above circumstances, the exploitation of labour intensive jobs with low pay, will certainly take place.

2.5.3.2 Vested Interest.

Hence from the above, cost reduction with the highest possible return through fully utilising the natural resources without being considerate to the environment will occur to some degree. It is proven true in many cases. As has been pointed out by Sleeman, private businessmen or public enterprise's major concern is how to reduce the cost of

⁵⁷ There are a substantial number of writings by Capitalist economists, and quite a few by moral philosophers of capitalist inclination. Among them are Acton H. B. a Professor in Moral Philosophy in his book *The Morals of Market...*, that the present writer has quoted above and his summer paper entitled "The Ethics of Capitalism", London, Foundation for Business Responsibilities, 1972. See also the writing of Antony Flew, a Professor in the same field in his discussion paper "The Profit Motive" as mentioned above.

⁵⁸ Ibid., p. 1.

production, especially in its cash form⁵⁹. It will be quite understandable if a capitalist businessman adopts the 'sacred' and famous saying of Machiavelli that 'ends justify means'⁶⁰. Eventually, in whatever ways, regardless whether they are ethical or unethical, the most important thing for him in business activities is to get as high a return as possible and attain profit maximisation.

The above vested interest phenomenon worsen with the emergence of secularisation, first exhibited in the time of the renaissance. The idea of secularisation separated worldly matters from religion. Consequently, the ethical aspects that sprang out of religion, which was being challenged by the capitalists, gradually lost their hold over humankind's activities. It severely affected the world of economic pursuit. Therefore, it is not strange that the capitalists keep on maximising their profit in their business as the emergence and spirit of secularisation has strengthened their own idea of capitalism. Hence, profit maximisation becomes a very vital consideration in capitalism before venturing in business activities and not the issue of acquiring profit ethically. In the above situation, capitalism is intrinsically selfish and heartless. Thus the saying of Aristotle; appears to be true.

"When goods are produced for sale at a profit, their use in satisfying needs is easily lost sight of and, is replaced by the desire to accumulate as much money as possible"⁶¹.

2.5.3.3 The Problem of Capitalist Competition.

When students of economics talk about the structure of the competitive market, they cannot avoid the four general types of markets as being categorised by economists. These markets are perfect competition, monopoly, monopolistic competition and

⁵⁹ Sleeman, John F., *Economic Crisis: A Christian Perspective*, Op. Cit., p. 133.

⁶⁰ See "Machiavelli, Niccolo" in *Micropædia* Vol. 7 and "Modern Philosophy" under "Philosophy, The History of Western" in *The New Encyclopædia Britannica* (1991), *Macropædia* Vol. 25, Op. Cit.

⁶¹ Quoted from Acton H.B., *The Morals of Markets...*, Op. Cit., p. 10.

oligopoly⁶². Whatever the situation, these four systems or structures of markets are placed under the competitive market of capitalism.

'Competitive Market', is a term used in which a very large number of small buyers and sellers trade among themselves freely and independently. The buyers and sellers are free to participate or not to participate in the market. This system is also called a free enterprise economic system. Free competition in a free market is a vital aspect in a capitalist economic system. There will be no capitalism without the existence of a competitive market. Although some people believe that the competitive process is an indication of a liberal society, to some others, it is an economic system in which the ruthless chaos of the devil has the upper hand⁶³.

The theoretical understanding of liberal society in capitalism is a total freedom. It is also applied in the life of the capitalists to the extent that all worldly matters and activities including the world of business should be entirely free from religious perspectives. Hence, moral and ethical values are also being freed and denied their places and role in human worldly activities.

It has often been claimed that the competitive market can spur efficiency in the allocation of scarce resources. The capitalists believe that it can be done through the size of machinery and equipment, lower cost of production, minimum amount of profit and an 'ideal' output for the consumers. In the real life of capitalists, this situation could not come into existence because this ideal situation can only be materialised in an environment of perfect or pure competition. This very ideal market state only exists in its theoretical framework and not in actual life. This is because the conditions for the existence of perfect competition are too idealistic to be fulfilled⁶⁴.

⁶² Perfect competition and monopolistic competition are the markets where each of which produce only a small part of the industry's output. In monopoly, the industry existed only with one single firm while oligopoly refers to the middle between both where there are few sellers. For further details see Mansfield, *Micro Economics*, (2nd. Ed), New York, W.W. Norton & Company Inc., 1975, pp. 233-350.

⁶³ Seldon, A., *Everyman's Dictionary of Economics*, Op. Cit., p. 69.

⁶⁴ There are four important conditions that must be fulfilled for a market to be categorised as a pure or perfect competition.

1) The commodity produced must be homogeneous where the buyer has no preference of one seller over the others. 2) Large numbers of buyers and sellers so they cannot influence the price of the product. Or in other words, price is considered as fixed. 3) All resources must be completely mobile and free to enter or to leave the market and 4) Perfect knowledge of relevant economic and

Hence, to say competition or the competitive market is parallel with those good things in the question of efficiency in the allocation of resources is not quite right. Instead, the trend in the world's economy itself especially in the United Kingdom, the United States, as well as in most industrial economies is moving towards the market of monopoly⁶⁵.

Ironically, the competitive market does not only take place in domestic production but also in the manufacturing sector as a whole which has become dominated by a handful of large corporations. For example, in 1970 a single firm in the United Kingdom, Hansard, controlled 50 per cent of 156 products covering a wide range of consumer and producer goods⁶⁶. A close study of the above trend shall reveal at least four important problems which could happen as a result of the above situation.

a) The emergence of monopoly.

The development of the competitive market itself threatened the very basis of a competitive economy through the activity of mergers and take-overs. The activities of mergers and take-overs in the competitive market cause the emergence of monopoly instead of perfect competition. Thus, the burden is put on the consumers' shoulders since the market of monopoly has a more decisive say about price manipulation. Usually it will lead to an increase in the price of the products and of course, the increase in the profit is something certain⁶⁷. This situation of increase in price and profit by the market of monopoly has been discussed by the father of capitalism Adam Smith in his book, 'The Wealth of Nations' (1776) in which he wrote,

"The monopolists by keeping the market constantly under stocked, by never fully supplying the effectual demand, sell their commodities much above the natural price and raise their emoluments, whether they consist

technological data by the consumers, firms and resource owners. For detailed discussion, see Mansfield, *Micro Economics*, Op. Cit., pp. 233-35 and Hanson, J.L., *A Dictionary of Economic and Commerce* Op. Cit., p. 86.

⁶⁵ George, K. D., *Big Business, Competition and the State*, Cardiff, University College of Cardiff, 1974, pp. 1-2.

⁶⁶ *Ibid.*, p. 2.

⁶⁷ Shepherd, W.G., *Market Power & Economic Welfare*, N. York, Random House, 1970, pp. 3-4.

in wages or profit, greatly above their natural rate"⁶⁸.

Hence, the activity of merger itself can damage and sometimes may destroy competition depending on the prevailing situation⁶⁹.

b) The elimination of competitors

Secondly, besides the above condition, the merger or take-over activity is being used as an important mechanism to eliminate small and medium sized competitors. This 'silent killing' is being ignored not only by the politicians but also by the economists. They even claim that this activity is an important part of the competitive process in the sense that it will contribute towards strengthening the competition and the improvement of efficiency⁷⁰. To some extent, the large firm purchases its supplies from another firm which is relatively small, not because it is cheaper but because it is an important customer for its own goods. The end objective of this purchasing activity of course, is also a kind of 'silent killing' of the smaller competitors⁷¹.

It is something not only peculiar but also unethical from the humanistic point of view that in the capitalist system, the process of elimination of their competitors is considered as an act of strengthening the competitive market and improving efficiency. The fact is that the trend of a market moving towards monopoly as seen above, is a first step towards burying the competitive market together with the 'silent killing' of small and medium size competitors. This is something which should not be concealed, as the main purpose of monopoly or market power is to increase and maximise their profit as well as avoiding competition⁷².

Furthermore, something agreed by the economists is that perfect or pure competition is a market where the available resources will be efficiently utilised. Thus, how can

⁶⁸ As quoted by Shepherd in his book, *Market Power & Economic Welfare*, Ibid., p. 181.

⁶⁹ Muller, W.F., *A Primer on Monopoly and Competition*, New York, Random House, 1970, p. 83. See also Chapter 5 and 6 of the same book for further elaboration on the structure of mergers and its negative effect on the market competition.

⁷⁰ George K. D., *Big Business, Competition and the State*, Op. Cit., p. 7-8.

⁷¹ Ibid., p. 10.

⁷² Hawley, E.W., *The New Deal and the Problem of Monopoly*, Princeton, Princeton University Press, 1966, pp. 3-4.

they also believe at the same time, that the act of merger or take-over can improve the level of efficiency in resource utilisation? This is a vital question since the act of merger and take-over will gradually change the existing competitive market towards imperfect competition and monopoly. This clearly contradicts the basic economic principles that the capitalists have developed.

c) The emergence of negative consequences.

As the competitive market develops into a monopoly or nearly its equivalent (or to use polite term that usually denotes a monopoly market as, 'a power market') then it will cause various unbecoming circumstances, especially to the consumers. Besides, there is a high degree of damage which may be caused by the existence of a 'power market' to the free character of economic life. The situation will also cause economic waste and exclusion. In whatever way that the market power or monopoly is developed, its existence will enable them to fully exercise their acquired power by controlling the price, output and retardation of technical progress. This situation will certainly contribute further towards inequality in distribution⁷³. Furthermore, it will cause inefficiency and misallocation of resources⁷⁴. And as has been pointed out by Shepherd, the market power will also cause many disturbances to the economic welfare of a society⁷⁵.

Thus, market power or monopoly is a market which has embodied within it various negative effects to the economic welfare of a society. Therefore, to some economists, the monopoly and market power is equal to the economics of evils, market controls, causes of economic inefficiency, misallocation of resources, technical stagnation, exploitation of unorganised groups, free utilisation of natural resources, lack of moral

⁷³ Shepherd, W.G., *Market Power & Economic Welfare*, Op. Cit., pp. 3-4.

⁷⁴ According to Shepherd, there are at least three main distinct ways market powers waste resources. Firstly, inefficiency within individual enterprises, which might not occur in theory but occur in its actual business sense. Secondly, overall static misallocation, as distortion away from the marginal conditions of efficient allocation among all markets and lastly, excess in advertising. For further detail see Shepherd, *Ibid*, pp. 51-3.

⁷⁵ For further elaboration on the aspect of disturbances of economic welfare caused by market power or monopoly, see chapter 4 on disturbances of performance, chapter 6 on equality and efficiency of financial market, chapter 12 on price and profit, chapter 13 on efficiency, growth and stability and chapter 14 on technical change and distribution. Shepherd, *Ibid*.

code⁷⁶ and also further growth of monopoly is partly based on the use of unfair practices⁷⁷. Thus, Herbert Agar and the anti-trusters⁷⁸ believe that monopoly capitalism is evil and self-destructive and should be replaced with a real democracy in order to make mankind better off both morally and physically⁷⁹.

President Franklin D. Roosevelt of the United States of America once said,

"I am against private socialism of concentrated economic power as thoroughly as I am against government socialism. The one is equally as dangerous as the other; and destruction of private socialism is utterly essential to avoid government socialism"⁸⁰.

d) Ceasing of the competitive market.

Fourthly, the establishment of monopoly or an approximation monopoly market will possibly lead to the end of the competitive market in the free enterprise economic system. This is because well established firms besides having the advantages of stopping small and medium size competitors through silent killing as has been discussed before, also have advantages in denying the entry of new competitors into the existing market. As has been pointed out by Bain, there are at least three important restricting barriers to enter into the established market, namely product differentiation, economies of large scale operation and control of patents or

⁷⁶ Hawley, E.W., *The New Deal and the Problem of Monopoly*, Op. Cit., pp. 3-4.

⁷⁷ *Ibid.*, p. 287.

⁷⁸ The anti-trusters are originally a group of United States scholars which was formed to combat collusion among companies with respect to prices, output levels or market shares. The group unofficially worked with President Franklin D. Roosevelt. Besides the above jobs, the main task of this group is the struggle to reverse the process of concentration of power in market. They have their own plans and program in combating the problem of power concentration. However, they are not really succeeding in reversing the situation. The movement had also been established in most major industrialised countries. For further detail, see Hawley, *Ibid.*, in chapter 15 on the antitrusters and their program, pp. 283-303. For information of antitrust law in the major industrialised countries, see Blair, John, M., *Economic Concentration; Structure, Behaviour and Public Policy*, New York, Harcourt Brace Jovanovich, Inc., 1972, pp. 555-620.

⁷⁹ Hawley, E.W., *The New Deal and the Problem of Monopoly*, Op. Cit., p. 291.

⁸⁰ *Ibid.*, p. 281.

resources⁸¹. A study by Bain also found out that this situation did influence the workability of competition and did lead to excessive profits⁸².

From the above discussions, it is clear that while the requirement for the existence of perfect competition is something very ideal and thus impossible to be met, the existence of monopoly, or market power (or something near to it) in the competitive market, inevitably is the trend of the contemporary world economic environment. This unbecoming situation has not only become the concern of socialist economists but also of capitalist economists because it will bring various disturbances not only to the welfare of society but, which is of the most concern, it will also threaten the capitalist economic system⁸³.

2.5.3.4 Unethical Characteristics in the System.

In addition to the above discussion on the problems of the competitive market, is the criticism about the existence of certain unethical characteristics in this system that seem to be unavoidable. The spirit of Capitalism itself as has been discussed before, which views everything from a materialistic perspective concerned only with how to achieve profit and maximise it. Furthermore, in the discussion of the problems in the competitive market, it is clearly seen that the competitive market itself can cause disturbances and damage to free enterprise and more importantly to the welfare of society. The situation worsens in the absence of moral and ethical considerations which have a close relationship with religion.

Hence, in this competitive market system where the role of religion has been undermined or has even been stripped away, the problems of aggression, emulation, rivalry, power, conflict, strife, manipulation, exploitation and other unethical

⁸¹ For further details, see Chapter 3 (economies of large scale as barriers to entry), Chapter 4 (product differentiation of established firms as barriers to entry) and Chapter 5 (absolute cost advantages of established firms as barriers to entry) in Bain, Joe. S., *Barriers to New Competition*, Cambridge, Harvard University Press, 1956.

⁸² Ibid., cover page.

⁸³ As an addition to the above negative effects of market power to market competition, there are a few others which have been pointed out by George K.D. such as, decline in the choice of commodities available to the consumers caused by the decline in the number of firms in the market, diminishing choice in the area of research and development and far reaching negative effects due to business failures. See George, K.D., *Big Business, Competition and the State*, Op. Cit., pp. 10-11.

practices in the business world are obvious and cannot be avoided. In fact the above characteristics go hand in hand with the act of scrupulous competitors under the name of development in order to maximise the profits. In the word of Seldon,

"When a businessman speaks of a highly competitive market, he generally means a market where each firm is keenly aware of its rivalry with a few others and where advertising, packaging, styling and other competitive weapons are used to attract business away from them"⁸⁴.

Since religion and moral values have lost their grasps over the system, the last portion of the above quotation '...other competitive weapons are used to attract business away from them...' can be understood to be that capitalists would use whatever way they wish without taking into consideration any ethical way in order to attain their primary goal, profit and profit maximisation.

It is also clear that the purpose of those weapons being used is to take away other people's possible gains and consequently the possible end of the process is that it will gradually exterminate their competitors from the business. Even in some situations, the capitalists will create 'short run business ethics' in order to manipulate unaware customers. What is meant by 'short run business ethics' is the ethics created to be implemented during the lag between technical change and law reform in order to exploit the consumers who would not be protected under the law⁸⁵.

Even the definition of competition itself shows that the act of competition is encouraging people to overpower each other. Hardley gave his definition of competition as the effort of different individuals engaged in the same line of activity, each to benefit himself, generally at the expense of others⁸⁶. Acton argued that the above situation is similar to an essay competition, where the rules and regulations are formulated to regulate the competition. Without these regulations the competition

⁸⁴ Seldon, A., *Everyman's Dictionary of Economics*, Op. Cit., p. 69.

⁸⁵ *Ibid.*, under the entry "Business Ethics", p. 40.

⁸⁶ Hardley, A., "Competition" in *Dictionary of Philosophy and Psychology*, Vol. 1, Op. Cit., p. 202.

could go beyond control to a situation he terms as 'jungle competition' as there is only one or so limited prize to be won⁸⁷.

Indeed, the above is a very weak analogy because in the absence of religious orientation in the capitalist system which currently puts moral values and ethical considerations into the dustbin, humankind although having intellect bestowed upon them, could even go beyond the laws of the jungle competition in order to fulfil their sole motive namely, profit maximisation. This is the Islamic point of view as far as the aspect of moral and ethical conduct in business is concerned, which will be discussed in chapter three.

The problems exist not only between the agencies or firms, even the relations between the employer and the employee tend to lose all humanity and to become a bargain in which each tries to beat the other. The labourers are treated as commodities that are in the words of Harvey, who quotes Aristotle's definition of slaves, not very far from 'living cattle'⁸⁸. Thus, the rivalry among agencies in order to pursue common economic ends will lead to the elimination of the sense of personal and social responsibility. Also the struggle among the groups in restricted competition of economic rivalry thus means elimination of some groups and survival of others⁸⁹. Hence, it is proven through the classification of competition by Clark which includes in it 'cut-throat', predatory and various sorts of unfair competition⁹⁰.

2.5.4 The Summary.

To conclude the above discussion on the capitalist system of economics, it is worth restating that, there are many weaknesses in the system. Furthermore, there are also various disturbances to the social life of a society as well as to the life of the firms in

⁸⁷ Acton H.B., *The Morals of Market...*, Op. Cit., p. 34.

⁸⁸ Harvey, J., (et al), *Competition; A Study in Human Motive*, London, Macmillan and Co., Limited, 1917, p. 2.

⁸⁹ Baldwin, J.M., (et al), "Rivalry" in *Dictionary of Philosophy and Psychology*, (Ed. by Baldwin, J.M.) Op. Cit., Vol. 2, p. 477.

⁹⁰ As quoted by David A. Revzan in his book, *A Marketing View of Spatial Competition*, Berkeley, University of California, 1970, p. 5.

the system as demonstrated. The reason seems to be that the moral and ethical values which are deeply related to religion are being neglected.

Although there might be various writings attempting to establish evidence and to explain that the aspect of religion is still there, unfortunately the writings and evidences provided do not prevail in the reality of today's business world. Experience of the present system of capitalism only makes people aware that these claims are unjustifiable. There were many instances in the history of capitalism whereby the capitalists destroyed quantities of their product in order to maintain the price of the goods in the market. They carried out such senseless and unethical behaviour only on the grounds of selfishness and to maximise their business profit.

The above citation suggests that, the capitalists are not able to think humanely in order to help other people get their basic needs particularly concerning food that was destroyed. These phenomena only exist in capitalist systems of economy and will continue for a long time until moral and ethical values are injected into their systems. Thus, according to Seldon, the moral standard of a businessman is lower than those undertaking other worldly activities because the prospect of financial gain overrides all other considerations⁹¹. This will not be the case for an Islamic businessman because he is bound to the strict rules and regulations of Islam when conducting his business. This aspect will be dealt with in depth in the next chapter of this research.

2.6 The Socialism.

Socialism connotes three different aspects; a set of doctrines and theories, the political movement and a group of economic systems⁹². Although in its early history of development, the doctrinal aspect was dominant, it was not the situation in its later development and in the present world. The political aspect of Socialism is predominantly taking over its doctrinal function.

⁹¹ Seldon, A., *Everyman's Dictionary of Economics*, Op. Cit., p. 40.

⁹² Sherman, H.J., "Socialism" in *Encyclopedia of Economics*, Op. Cit., p. 872.

There are no precise words or definition that is agreed by the adherents as well as the admirers of Socialism. In the words of Crosland, a British socialist, Socialism is "a set of values or aspirations, which socialists wish to see embodied in the organisation of society"⁹³. Some historians have traced that the ancestry of Socialism can be found further back in primitive society up to the time of Plato, as was demonstrated in his writing known as 'The Republic'. However the word Socialism was first used in the publication of the English co-operative Magazine in 1827⁹⁴. This periodical was a means of expounding and furthering the views of Robert Owen of New Lanark, who was considered to be a forerunner of Socialism and the co-operative movement⁹⁵.

2.6.1 The Origin and Development of Socialism.

In modern thought, the development of socialist ideas was profoundly affected by the experience of the French Revolution⁹⁶. There were writers and thinkers who emerged, especially in France and England, who opposed the social and economic dislocation during that time, as a result of the industrial revolution. They counteracted the mode of production of the Capitalists which prevail injustices, and inequalities in society. Hence the idea according to Lichtheim was in fact an intellectual system spun by men to set right injustices of social order at the time. On the other hand, it was a movement of class of the industrial proletariat that emerged into the world's scene in the middle of the nineteenth century who described themselves as communists⁹⁷.

The development of the socialist movement according to Lichtheim, can be seen in various stages⁹⁸. The first stage of the movement was after the French Revolution had begun to cool whence it took the form of romantic conservatism which laid emphasis on social harmony. However, in the second stage which began in the year of 1830, the challenge of the socialist movement was more towards changing society and had no

⁹³ "Socialism" under the entry "Modern Socio-Economic Doctrines and Reform Movement" in *The New Encyclopædia Britannica* (1991), Macropædia Vol. 27, Op. Cit., p. 442.

⁹⁴ Cole, Magaret, "Socialism" in *The Encyclopedia of Philosophy*, (Ed. by Edwards P.), Vol. 7, New York, Macmillan Publishing Co. Inc., & The Free Press, 1972, p. 468.

⁹⁵ "Owen, Robert" in *The New Encyclopædia Britannica* (1991), Micropædia Vol. 9, Op. Cit., pp. 23-4.

⁹⁶ Lichtheim, G., *The Origins of Socialism*, London, Weidenfeld and Nicolson, 1969, p.3.

⁹⁷ *Ibid.*, p. 3.

⁹⁸ For further and detail reading, see Lichtheim, *Ibid.*, chapter Introduction.

desire to return to an earlier age. They combined both the nationalist faith in science and industry with a radical critique of the new individualism.

The next stage started in the year of 1848, the period when Chartism was being defeated and of the consolidation of Victorian society. During this time the Communist Manifesto had also been published. During this stormy year, Lichtheim stated that although the socialist movement still believed in personal liberty and rationality, they categorised their movement as a critique of liberalism. They presented themselves as "a creed transcending the battle-cries of the parties who had confronted each other in the course of the French Revolution"⁹⁹. During this time the theorists belonging to all three schools namely conservative, liberal and socialists had been established. However as compared to the other two, the socialists of this period lacked institutional backing and the immediate issue was the new social order from the turmoil of political and economic change.

England and France were the two countries from where this new movement was being born. Jacobinism remained dominant for years in France while Robert Owen and his followers took action in Britain. Conceptually, therefore socialism in its origins is an Anglo-French creation¹⁰⁰. By the 1890's, the status of socialism as a doctrine was fully developed and by the end of the 19th century, socialism became an organised political force in all Western States¹⁰¹.

2.6.2 Socialism as an Economics System.

The emergence of Socialism as we have seen in the earlier discussion, is a result of the industrial revolution in Europe. During that time it was a movement that had attacked the existing economic system which was based on the free-enterprise of Capitalism. Their demand was for the establishment of a new social order that was a more just and classless society. It has always been claimed that socialist's critiques of Capitalism are based on and emphasise at the new ethical values. This is not strange because the economic system of Capitalism that was dominant during that time was

⁹⁹ Ibid., p. 6.

¹⁰⁰ Ibid., p. 10.

¹⁰¹ Mellor, A. S., "Socialism" in *Encyclopædia of Religion and Ethics*, Op. Cit., Vol. 11, p. 635.

too individualistic. Hence, socialism demands a complete reorganisation of the social order and industrial existence which is revolutionary in intention and aim¹⁰².

It was during the emergence of the socialist ideology of economics that the private and individual ownership of property, especially the factor of production was obvious. In fact this is the core of the capitalist system that was dominant during this time. As a movement of anti-capitalism, Socialism sees that private and individual ownership was the root of evil in the existing system. Therefore the abolition of the private and individual ownership is the collective demand of all socialist groups despite their varying in many details¹⁰³.

This abolition is something necessary and very important for the establishment of a new social order in accordance with their ideology. Hence, in this respect, socialists believed in a radical change in ethical concepts and values of property and private possession. The abolishment of all factors of production from the hand of private and individual ownership was agreed by socialistic theories though they were varied in the question of possessing other property¹⁰⁴.

Besides the above, Socialism is the economic system which emerged as a result of the rising working class awareness that their privileges had been taken away by the property owner. They, at the end, would possess nothing except their ability to work under various limitations prescribed by the property owner. Hence, it is something unjust, ethically evil, restrictive and oppressive¹⁰⁵. Thus, this awareness among the working class led to the demand for more economic liberty, more equality of opportunity and more personal freedom as they realised their personal worth in the economic development.

As other human-made systems, Socialism is also subject to change based on the contemporary situation, the demand of society and it also depends on its suitability to

¹⁰² Ibid., p. 647.

¹⁰³ There are varieties of socialist ideology and the most widespread form of socialism is Marxism. Over one third of the world has Marxist Socialism as their official dogma. Within Marxist ideologies, there are still many varieties. For further detail see Sherman, H.J., "Socialism", Op. Cit., p. 872.

¹⁰⁴ Mellor A.S., "Socialism", Op. Cit., p. 647

¹⁰⁵ Ibid., p. 647.

the place of operation. Therefore, we may notice that the system is ever-changing and different socialist countries have their own version of socialist economic systems, from the most radical system of Communists up to parliamentary socialism. In fact, the economic system of socialism continues and will continue to change itself as long as an imbalance of economic well-being prevails in society¹⁰⁶.

When one studies the Socialist economic system, he cannot ignore the question of ethical values. This is because the emergence of the socialist system as a whole is a result of moral and ethical criticism of the capitalist system. Therefore one writer wrote that one of the obvious characteristics of Socialism is its role as an ethical criticism of the capitalist economic system¹⁰⁷.

2.6.3 Socialism vs Humanism.

As was discussed earlier when talking about the capitalist system, there were arguments put forward by the anti capitalists which undoubtedly shows us the real weaknesses of the system. As there are many arguments against capitalism, there are also many arguments forwarded by the economists as well as by the anti socialist group on the obvious weaknesses of Socialism. Here are some of those arguments.

2.6.3.1 The Concept of Equality.

One of those arguments is concerning the concept of equality, the core of the socialist ideology. The concept of equality in the socialist system means that it wants to build a classless society which is based on everyone having the same status of living and income. Thus, the existing society that is based on free enterprise needs to be reconstructed. Thus, through the program of reconstructing the existing society, it will create equality in society especially relating to the aspect of economic well being. Hence, it will totally abolish a society with various hierarchical classes and which is diversified in its income levels and its standard of living. Consequently, it will lead to the rejection and abolition of the evil of class in capitalist societies.

¹⁰⁶ Ibid., p. 647.

¹⁰⁷ Ibid., p. 647.

The dominant concept of equality as being brought forward by the socialists can be easily argued from various angles. This is because the concept itself is very vague and too idealistic to be implemented by any society. This situation is something to be expected because the foremost reason for the emergence of socialism as a doctrine is to replace the evil of inequality that prevailed in capitalism with that of an equal society. Since it was an immediate and spontaneous reaction to the existing society of the time, to come out with a very idealistic idea is to be expected due to the hatred of the existing order and enthusiasm.

a) The idealism of the concept.

The concept of equality as put forward by the socialists is too idealistic to the extent that it is just an illusion. No socialist country from the birth of this doctrine (middle of the nineteenth century) up until the modern world of today shows the real concept with its practical side of equality as was desired and propagated by the socialists.

In contrast, what the world has witnessed in the late 20th century, has been the demise of many socialist countries that held this concept without being able to implement it in the practical life of Socialism. Hence, this really shows us that the concept of equality which was formulated was just an illusion. It cannot be materialised though socialist ideology managed to influence and control many countries in the early 20th century. In the words of Marshall, "full equality or anything close to it is a snare and a delusion; it is neither desirable nor possible". He further argued that "the only possible equality in very complex industrial society is just 'moderate equality' where economic differences are tempered by social rights that are available to everyone"¹⁰⁸.

In one of his writings, Westergaard argued that there was much improvement in the aspect of income equality in Britain as the result of public policy, economic change and trade unions that favoured the socialist ideology¹⁰⁹. Whatever is the argument and

¹⁰⁸ Marshall, T.H., *Citizenship and Social Class* as quoted by John Westergaard, "Income and Wealth and the Welfare State" in *Socialist Arguments* (Ed. David Coates and Gordon Johnson), Oxford, Martin Robertson & Co. Ltd., 1983, Chapter 7, p. 46.

¹⁰⁹ *Ibid.*, p. 46

explanation, the reality is that it is still far from full equality as prescribed in the socialist ideology. Furthermore, the equality of chances as stressed by many socialists seems to be unavailable to all British citizens as unintentionally mentioned by Westergaard in the same writing. This is especially based on skin colour and the gender. Unfortunately however, Westergaard categorised this kind of poverty and class in British society as something that was only superficial¹¹⁰.

b) Different ability, different opportunity.

The second argument put forward against the socialist concept of equality is regarding the question of equality of economic well being for every person under socialism. This is something not possible because humankind has different talents and opportunities. By this diversification of talents and opportunity, society has been divided into various groups of economic well-being. Two different people given a similar opportunity in the same environment, would not produce the same result. This is because every human being is created with different talents, potentials, skills and abilities. Thus, to be equal in every aspect is something beyond the reality of human life even when provided with the same opportunity.

c) The reality of the socialist country.

Thirdly, the concept of equality as prescribed in the ideology of socialists, is not being totally practised by the socialist countries themselves, especially when a comparison is made between the life style of the socialist leader and the masses. The leader and other personnel in the rank of leadership are the champions of equality in the eyes of society, however in reality their lives are very different from the ordinary people. While the rich live in very comfortable houses, the ordinary people do not, while the rich travel in very luxurious cars and aeroplanes, the bulk of the populace do not.

There are many other imbalances occurring between the life style of leaders as compared to the life style of the ordinary people in any socialist countries. One good

¹¹⁰ Ibid., p. 48.

example of these imbalances occurred during the process of overthrowing the President of the Socialist Republic of Romania in the year 1989. The overthrown President had flown away in his personal aircraft, and his property invested in foreign countries was said to be billions of dollars¹¹¹. Surprisingly, the masses could not realise this imbalanced situation until something happens to their leaders, especially through *coup d'état*, or the masses rebellion to overthrow the existing government.

2.6.3.2 The Abolishment of the Private Property.

Another aspect that has always been a target of anti-socialist groups and even of the economists is the trend of nationalising private property. This step is taken to suit socialist ideology. As discussed above, the establishment of socialism was strongly based on and motivated by the existence of negative consequences of private and individual ownership of property in capitalism, especially the means of productions. This is their constant basic ideology even though according to Snowden, the abolition of private property is not the aim of socialism. According to him, socialism only seeks to 'socialise' such kinds of property and not to abolish it¹¹². However the use of the word 'to socialise' by him implies nothing more than to use private property for the benefit of the whole society. Hence, it is understood to have the same meaning, that is to abolish private and individual ownership.

To totally abolish private or individual ownership is something very difficult to justify due to the nature of human beings. It is in the nature of humanity that every individual needs to have some possessions in their hand for the purpose of future security life or as financial security if any emergency should occur or happen to them. Abolition of private or individual ownership will hinder people from being active workers because they will receive remuneration just according to their needs without any additional rewards or 'incentive' amount. Whatever their contribution is to the economic development of a socialist country, they will only receive an equal benefit from the government. Consequently it will lead to the problem of productivity.

¹¹¹ The Socialist Republic of Romania's President that had been overthrown from the Socialist government was Nicolae Ceausescu in November, 1989. See "Ceausescu, Nicolae" in *The New Encyclopædia Britannica* (1991), Micropædia Vol. 3, Op. Cit., p. 1.

¹¹² Snowden, P., *Socialism and Syndicalism*, London, Collins' Clear-Type Press, n.d., p. 187.

People will do work only to fulfil their needs and no additional effort would be given as this effort will carry no merit at all. Hence, it will create an environment of laziness in society especially among the more enthusiastic workers.

The above situation will eventually lead to a reduction in quantity as well as quality of their production. One good example can be found in the agricultural sector in the Soviet Union. In the year of 1965, the agriculture programme planned by the government only managed to achieve 10 per cent of its target. They realised that the failure was because of the government policy as regards to private ownership by the farmers. Then, a reform was made concerning this particular aspect by giving more freedom to the farmers to own more property¹¹³. Thus to possess property is integral and vital component of human nature that cannot be separated from them.

2.7 Conclusion

As a conclusion of the above discussion, one may easily realise how it was that total freedom in the possession of private property and in economic activities created many problems in the capitalist system of economics. The freedom given was used only to fulfil the desires of a few people and their judgement was only based on the materialistic point of view, without taking other things into consideration. Hence, injustices, imbalances and other kinds of evil prevailed in the system. In contrast, the socialist economic system suppressed the liberty of the people by abolishing private and individual ownership. This is clearly opposed to the basic nature of human beings who need to possess something individually as their own saving for future financial security.

As an alternative to the above two systems, there is a system that has been praised by a French Economist as well as by a French Orientalist. Austry mentioned that in order to develop the economy of a country, it is not necessary to be constrained by the existing systems; i.e. capitalism and socialism. There is another more reliable system for the modern world which is the Economic System of Islam. He was of the opinion

¹¹³ Assal, M.A., and Karim, F.A., *Al-Nizām al-Iqtisādī fī al-Islām Mabādīuhū wa Dāfuhu* (tr. *Ekonomi Islam; prinsip-prinsip dan tujuan-tujuannya* by H. Abu Ahmadi and Ansori Umar Sitanggal), Singapore, Alharamain Pte. Ltd., 1984, pp. 25-30.

that this system will be dominant in the near future as it is a complete system of life¹¹⁴.

Moreover, another French Orientalist, Raymond Charles, believes that this system has its own economic approach as regards to production and distribution. In the aspect of production, the system offers a lot of respect to employees and forbids all kinds of exploitation. Regarding distribution, the system has two methods; firstly every individual has to have what he/she needs and secondly, every individual deserves what he/she has done¹¹⁵. Thus the Economic System of Islam is an existing and promising system expanding, in more recent years with the potential for increasing human happiness and caring for the nature and its resources.

¹¹⁴ Jacquen Austray is a Professor of Economics from France. His encouraging opinion on Islamic Economics can be found in his book entitled *L'Islam face au développement économique*. This opinion is quoted in *Al-Niḡām al-Iqtiṣādī fī al-Islām...*, Ibid., p. 10.

¹¹⁵ Ibid., p. 10.

CHAPTER 3

BUSINESS ETHICS IN ISLAM.

3.1 Introduction.

Islam as seen by the Muslim was revealed to humankind through the Prophet Muhammad as a guidance to achieve *al-falāḥ* (the real success)¹. Muslims believe that this is the religion that has been revealed and preached by all the prophets of God². Hence, Islam does not deny the truth of other divinely inspired religions, particularly those which were sent to the Prophet *Mūsā* (Moses) and to *ʿĪsā* (Jesus). The message is purposely revealed to guard humankind from the influence of Satan and evil desire³, and to provide humankind with the right path to achieve success in the next world.

Muslims believe that Islam is the final revelation for humankind, and serves as a way of life that is pertinent to all human races and applicable for all times. Notably, authenticity of the faith has been preserved by the Qurʾān and the detailed account of the Prophet Muḥammad's life, namely the Sunnah. This fact has been acknowledged by Nicholson in the following terms;

"The Koran is an exceeding human document reflecting every phase of Muḥammad's relationship to the outward events of his life; so that there we have materials of unique and incontestable authority for tracing the origin and early development of Islam such materials as do not exist in the

¹ *Al-Falāḥ* here as understood by the Muslim, refers to the absolute success in the hereafter and it may be achieved in this worldly life. The success or victory achieved is not being measured by material achievement alone, but more importantly is to live a life that attains God's pleasure (*riḍā*). See 'Alī, 'Abdullāh Yūsuf, *The Holy Qurʾān: English Translation of the Meanings and Commentary*, (Revised & Edited by IFTA), Madīnah al-Munawwarah, IFTA, 1410H., see footnote no. 2865 from *sūrah al-mu'minūn* (chapter of the believers, 23:1-11).

² The Qurʾān, 3:83. There are many other verses that reflect the same meaning such as 42:13 and 2:136.

³ The Qurʾān, 12:53 and 7:14-7. There are many other verses in the Qurʾān on the role of *shaiṭān* (Satan) to influence humankind.

case of Buddhism or Christianity or any other ancient religion"⁴.

3.2 Islam: A Way of Life.

Islam requires a full submission from its followers. Submission in Islam represents the central core of the faith and this seems to be a unique feature of the religion. Hence, to fulfil the above requirement, no separation is made between material and spiritual, permanence and change⁵, balance between the individual and society as well as integration between this worldly life and the life after death⁶. In other words, Islam propagates the idea of integration between this worldly life and the life after death as embodied in the concept *al-dīn* (a way of life).

Al-dīn which has usually been wrongly translated as religion⁷, refers to a way of life that includes every aspect of human activity, material or spiritual. Muslims believe that as long as all of these activities are carried out in accordance with the prescribed *sharī'ah* (Islamic law), with the good intention of seeking God's *riḍā* (pleasure), then the requirement for full submission is being met.

One point worth noting is that, religion in the understanding of Western religious history refers to an exclusive relationship between humankind and God which is concerned only with spiritual matters⁸. In contrast, *al-dīn* in Islam is concerned with the relationship between humankind with God, with their fellow humankind, with

⁴ Nicholson, R.A., *Literary History of the Arabs*, Cambridge, p. 143 as quoted by Khurshid Aḥmad in *Islam its Meaning and Message*, (Ed. by Khurshid Aḥmad), London, Islamic Council of Europe, 1975, p. 43.

⁵ This aspect is very important and needs to be correctly understood for Islam has been accused of being a stagnant religion and a religion that is unable to bring about mankind to a new and modern civilisation. This accusation by western writers is far from the truth because as is pointed out by al-Farūqī in his book, *Islam*, with the correct understanding of *al-tawḥīd* will bring mankind to very high achievement and civilisation. For further reading, see al-Farūqī, Ismā'īl Rāji, *AL-TAWḤĪD: Its Implications for Thought and Life*, Virginia, The International Institute of Islamic Thought, 1992. "A civilisation must of necessity, pass through various phases of change and a process of assimilation and diversification. Its strength and weakness will be judged by its ability to adjust to a changing environment, yet preserve its original identity and parameters". These are the advantages of Islam. See Sardar, Ziauddin, *The Future of Muslim Civilisation*, London, Mansell Publishing Limited, 1987, pp. 35-52.

⁶ For further details refer to Khurshid Aḥmad, "Islam: Basic Principles and Characteristics in Islam" in *Islam its meaning and message*, Op. Cit., pp. 27-44.

⁷ Gardet, L., "*al-dīn*", *The Encyclopaedia of Islam* (Ed. by B. Lewis et al.), Vol. 2, Leiden, E.J. Brill, 1964,.

⁸ Ibid.

other creatures of God, including the environment and the universe, and with themselves. Although the main focus is on the relationship between humankind and their God, and with their fellow humans in fulfilling their duty as God's vicegerency on earth, the other relationships must not be neglected since they are part of the above duty. Muslims believe that the other creatures have been created basically for humankind to carefully use to fulfil the aforementioned duty.

"Do ye not see that God has subjected to your (use) all things in the heavens and on earth, and has made His bounties flow to you in exceeding measure, (both) seen and unseen? Yet there are among man those who dispute about God, without knowledge and without guidance, and without a Book to enlighten them"⁹.

However, despite all of these bounties, the lives of humankind are full of difficulties and turmoil. The reason is because human beings do not establish good relations in those aforementioned relationships and do not carry out their duty as demanded. As a result all sort of crises, locally or internationally, economically, politically as well as socially are seen everywhere, carried out by all levels of humankind. These unbecoming consequences are caused by those with selfish and vested interests, who are only concerned about fulfilling their own desires without considering the welfare of other people. Hence in this respect, those relationships must be well taken care off.

It is worth mentioning here that Muslims view that to establish good relationships on those aspects is a part of *'ibādah* (worship) in its wider sense. Consequently, this understanding, one will view that all worldly affairs whether political, social or economic, are seen as an act of worship that should be carried out with good intention in accordance to the *sharī'ah*. Hence, worship is not only concerned with the exclusive relationship between human and God, but it is applicable to all aspects of human life. This is clearly seen in the meaning of Islam which comes from the root word *slm* that has various meanings. One of its meanings is to surrender ourselves to

⁹ The Qur'ān, 31:20.

God and be fully obedient to Him, and to make peace with others¹⁰. In the words of Maudūdi, he says,

"Islam is an Arabic word and connotes submission, surrender and obedience. As a religion, Islam stands for complete submission and obedience to God. Another literal meaning of the word of Islam is 'peace' and this signifies that one can achieve real peace of body and mind only through submission and obedience to God. Such a life of obedience brings with it peace of the heart and establishes real peace in society in large"¹¹.

In other words, every activity must be organised in accordance with the *sharī'ah* of Islam which is based on the paradigm of *al-tawḥīd* (belief in the oneness of God), *al-'adālah* (justice) and *iḥsān* (to do good)¹².

In short, to establish a good relationship with God, *al-tawḥīd* is a very essential pre-requisite not only for humankind to achieve success in the life of the hereafter but simultaneously to achieve success in this mundane life. The relationship will not only make humankind concerned about him/herself and his/her relationship with the Creator, but at the same time it will drive humans to establish a good relationship with other fellow humans in particular and with other creations of God.

"Thus, an invitation to *al-tawḥīd* is an invitation to an all comprehensive and all prevailing revolution, which changes not only religion but the entire system of living. It provides a new philosophy of life, new values and a new ideology which lift a man far above his fellow-beings"¹³.

¹⁰ Khurshid Aḥmad, "Islam: Basic Principles and Characteristics", Op. Cit., pp. 28-9.

¹¹ Maudūdi, Abū A'lā, *Towards Understanding Islam*, Leicester, The Islamic Foundation, 1980, p. 17.

¹² Al-Habshi, S. Othman, *Islam, Ekonomi dan Pengurusan* (Islam, Economics and Management), Shah Alam, Hizbi Publication, 1989, pp. 12-3.

¹³ Raḥmān, Afzal, *Islam; Ideology and the Way of Life*, London, The Muslims Schools Trust, 1980, p. 184.

3.3 Economic Well Being in Islam.

As mentioned in the previous discussion, Islam is a way of life. It provides the guidance needed by human beings in all aspects of their life. Islam is neither a *rahbāniyyah* (ascetic) nor a *māddiyyah* (materialistic) religion¹⁴. It harmonises both aspects in its teaching. The pursuit of the *māddī* (material) has to be incorporated with the importance of the spiritual aspect. The mundane world must be guided by spiritual inclination in order to ensure that every act of pursuing God's bounties is being ethically carried out. In other words, Islam integrates¹⁵ both aspects so as to make humankind succeed in both worlds.

As stated before everything that has been created by God in this world is for the benefit and comfort of human beings to make humankind better serve the only God¹⁶. Thus, human beings should utilise all bounties bestowed upon them in order to be obedient servants of God, the Provider and the Sustainer of the Universe.

Muslims are taught that they have to strive for their livelihood in this world. God provides everything and the duty of humankind is to use their capabilities, brain and healthy body to acquire and utilise justly all the bounties. The bounties will never come to them unless they work towards it. Hence, it is obligatory for every leader of a family to find ways and means of supporting their families. The basic needs for their life such as food, clothes, water and shelter are to be provided for them. God explicitly mentions these basic needs in the Qur'ān¹⁷.

Islam is concerned with the well being of everyone in a society, especially when it comes to the question of basic needs. The welfare of an individual who is unable to strive for his/her basic needs shall be under the guardianship of the rich in the society. The responsibility must go on to the society and then to an Islamic government if

¹⁴ Raḥmān, Afzal, *Economic Doctrines of Islam*, Lahore, Islamic Publication Ltd., 1974, pp. 9-19.

¹⁵ The Qur'ān, 28:77

¹⁶ The Qur'ān, 31:20. See also 26:7-8, 45:13, 79:30-3.

¹⁷ See the Qur'ān 20:118-9. See also some verses on the various kind of human needs such as shelter and garments (7:26,31,80-1), transportation (17:70), roads, channels and communication (20:53, 21:31, 22:27, 23:22, 43:10, 71:19-20), foods (10:24, 80:24 and others), water (25:50, 67:30 and others) and fire (56:71-3).

nobody carries this social responsibility. This means that no one in the society shall be without the bounties provided by God on this world as far as these basic needs are concerned.

In this respect therefore, Islam stresses that a healthy and able bodied person must strive and work to acquire his/her livelihood. The Qur'ān and the Sunnah emphasise that work and labour efforts are the natural corollary of human's existence. Even the Prophet Muḥammad (saw) strived for the bounties of God as shepherd and merchant. Hence, Islam requires human to earn his/her livelihood and not live on charity¹⁸. In one of his traditions, the Prophet (saw) said,

"Charity is permitted (halal) except for the rich and the able-bodied"¹⁹.

Furthermore Islam does not put any limitation concerning the amount of wealth that a person accumulates. An individual can acquire as much wealth as he/she can achieve as long as it is done in a correct and just way as prescribed in the *sharī'ah*. The wealth accumulated should than be spent in a right and permissible way as repeatedly stressed by the Qur'ān²⁰.

It is clear from the above that, there are two conditions prescribed in the *sharī'ah* as far as the pursuit and possession of wealth are concerned. Firstly, Islam strongly refutes the philosophy of Macheivelli, an Italian philosopher which stresses that 'ends justify means'²¹. In Islam, both the objective and the way of achieving it must be approved of by the *sharī'ah*. Every noble goal is valued as a good *'amal* (action)

¹⁸ In the Qur'ān, *Allāh* mentioned that man shall have a benefit from what they earn, and women shall have a benefit from what they earn. (4:32). In one of his traditions, the Prophet says, "He who begs without needs is like a person holding a burning coal in his hand", reported by al-Bayhahaqi as quoted by al-Qaraḍāwī, Y., *The Lawful and the Prohibited in Islam*, (tr. by Kamal El-Helbawy, et. al, reviewed by Ahmad Zaki Hammad), London, Shorouk International Ltd., 1985, p. 126.

¹⁹ This *ḥadīth* is reported by al-Tirmidhi in his book *Sunan al-Tirmidhī*, n.p., Dār al-Fikr, 1983, in *kitāb al-zakāh*, *ḥadīth* no. 589.

²⁰ There are many verses concerning this aspect such as the Qur'ān, 28:77 and 61:11.

²¹ Niccolo Machiavelli (1469-1527), writer, stateman and political theorist. His political philosophy was confusing as an outcome of the conflicting ideas between political necessity and moral responsibility. He put the end (to unify Italy) above the question of morality. Refer *The New Encyclopædia Britannica*(1991), *Micropaedia* Vol. 7 and *Macropaedia* Vol. 25, Op. Cit., under the entry "Machiavelli, Niccolo" and also "Philosophy, the History of Western" respectively.

provided that the means of attaining it are also good. Consequently, the effort and work done are considered as an act of *'ibādah* (worship)²².

Secondly, property is an *amānah* (responsibility) from God that should be taken care of. Thus, human beings must possess a sense of accountability before God in their way of dealing with it. All responsibilities demanded of wealth and property possessed must be fulfilled. God commanded humans not to spread evil on this world through their property. Instead, humans have to strive to spread good and helping other people in order to win *marḍātillāh* (God's pleasure) in the hereafter²³. Thus, humans have to spend their wealth in accordance with God's Will. Every single thing related to their possessions, their methods of acquiring and spending it, will be asked by God. One's success in the life of the hereafter depends also on how far one manages to be a good trustee of God's bounties in this worldly life²⁴. Hence, human has to strive to spread good to other people specifically through the bounties bestowed upon them by God.

In view of the above discussion, it can be concluded that Islam teaches human to live a life of neither famishing nor scrounging. In contrast, Islam teaches humans to strive towards a comfortable life in this world so as to make them better able to serve the Creator and Sustainer of the universe. Thus, human's economic well being is explicitly stressed in the teaching of Islam. However, Islam is very concerned with the means of acquiring wealth and the way of spending it. It must be done in accordance to the teaching of the *sharī'ah*. Precisely, the question of *al-ḥalāl wa al-ḥarām* (the lawful and the unlawful) in Islam must be seriously taken into consideration in whatever economic activity one might be involved. Accordingly, Islam provides clear guidance on these subjects. Hence, the dimension of ethics is very prominent in the teaching of economics in Islam.

²² Worship in its correct Islamic understanding refers to every activity of human beings that is carried out in accordance to the *sharī'ah*. Unfortunately it is not the understanding of worship as understood in the Western community, which refers exclusively only to the relationship of human beings with their God. See Gardet, L., "*al-dīn*", *The Encyclopaedia of Islam*, Op. Cit.

²³ In the Qur'ān, God mentioned that the bounties bestowed upon man should be used to attain God's pleasure on the Day of Judgement (28:77).

²⁴ The Qur'ān, 28:76-9.

3.4 Ethics from the Islamic Perspective.

Ethics or *akhlāq* in Arabic, has a great importance in the teaching of Islam. It is seen as one of the basic principles for all the prophetic teachings which is important and unchangeable. In one of his traditions, Prophet Muḥammad (saw) says,

"I have not been sent except for the perfection of moral conduct"²⁵.

This clearly shows us that one of the vital missions of his messengership is for the perfection of the moral behaviour of human beings.

3.4.1 The Dimension of Ethics in Islam.

The dimension of ethics in Islam is not only concerned with the relationship between humans and God or humans with themselves, but also refers to the relationship of humans to the environment, animals, other creatures of God as well as to themselves. All of these relationships have been repeatedly mentioned in the holy Qur'ān and the Sunnah of the Prophet Muḥammad. Lack of one of those relationships implies that human does not fully grasp the understanding of the ethical dimension of Islam. This is important in the quest for wealth and property within the framework of Islam. Then, the correct understanding of the ethical dimension will enable an ordinary 'economic man' to transform themselves into an 'Islamic economic man'.

3.4.2 Ethics in the Pursuit of Economic Well Being.

In the pursuit of economic well being, Islam prescribes guidelines and ethical principles to be adhered to. These ethical principles in economic life are necessary in order to make humans not 'too materialistic' in their pursuit of wealth. By 'too materialistic' the present writer means to attain material goals without taking into

²⁵ Aḥmad Ibn Ḥanbal, *Musnad Aḥmad*, Egypt, Dār al-Ma'ārif, 1980, in *kitāb bāqī musnad al-mukthirīn*, *ḥadīth* no. 8595.

consideration the ways of achieving them. In other words, as long as their objectives are achieved, the means of getting them will become a secondary matter.

As humans become very 'wealth oriented', they will neglect their responsibility towards society, the environment and the other creatures of God. These individualistic personalities will accumulate wealth at the expense of others. This is what we are witnessing in the so called 'highly civilised' state of human beings today. This situation will not contribute further to the process of future development of any nation. Instead, it will lead to a 'silent destruction' of future generations.

In contrast, Islam teaches that ethics in the business world is vital and in fact is the core of the economic system of Islam. There would not be an economic system of Islam if there was no ethical dimension to it. It is so important in order to ensure that humankind is not involved in the process of '*de civilisation*' in the effort of pursuing material well being. Rather, they will accumulate as much wealth and property as they wish, but at the same time contributing to the process of human development, materially, environmentally, morally as well as spiritually.

3.4.3 Ethics in Possession of Wealth.

One's possession of wealth and property does not mean that he/she is allowed to spend his/her belongings in any way they like. As mentioned before, since property is bestowed upon humans as an *amānah*, hence, humans have to spend it in accordance with God's Will and not their own will. Therefore, one must not squander the property on luxurious things such as using gold and silver vessels, costly silk (especially for male) and unwise spending. The Islamic government is permitted to take over another person's wealth if it is being spent 'uselessly'.

In short, Islam holds ethics in a very high regard. Significantly, it provides a particular guideline on how one should ethically acquire and spend wealth. In searching for wealth, one should obtain it rightly without any kind of injustice and

malpractice as ordered by God²⁶. As regards spending it, one must be involved in neither a luxurious and extravagant style of living nor in a life of stinginess²⁷.

3.5 Islamic Ethics in the Business World.

In the previous discussion, it is very obvious that the existence of Islamic ethics in the business world is essential. This is especially true in today's 'modern civilisation' whereby to maximise profit becomes the sole objective of business activities. Hence, the tendency of malpractices in business is great. The revealed Islamic ethics as believed by Muslims are competent enough to offer solutions or at least to minimise the prevailing problems in the business world.

In this following discussion, the present writer will focus on two important aspects. First on the deliberation of a few concepts in Islam that periphrastically play an important role in the moulding and preserving of ethics namely *tawḥīd*, *iḥsān* and *tawakkul*. This discussion will be very important as it will reveal how these core concepts in the teaching of Islam will be obliquely injected into as well as stand guard over ethical and moral values in the business life of an 'Islamic economic man'.

Secondly, there are many Islamic decrees dictated in the *sharī'ah* that are purposely revealed by the Law Giver as a guidance and to bring *'adālah* (justice) to human beings in relation to their business activities whether in production, consumption, distribution and other activities²⁸. The discussion of *al-ḥalāl wa al-ḥarām* (the lawful and the unlawful) and the importance of *'aqd* (contract) in Islam will be very meaningful as it will demonstrate how these decrees will drastically transform the 'ugly' environment of the modern business world which is full of hatred and malpractices into the 'pleasant' environment. *Ribā* (interest), *iḥtikār* (hoarding) and other malpractices in the business world will also be discussed in this section.

²⁶ *Allāh* mentioned in the Qur'ān, "Do not eat your property among you in a wrong manner". the Qur'ān, 2:188, 3:130, 4:2 and 29.

²⁷ The Qur'ān, 65:67.

²⁸ Raḥmān, Afzal, *Economic Doctrines of Islam*, Op. Cit., pp. 48-58.

3.5.1 Important Islamic Concepts for Business.

There are various concepts that collaborate with the moral escalation and the personality development of an individual in Islam. These concepts are at the core in the teachings of Islam and will significantly contribute to character building and its preservation, provided that it is clearly understood.

3.5.1.1 Tawḥīdic Paradigm.

The relationship of human and God is essential for a human's success in this worldly life as well as the life of the hereafter. Thus, to establish this relationship is vital for without this relationship, every good action that humans do is meaningless and will not be considered and counted before God. This reflects the importance of this relationship as the foundation and bedrock of Islam. This is what has been termed in Islam as *al-tawḥīd* i.e. belief in the existence and oneness of God, His Supremacy of Being.

Al-Tawḥīd, is the foremost fundamental teaching in Islam. As perceived by Muslims, fully conscious acceptance of this short expression, "there is no deity except *Allāh*" who will totally transform humankind and differentiate their status to the other fellow humankind who do not accept it. Accordingly, it will produce personalities with an entirely different view on the objective of their life in this world²⁹.

This concept demands, that God is the only being worthy of worship and obedience. Through the understanding of His attributes in addition to the above worship and obedience, real impact will be contributed to the life of human beings. The correct understanding of the concept will fashion human's life in accordance to the law and guidance of the Divine Will³⁰. This belief as perceived by Muslims will lead the believer to success in the life of this world as well as the life of hereafter³¹.

²⁹ Maudūdi, Abū A'ālā, *Towards Understanding Islam*, Op. Cit., pp. 61-72.

³⁰ See Raḥmān, Afzal, *Islam; Ideology and the Way of Life*, Op. Cit., pp. 1-10.

³¹ Maudūdi, Abū A'ālā, *Towards Understanding Islam*, Op. Cit., pp. 68-72.

In other words, the term *al-tawḥīd*, is not to be understood blindly in its literal meaning only, 'there is no deity except *Allāh*'. This simple expression should not be merely taken literally because the meaning of this short expression carries and covers every aspect of human life in its diversity³². Hence, to understand its correct interpretation is important as this will remove the incorrect understanding of the word by the West, that subsequently led to the labelling of Islam as a stagnant and uninnovative religion.

The *kalimah* (word) *al-tawḥīd* consists of everything needed to be said about human beings, their behaviour and surroundings and the universe as a whole. Everything in this universe is related to this very short phrase. For the purpose of this topic, the present writer will deduce a few things from the *kalimah* in order to show how this concept is applicable to the business world.

First of all, the *kalimah* carries the weight of God being the only one who is worthy of human worship and obedience. When one utters this phrase with full understanding and consciousness, he/she becomes bound to follow the guidance prescribed in the teaching of Islam in his/her daily life, inclusive of economic and business life. In every single economic activity, Islam is the foremost yardstick to judge the permissibility of the activities to be carried out. This is because any act to be considered as an act of *'ibādah* (worship),³³ it must be done in consistency to the *sharī'ah*. Thus, with this act of obedience, it will promise the final success that every *mu'min* (believer) searches for, the success in the life of the hereafter.

Secondly, God is the only one worth worshiping. Therefore humans should not put anything else beside Him, as this is an act of *shirk*,³⁴ (associating God with others)

³² al-Farūqī, Ismā'il Rāji, *Al-Tawḥīd: Its Implications...*, Op. Cit., pp. 9-16

³³ As is discussed previously at the beginning of the chapter, the connotation of worship does not correctly imply the real understanding of the word *'ibādah* in Islam. As worship in the western's understanding only refers to an exclusive relationship between the Creator and the creatures, the correct understanding of *'ibādah* is everything that man does including in economic life. However, it must be done in accordance to the teaching of Islam in order to get *riḍā* (pleasure) of God. For further reading on the western understanding of the concept, refer Gardet, L., "*al-dīn*", *The Encyclopaedia of Islam*, Op. Cit.

³⁴ *Shirk* literally means association, to put partner. Technically, associating a companion with God or worship another besides God, or precisely, polytheism. See Goldziher, "*Shirk*", *The Shorter Encyclopaedia of Islam*, Ed. by H.A.R. Gibb and J.H. Kramers, Leiden, E.J. Brill, 1974.

whether in the form of a human being, matter or spirit and seen or unseen. This act of associating God with His creatures in the form of material well being as this is the topic of the discussion, must be avoided since it will make human neglect his/her initial purpose of seeking the pleasure of his/her Creator in his searching, possession and spending wealth. Nevertheless, this is the core of the Communist economic system whereby matter has taken the place of God³⁵. It seems to us that the capitalist system matter is worshipped as God, in the sense that material achievement becomes the first and foremost consideration in everything that they intend to do³⁶.

Thirdly, it is obvious from the *kalimah* that the concept of the oneness of God implies that there is no other Creator, Provider and Sustainer of the universe except 'the only God'. This denotes that everything created and provided by God, the only Sustainer of the universe, is to be used as an instrument for human to serve God and attain His pleasure. Hence, in order to acquire all the bounties that God has created in this world, human has to attain and spend them in ways that do not contradict God's Will.

The possession of property is a bounty from God, and the process of attaining it must be conducted to seek God's pleasure. While the means of securing wealth must always be carefully observed, the bounties bestowed must not be used in spreading mischief and evils. Instead, they must be used as strictly as possible in order to spread goodness and eliminate evils. Therefore the plentiful bounties from God are bestowed upon human to see who is really obedient among His servants in carrying the *amānah* (responsibility) that God has given them. Disgracefulness is given to His servant who fails in this test while a joyful life in this world as well as in the hereafter is given to those who manage to pass through this unexpected test.

Fourthly, everything that has been created by God is of the same status, i.e. the creatures of the only Creator. Nothing can differentiate between the status enjoyed by them except by the virtues of *taqwā* (righteousness). In order to attain this high and special status, human has to perform everything in his/her life in accordance with the good *akhlāq*, good moral conduct as are prescribed in the teaching of Islam. Referring

³⁵ Ibid., p. 187.

³⁶ Refer to the discussion on this subject in chapter 2 of this research under the sub-topic 'Ethic in Capitalism'.

this principle to the business world, human has to consolidate his/her business activities to the materials that are *ḥalāl* and beneficial to human beings³⁷. Every business activity to be pursued, must conform to the values and norms that have been set by the *sharī'ah*.

Although this universe has been set out by God in order for human to use it, it does not mean that human can use it indiscriminately, in what ever way he/she likes. There must be respect for each other creatures and environment as a whole. By using all the bounties carefully, it reflects human's consciousness towards his/her acceptance of the *kalimah al-tawḥīd* and at the same time shows his/her thankfulness to the only Sustainer. Simultaneously, this will create a positive attitude towards the environment and its value to the life of human beings. The indiscriminate use of the environment is an indication of human's failure in carrying out his/her *amānah* mission and responsibility as the 'care taker' of the universe as is demanded by the *kalimah*³⁸. This is a very serious problem facing the economic activities of today's 'modern civilisation'. The 'aggressive' attainment of economic well-being is gone too far to the extent that it denies the importance of preserving the environment for the respect, enjoyment and appreciation of future generations.

In summary, we may say that the importance of the *kalimah al-tawḥīd* in the life of the economy is irrefutable. It leads to an economic life of harmony in respect to the life of human beings as well as to the welfare of the other creatures of God. It is something not strange for the *kalimah* will inject norms and values to human life that will entirely change human's attitude and relationships towards other creations of God. In the word of al-Farūqī,

"*Tawḥīd* commits man to an ethic of action; that is to an ethic where worth and unworth are measured by the degree of success the moral

³⁷ In this respect therefore, to be involved with other countries' political chaos with the intention of promoting and increasing the sale of their deadly weapons is not permitted in Islam. This happens in today's 'civilised nation' of the late 20th century, whereby the involvement of a few so called 'super powers' in the small and under developing countries is hidden behind 'the peace process', political stabilisation and battling terrorism. These are only the 'masks' they use to cover their foremost intention of economic benefit they are getting.

³⁸ Al-Habshi, S.O., *Islam, Ekonomi dan Pengurusan*, Op. Cit., p. 21.

subject achieves in disturbing the flow of space-time, in his body as well as around him"³⁹.

3.5.1.2 Iḥsānic Realisation.

It is very obvious that people have been given by God an instinct to be comfortable and happy if someone is doing good to them. In fact, this attitude is imparted by God as a permanent value not only to humans being, but also to the other creatures. The realisation of the concept of *iḥsān* (to do good to others) is far more important in dealing with the business world due to the consequences it can have on all focus of life. This is so because the relationship between human and human, human and the environment, human and animal and human with the other creatures of God in the business world is inevitable. Thus, it demands that human realises the concept of *iḥsān* in every relationship during his/her pursuit of economic well being.

Iḥsān literally means to do good to others. Some viewed that the word could be associated with the word *al-takāful* in its wider understanding of 'to perform good deeds and help others'⁴⁰. However, in one of the *ḥadīth ṣaḥīḥ*, the Prophet as he replied to a question posed by the angel Gibreal about *iḥsān* said, "*Iḥsān* means that you worship God as though you see Him and if you do not see Him, know surely that He always sees you"⁴¹.

The above *ḥadīth*, clearly shows us, the word *iḥsān* refers to an act of doing good especially in the aspect of worshipping God. In other words, it must be done carefully, sincerely as well as faithfully in order for it to be accepted by Him. As the concept of *'ibādah* (worship) in Islam covers every aspect of human life including business activities as discussed previously, hence, to perform business in accordance

³⁹ Al-Farūqī, Ismā'il Rāji, *Al-Tawḥīd: Its Implications...*, Op. Cit., p. 196.

⁴⁰ 'Ulwān, 'Abdullāh Nāsiḥ, *Al-Takāful al-Ijtimā'ī fī al-Islām*, Cairo, Dār al-Salām, 4th. Ed., 1983, p. 20.

⁴¹ Bukhārī, *Ṣaḥīḥ al-Bukhārī*, Beirut, Dār al-Qalam, 1987, in *kitāb al-īmān, ḥadīth* no. 48. See also Muslim in his *Ṣaḥīḥ Muslim*, n.p., Dār Iḥyā' al-Turāth al-'Arabī, 1972 in *kitāb al-īmān, ḥadīth* no. 10. See also Al-Nawawī, *Matan al-Arba'īn al-Nawawīyyah* (Al-Nawawī Forty *Ḥadīth*, tr. by 'Izz al-Dīn Ibrāhīm and 'Abdullāh Wadūd), Beirut, Dār al-Qur'ān al-Karīm, 1990, *ḥadīth* no. 2.

to the understanding of *iḥsān* is also required. This means, an 'economic man' is bound to the moral values and norms as stipulated in the *sharī'ah*.

Furthermore, the wider concept of *iḥsān* (to do good), is significantly applicable to be implemented in the business world. The relationship of human to each other, human and the environment and even human and the other creations of God as was discussed is unavoidable in the business world. This inevitable relationship demands a human of economics to possess and implement the understanding of *iḥsān* in his/her world. This will consequently prevent him/her from being corrupt and involved in any kind of malpractices in his/her business dealing. Thus his/her *iḥsān* will cause good to him/herself, society and to the business world as a whole.

Notably, the comprehensive understanding of *iḥsān* refers to an act of doing good to the poor and the weak in the society. *Iḥsān* in economic life relates to the transferring of economic well being from the rich to the poor and to the weak. This is demonstrated in the obligation of *zakāh* (obligatory charity), *ṣadaqah* (voluntary charity), *kaffārah* (obligatory compensation) and *farā'id* (law of inheritance). In other words, it is a top to bottom movement of wealth in the society's economic well being⁴². This implies that, the poor and the weak have some right to the property of the rich⁴³, to ensure that everybody possesses the minimum needed in order to be God's servant. Sufficient sustenance for life with a reasonable amount of leisure, are essential items as regards the rights of humans⁴⁴.

The concept of *iḥsān* will undoubtedly promote a conducive environment in the world of business, as this bona fide understanding will inject the feeling of eagerness to do good to others. Additionally, if this understanding is practised in the light of *al-tawḥīd*, it will eradicate or at least minimise the existing problems in the business world.

⁴² Al-Habshi, S.O., *Islam, Ekonomi dan Pengurusan*, Op. Cit., pp. 30-1.

⁴³ The Qur'ān, 70:24-5.

⁴⁴ Hadibah, 'Abd al-Wahhāb, "The Religious Conscience in Present-Day Muslim Society" in *The Islamic Review*, Vol. 55, No. 4, Surrey, 1967, p. 9.

3.5.1.3 Actualisation of *al-Tawakkul*.

Al-tawakkul means to surrender and rely upon the only Creator. However, the word is not to be understood as relying on the supremacy of God blindly without any effort being done which is termed in Islam as *al-tawāku*⁴⁵. It is demanded that human should totally rely upon God in every business activity he/she is involved in, after an tirelessness endeavour. The result of the energy spent depends on the Will of God, and it will depend also on the effort that one has accomplished as stated by God in the Qur'ān⁴⁶.

The actual understanding of *al-tawakkul*, will lead human to the life of timelessness in his/her effort to achieve success. Human beings will realise that the success of their work will depend on the energy they put into the work and at the same time they will rely on the Will of God. If their work fails, they will be aware that the Will of God is not with them. A correct understanding will cause them to work even harder in the belief that God will see and reward their energy, if not in this world in the life of the hereafter. This will produce determined, energetic and vigorous 'Islamic economic man' in their search for God's bounties.

Al-Tawakkul will obliquely play an important role in moulding the positive attitudes of an 'Islamic economic man'. The embodiment of an accurate understanding shall remove any unhealthy feeling and envy towards other people's property, as he/she believes that the property is being granted to the right owner by God. Furthermore, he/she realises that the property is a kind of *amānah* that should be managed properly. As the understanding sinks deeply into the heart, unhealthy feelings towards others' property would not tyrannise one's life. This would lead to a life of healthy competition in exploring God's bounties as well as in the fulfilment of the *amānah* demanded out of the bestowed property. Consequently, the life of everyone in the society, the poor, the weak, the rich, the Muslim and the Non-Muslim would be in peace and harmony. Hence, *al-tawakkul* acts as an 'invisible force' in the character and ethical development of an 'Islamic economic man'.

⁴⁵ See *Mu'jam al-Wāsiṭ*, (Ed. by Ibrahim Anis et al., 2nd Ed.), Vol. 2, Cairo, Dār al-Fikr, 1973, p. 1054.

⁴⁶ The Qur'ān, 4:32

3.5.2 The Decree of *al-Ḥalāl wa al-Ḥarām*.

During the emergence of the united Arab tribes under the banner of Islam, there were two super powers that for a long time had established their superiority. The Arab tribes were no match for these two empires who possessed a unique administration with a highly differentiated and well-trained civil service. Their military services were superb and they had an excellent economic environment with financial strength⁴⁷. However, these two super powers did not possess two important factors as were practised by the Muslims, that is the unshakeable belief in the religion of Islam and the strength of moral discipline.

The moral discipline which was partly inspired by revelation and partly from their old traditions that were injected with religious belief, undoubtedly was one of the important factors that contributed to the emergence of Islam as a 'super power' in political and socio-economics. In a very short period, Islam challenged and defeated the superiority of the Persian and Byzantine Empires⁴⁸. Remarkably, Islam produced men with skill and competence in business and economics that enabled them to dominate the markets of the whole civilised world during that time⁴⁹.

As the main purpose of an 'Islamic economic man' is to secure *marḍātillāh* (God's pleasure) in every economic activity, thus, the injection of the Islamic moral discipline in achieving the aim is inevitable in his/her searching for the bounties on earth. Hence, the decree of *al-ḥalāl wa al-ḥarām* (the lawful and the unlawful), the revealed ethics, should significantly contribute to the achievement of the business purpose, and should play an important role in determining the broad contours of the economic system⁵⁰.

In short, the decree of *al-ḥalāl wa al-ḥarām* in the words of Qaradāwī,

⁴⁷ Hasanuzzaman, S.M., *Economic Functions of an Islamic State (Early Experience)*, Leceister, The Islamic Foundation, 1991, p. 104

⁴⁸ Ibid., p. 104.

⁴⁹ Hadibah, 'Abd. al-Wahhāb, "The Religious Conscience...", Op. Cit., p. 9.

⁵⁰ Hasanuzzaman, S.M., *Economics Functions...*, Op. Cit., p. 34.

"The *ḥalāl wa al-ḥarām* are part of the total legal system of Islam, its *sharī'ah*, a system whose primary objective is the good of mankind. The Islamic *Sharī'ah* removes from human beings harmful burdensome customs and superstitions, aiming to simplify and ease the business of day-to-day living. Its principles are designed to protect man from evil and to benefit him in all aspects of his life. And they are designed to benefit every-one in the community - the rich and the poor, the rulers and the ruled, the men and the women - as well as to benefit the whole of humanity throughout the earth in various countries and climes, with its multitude of groupings, and in every period of time throughout succeeding generations"⁵¹.

3.5.2.1 *Al-Ḥalāl wa al-Ḥarām* in Goods and Commodities.

The injunction of *al-ḥalāl wa al-ḥarām* in Islam as far as the business world is concerned, is divided into two aspects i.e. commodities and activities. The following sub-topic discussion will focus on the commodities that are forbidden in a transaction. There are many injunctions stated in the two basic sources of Islam, the Qur'ān and the Sunnah⁵² with regards to the prohibition. Generally, the prohibition of certain goods and commodities, with the mercy of God, is based on their impurity and harmfulness⁵³. Impurity and harmfulness of commodities refer to their effect on physical and mental healthiness as well as to the healthiness of one's *'aqīdah* (belief).

Examples of commodities which are not permitted to be traded by the Muslim for the above reasons are *al-khamr* (alcohol), pigs, idols and dead animals. In one of the *ḥadīth ṣaḥīḥ* (authentic tradition), the Prophet (saw) mentioned,

"Surely, God and His Messenger have prohibited the sale of wine, the flesh of dead animals, swine and idols"⁵⁴.

⁵¹ Qaraḍāwī, Yūsuf, *The Lawful and the Prohibited...*, Op. Cit., p. 6.

⁵² The Qur'ān, 7:32-3 and 157, 5:4-6 and 10:59. There are many *aḥādīth* that mention the prohibition of commodities due to their impurities such as *al-khamr* (liquor), *laḥma al-khinzīr* (pork), *daman masfūḥan* (running blood) and others. Refer to Qaraḍāwī, Y., *Ibid.*, chapter 2, pp. 39-78.

⁵³ *Ibid.*, p. 24.

⁵⁴ Bukhārī, *Ṣaḥīḥ al-Bukhārī*, Op. Cit., in *kitāb al-buyū'*, *ḥadīth* no. 2082.

"When God prohibits a thing, He prohibits (giving and receiving) the price of it as well"⁵⁵.

There are many *aḥadīth* on the prohibition of *al-khamr* and cursing those involved in the activity⁵⁶. In another *ḥadīth* the Prophet (saw) described ten activities related to alcohol which are not allowed in Islam including selling and serving as well as working in a place which produces it⁵⁷. The prohibition of *al-khamr*, flesh of dead animals, is based on its harmful effects on physical and mental healthiness, while the prohibition on the transaction of idols is based on their effects on the purity of one's *'aqīdah* (belief).

The above is also applicable to the sale of drugs and other things that are dangerous to society⁵⁸. There are a few new *fatāwā* (religious rulings) that categorise commodities as *ḥarām* (unlawful) to trade. One example of these is cigarettes⁵⁹. The ruling has been pronounced since new technology and research found the dangers of cigarettes to the health of an individual over certain periods. The ruling is based on the verse which means,

"Do not throw yourself into the valley of destruction"⁶⁰.

Furthermore, there are *aḥadīth* which prevent Muslims from being involved in any activity that could be dangerous to themselves. However, there are plenty of other things that could be transacted as business commodities. The *ḥarām* commodities are easily hidden behind thousands of *ḥalāl* (lawful) commodities that God has created on the earth. Thus, there is no reason why human could not stop selling those *ḥarām* things that bring unhealthiness and destruction to society, since there are plenty of

⁵⁵ Abū Dāud, *Sunan Abī Dāud*, Beirut, al-Maktabah al-'Aṣriyyah, n.d., in *kitāb al-buyū*, *ḥadīth* no. 3026. See also *Musnad Aḥmad*, Op. Cit., *kitāb musnad bani Hāshim*, *ḥadīth* no. 2546.

⁵⁶ For further detail, refer Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., pp. 72-6.

⁵⁷ Ibn Mājah, *Sunan Ibn Mājah*, n.p., Dār Iḥyā' al-Turāth al-'Arabī, 1975 in *kitāb al-Ashribah*, *ḥadīth* no. 3372. See also *kitāb al-buyū* in *Sunan al-Tirmidhī*, Op. Cit., *ḥadīth* no. 1216.

⁵⁸ Ibid., pp. 76-8.

⁵⁹ Qaraḍāwī, Y., *al-Fatāwā al-Mu'aṣirah*, (tr. *Fatwa-fatwa Semasa* by al-Ḥamīd al-Ḥusaini), Jakarta, Yayasan al-Ḥamidiy, 1996, pp. 827-44.

⁶⁰ The Qur'ān, 2:195. See also 4:29. In one tradition, the Prophet (saw) said, "Do not harm yourself or another" reported by Ahmad in *Musnad Aḥmad*, Op. Cit., in *kitāb baqī musnad al-anṣār*, *ḥadīth* no. 21714. See also Ibn Mājah, *Sunan Ibn Mājah*, Op. Cit., in *kitāb al-aḥkām*, *ḥadīth* no. 2331.

other goods and commodities which could be traded to generate income. Here is the important role played by the basic moral discipline of Islam that is embodied in the concept of *al-ḥalāl wa al-ḥarām* in the business world.

3.5.2.2 *Al-Ḥalāl wa al-Ḥarām* in Activities.

In the above discussions, it is shown that the forbidden commodities to be traded are very small in number. They would not pose any problems to the business world as the alternative commodities are in abundance. However, the problems faced by today's business world are to do with the method and manner that the transaction is carried out. As the purpose of a 'conventional economic man' is to maximise profit, methods and ways available are to be fully utilised, regardless of their suitability and conformity to human morals and values.

Hence, Islam stresses in its teaching that human should not go beyond the limitation prescribed as related to the methods and ways of indulging in the business world. Therefore, Islam introduces a few injunctions that guide human on to the right track of creating a good and pleasant business environment. The following discussion will focus on the abolition of *al-ribā* (interest or usury), *al-maisir* (gambling), *iḥtikār* (hoarding), and a few other malpractices that occur in the business world.

a) Unethically earning from *ribā*⁶¹.

Ribā literally means an 'addition'. Technically, it refers to any predetermined additional amount that is charged on the monetary transaction, money lent or borrowed. *Ribā* also implies or connotes a kind of reward that can be achieved without any work done⁶², regardless of the term used to describe the transaction, and

⁶¹ For further discussion on the definition of the word refer Musleḥuddīn, M., *Insurance and Islamic Law*, Lahore, Islamic Publications Ltd., 1979, pp. 143-165. For the definition of the word from an orientalist point of view, refer to Schacht, Joseph, *An Introduction to Islamic Law*, Oxford, Clarendon Press, 1964, p. 145.

⁶² Ghannāmeḥ, 'Abdullāh, "Interestless Economy" in *Cotemporary Aspects of Economic Thinking in Islam* (Ed. by the Muslim Students' Association of The United States and Canada), Maryland, American Trust Publications, 1968, pp. 56-7.

regardless of any language manipulation in which the concept is interpreted⁶³. In other words, any increase in a loan granted whether it is for business purposes or for consumption, among individuals, institutions or the government is *ribā*⁶⁴. This is the most crucial problem faced by the modern world because this practice is already implanted deeply into almost every economic and business activity.

The above describes the *ribā* that is attached to financial transactions that are classified and known as *ribā al-nasī'ah*. However, there is another type of *ribā* that is based on barter transactions as stated in the *ḥadīth ṣaḥīḥ* whereby the Prophet (saw) prohibited the barter transaction of six identical commodities⁶⁵. This is what is termed as *ribā al-faḍl*, transactions based on commodities exchange rather than financial exchange. In today's modern economic environment *ribā al-faḍl* is not as important as *ribā al-nasī'ah*.

It can be clearly seen that the customisation of *ribā* in society causes many injustices and thus its prohibition in every decent religion of *Yahūd* (Jews) and *Naṣārā* (Christians)⁶⁶ and Islam is clearly stated and is not astonishing. The practice creates an environment where the financially weak can be exploited in the business world. That is why the Catholic churches taught a war on *ribā* for many centuries⁶⁷.

⁶³ Khurshid Aḥmad, "Inaugural Adress" in *Elimination of Ribā from the Economy*, Islamabad, Institute of Policy Studies, 1994, p. 3.

⁶⁴ For the comprehensive definition on *ribā*, refer to the writing of Khursid Ahmad "Elimination of *Ribā*: Concept and Problems" in *Elimination of Ribā from Economy*, Op. Cit., pp. 33-44.

⁶⁵ From Abū Sa'īd al-Khudrī, he said, The Prophet Muḥammad (saw) has said that "gold in return for gold, silver in return for silver, wheat in return for wheat, barley for return for barley, dates in return for dates, salt in return for salt, can be traded if and only if they are in the same quantity and that it should be hand to hand. If someone gives more or takes more, then he is engaged in *ribā* and accordingly has committed a sin". Nasā'ī, *Sunan al-Nasā'ī*, n.p., Dār al-Bashā'ir al-Islāmiyyah, 1986 in *kitāb al-buyū'*, *ḥadīth* no. 4488. See also Muslim, *Ṣaḥīḥ Muslim*, Op. Cit., in *kitāb al-musāqāt*, *ḥadīth* no. 2969.

⁶⁶ For the prohibition of *ribā* in both religions, refer to the Old Testament, Ex. 22:25 and also refer to the Gospel of Luke 6:30. However, the original teaching has been distorted. In the Christian world, though churches once were fighting *ribā*, they have not only failed but the problem of it has become rampant and common in the life of their society. The real distortion of religion occurred among the Jews whereby the prohibition of *ribā* in the Old Testament (Ex. 22:25) which applied to everyone in a society was changed only to the Jews alone. "You may lend on interest to a foreigner, but to your brother, you shall not lend on interest" (Deut. 23:20). All the above are quoted from al-Qaraḍāwī, *The Lawful and the Prohibited...*, on the discussion of "the prohibition of *ribā*", Op. Cit, pp. 264-5.

⁶⁷ Wafi, 'Alī Abd. Wāḥid, *Ḥuqūq al-Insān fī al-Islām* as quoted in *Al-Niẓām al-Iqtisādī fī al-Islām* by Aḥmad Muḥammad al-Assal and Fathī Aḥmad A. Karīm (tr. Sistem Ekonomi Islam by Ansori Umar), Singapore, 1984, p. 85.

However the church opposition of usury stumbled during the Middle Ages, when it made a small amount of usury legitimate to cover the cost of making loans⁶⁸.

Though in the religion of *Yahūd* mentioned, *ribā* is permitted on the Non-Jews, yet the element of injustice and cruelty remains, since the charged, is purposely for the economic domination of other religions and consequently demolishing it⁶⁹. Even the Arabs of *jahīliyyah* (the period of ignorance), disapproved of *ribā* and considered it as the dirtiest tactic for gaining income. This is evident in the writing of Ibn Hisham whereby in the process of rebuilding the *ka'bah* (the house of *Allāh*) the *Quraysh* of Mecca rejected a donation which came from *zinā* (adultery) and *ribā*⁷⁰. Clearly, *ribā* is a prominent method used to exploit others and gives privileges to the capital owner of 'unearned income'.

In Islam, *ribā*, whether it is at a low or high rate, is strongly condemned by the Qur'ān⁷¹ and the Sunnah⁷² of the Prophet (saw) to the extent that God and His Messenger pronounces war against Muslims who indulge themselves in *ribā*⁷³. In one of the verse in the Qur'ān, it stresses and compares the act of taking *ribā* to the punishment of God⁷⁴. Therefore, in this respect, the condemnation is not only to the giver and receiver of *ribā* but also to the writer and witness of *bay' al-ribawī* (interest based transactions)⁷⁵.

There is an unpopular opinion expressed by few writers that the injunction on the prohibition of *ribā* only applies to the consumption loan that they call usury and does not apply to any loan for production purposes, what is termed as interest. Their

⁶⁸ Gordon, Wendell, *Institutional Theory and Comparative Theory*, London, University of Texas Press, 1980, p. 178.

⁶⁹ *Al-Nizam al-Iqtisādī...*, Op. Cit., p. 85.

⁷⁰ Ibn Hisham, *al-Sīrah al-Nabawīyyah*, Vol. 1, al-Halabī, 1955, p. 194.

⁷¹ The Qur'ān, 2:275-6, 278-9 and 30:39.

⁷² For further details on the prohibition of *al-ribā* in the Qur'ān and the Sunnah refer to the writing of Chapra where he lists all the verses and traditions of the Prophet in his writing. See Chapra, M.Umer, *Towards a Just Monetary System*, Op. Cit., pp. 235-46.

⁷³ The Qur'ān, 2:278-9.

⁷⁴ The Qur'ān, 2:275.

⁷⁵ "God has cursed the one who takes interest, the one who pays it, the one who writes the contract, and the one who witnesses the contract". See Muslim, *Ṣaḥīḥ Muslim*, Op. Cit., in *kitāb al-musāqāt*, *ḥadīth* no. 2995. See also Aḥmad, *Musnad Aḥmad*, Op. Cit., in *kitāb bāqī musnad al-mukthirīn*, *ḥadīth* no. 13744.

argument is based on two points. Firstly, according to them, there is no evidence in history that loans for production purposes were in existence. Secondly they argue that loans for production purposes in the modern world is a kind of collaboration to increase the wealth of both the lender and the borrower⁷⁶.

However, there are strong counter attack arguments by Muslim scholars as well as Muslims economists concerning the above view. There is ample evidence in history relating to loans of production purposes during the time of the revelation⁷⁷. Even according to Maudūdi as quoted by Khan, loans for production purposes had taken place since the ancient period of Babylon and Egypt where the temples acted as lenders to the farmers at a fixed rate of return⁷⁸.

Although they claim that loans for production purposes is a kind of collaboration to gain wealth for both parties, the evils of *ribā* are obviously still there. Lending money with additional and fixed return for certain periods without any risks to be faced is obviously a kind of *ribā* that is prohibited by Islam. There has been complete unanimity and *ijmā'* (consensus of the Muslim scholars) on its prohibition⁷⁹.

Since *ribā* is seen by Islam as an unethical way of gaining wealth which creates uneasiness in the individual as well as at the social level, its prohibition is truly in accordance to the main economic objective of Islam that is to gain *maḥḥabātillāh*. At the individual level, *ribā* creates selfishness, miserliness, greediness and laziness⁸⁰. While at the social level, it will create a class in society that accumulates property selfishly and denies other people's right to it. It concurrently creates malevolence in them towards the weak and needy in the society⁸¹.

The economic system of Islam is aimed at the realisation of justice particularly in the relationship between the financier and the entrepreneur. Risk and profit in the

⁷⁶ Khan, Waqar M., *Towards an Interest-Free Islamic Economic System*, Leicester, Islamic, The Islamic Foundation, 1985, p. 26.

⁷⁷ See Abū Zahrah, M., *Buhūth fī al-Ribā*, Dār al-Buhūth al-Islāmiyyah, Kuwait, 1970, p. 53. See also Khan, Waqar M., *Towards an Interest-Free...*, Op. Cit., pp. 26-8.

⁷⁸ Ibid., p. 28.

⁷⁹ Khurshid Aḥmad, "Elimination of *Ribā*...", Op. Cit., p. 37.

⁸⁰ For further detail, refer Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., pp. 264-7.

⁸¹ Khan, Waqar M., *Towards an Interest-Free...*, Op. Cit., p. 26

business are to be shared accordingly and it must not be the other way round, where the financier is assured of a positive return while this is not the case for the entrepreneur as manifested in the *ribawī* system⁸². In order to get rid of those evils associated with *ribā* and to contemplate the pleasure of God in economic activity, Muslims have to abide by this injunction faithfully. Furthermore, to avoid any confusion, the problem of *ribā* should not be dealt with in an isolated way as a religious injunction per se but must be viewed as an integral part of an Islamic economics order⁸³.

b) The prohibition of *al-maisir* (gambling).

Islam has granted permission regarding various methods of earning a livelihood. Human being is bestowed with a brain and physical strength and good health to strive for God's bounties. Hence, the elements of chance, luck and dependence on empty wishes are not commensurate with those strengths entrusted upon them. Therefore, earning a living through this method i.e. *al-maisir* (gambling) is forbidden in Islam⁸⁴. As well as it taking a person away from honest labour, serious work and productive effort, it reflects one's disrespect for the laws of causation which God has established⁸⁵.

In the Qur'ān, God has compared *al-maisir*, with other evils such as *al-khamr* (intoxicants), *al-azlām* (divining by arrows) and *al-anṣāb* (idolatry). God even equalised it with the attributes of Satan. As Satan is human's durable enemy, to get rid of Satan, human should not be involved in and participate in these self-destructive activities. Thus, God will grant success upon humankind as they manage do away with this bad habit⁸⁶.

The prohibition of *al-maisir* does not solely depend on the above reasons. The consequences of the habit itself do nothing for the harmonious and peaceful life of a

⁸² Chapra, M.Umer, *Towards a Just Monetary System*, Op. Cit., p. 64.

⁸³ Ibid., p. 64.

⁸⁴ Al-Syirāzī, *al-Muhadhdhab*, Vol. 2, Beirut, Dār al-Fikr, n.d., p. 325 as quoted by Nordin Ngadimon, "*Konsep-konsep Pelaburan...*", Op. Cit., p. 36.

⁸⁵ Qaradāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 304.

⁸⁶ The Qur'ān, 5:90-1 and 93.

society, because they will create frustration, regret, and disappointment to the losers⁸⁷. Furthermore, to release themselves from the addiction of gambling is actually a difficult task. This makes them non-productive factors of production and parasites on society. Hence, it is obvious that gamblers are senseless. Everything they do is for their gambling addiction⁸⁸. The prohibition of it is therefore sternly and repeatedly mentioned in the Qur'ān and the traditions of the Prophet (saw) and is categorised as grave sin⁸⁹.

c) The denouncement of *al-iḥtikār* (hoarding).

Al-Iḥtikār literally means to hoard, reserve, store and other with similar meaning. Technically, it refers to an act of hiding goods especially consumption goods in order to reduce their availability in the market. This is purposely done in the hope of attaining high profit as a result of steep price increases caused by 'scarcity' of the particular goods in the market. Undoubtedly, a hoarder is an oppressor of society through this unethical activity⁹⁰. This vested interest approach in the business world is vehemently rejected by Islam. In one of his traditions, the Prophet (saw) mentions that "the practice of *al-iḥtikār* is unlawful"⁹¹.

In another tradition, he (saw) described that anyone who is involved in the practice is a sinner⁹². The term sinner here according to Qaraḍāwī, is the same appellation that God specified upon the great tyrants in the human history such as *Fir'aūn* (Pharaoh) and *Hāmān*⁹³. In another *ḥadīth* narrated from M`aqal bin Yassar, he says,

"Whoever interferes with the prices of the Muslims' goods in order to raise them deserves that God should make him sit in the Fire on the Day

⁸⁷ Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 305.

⁸⁸ *Ibid.*, p. 305.

⁸⁹ The Qur'ān, 2:219, 5:93-4 and 90-1. See a few traditions quoted by Qaraḍāwī in *The Lawful and the Prohibited...*, Op. Cit., pp. 304-6..

⁹⁰ Ibn Taymiya, *al-Risālah fī al-Hisba*, (tr. Public Duties in Islam by Muhtar Holland), Leicester, The Islamic Foundation, 1987, p. 32.

⁹¹ Muslim, *Ṣaḥīḥ Muslim*, Op. Cit., in *kitāb al-musāqāt*, *ḥadīth* no. 3012. See also *Sunan al-Tirmidhī*, Op. Cit., in *kitāb al-buyū'*, *ḥadīth* no. 1188.

⁹² Aḥmad, *Musnad Aḥmad*, Op. Cit., in *kitāb baqī musnad al-mukthirīn*, *ḥadīth* no. 8263.

⁹³ Al-Qur'ān, 28:8. See also Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 257.

of Resurrection"⁹⁴.

There are many other *aḥādīth* prohibiting this bad attitude of business activity, hoarding and hiding goods for higher profit in a short time. This shows how Islam perceives this phenomenon as a great threat to the harmony of a society, hence prohibiting it before the habit jeopardises the peacefulness of society. Instead, Islam advocates selling commodities in the market for a reasonable profit, and providing more supplies at the same price. This practice will benefit everybody, individual profit is gained as well as public interest served⁹⁵.

Unfortunately, in today's business world, *al-iḥtikār* is one of a variety of methods used by indiscriminate traders to accumulate wealth and property over a short period. Consequently, the practice would neglect and injure the public interest for the sake of their profit over a short period on small capital used⁹⁶. Hence, the prohibition of *al-iḥtikār* is to protect the free market from being dominated by unscrupulous and amoral traders whose sole concern is with the maximisation of their profit.

3.5.3 Other Malpractices in the Business World.

There are a few other malpractices associated with the business world. The on going discussion will concentrate on these elements that are rampantly practice in today's business world. These malpractices include deceit, exploitation and manipulation in trading and trading involving uncertainty.

3.5.3.1 Deceit in Trading.

Deceit in trading always occurs in two situations i.e. in term of its quality as well as its quantity. In terms of quality, it can occur where the goods are not up to the

⁹⁴ Reported by Aḥmad, *Musnad Aḥmad*, Op. Cit., in *kitāb al-'asharah al-mubashshirīn bi al-jannah, ḥadīth* no. 130.

⁹⁵ Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 257.

⁹⁶ Othman, M. Saedon, "*Kepentingan dan Keperluan Sharī'ah Islam dalam Kegiatan Perniagaan dan Perdagangan*" (The Importance of *Sharī'ah* in Trade and Commerce), paper presented in the Seminar of Share and Investment in the Stock Market: Islamic Perspective, Petaling Jaya, Malaysia, 26-27, April 1994,

expected standard. For example in a situation where the trader shows to the buyer a high quality of goods, but the goods bought are not of similar quality to the goods shown in the shop or in the catalogue. This often happens in today's modern style of house to house business through the wide use of catalogues. Every photo and description of goods provided in the catalogue is in a very captivating and attractive. Nevertheless, this is often not the case whenever the goods ordered have been received.

In one occurrence, when the Prophet Muḥammad (saw) was passing by a grain merchant, he felt curious and thrust his hand into the heap of grain and found the same grain but of low quality. The Prophet (saw) said,

"Why did you not put it on the top so that people could see it? He who deceives us is not of us"⁹⁷.

From the above, clearly fraud enters into the market with the concealment of defects and the misrepresentation of goods⁹⁸. Islam strongly rejects this attitude in the business world, in what ever form and style it might be presented. Every defect that is found in the goods needs to be declared to the potential buyer and the act of hiding any imperfection is an act of *ẓulm* (transgress)⁹⁹. Discarding this bad attitude from the business world will cause the feeling of believing each other to flourish between the buyer and the seller and hence, harmony will prevail.

The second type of deception in trading is concerned with the quantity of the goods. In many verses of the Qur'ān, God stresses the importance of giving full measurement to the buyer¹⁰⁰. Although absolute accuracy is something unattainable, the most accurate within human capabilities is demanded. In addition, correct measurement in business is the right of every individual buyer regardless of their skin

⁹⁷ Ibn Mājah, *Sunan ibn Mājah*, Op. Cit., in *kitāb al-tijārāt*, ḥadīth no. 2216. See also Aḥmad, *Musnad Aḥmad*, Op. Cit., in *musnad al-mukthirīn min al-ṣaḥābah*, ḥadīth no. 4867.

⁹⁸ Ibn Taymiya, *Public Duties in Islam*, Op. Cit., pp. 29-30.

⁹⁹ Othman, M. Saedon, "The Importance of *Sharī'ah*...", Op. Cit., p. 32.

¹⁰⁰ See the Qur'ān, 4:107, 6:152, 7:85, 12:52, 17:35, 26:181-3, 55:9 and 83:1-6.

colour, nationality as well as religious belief. Those who intend to maximise profit through withholding full measure in their business is disgraceful¹⁰¹.

3.5.3.2 Manipulation in Business

Manipulation in the business world can be distinguished in two aspects i.e. manipulation in the market in order to influence its price and also exploitation of labour. In both cases, the intention of traders is only to maximise their gain. These unethical business approaches of attaining high profit are fiercely renounced by Islam.

a) Market's manipulation.

The manipulation of the market occurs in various ways when in any way, a just price does not prevail. In the case of *al-iḥtikār* (hoarding) discussed previously, the act itself will lead to market instability and consumer chaos. Accordingly, when highly needed goods are scarce, as a result of hoarding, the consumer, compulsorily, will be willing to buy the goods at any price offered. This interference of smooth market movement as discussed previously is disallowed in Islam¹⁰².

Market interference through power abuse is another kind of market manipulation that causes instability in the price of goods. One very good example of this manipulation of the market by people in power was clearly demonstrated at the Kuala Lumpur Stock Exchange (KLSE), Malaysia early 1994. A statement by the Malaysian Government's Economic Advisor on Malaysia economy led to the crash of stock prices in the KLSE and caused great loss to the society¹⁰³. Hence, this approach of attaining high profit through the instabilisation of the market by people in power is unlawful in Islam¹⁰⁴. Similarly, spreading rumours by 'insiders' in order to untabilise

¹⁰¹ The Qur'ān, 83:1-6.

¹⁰² Refer to the previous discussion in this chapter on the sub-topic 'denouncement of hoarding'.

¹⁰³ Hussin Salamon, "Speculation in the Share Market...", Op. Cit., p. 15.

¹⁰⁴ See al-Assal, Aḥmad Muḥammad and Fathī Aḥmad 'Abd. Karīm, *Al-Niẓām al Iqtisādī fī al-Islām...*, Op. Cit., p. 94. See also Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 255.

the market's price in a stock market in the way that usually happens¹⁰⁵ is against the spirit of *al-‘adālah* (justice) in Islam.

The influence and the work of middle-men¹⁰⁶ are also a type of market manipulation that cause injustice in the area of the price of goods, especially in agricultural products. Injustices done are not only to the consumers but at the same time at the expense of the producers' 'expected profit'¹⁰⁷. Through the work of a middle-man, the price will be higher than it should be, hence, a burden to the consumers and unearned profit to him/her. Also, the rural crop producer suffers 'unexpected losses' as he/she him/herself could sell it at relatively higher price in the town. The middle-man gains another unearned profit from the difference between the real price that the crop producer could sell at, and minus the actual price that the crop producer receives from the middle-man. Hence, the middle-man makes double unearned profit. Therefore, this 'soft' unethical approach in getting profit is strongly condemned by the Prophet in his *aḥādīth*¹⁰⁸.

Another type of market manipulation is on the price of the goods themselves. Some traders, knowingly that they are the only supplier of particular needed goods or services, exploit this opportunity by charging an exorbitant price. Though *sharī‘ah* does not directly tackle this problem, the practice clearly shows selfishness and materialism in the business world and obviously defies the concept of *al-iḥsān*, *al-‘adālah* and avoiding *ẓulm* in business as propagated by Islam.

b) Exploitation of labour.

Exploitation of labour is another unethical approach to maximising the producer's profit, through the reduction of capital used in production. The exploitation of labour

¹⁰⁵ Chapra, M. Umer, *Towards a Just Monetary System*, Op. Cit., p. 97.

¹⁰⁶ A middle-man here does not refer to the system of brokerage that is allowed in Islam in order to stimulate and make business exchange be smoothly done. But it refers to the activities of a city resident who cuts the way of rural dweller at the middle-way. Refer Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 259-60.

¹⁰⁷ This situation can easily be seen, especially in the case of agricultural production whereby the middle-man interferes in the market by monopolising the production.

¹⁰⁸ For further detail on these *aḥādīth*, see Qaraḍāwī, *The Lawful and the Prohibited...*, Op. Cit, pp. 258-9.

usually happens in two different ways. The obvious exploitation is by giving low or unsuitable remuneration for to the job done, while neglecting the welfare of the workers is another aspect of labour's exploitation.

In the first aspect of labour exploitation, the producer or employer usually gives their workers a low salary as compared to their job responsibilities. This is often true especially if the company is to be set up in a rural area whereby the rate of illiteracy is high. Illiteracy here refers to its real understanding as well as to being illiterate concerning the law and the rights of the labourer. The unethical producer could exploit the situation by giving them a very low wage. This is rampant in the 'poor countries' as well as in some developing countries. In many cases of poor countries, the exploitation of 'young and underage' labour is obviously seen. The government could not do anything as the invisible force of 'poor economic conditions' is very strong.

With respect to the welfare of the workers, it could happen in various ways. Sometimes companies do not provide insurance cover for their workers, or there could be a lack of basic facilities on the production sites, a lack of meetings between the employers and the employees, no medical entitlement, no special benefit for retired workers and other sorts of individual and social welfare that may be needed by the workers.

The above various approaches applied by the producers in order to ensure their production costs reduced, are condemned in Islam. Islam promotes that good relations and environment between the employers and employees are to be established as these will provide a conducive place for the future development of a company. Therefore, a French orientalist admitted in his writing that Islam has its own approach of attaining economic well being. In the aspect of production, Islam holds labour work in a very high regard and prohibits any kind of exploitation. While with the aspect of distribution, Islam bases this on two distinguishing approaches, for everyone according to their needs and for everyone according to their labour work. More importantly, according to him, Islam is very concerned with the enormous differences

between the poor and the rich¹⁰⁹. Hence, Islam prohibits any kind of exploitation towards the workers in what ever form it might take place in a society.

3.5.3.3 Business Involving *al-Gharār*.

Al-Gharār literally mean uncertainty. The definition of *al-gharār* given by *fuqahā* (Scholars of Islamic jurisprudence) as related to the business world varies¹¹⁰. However it can be deduced from various definitions given that it refers to uncertain things that exist in a transaction whether in terms of the price and payment of goods, the condition of goods, quantity of goods, reception of goods as well as their security¹¹¹. There are many *aḥādīth* of the Prophet on the matter to the extent that some compilers of the *ḥadīth* had one specific chapter on these issues in their *ḥadīth* compilation¹¹². The purpose of the prohibition is to avoid any future disputes between both parties or unjust appropriation of other people's money¹¹³.

However, in certain situations, the existence of unexcessive *al-gharār* is permissible and the transaction is valid and allowed in *sharī'ah*¹¹⁴. In other words, any transaction that involves very clear and obvious elements of uncertainty is prohibited while a small and bearable element of uncertainty is allowed, especially in the transaction of needed goods.

3.5.4 The Importance of 'Aqd in Business Transactions.

'Aqd (contract) in a business transaction¹¹⁵ including in a financial loan is undeniably a very important measure to ensure 'adālah (justice) prevails and to avoid any

¹⁰⁹ Charles Raymond, *Loi Islamique et Socialisme Musulmanne Uevue dele Vie Fudiaire*, Paris, 1969, p. 6-10 as quoted by Ahmad Muhammad Assal and Faḥī Aḥmad 'Abd Karīm in *al-Niḡām al-Iqtisādī fī al-Islām...*, Op. Cit., p. 10. In this respect hence, we can realise how important are the institutions of *zakāh* (compulsory charity), *infāq* and *ṣadaqah* (voluntary charity), *waṣāyā* (law of inheritance) as well as other obligations demanded out of property posses in Islam.

¹¹⁰ Ibid., p. 91.

¹¹¹ Hussin Salamon, "Speculation in the Share Market...", Op. Cit., p. 13.

¹¹² See the chapter on *kitāb bay' al-gharār* in *Ṣaḥīḥ Muslim*. Op. cit.

¹¹³ See Qaradāwī, *The Lawful and the Prohibited...*, Op. Cit., pp. 253-4. See also Othman, M. Saedon, "The Importance of *Sharī'ah*...", Op. Cit., p. 37.

¹¹⁴ Qaradāwī, *The Lawful and the Prohibited...*, Op. Cit., p. 254.

¹¹⁵ The connotation of 'aqd does not only reffer to business transactions. It refers to every activity that involves in it two or more parties including a marriage contract. However, the focus in this

inconvenience and injustice. At the same time it will ensure the right of both parties in the transaction which is being fulfilled. These are the main purposes of holding ‘*aqd* in Islam¹¹⁶ as the property of every individual is sacred and it should not be transferred unjustly¹¹⁷.

As to establish ‘*adālah* in the business world is the main objective thus, a few conditions of ‘*aqd* are to be fulfilled in all business transactions. Although, an ‘*aqd* can be done in what ever way or in any language, it must be done in a harmonious environment. In other words, both parties should be aware of every consequence that may prevail from the ‘*aqd* and more importantly, there must be no element of *ikrāh* (compulsion) in the ‘*aqd*¹¹⁸. In addition, an ‘*aqd*, especially in any loan that involves money is to be done in written form and must be witnessed by two sound witnesses. This was mentioned by God in a long verse, whereby adhering to it means prevailing justice in the transaction¹¹⁹.

Another important condition is that the ‘*aqd* done must not embody in it any element that is against the *sharī‘ah* and *ahklāq* (moral values). Hence, Islam prohibits all kinds of contracts that possess the elements disapproved by *sharī‘ah* such as ‘*aqd* and sale made during the *ādhān* (call for prayer) especially Friday prayer¹²⁰, ‘*aqd* to be done on other person's ‘*aqd*, and ‘*aqd* on the selling of goods that are to be used to harm an individual or harmful to the society¹²¹.

In the previous discussion, among the malpractices in the business world are those done in terms of the price and quantity of goods as well as deceitful transactions. To be valid, an ‘*aqd* done must be free from these malpractices. The quantity and quality must be fully realised by both parties and no existence of any other elements of

discussion is on the business world, including labour and wages, sales and payment and all sort of business transactions.

¹¹⁶ Aḥmad M. Assal and Fathī A. Karīm, *Al-Niẓām al-Iqtisādī fī al-Islām...*, pp. 187-95.

¹¹⁷ The Qur’ān, 4:29.

¹¹⁸ Aḥmad M. Assal and Fathī A. Karīm, *al-Niẓām al-Iqtisādī fī al-Islām...*, Op. Cit., pp. 186-7.

¹¹⁹ The Qur’ān, 2:282

¹²⁰ The Qur’ān, 62:9. In this respect, Muslim Scholars unanimously agreed that the sales of goods and ‘*aqd* done after the second *ādhān* on Friday is *ḥarām* (unlawful). See Aḥmad M. Assal and Fathī A. Karīm, *Al-Niẓām al-Iqtisādī fī Islām...*, Op. Cit., p. 194.

¹²¹ *Ibid.*, pp. 191-6.

malpractice must be in the *'aqd*¹²². Hence, the importance of an *'aqd* in ensuring every business transaction is done ethically, is clearly manifested in the above discussion.

3.6 Conclusion.

As Islam is the religion that focuses on the success of humankind achieving *marḍātillāh* (the pleasure of God), hence, attaining this objective is a priority for each Muslim in every activity including in the business world. The core concepts in Islam such as *al-tawḥīd*, *al-iḥsān*, and *al-tawakkul* really play a vital role in the moulding of ethical and moral behaviour in order to become an 'economic man' in the modern business world. Hence, it is obviously necessary for *al-'adālah* to prevail in the business world. This is undeniably true if the real understanding of these concepts is fully grasped.

More importantly, these core concepts are supported by the decrees revealed by God in the realisation of *al-'adālah* in the business world. These 'supportive' decrees are revealed as a preventive measure for the business world. Islam takes a step of preventing any kind of mal-practices before they are allowed to spread in the business world. Thus, if these preventive measures in the business world are faithfully adhered to by every 'economic man', it will undoubtedly create a model of a harmonious economic environment in every business transaction.

¹²² Refer to the previous discussion on the sub-topic of malpractices in the business world.

CHAPTER 4

THE STOCK MARKET IN A MODERN ECONOMY

4.1 Introduction.

The contribution of the major financial market to the running of the financial system in a country is undoubtedly very important. This market can be classified into two types; money markets and the capital markets. Money markets are the places where liquid financial assets are traded. These involve organisations such as institutions of commercial banks, discount houses and the government, which deal with bills of exchange, treasury bills, and trade bills. Capital markets are established in order to trade long term credit such as common stocks, bonds and mortgages and new issues of these financial instruments.

These financial markets are very organised institutions in the sense that they have a defined membership, rules and regulations to be adhered to and enough facilities in terms of information links etc. to undertake the dealing process¹. In dealing with medium and long term sources of capital, the capital market can be viewed from two opposite sides; the demand side and the supply side of the markets². The demand side is represented by industry, commerce, the government, local authorities and other organisation which require capital to finance their economic and developmental activities. The supply side of the market involves stock exchanges, investors and investment and money saving institutions such as insurance companies, unit trusts, pension funds and banks.

The securities market is the component of the capital market which deals primarily in shares and bonds. Money invested in these securities can be liquidated before their maturity date. The trading of shares and bonds is organised into two markets; the primary and secondary markets. The primary market is concerned with the issuing of

¹ Bain, A. D, *The Economics of the Financial System*, Oxford, Martin Robertson & Company Ltd., 1981, p. 194.

² Even though banks are on the supply side of the capital market, bank overdrafts are not considered as the product of the market. See *A Dictionary of Economics and Business* (Ed. by Stiegeler, S.E), London, Pan Books Ltd., 1986, p. 51 under the entry "capital market".

new securities for capital accumulation where it can usually be mobilised and placed with investors. The secondary market focuses on the trading of existing securities. In this chapter however, the discussion will only focus on the stock market as the principal trading market in securities.

4.2 The Stock Market.

The stock market is a highly organised market which deals with the buying and selling of securities³. The securities issued by either central or local government as well as by public companies are traded here, and include bonds, common and preferred stocks. The markets are only open to their members, and give them the chance to buy or to sell their securities or to transact on behalf of their friends or clients. In other words, a stock market plays an important role as an association of dealers in securities. It can only be participated in by its members. The membership as well as the transactions occurring are closely monitored according to a prescribed set of rules in order to maintain the standards of the stock market. Similarly, companies and other security issuing bodies have to meet the prescribed requirements in order to have their securities listed in a stock market.

Hence, the existence of a stock market is very important in a modern economy. It is a secondary market for the transaction of securities. The existence of the market provides a very good opportunity for the listed companies to raise their capital for further development of the companies. The public can invest their surplus income in the companies for saving purposes and can gain profit from this business venture. Besides, there are many other important functions being carried out by the stock market in a modern economy. The important functions played by stock markets will be described in detail in the final part of this chapter.

³ Stock market securities are split into two different categories; gilt-edged and commercial securities. However according to Evans, the precision of this division is something not absolute as the definition of gilt-edged securities is apt to vary. See Evans R.W., and Makepeace G.H., *Monetary Theory, Institutions and Practice: An Introduction*, London, The Macmillan Press Ltd., 1979, p. 89.

4.3 Brief History on the Establishment of a Stock Market.

A stock market in a modern economy is a complex business and market institution for capital. It has its own sets of rules and mode of operation, with a very structured management and organisation. However, when we refer to the history of its development, we may find that this fully organised economic organisation began as a very small society with a small volume of shares transacted as compared to the present operation of a stock market. It was simply an informal association set up between merchants to discuss, negotiate and trade their securities and shares.

4.3.1 The Early Stage of its Development.

In the Middle Ages, the trading of agricultural and other commodities took place actively among the European community. The nature of the trade demanded more convenient methods of payment, which were initially based on a credit system. The credit system operating was supported by commercial documents such as drafts, notes and bills of exchange⁴.

However, when the use of the system became more widely implemented and the commercial values of these documents were recognised, it became necessary to create a proper place for the traders to trade these documents. In the 12th century, Philip the Fair (1268-1314) initiated '*courratier de change*' or '*agent de change*', a role similar to the modern stock broker. This institution was established for the purpose of creating a proper place for stock trading and for supervising the embryonic stage of the market⁵.

At the same time in Bruges, Belgium, traders usually gathered at the front house of Van der Buerse to trade their commercial documents. As an aside, the name '*bourse*' which is synonymous with the activity of selling and buying commercial documents, in a similar way to the modern stock market, is taken from Buerse's family name. The

⁴ "Securities Trading" under the entry "Markets" in *The New Encyclopædia Britannica* (1991). *Macropædia* Vol. 23, Op. Cit., p. 559.

⁵ *Ibid.*, p. 559.

same development was taking place in other parts of Europe in the 16th and 17th century such as in Holland, Great Britain, Germany and Denmark⁶.

In Great Britain, the embryonic stage took place with the existence of the Royal Exchange at the end of the 17th century. During this period, the prosperity of Great Britain's economy was clearly manifested in the public wealth and capital accumulation. The capital accumulated by the public was not being fully utilised towards the further economic development of Great Britain's economy.

4.3.2 The Later Stage of its Development.

However, the situation changed when William III introduced a government security, the 'Stock of National Debt' where the public invested in the stock and traded in the Royal Exchange⁷. In 1693, stock brokers and stock jobbers⁸, unique professions in the modern London Stock Exchange, were said to be actively participating in the Royal Exchange. They were busy transacting 5 million Stocks of National Debt⁹. However in 1700, they abandoned the Royal Exchange and then moved to transact their stock at the New Jonathan, a coffee house¹⁰.

The largest stock market in the present time, the New York Stock Exchange, started with the agreement of 24 merchants to hold a daily meeting under the buttonwood tree on Wall Street beginning on July 17, 1792¹¹. The purpose of the meeting was to discuss and trade their stocks and shares in a very informal situation. The need for a formal and organised market appeared after the sale of eighty millions dollars worth of bonds which were authorised by the first congress in 1790 and after the stocks of three banking institutions were incorporated¹².

⁶ Ibid., p. 559.

⁷ Poley, A.P., *The History, Law, and Practice...*, Op. Cit., pp. 5-6.

⁸ These two institutions; jobbers and brokers are the main institutions in the daily business operation of the London Stock Exchange. Further elaboration on these institutions will be dealt in the sub-topic of Jobbers and Brokers in the later part of this chapter.

⁹ Poley, A.P., *The History, Law, and Practice...*, Op. Cit., pp. 5-6.

¹⁰ Ibid., p. 1 and 6.

¹¹ Arnold, Henry C.F., "Stock Exchange", Op. Cit., p. 896.

¹² *The New York Stock Exchange: History, Organisation, Operation and Service*, prepared by the Committee on Publicity New York Stock Exchange, New York, NYSE, 1932, p. 5.

The existence of the New York Stock Exchange, made the United States an economic power of the world and a centre for financial trading. The existence of the New York Stock Exchange in the city of New York is the foremost reason that the city is considered to be the source of 'half the world's capital', and the place which dominates the markets of the world¹³. Also, it is said that this city is a place where the techniques of trading, the experience of markets and the excitement of dealing are to be found. Thus, the New Yorkers proudly claim that their city is the 'capital of capitals'¹⁴.

The second largest stock market in the present time, The London Stock Exchange, started with a regular meeting of London brokers at Jonathan's Coffee House before moving to a room in Sweeting's Alley. They officially named the room The London Stock Exchange. It is believed that the London Stock Exchange was the first exchange to use the formal name of stock exchange¹⁵. Through the eighteenth century, the London Stock Exchange dealt in the securities of a few firms only as well as three financial companies which included the Bank of England, The South East Company and The East India Company. At the same time other stocks and shares were traded informally in provincial cities¹⁶. In December 1980, the London Stock Exchange set out to cater for the needs of over 2600 companies and stocks of the British Government¹⁷.

In short, the developmental history of stock markets can be traced back to the 12th century in France. During this period, the market can be considered to have been in the incipient stage of its development. However in the 16th and 17th century, similar institutions were established in other parts of Europe¹⁸. The formal use of the term 'stock exchange' started in the 18th century when the London Stock Exchange took its name officially. By this time, stock markets had developed into fully organised

¹³ Hamilton, A., *The Financial Revolution: The Big Bang and the Explosion of the World's Money Markets*, Middlesex, Penguin Books, 1986, p. 113.

¹⁴ *Ibid.*, p. 113.

¹⁵ Arnold, Henry C.F., "Stock Exchange", *Op. Cit.*, p. 896.

¹⁶ Kindleberger, C.P., *A Financial History of Western Europe*, London, George Allen & Unwin, 1984, p. 199.

¹⁷ Bain, A.D., *The Economics of the Financial System*, *Op. Cit.*, p. 195.

¹⁸ "Securities Trading" in *The New Encyclopædia Britannica* (1991), *Op.Cit.*, p. 559.

institutions such as in London in 1773, Philadelphia in 1791 and in New York in 1792¹⁹.

Between the 12th and 16th century, stock markets were simply composed of meetings among the merchants to discuss and trade their shares as well as selling on behalf of friends or other people. They gradually evolved, until they achieved their very influential and importance role in the modern economy of today. They can even be used as an indicator of the economic strength of a country. A stock market can stabilise an economy as well as cause an economy to crash. One important example of this is when the crash of The New York Stock Exchange, November 1929, led to The World Great Economic Depression which started in 1929²⁰.

4.4 The Functions of a Stock Market.

The history of the establishment of stock markets shows that in the beginning, especially during the seventeenth century, they were just informal daily meetings among the merchants to discuss their business activities. Also they were places for selling or buying their shares or transacted shares on behalf of friends or other people. However the function of stock markets in the modern economy does not only consist of these two traditional functions. Some of the functions of a modern stock market are as follows:

a) A stock market is established for the purpose of serving as a secondary capital market to the public, as well as to companies. Hence, the public and companies will have a proper place to sell their shares or to buy new shares.

b) A stock market is a place where a company can get additional capital for their expanding operation. This could be done through the borrowing of capital from financial institutions.

¹⁹ Ibid., pp. 559.

²⁰ Born, Karl E., *International Banking in the 19th and 20th Centuries*, Warwickshire, Berg Publishers Ltd., 1983, p. 256.

c) A stock market is a place where the public can make an assessment of the present performance and future potential of listed companies. This will indirectly help the public to invest their surplus income in the right place at the right time.

d) The existence of a stock market leads to the liquifying of capital. This can be seen through the high volume of shares transacted in the everyday business of stock markets. A stock market provides company's shares with two important aspects, shares liquidity as well as marketability of the shares.

4.5 The Operation of a Stock Market.

As a highly organised market, a stock market's operation is organised in such a way as to avoid any possibility of market manipulation by the public. This is clearly mentioned in the constitution of the New York Stock Exchange, whereby the objective of the New York Stock Exchange is "to furnish exchange rooms and other facilities for the convenient transaction of their business by its members; to maintain high standards of commercial honour and integrity among its members; and to promote and inculcate just and equitable principles of trade and business"²¹. Hence there are a few committees that are responsible for the running of a stock market. In addition, the business dealing in a stock market is not open to the public. Instead it is restricted to their members only. The operation of a stock market can be divided into two in the following way.

4.5.1 Administrative Operation.

The stock market was established in order to create a conducive place for business dealing and to ensure no market manipulation in the trading of shares and securities. Therefore, the establishment of a stock market was totally separate from any financial company, bank or other institution. It was established with its own business entity,

²¹ The New York Stock Exchange: History, organisation, operation and services, Op. Cit., p. 9.

constitution and governing committee. For the purpose of further elaboration on the administrative operation, the Kuala Lumpur Stock Exchange of Malaysia will be taken as an example.

The operation of the Kuala Lumpur Stock Exchange is undertaken by their own governing body i.e. the Kuala Lumpur Stock Exchange Limited, which was established under the Company Acts of Malaysia, 1965. In other words, it is not under the direct control of the Malaysian Government but it is regulated by the Company Acts²².

The Kuala Lumpur Stock Exchange is managed by a Board of Directors which consists of eight members²³. One member of the Board of Directors represents the Ministry of Finance and the other members are elected to represent the brokerage firms which are the members of the Kuala Lumpur Stock Exchange. The Board of Directors serve for one full year and the members of the Board of Directors can be re-elected for this governing committee for not more than six consecutive years. However after a year's retirement, a member can be re-elected onto the Board of Directors²⁴.

The Board of Directors have been given mandate to ensure the smooth running of the Kuala Lumpur Stock Exchange. The duties of the Board of Directors are firstly, to produce licences for membership for any firm that meets all the requirements for participating in the Kuala Lumpur Stock Exchange. Secondly, to impose a fine on any member or company that does not observe the etiquette that has been prescribed in its constitution for business transactions. Thirdly, to create, modify and to implement rules and regulations to be adhered to by its members. Fourthly, to give permission to any new company that fulfils all the requirements, to be listed in the Kuala Lumpur

²² Ismail Ibrahim, *Saham dan Pasaran Saham* (Share and Share Market), Kuala Lumpur, Dewan Bahasa dan Pustaka, 1994, p. 4.

²³ The number of members in The Board of Directors as a governing committee varies from one stock exchange to another. For example the Board of Directors of the New York Stock Exchange comprises of forty-two members including the President of the Board of Directors and a Treasurer. *The NYSE: History, organisation, operation and services*, Op. Cit., pp. 9-11.

²⁴ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 9.

Stock Exchange and lastly, to closely observe the financial condition and the ownership of the Kuala Lumpur Stock Exchange²⁵.

To ensure the smooth running of the market, the members of the Board of Directors will be channelled to lead various portfolios. In other words, the government of the exchange is in the hands of various standing sub-committees of different departments. For example, the forty-two members of the New York Stock Exchange's Board of Directors are spread into thirteen standing sub-committees²⁶. In this respect, the Kuala Lumpur Stock Exchange has established five departments that work to ensure the smooth running of the Kuala Lumpur Stock Exchange²⁷.

4.5.2 Business Operation.

As mentioned in the previous discussion, the existence of a stock market is very important. Economists agree that there can be no modern economy without the contribution of a stock market. This is because the efficiency of a primary market is greatly dependent on the efficient operation of a secondary market, which is the stock market.

The function of a primary market is to accumulate funds to finance any activity planned by either the government, local authorities or public companies. In order to raise funds to finance activities, they will issue securities in which the public can invest money. The issuer will accumulate funds for their economic activities while the public are able to take the opportunity to be a share holder. This transaction is well known and takes place in the 'primary market'.

However, some of these capital suppliers, under certain circumstances; for example when they urgently need money, intend to withdraw their holdings and liquidate their shares through selling them. At the same time, there are many individuals amongst the public who possess capital and intend to invest their income surplus. As the issue of new shares are limited, and not everyone has the privilege of buying them, they cannot

²⁵ Ibid., p. 10.

²⁶ The NYSE: History, organisation, operation, and services, Op. Cit., pp. 9-11.

²⁷ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., pp. 10-14.

invest through the primary market. As an alternative, they need to go to a secondary market, and buy from those who intend to liquidate their shares. Thus, through this mechanism, capital suppliers are continuously available to support the business activity of the companies, local authorities or Governments. At the same time, those who need money urgently can simply liquidating their stocks and shares by selling them. This situation of easy selling and buying makes the economy operate smoothly and harmoniously. This environment made the secondary market more attractive to the public, so that they could participate in business activity. The economists acknowledge that,

"an efficient secondary market is a necessary condition for an efficient primary capital market and any factors, whether real or artificial, which reduce the marketability of securities on The Stock Exchange automatically reduce its effectiveness as a means of raising capital. This degree of efficiency both of the primary and secondary markets has a direct influence on the economic climate and potential of the Nation"²⁸.

4.5.2.1 People involved and terms used.

There are various concepts used in the daily business operation of a stock market. Anyone who intends to study and understand better the operation of a stock market has to be aware of the people involved, and the terms and concepts used. In the following, the illustration of this subject will be divided into two; firstly, the present writer will explain the presence of individuals or organisations who are directly involved in the business operation of a stock market, such as investors, speculators, brokers, and jobbers. Secondly, explanations of a few concepts and terms which are used in the daily transaction of a stock market will be given.

There are many people involved in the business transactions of a stock market. However, this illustration, will only take into account those who are directly involved in the daily transaction of shares taking place in the market. In this respect, the people

²⁸ City Capital Markets Committee, "Supervision of the securities Market: Answers to questions contained in the Inquiry of the Department of Trade June 1974", London, CCMC, December 1994, p. 5.

involved can be divided into two big groups based on their position in the stock exchange business transactions. The first group consists of the capital suppliers or customers which include sellers and buyers of shares. The second group comprise of the people acting as middlemen in the transaction who are termed brokers and jobbers.

a) Investors and Speculators.

Those people who possess income surplus go to a stock market to invest their money through buying shares to get profit. Hence, they are the capital suppliers in the stock market. Nevertheless, we can further divide this group into two, namely rational investors and irrational investors or more correctly, speculators. Hereafter, these two words, investor and speculator will be constantly used to indicate two different categories of people with different attitudes concerning their participation in the stock market and different contributions towards the progress or regress of the economic institutions²⁹.

Investors are those who invest their income surplus with the intention of getting profit for the future. Therefore, in order to do this, they usually invest their money for a long period. This is purposely done for 'business profit' in terms of dividends, the profit gained from the business activities of the company participated in. They will keep their shares for a long period unless there are unavoidable circumstances which force them to liquidate their shares³⁰.

Additionally, investors will also get 'capital profit' through the increase in share value. This materialises as the good progress and achievement of the company participated

²⁹ The investors are a group of people who participate in the business of stock market with a good intention, to get business profit for their genuine investment. In contrast, the speculators are a group of people who participate in the daily transaction of a stock market for the sole purpose of getting quick capital profit through 'genuine speculative judgement' on share price movements. For further elaboration on the differences between these two groups, refer to chapter 6 of this research where a detailed account of them is made.

³⁰ These unavoidable circumstances that usually force the real investors to liquidate their shares for example are catastrophes that strike them or any members of their family which need urgent financial assistance or any problems that need urgent financial guarantees. The progress and achievement of the company participated in will also contribute to a great extent to any decision whether to continue with the company or liquidate their share in order to invest in other companies.

in is reflected in the increased value and assets of the company. Consequently the share price of the company will also rise. Hence, in this situation, the real investor will gain two profits, business profit as well as capital profit. However, as their main purpose of investing money is to gain future profit for their future security, the capital profit that manifests in the increase of share prices will not alter their main objective of investing money. This is the reason why they tend to hold their shares for a long period and they will not be tempted by situations prevailing in the market.

In contrast to the above speculators, are those who inject their income surplus for a quick profit which is termed 'capital profit'. They are merely interested in utilising the legal title of commodities and securities as a store of wealth which will increase their capital gain in the future³¹. They actively participate in business transactions, buying and selling, selling and buying shares, and getting quick profits from the price differences. The more actively they participate, the more possibility they have of getting a handsome profit. This is because the speculators hold a philosophy of making profit all the time and as frequently as possible, even though it is not a large profit, rather than making a large profit only once in a while³². Therefore, they usually hold shares for a short period and always react quickly according to the condition of the market. The result of their participation makes transactions taking place in the stock market very active.

Additionally, some speculators buy or sell shares without taking into account economic analysis. If they see any inefficiency in the market, especially in the aspect of share prices, if they are under valued or over valued, they will act accordingly. If they believe that the price is under valued, and should be higher than in the present market, they will buy in order to re-sell later. In contrast, if they believe that the price is over valued, they will sell the shares for the purpose of re-buying them whenever the price reduces due to what they called market adjustment. This action of selling and buying based on market sentiments is clearly contrary to the investment prerequisite which is very much concerned with analysing the economy before investing.

³¹ Davidson, P., *Money and the Real World*, London, Macmillan Press Ltd., 1978, pp. 106-7.

³² See Aubrey, W.H.S., *Stock Exchange Investments...*, Op. Cit., p. 111.

Those are the two different categories of 'investors'. In economic literature's, these two categories are categorised in the same group, as investors. Although in some of this literature, the writers usually further explain on the existence of speculators, nevertheless, they treat the speculators as part of the investors. This will not be the understanding of the term used in this research. As the two categories possess distinguishable characteristics, The present writer suggests in this research that they should not be categorised under the same category. Hence, those who make investment are investors and those who indulge in pure speculation are speculators³³.

b) Jobbers and Brokers

The second group that is directly involved in business transactions of the stock market, are 'brokers' and 'jobbers'³⁴ who act as middlemen. The existence of these two professions dates back to the late seventeenth century, in the year 1693. They were said to have actively transacted 5 million pounds of National Debt in the Royal Exchange. The profession sprang into existence prior to the formation of the United Kingdom National Debt. From that period the number of brokers and jobbers has increased steadily until the formation of the modern London Stock Exchange of today³⁵.

i. The jobbers

In the manufacturing and production sectors, jobbers serve as middlemen who buy goods from manufacturers and producers and sell them to retailers³⁶. They usually buy goods cheaply and re-sell with a higher price to make profit. However the term is more familiar in the stocks and shares transactions of the London Stock Exchange. A

³³ For further explanation on the second group, refer to chapter 6 of this research where a detailed account of this group is made.

³⁴ 'Jobber' is a unique term for a middleman who works between the brokers. The jobbers do not deal directly with the public. The term is only used in the London Stock Exchange and is similar to 'floor brokers' in the New York Stock Exchange and 'traders' in the Kuala Lumpur Stock Exchange of Malaysia. See Amling, F., *Investments; An Introduction to Analysis and Management*, New Jersey, Prentice-Hall Inc., 1965, p. 160. See also Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 16.

³⁵ See Poley, A.P., *The History, Law, and Practice...*, Op. Cit., pp. 5-7. See also Hanson, J.L., *A Dictionary of Economics and Commerce*, Op. Cit., under the entry "Jobber".

³⁶ "Jobber" in *The New Encyclopædia Britannica* (1977), *Micropædia* Vol. 5, Op. Cit.

jobber in this exchange specifically refers to a trader who deals in securities transactions between the brokers. As brokers are not allowed to deal with each other, a jobber is responsible for mediating between them. Nevertheless, jobbers are not allowed to do business with the public.

Jobbers usually specialise in certain types of shares. They do not offer their service on the basis of commission but benefit from the transaction through a price mark up on the share traded. The jobbers will give two price quotations on a particular share to the brokers without having any idea of whether the brokers intend to buy or to sell. The higher price quotation is the selling price while the lower price is for buying. However, a praiseworthy attitude of the jobbers is their flexibility for negotiation on the price quoted. Their openness for bargaining makes the market more active, dynamic and 'alive'³⁷. Through this mechanism, they manage to get profit by the price difference between the upper and lower quotations. Their profit is known as the 'jobber's turn'.

The jobbers presence meaningfully eases the difficulty which would have been faced by the selling brokers in finding the buying brokers and vice versa, with opposite orders. The results of their contribution greatly improves the business operation of the stock market, and smooths the securities transactions between the brokers as the agents of the customers³⁸. In the other stock markets of the United Kingdom, the job of jobbers is done by some stock brokers called 'dealers'³⁹. While in the New York Stock Exchange and the Kuala Lumpur Stock Exchange of Malaysia, they are called 'floor brokers' or 'two-dollars'⁴⁰ brokers and traders⁴¹ respectively.

³⁷ Pearce, D.W., *The Macmillan Dictionary of Modern Economics*, London, The Macmillan Press Ltd., 1981, p. 227.

³⁸ Seldon, A. and Pennance, F.G., *Everyman's Dictionary of Economics*, Op. Cit., p. 200.

³⁹ As was mentioned before, jobbers are unique characters that are only present in the London Stock Exchange. In the other stock markets of the United Kingdom, the jobber's job is done by some stock brokers.

⁴⁰ See "Securities Trading" in *The New Encyclopædia Britannica* (1991), Op. Cit., p. 560. According to Amling the 'two dollars brokers' term emerged because they used to get two dollars commission for executing an order. See Amling, F., *Investments; An Introduction to Analysis...*, Op. Cit., p. 160.

⁴¹ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 16.

The existence of the jobbing system is significantly felt, because it leads to a greater level of liquidity, eases the brokers' job of finding matching orders between them, and allows the broker to deal with odd lots of equities⁴². Ironically, the jobbers only acquire a minimum profit through a small margin mark up price despite the useful job they perform.

The market mechanism existing in the nature of their job demands that the two price quotations must be set in such a way that they suit the prevailing market price. If a jobber increases his price over the other jobbers unscrupulously, the brokers or sellers will turn their back on him and do business with other more scrupulous jobbers. This will end up unpleasantly, with the piling of unsaleable shares on to his/her account, leaving him with no other option except to sell them at a loss. On the other hand, if he reduces the price without thought and analysis much lower than the other jobbers, brokers and buyers will happily 'jump on his head' finishing everything within seconds without him having the possibility of replacing his account except at a loss⁴³.

Nevertheless, the institution of jobbers has been subjected to criticism as being too expensive and manipulative. Henceforth, the number of jobbing firms has been continuously reduced in recent years with only two firms operating actively out of the remaining nineteen firms⁴⁴.

ii. The brokers.

A broker is an agent who serves as a middleman, who negotiates to purchase or to sell for a commission or fee which is termed 'brokerage'⁴⁵. They are present in almost

⁴² Stonham, P., *Major Stock Markets of Europe*, Hants, Gower Publishing Co. Ltd., 1982, p. 219.

⁴³ This situation is to be understood with the fact that he only specialises in certain securities. To replace his sold securities, he needs to buy the same type of securities that he specialises in, from the market at the prevailing market price. As his price was much more lower than the prevailing price, he would not be able to replace his empty account unless he bought from the market at a loss. See Berman, H.D., *The Stock exchange; An Introduction for Investors* (4th. Ed.), London, Sir Isaac Pitman & Sons Ltd., 1963, p. 13.

⁴⁴ Stonham, P., *Major Stock Markets of Europe*, Op. Cit., p. 219.

⁴⁵ The percentage of commission for the broker is usually fixed by the market authority. In the case of the Kuala Lumpur Stock Exchange of Malaysia, for every selling or buying contract executed by the broker, the customer has to pay a fixed commission of 1 cent for every unit of share priced below RM1.00. While for shares priced above RM1.00, the commission is 1 percent of the total transaction executed. See Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 32.

every economic activity such as goods and services, assets and properties, stocks and bonds, in insurance companies and others. Due to the fact that they work on commission, a unique character of the brokers is that they usually purchase and sell securities which are not in their possession and without having their title changed into their name⁴⁶. They work on behalf of the public and not for their own account, except for bill brokers,⁴⁷ the brokers called 'registered traders' and the specialist brokers called dealers⁴⁸.

The brokerage paid to the brokers is proportionate to the value of the particular transaction they have completed. Unlike the negotiated system of commission that operates in the United States of America, the system implemented in the United Kingdom as well as in the other major stock exchanges of Europe, is a minimum commission system which varies according to the type of securities⁴⁹.

Besides negotiating for buying or selling, they also fully utilise their vast knowledge of the market through giving advice to their customers,⁵⁰ suggesting whether to buy or to sell. At the same time they are usually involved in the issue of new securities such as arranging for those securities to be quoted on the stock market. In this respect, they form the core market along with other financial institutions and issuing houses which sub-underwrite new issues⁵¹. As these type of issues have not been previously listed and traded in the stock market, although they are quoted on the floor of the stock market, they may be placed with buyers by issuing stockbrokers⁵².

⁴⁶ "Broker" in *Encyclopædia Britannica* (1977) *Micropaedia* Vol. 2, Op. Cit., p. 291.

⁴⁷ Hanson, J.L., *A Dictionary of Economics and Commerce*, Op. Cit., p. 53 under the entry "Broker". Bill brokers refer to a commercial organisation which sells commodities at discount prices. In stock markets the term refers to a member of the London Discount Market, who borrows money from financial institutions on a short term basis. They use the money to buy bills of exchange and short-dated government bonds. They get the Bank of England's agreement and privilege to borrow money with a lower interest rate and lend it with a higher rate. See Seldon, A. and Pennance F.G., *Everyman's Dictionary of Economics*, Op. cit., p. 97.

⁴⁸ "Securities Trading" in *The New Encyclopædia Britannica*, Op. Cit., p. 560.

⁴⁹ Stonham, P., *Major Stock Markets of Europe*, Op. Cit., pp. 220-1.

⁵⁰ Pearce, D.W., *The Macmillan Dictionary of Modern Economics*, Op. Cit., p. 409 under the entry "stockbroker".

⁵¹ Sub-underwriting new issues refers to a guarantee to buy any part of shares issued that were not bought by the public or by the existing shareholders. Furthermore these shares have not previously been traded in any stock exchange. Hence, new securities here do not refer to the shares that are newly issued by a company. See Pearce, D.W., *Ibid.*, p. 306 under the entry "New Issues Market".

⁵² *Ibid.*, p. 306.

Type of brokers.

There are different types of brokers⁵³ who deal in the stock market such as commission brokers, the specialist brokers, floor brokers or 'two dollars' brokers, odd-lot firms brokers and registered or floor traders. Commission brokers are the brokers who execute customer orders, at or near to the prevailing market price. Specialist brokers have two different functions. The first refers to those who specialise in certain issues, one or more, executing limited orders for other members. The second, act as dealers, they deal in securities for their own account. As they have a unique position, operating as dealers as well as brokers, they are closely watched and regulated by the Exchange and Securities Exchange Commissions. Otherwise they could take advantage through their wide knowledge of the market, at the expense of the customers.

Floor brokers refer to those who deal with the orders of other brokers and they are not allowed to deal directly with the public. They usually do not belong to any member firm and their presence is very important, especially during the busy times of the brokers. Originally in the New York Stock Exchange, they accepted only \$2 as the commission for their job, consequently they gained the name of '2 dollars brokers'⁵⁴.

Odd-lot firms' brokers are those who associated themselves with odd-lot firms. This means that the quantity of shares involved in any particular transaction handled by these firms is not in the standard quantity of 100 share lots. The registered traders, or the floor traders, are those who deal in the market for their own account and receive income from their transactions. Some of these traders are full time workers in the stock market while some others do it on a part time basis, where they concentrate on dealing shares for commission⁵⁵.

⁵³ For a detailed illustration on this subject refer to Amling, F., *Investments: An Introduction to Analysis...*, Op. Cit., pp. 159-60. See also "Securities Trading" in *The New Encyclopædia Britannica*, Op. Cit., p. 560.

⁵⁴ Amling, F., *Investments: An Introduction to Analysis...*, Op. Cit., p. 160.

⁵⁵ Their existence is criticised because they do not contribute any real economic function in the business of the stock market. Moreover, their involvement is said contribute to the market instability. See Amling, F., *Ibid.*, p. 160.

Bond brokers are those who deal with bond issues traded on the bond trading floor in the New York Stock Exchange. These bond issues comprise of free bonds and cabinet bonds. Free bonds refer to bonds issued that are actively traded on the floor while cabinet bonds are bonds transacted using metal cabinets where all the documents about the dealings are kept⁵⁶.

The above are the two vital roles, customers and middlemen, who are present in any stock market. They participate in and are actively involved in the daily business transactions of the stock market. It is impossible to organise a stock market in a modern economy without the presence of these two groups of players. Their presence implies the existence of the stock market. These are the core elements that make the stock market function smoothly.

4.5.2.2 Few Concepts and Terms.

In the daily business operation of stock markets the people involved use various instruments and terms during their business transactions. The following are some of these concepts and terms. Different concepts or terms used indicate different types of business transactions are being undertaken.

a) Orders.

Investors or speculators who intend to invest their surplus money can buy shares through an order. An order generally refers to an instruction given by a customer to his broker to buy or to sell shares. In a particular order details of the account holder, the type of shares involved, the highest price the customer is ready to pay (for a buying order) and the lowest price he/she is willing to sell for (in the case of a selling order) are clearly mentioned. This is to make sure that the broker who receives the order is able to execute the order correctly and at the utmost level of his/her professionalism. Hence for the broker to know and understand the type of orders, is a great advantage for the customer, as it will lead to an easier communication with his/her broker.

⁵⁶ Ibid., p. 160.

i. Type of orders

There are different types of orders⁵⁷ such as market orders, limit orders, stop-loss orders, open orders, time orders and discretionary orders or accounts.

A market order is an order to sell or to buy a stated amount of shares at the most attractive price available at the time the order reaches the trading floor. This is the quickest method in securities transactions as the securities are transacted immediately they reach the floor. However, the customers may or may not be getting the highest selling price for their shares with respect to a selling order or the lowest price that they are willing to pay in a buying order.

A limit order refers to an order to buy or sell shares within the customer's specified price range. The price limit is prescribed clearly, both for the highest price they are ready to pay as buyers and the lowest price they are willing to let go their shares for as sellers. If the broker is not able to sell or to buy shares at the prices quoted, then he/she will inform his/her customer. The customer will then cancel the order or if he/she intends to continue with his/her intention, he/she can give a new order.

A stop-loss order is designated purposely to protect the customer from market reversals. It will protect the customer from a bigger loss on the capital profit and on many occasions it will protect against a bigger loss on the capital invested. This type of order is only used for selling shares.

An open order refers to an order that has a limit on the time of execution. The time limitation is agreed between the customer and the broker. If the stipulated time is passed without having the order executed (to buy or to sell), the customer has to give a new order because the previous order is automatically terminated once the time is

⁵⁷ For further details on the subject refer Amling, F., *Investments: An Introduction to Analysis...*, Op. Cit., pp. 185-8, Berman, H.D., *The Stock exchange...*, Op. Cit., pp. 46-53, "Securities Trading" in *The New Encyclopædia Britannica*, Op. Cit., p. 561 and Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., pp. 26-30.

reached. This type of order is usually given by the broker to his permanent and regular customers.

A time order is a kind of limit order, as described above, with the additional characteristic of time limitation. The order is carried out by the broker within the time agreed between them, and at the specified price given by the customer. The time limit is usually one day, one week, one month etc. This order in actuality is a combination between the limit order and the open order mentioned above.

A discretionary order or a discretionary account is a unique order. This is because the customer gives his broker full discretion to handle his account. His broker can decide the question of whether to sell or to buy, the price consideration, the amount of shares, time and all other options. In other words, the broker is fully responsible for the customer's account. This is usually done by customers with a big account to manage⁵⁸.

To manage this type of account the customer usually selects the most reliable broker with the belief that the brokers know the market better and will handle his/her account properly and honestly. In certain cases, this order is used by the customer who is away for a certain period of time or is ill. In order to ensure a continuity of his/her dealings in shares, the broker is the correct choice to handle the account. This type of order must get approval from a partner of the brokerage firm and the consent of the customer⁵⁹.

ii) Offer Limit Order.

There must be an offering price for every order made. The offering price is usually different to the existing price in the market. An offer limit order refers to the minimum level of price difference between these two prices, the price offered by the customer and the current price in the market. This minimum difference is fixed by the exchange authority. In Malaysia's Kuala Lumpur Stock Exchange, 0.5 cent is the

⁵⁸ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., pp. 29-30.

⁵⁹ Amling, F., *Investments: An Introduction to Analysis...*, Op. Cit., p. 187.

minimum difference on a unit share price RM1.00. For share prices between RM1.00 and 2.99 the difference is 1 cent, between RM3.00 and RM4.99 it is 2 cents, between RM5.00 and RM9.95 it is 5 cents, between RM10.00 and RM24.90 it is 10 cents, between RM25.00 and RM99.50 it is 50 cents and between RM100.00 and over the difference is RM1.00⁶⁰.

b) Options; Puts and Calls.

Options in a business contract or agreement allow the holder to buy or to sell property, commodities or securities at an agreed price for a stipulated time. The contract is unaffected by any movement of price or other movements in the market or any economic disturbances taking place during the period. Hence, the contract is speculative in nature⁶¹ and termed by Lechner as a 'naked option'⁶². This is because a buyer could gain profit or incur loss depending on the current price at the time of delivery, and the type of option cost paid. Profit will be gained if the current price is greater than the option cost, and loss incurred if the current price is lower than the option cost in the option right to buy.

For example, if a buyer expects an increase in price of a particular security, he/she will pay option money to a dealer for the right to buy at the specific price and date in the future. Meanwhile, if he/she expects a price decline, he/she will pay option cost for the right to sell in the future on a specific date and at a specific price. If in these two cases, his/her expectation is correct, he/she will make a profit by taking the option. In the first situation the term 'calls' is used and 'puts' is the terms that describes the second situation. However, if his/her expectation is incorrect, he/she can abandon the option and he/she will lose his/her option money.

⁶⁰ See Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., pp. 30-1. RM here signifies 'Ringgit Malaysia' the Malaysian currency and RM1.00 is equivalent to 100 cents.

⁶¹ In the words of Smith, "Options present the investors with a myriad of new strategies, some are very conservative, such as covered call writing while others are very speculative, such as naked call writing". See Smith, C., *Option Strategies: Profit-Making Techniques for Stock, Stock Index and Commodity Options*, New York, John Wiley & Sons, 1987, p. 2. See also Pearce, D.W., *The Dictionary of Modern economics*, Op. Cit., p.318 under the entry, "Option".

⁶² Lechner, A., *Street Games: Inside Stories of the Wall Street Hustle*, N. York, Harper & Row Publishers, 1980, p. 87.

If a customer makes an option agreement to buy or to sell it is called a 'double option'. In this situation, he/she can pay for the two options, the right to buy or to sell, as he/she does not really know whether the price is going to increase or to decrease. In this situation, he has to pay option money for the two options taken. As the option activity in the business operation of the stock exchange is clearly speculative in nature, it was prohibited at the London Stock Exchange in 1939 before being restored in 1958⁶³.

A stock purchase warrant is another form of option which enables its owner to buy shares of a common stock at the exercise price of the warrant which has already been specified. The purchase warrant is usually given with bonds or preferred stock. The holders can have the option to buy common stock of that particular company at a specified price in the future.

This purchase warrant is used to make the bonds and preferred stock more attractive to the investors. It is also an advantage for the company because converting the warrant into common stock means an increase in capital of the company. However, this purchase warrant is usually popular during an upward trend of price movement while in a situation where the current price is lower than the issuing price, the purchase warrant will have no value⁶⁴.

c) Buying in, Selling Out, Offsetting and DOM.

In any selling contract carried out by the broker, the seller is responsible for delivering his/her share scripts within a certain time period. In a usual transaction, if everything is running smoothly, the script of the shares will be handed to the seller's broker in time and the seller will receive full payment from the broker. However, if the seller fails to do so or deliberately does not want to deliver his/her script in time, the broker will send notice to re-buy the shares in the open market. This action of re-buying undelivered shares by the broker is termed 'buying in'. Any loss incurred in

⁶³ Seldon, A., *Everyman's Dictionary of Economics*, Op. Cit., p. 254 under the entry, "Option Dealing".

⁶⁴ See "Finance, Business" in *The New Encyclopædia Britannica* (1977), Macropædia Vol. 7, Op. Cit., n. 301. See also Ismail Ibrahim. *Saham dan Pasaran Saham*, Op. Cit., p. 69.

the process will be borne by the seller as he/she failed to deliver in the time stipulated.

After receiving the shares from the seller's broker, the buyer's broker will deliver the script to his customer and the buyer will accordingly pay the full amount for the buying. In the event of the buyer's failure to collect the script in time, his/her broker will send notice to the open market to re-sell the uncollected shares' script and this is called 'selling out'. Any loss incurred from the action taken is the buyer's responsibility to bear.

In contrast to the above, a seller can make an 'offsetting' purchase on his/her sold shares through re-buying the shares in the open market before the date of delivery. This usually takes place in a situation where the price of those particular shares declines between the time of the selling contract and the time of delivery.

The same step could be taken by the buyer where he could make an 'offsetting' sale on his 'yet to be delivered' shares through re-selling the shares in the open market before the time of delivery is passed. This procedure is taken by the buyer whenever the price of the shares bought increases before the time of delivery. In these two cases, the individual involved makes profit on the shares' price movement through exercising the offsetting activity. All transactions taking place are recorded in the broker's 'contract account' or 'contract trading'. These activities have been banned in the Kuala Lumpur Stock Exchange since February 1990⁶⁵.

DOM or delayed one month trading is a unique attribute of the Kuala Lumpur Stock Exchange. The purpose of introducing this system in 1985 was to make the market more attractive to investors and speculators⁶⁶. The system allows the customer not to deliver (for the seller) or not to pay (for the buyer) any transaction executed within one month. The delivery of the scripts or the payment to their respective brokers usually takes place on the last day of the month. The system gives plenty of

⁶⁵ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 35.

⁶⁶ Ibid., p. 35.

opportunities for the parties involved, especially for the speculators, in order for them to advantageously use their available scripts and capital for their speculative activity.

d) Trading on Margin.

The word 'margin' in economics commonly refers to four different uses⁶⁷. One use refers to a type of trading base on margin that is commonly practiced in the business transactions of stock markets. The existence of this type of transaction gives more room for speculators to get a larger profit provided that their speculative judgement is correct. Otherwise they might also get bigger losses. The system permits customers to pay only a portion or percentage amount, "margin", of the total buying price to their brokers. As the rest of the payment is secure through the brokers' loan, the shares bought through this trading are usually kept by the brokers as a collateral.

If the price of the particular shares increases as expected, the speculators will get a bigger profit than the profit they could have received without indulging in this trading. However, if the price decreases unexpectedly, the losses faced are also bigger than would have been incurred without being involved in this system. In the event of loss, the customers have to top up the amount of the margin so as to ensure the margin positions held by the brokers fulfil the minimum requirement.

As this system of trading is greatly speculative in nature, the United States government through the Federal Reserve Board regulated that a minimum initial margin is required. This regulation was passed under the authority of Securities Exchange Acts of 1934 with the special purpose of avoiding an excessive use of credit for speculative activity. While in the United Kingdom, the selling on margin is banned⁶⁸.

⁶⁷ Four different usage of the word margin in economic are as follows:-

- 1)The difference between the selling price and the cost.
- 2)The minimum profit for an economically sound transaction.
- 3)The final unit used in a production or consumption.
- 4)The Difference between the amount of loan and the current price of the security.

A Dictionary of Economics and Business (Ed. By Stiegeler S.E), Op. Cit., p. 253 under the entry "margin".

⁶⁸ See "margin" in The New Encyclopædia Britannica(1991), Micropaedia Vol. 7, Op. Cit., p. 837.

e) Sells Short, Buys Long; Bull, Bear⁶⁹ and Stag.

'Short' selling and 'long' buying is another mechanism used by the speculator to gain profit through price differences and it is used for short term transactions. He/She can either sell 'short' or buy 'long'. Short selling refers to a position taken by a speculator to sell securities which he/she does not possess, or if he/she possesses them he does not intend to deliver them to the buyer. The speculator usually takes this position in the expectation of a price decrease. When the price decreases, he/she can make an 'offsetting' purchase and gain profit from the price difference. In this situation, he/she is a 'bear' and he/she is taking a 'bearish' position.

'Long' buying refers to a speculator's activity when he/she buys securities that he/she does not really want or intend to hold. This position is taken in the hope of making an 'offsetting' sale in the future with the expectation of a price increase. In this situation, the speculator is a 'bull' and he/she is taking a 'bullish' position.

'Stag' is another term used to indicate the speculative activity of attaining profit through speculative judgement. 'Stag' refers to a speculator who applies to purchase newly issued securities. The purpose of his/her application is to re-sell them in the stock market whenever the particular shares are traded in the market. As nearly every new issue is oversubscribed⁷⁰, a 'stag' can expect a profit by re-selling the shares in the stock market. However his/her fortune will also greatly depend on whether he/she succeeds in his/her application to buy the shares issued, since there are many other contenders for the same shares.

Hence, to increase his/her chances of getting those shares, a 'stag' will usually make further speculative judgement, and this time not on the trend of the price movement, but speculating on the methods of share allocation. If he/she expects that the

⁶⁹ For further illustration of these activities and their negative effects to the stock market as well as to the economic condition of a country as a whole, refer Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., pp. 95-101.

⁷⁰ Oversubscription refers to a situation where the application for newly issued shares is greater than the number of shares to be issued. These very highly demanded and popular shares will have their prices immediately increased above the premium (price at the time of issued) whenever they are being traded in the stock market. Vice versa, undersubscription refers to the reverse situation.

allocation will favour a large application, he/she will then combine his/her capital and make a large application. If he/she believes that the allocation method will favour small investors or a small application, he/she will turn his capital into various smaller portions. This will also be followed if he/she thinks that a ballot system will be used⁷¹.

4.5.2.3 Malpractices in the Business Transactions of Stock Markets.

The daily business of stock markets nowadays are participated in by individuals from all walks of life. The situation is more clearly seen in countries which have a fast-growing economic prosperity. This situation creates a conducive environment for the people to invest their money in viable ventures of their choice. Hence, a good place to invest their money is through participating in the business transactions of stock markets, as this institution is established to cater for the needs of this group of people.

Furthermore, the market is more attractive with the presence of 'market players' or specifically, speculators. The existence of speculators make the market an active and dynamic place. Their quick profit, 'capital profit', on many occasions as witnessed in the history of financial crises, has tempted genuine investors to indulge in the same activity⁷², speculative activity. As the process of attaining profit is very competitive and so attractive, to a certain extent, regardless of whether they are investors or speculators, the tendencies to practise unfair dealings are present. The following are a few common malpractices that frequently take place in business transactions of stock markets, such as market manipulation, rigging, inside trading and cornering.

⁷¹ See A Dictionary of Economics and Commerce, Op. Cit., pp. 400-1 under the entry "stag" and p. 308 under the entry "oversubscription".

⁷² In certain circumstances, genuine investors are attracted and carried away by the quick capital profit gained by the professional speculators. In this situation, they will change their 'colour' and motive for investing their money from being sober investors into 'blind speculators'. This phenomenon, as rightly pointed out by Kindleberger, is obvious in every financial crisis that has taken place in history. See Kindleberger, C.P., *Manias, Panics, and Crashes; A History of Financial Crises*, London, The Macmillan Press Ltd., 1978, p. 30. See also the discussion of the subject in this thesis in chapter 6 under subtopic, 'Speculation and Financial Crises'.

a) Market Manipulation.

Market manipulation in stock markets refers to an activity done by an investor or a group of investors who manipulate the price of shares in the market. They govern the share price 'artificially' through buying or selling securities for the purpose of price increase, price decrease or to make the price stable. All these activities are done in order to attract or lure small investors or blind speculators to buy their shares or the shares of the same company. Through this activity, they will have the chance of making profit at the expense of small investors and small unprofessional speculators⁷³. As this activity is unfair business practice in relation to the small investors and speculators, the market authorities have imposed various regulations to minimise it⁷⁴.

b) Market Rigging.

Market rigging, refers to any step taken to influence the market temporarily for the purpose of making profit at later stage. The transaction executed by the speculators is only to make the particular shares appear to be being actively transacted, and hence attractive. This will consequently attract others among the investors and blind speculators to participate in the transaction of the same shares, hence creating the chance of making profit.

Rigging can be accomplished in various ways. A speculator might buy a large amount of some particular shares and then continue to buy the same shares repeatedly. On certain occasions a rigging activity will take place where there are no 'genuine sales'. Inherent in this method of rigging, the speculators will have their shares 'transacted'

⁷³ Teweles, R.T., Harlow, C.V., and Stone, H.L., *The Commodity Futures Game*, New York, McGraw Hill, 1965, pp. 229 and 302.

⁷⁴ In the business operation of the Kuala Lumpur Stock Exchange, a few requirements have been imposed to stop the practice of market manipulation. These requirements are as follows:

1) Speculators and investors are not allowed to indulge in more than one transaction on the same shares in a single day.

2) Speculators and investors are not allowed to spread or circulate any incorrect information that could influence others to buy or to sell shares and accordingly could effect the market price of shares.

3) Speculators and investors are not allowed to spread any untrue information or rumours on shares price movement as this false information may cause others to sell or to buy those particular shares.

4) Speculators and investors are not allowed in whatever way to influence others on their decision to buy or to sell certain shares. See Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 46.

without having the script delivered and transferred to the buyer. Market rigging could also take place whenever a speculator makes an order to buy a particular share, stating a certain amount and an agreed price. However at the same time he/she makes an order to sell the same shares, at the same amount and price.

All of these activities commonly influence the share market although there are no 'genuine sales' taking place. These activities will accordingly create a good chance for the speculators to make profit as the activities will push the price up. Hence they will sell their 'over-demanded' shares to the investors and blind speculators who were attracted by the apparent of the shares in the market.

Rigging activity is carried out through falsification concerning the shares' activeness in the market, and no genuine sale of the shares has taken place. It has been banned from the business transaction of the Kuala Lumpur Stock Exchange. Anyone indulging him/herself in market rigging, will be fined and/or face a jail sentence of not more than 3 years⁷⁵.

c) Market Cornering.

'Cornering' in economics refers to a situation where an individual, firm or cartel buys or gains control of the supply of a commodity, thus gaining control of the price. This is a profiteering activity and on certain occasions is mercilessly anti-social, as the activity could lead to needy people dying of starvation⁷⁶.

Cornering in a stock market refers to a situation where shares of a particular company are controlled by an individual or group of individuals. This activity therefore, could happen more easily to a small company, as to take control of such a company one does not need to possess a very big fund. When they gain control on shares of certain companies, they can carry out more injustices to others through manipulating the

⁷⁵ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., pp. 46-7.

⁷⁶ In 1940s an Indian firm managed to control the supply of rice and implemented market 'cornering' in the trading of that particular commodity. This led to thousands of Indian dying of starvation. See A Dictionary of Economics and Business (Ed. by Stiegeler S. E.), Op. Cit., pp. 85-6 under the entry "corner".

market. One illustrative example for this is their manipulation of the activity of 'short selling'.

As mentioned before 'short sellers' are those who sell shares without having the shares in their possession, or if they do possess them, they have no intention to deliver them to the buyer. This is because their intention is to make an 'offsetting purchase' when the price of the shares has risen. In this situation, where they do not possess the shares they have to borrow from others for 'temporary' delivering of the shares.

As those who practice cornering control the shares, short sellers have to turn to 'the cornerers' for script borrowing purposes. However, the cornerers will ask for the script back after the short seller has executed the transaction without giving the short sellers the chance to deliver the script to the buyer. As the short sellers desperately need the script to deliver to the buyers, they unwillingly buy the particular shares from the cornerers at the higher price fixed by the cornerers. By this means, the 'market cornerers' gain their profit.

This unfair trading activity gives additional advantages to large and professional speculators at the expense of small speculators and investors. This is because those who intend to gain control over shares of a company must possess large enough funds. These funds can only be materialised by the professional speculators with large funds available and certainly not by those who possess small funds such as small speculators and investors. Therefore to minimise the possibility of this cornering activity, the Kuala Lumpur Stock Exchange has made very strict requirements⁷⁷. One of these requirements states that any company to be listed in the Kuala Lumpur Stock Exchange is required to have a relatively large capital to prevent any cornering activity taking place relating to the shares of that company. In other stock exchanges, government regulations and anti trust laws are used to curb the practice of market cornering⁷⁸.

⁷⁷ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., pp. 47-8.

⁷⁸ A Dictionary of Economics and Business, (Ed. Stiegeler S.E.), Op. Cit., p. 86.

d) Inside Trading.

'Inside trading' is another banned activity in the business transactions of stock markets. This type of transaction refers to an action of buying or selling based on inside information obtained by the seller or the buyer from an insider,⁷⁹ or else the transaction is executed by the "insider" himself. This information which is termed in modern corporations as 'confidential price sensitive information'⁸⁰ gives an excellent advantage to the recipient of the information at least in two different ways.

The first advantage is in the aspect of profit gain. After obtaining some useful information about a company, the recipient will quickly buy shares in that company. By announcing complementary information to the public relating to the company's achievements and performance, progression and viable future plans, the image of the company will rise in the buyers estimation. Consequently, the share prices will promptly increase as everybody rushes to the market to buy the shares. By this time, the recipient will re-sell his/her shares those that he/she bought earlier to gain an unearned profit.

The second advantage is that the recipient can avoid capital loss or at least avoid a bigger loss. Any negative information concerning a company such as a big loss, a large debt, bankruptcy or concerning a company closing down will automatically lead to a fall in their share price. After the negative 'inside' information is received, the recipient will sell his/her shares to the unsuspecting public. Through this process, they unfairly gain profit and scandalously avert themselves from loss.

This unfair dealing gives an opportunity to only a very few lucky people who can gain a big profit of 'unearned income' at the expense of other people. As getting this

⁷⁹ The definition of an insider according to the Securities and Exchange Commission includes all of the officers, directors and persons who have a beneficial ownership of more than 10 percent of any class of equity of any corporation. See Securities and Exchange Commission, Securities Exchange Act of 1934 as amended to January 1964, Washington, US Government Printing Office, 1964, p. 2. However the definition given by Qureshi is wider and includes agents of the company such as auditors, accountants, solicitors, consultants and officers of a stock market. See Qureshi, M.I., "Insider Trading: Prevention and Cure", in *International Islamic University Malaysia Law Journal*, Vol. 3, No. 1, Kuala Lumpur, IIU Press, January 1993, p. 86.

⁸⁰ *Ibid.*, p. 85.

information is very important in the business dealings of the stock exchange, some speculators senselessly offer money to get it. The practice is banned under the United Kingdom Company Act 1980⁸¹.

4.5.2.4 Trading Procedures⁸².

In the aspect of listing, trading and clearing of securities, all stock markets accomplish the same functions. However, the methods of trading are different between the stock markets. The difference between the system employed in the New York Stock Exchange, which is based on an auction system, and the system operating in the London Stock Exchange, which is based on a jobber and a broker system is distinguishable. The other stock markets are more or less similar to the system that operates in the New York Stock Exchange with a few different amendments that suit the government and society. The following discussion on the methods of securities trading will be based on these two most established stock markets.

a) Auction Market.

The New York Stock Exchange, like most other stock markets, operates based on the system of an auction market. In this system the competitive market bidding ascertains the price of securities. The auction and bidding price on any security at a large and active market will continue for the whole trading day. Meanwhile in a smaller and not very active market, the auction of a security will be based on a rotation basis and at a specified time. This situation is to suit the activeness of the market.

To make an order to buy or to sell, a customer will pass the order to the local office that represents a correspondent member firm of the New York Stock Exchange. The representative will then send the order to the main office or directly send it to the receiving clerk at the New York Stock Exchange. The clerk will hand the order to the firm's floor broker who will submit and participate in the auction post. However the

⁸¹ A Dictionary of economics and Business, Op. Cit., p. 204 under the entry "insider".

⁸² For a detailed discussion on the subject, refer to "Securities Trading" in The New Encyclopædia Britannica, Op. Cit., pp. 560-1.

execution of the order will depend to the type of orders⁸³ given by the client. If the order is for selling security, the highest bidder for that security is the one who will purchase it. In the case of an order to buy, the broker will try to bid for the lowest possible price.

However, in the auction market, there is another method which is commonly used. This method is known as a 'cross matching order'. In this method, the matching orders are assembled and then cross execution, sale and purchase is done at the current securities price in accordance with the rules prescribed. Hence, it is based more on negotiation than pure auction. Nevertheless, if these two methods are not feasible, the exchange authority usually provides other alternative methods to ensure that the trading processes take place smoothly⁸⁴.

b) Jobber and Broker Market⁸⁵.

This is a unique system that operates in the London Stock Exchange. When the broker receives an order from his/her customer, he/she will meet jobbers for the purpose of executing his/her order. The broker will ask the price of the particular security without having to mention his/her intention of whether to buy or to sell that security. The jobber will give two different price quotations on the same security, where the higher is meant for his selling price and the lower is for buying. The broker will negotiate for the price gap to be reduced. The broker will meet other jobbers and repeat the same process until he/she feels satisfied with the price range of the security.

⁸³ To understand the various types of orders, refer to the discussion of this subject in the earlier part of this chapter.

⁸⁴ The New York Stock Exchange permits special trading procedures as follows;

a) Secondary distribution refers to a transaction procedure for stock which resembles underwriting of a new issue. This procedure is carried outside the trading hours and outside the market floor at the price regulated by the exchange authority.

b) Exchange distribution which refers to an accumulation of buying orders by a member firm who crosses them on the floor.

c) Special offer refers to the offering of a block of shares in the exchange at the price below that of the last sale or below the current offer and above the current bidding price. The offerer will pay a certain amount of commission for the transaction.

d) Specialist block purchase allows the specialist to buy blocks of shares under the bidding price outside the market. For further details refer to "Securities Trading" in *The New Encyclopædia Britannica*, Op. Cit., p. 561.

⁸⁵ To understand the functions of these two professions in the London Stock Exchange, refer to the discussion on this subject in the early part of this chapter.

He/she will then return to the jobber who offered the lowest of the higher price quotations if his/her purpose is buying. If the order from his/her client is for selling he/she will return to the jobber who offered the highest of the lower price quotations to sell the security.

The broker will receive commission from his/her client which is termed 'brokerage' for the job done. The amount of the commission varies depending on the type of security, the volume of the transaction and the system of commission followed by the particular stock market. The jobber will try to maximise his/her 'jobber's turn' through adjusting the two price quotations. Under this system, the jobber is not allowed to deal directly with the public. He/she is acting as an intermediary between the brokers and also makes transactions with the other jobbers. Similarly, the broker is not allowed to make any transaction between them.

4.6 The Importance of a Stock Market in a Modern Economy.

The important functions of a stock market in a modern economy are something undeniable. It plays an integral and fundamental role in the economic development of a country. An active stock market is one indication relating to the economic enhancement of a country. Similarly, a very inactive stock market is a reflection of the unstable economic condition of a country. The fall of any established stock market in any particular country may affect the economic strength and development of that particular country. To some extent, as shown by Born, the fall of the New York Stock Exchange, an established market, caused economic crisis not only to America but also to the world's economy as a whole⁸⁶.

One very 'classic' example was the crash of Wall Street in 1929 that led to the world's great depression between the years 1929 and 1932. This clearly exemplifies the importance of the role of an efficient stock market and its relationship to the economic condition of a country. Therefore the majority of the world's countries which are non communist countries, have established this economic institution as the pillar of their

⁸⁶ Born, K.E., *International Banking in...*, Op. Cit., p. 256.

economic system. In general, the role played by the stock market in the development and enhancement of the economy of any country are as follows.

The existence of a stock market is fundamental to a country as it provides a secondary capital market for securities that are issued by the registered companies. This is very important in order to ensure that the shares issued are always at a high potential of marketability. This is also applicable to the selling of the securities of new companies listed in the market. This will directly lead to the active participation of investors in the primary market as there is opportunity to sell their shares in the secondary market, when they need to turn their equities into cash.

In other words an active and efficient secondary capital market in which investors can easily buy and sell their securities can give strength to the primary capital market. According to Bain, there are at least four ways that the secondary market has an influence on the primary market⁸⁷. Firstly, through capital liquidity provided by the secondary market which can turn securities into cash at any time the investors wish. Secondly, in the process of pricing new securities issued by the same company, the price will depend on the existing price of the same shares in the secondary market. Hence it reflects the real future prospects of the company and accurately fixes the price of the newly issued shares.

Thirdly, the secondary market contributes to the operation of the primary market by enabling a wider range of institutions to participate in the underwriting of new issues. Finally, the existence of a secondary market can help most institutions involved in the primary market to make a quick decision whether to subscribe or to underwrite a new issue of a company. This can be done quickly as they are also involved in the secondary market which continuously analyses the performance of the company in the secondary market.

Hence the active activity of buying and selling stocks and shares directly invites new investors to participate in a company which is newly listed in the stock market. This

⁸⁷ Bain, A.D., *The Economics of the Financial System*, Op. Cit., p. 194.

simultaneously contributes to the economic development of a country and offers the opportunity for financial gain for the investor.

The existence of a stock market will ensure the assets possessed by the public in the form of stocks and shares become more liquid. The liquidity of the asset is very important because the more liquid the asset, the more investors will participate in the market. It will avoid hesitation on the side of the investors because whenever they need cash, they can easily let their assets go. Similarly, when they have extra cash, they can easily enter the market and buy shares. Hence this easy ability to buy and sell their equities in the secondary market will open the doors to new investors into the market. The increase in the volume of investment generally means an increase in the economic well-being of the whole nation.

A stock market is also expected to play its part as an efficient mechanism of redistribution of scarce resources of a country. This is done through an active participation of the public in the companies listed. Their investment will create new opportunities for the public to be involved in the expending economic activities of the listed companies. It is obvious that a company with additional capital acquired from the selling of their shares in the stock market, will expand their economic activities. Thus, a stock market in this respect indirectly plays a role in the process of redistribution of income and wealth in a country⁸⁸.

The other major function of the stock market is to act as an agent of effective investment in scarce resources accumulated through the secondary market. Scarce resources as viewed by economists are an obstacle that is always faced by an economic institution. This is something which cannot be avoided. However, the problem can be reduced through efficient usage of the resources. Thus, the capital of the community accumulated through selling of shares and stocks in a stock market, can be invested in the place of most profitable use.⁸⁹ Hence, to make sure that the existing assets of a firm are profitably utilised is also a function which is reasonably expected to be performed by the stock market⁹⁰.

⁸⁸ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 3.

⁸⁹ Arnold, Henry C.F., "Stock Exchange", Op. Cit., p. 898.

⁹⁰ Singh, A., *Take-Over: Their Relevance to the Stock Market...*, Op. Cit., p. 2.

The other function of a stock market is to develop a healthy competition among the companies listed. The increased numbers of new companies listed in the stock market means that investors have a choice of companies in which to invest their capital. Thus, to accumulate a bigger amount of additional capital through this secondary capital market, a company must market itself well in the eyes of potential investors. This leads to healthy competition in maintaining and increasing their prestige as a good company for the public to invest in⁹¹.

4.7 Conclusion.

In conclusion, one may say that the existence of stock markets in the modern world is very important. Its contribution to the economics of the modern world is undeniable. This is clearly shown by the great volume of daily business transactions that take place in any stock market, the total of which is valued at millions of dollars. Furthermore, the role played by a stock market in the development and advancement of the economy of a country, as discussed above, is something intrinsic to the success of the country's economy. It is not only in the aspect of the redistribution of income and wealth, which a stock market does indirectly, but also as is pointed out by Singh, a stock market is able to direct the investment of the public into their scarce resources and thus into the most profitable use of their capital.

In addition to the above, a stock market, in the economy of the modern world, can play its role as an indicator of the economic prosperity of a country. Active transactions and business dealings in a stock market is an indication of a rapid and positive development of the economic position of a country. Besides, as is discussed above the fall of a stock market may effect the economy of that particular country, as well as to some extent, the economy of the world as a whole. Therefore, it is not surprising that there are economists who dare to say that, no modern economy can exist without a well-organised stock market⁹².

⁹¹ Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 4.

⁹² Khan, M. Akram, *Issues in Islamic Economics*, Op. Cit., p. 87.

CHAPTER 5

ISSUES IN THE STOCK MARKET FROM THE ISLAMIC PERSPECTIVE.

5.1 Introduction.

The previous discussions on ethics in Islamic economics, will enable readers to appreciate their contribution to minimise the elements of malpractices in the modern business world. The elaboration concerning the modern stock market in the fourth chapter, gave a general world view of this institution, especially on the mechanism of speculative business transactions which is the main concern of this research.

In this chapter, the focus will be on some aspects of conventional economic practices that operate in the stock market which always concern Muslim Economists. The issues which are to be explored here are the conventional organisational aspects of the company, the flow of investment, capital accumulation, profit reimbursement, issues concerning the speculative loan, share valuation method and the problem of the speculative transaction mechanisms. This discussion will only provide a general picture on the stock market from the Islamic perspective, as far as the question of its permissibility is concerned because the discussion of these issues will be a concise one in this chapter. Nevertheless, the issue of speculation in the stock market will be dealt with in great detail from the conventional as well as from the Islamic perspective, in the next chapters because this is the main subject of this study.

5.2 The Issues from the Islamic Perspective.

There are some controversial issues relating to company and stock market business operations when viewed from the Islamic perspective. In other words, they are alien to the Islamic economic system, though they are commonly practiced in capitalism. These issues have always stood as barriers, preventing Muslim individuals from being involved in the business of stock market as they seem to not conform to the *sharī'ah* (Islamic Law). Hence it is a great challenge, not only to Muslim economists

but also to the increasing numbers of non-Muslim scholars, to undertake further research in the subject.

It is to be hoped that through their contributions, a few amendments will be made to accommodate Muslims into the market, which will simultaneously be accepted as part of the Islamic economic system. This is actually the main objective of this research work. For the purpose of this discussion the above issues will be divided into five main sub-topics namely, the conventional aspect of a company, the flow of investment, capital accumulation, issues on shares and the mechanism of speculative transactions in the stock market. These issues need to be injected with the Islamic system so as to make the business of the modern stock market participatable by Muslims.

5.2.1 The Conventional Concept of Company.

Almost all the countries in the world are still dominated by the conventional system¹ of economics especially capitalist and socialist countries. A few Muslim countries are in the very early stage of implementing an Islamic economic system as an alternative to the existing, dominating, conventional systems. As some aspects of the Islamic economic system were implemented a few decades ago, the conflict with the conventional system with regard to various economic aspects is unavoidable. One of the recent clashes was on the conventional concept of a company as viewed from an Islamic perspective. This caused doubt as regard to the business permissibility in the stock market for Muslims. According to Man², the conventional aspects of companies participating in today's stock market can be seen in two major aspects.

Firstly, the existing conventional companies are only concerned with capital-sharing and neglect the importance of sharing the power to manage the company. This type of

¹ What the present writer means by the conventional system of economics here, is the system that has been put in practice in all parts of the world regardless of its dominancy. In other words, it refers to all 'isme' or man made systems of economics as opposed to the Islamic System of Economics which is based on the revealed guidance

² Man, Z., "Share and Investment in the Share Market: A General Observation on Related Issues from Islamic Perspective", a paper presented in the seminar series on Islamic Economics, National Productivity Centre Hotel, Petaling Jaya, Malaysia, 26-27 April, 1994, pp. 11-5.

conventional contract of partnership which neglects power sharing, does not conform to the company contract in Islam, *sirkah* (partnership). Secondly, the contract of this type of company is suited to the contract of *muḍārabah*³ (profit-loss-sharing) rather than *sirkah* (partnership) contract. This is because in the *muḍārabah*, contract, which was called *muqādarah* in Arabia and is known as "commenda" in the western world⁴, power is exclusively given to one party, the entrepreneurs who have the knowledge or know-how to run the business.

5.2.1.1 The Question of Power Sharing.

Regarding the question of sharing power, in the conventional company the investors legally possess the right to vote and to voice. Accordingly if this right is exercised, they are able to control the policies and be directly involved in the operation of the business venture through this 'democratic system' of managing the company⁵. However to keep this democratic system alive as pointed out by Samuelson, is a difficult task⁶. This opinion is well supported by today's company business practises where the power sharing concept seems to be diminishing.

This erosion of power sharing is usually as the result of a claim for 'practical purposes'⁷. Even as early as 1966, a study on 200 corporations in the United States

³ The *muḍārabah* contract is a dominant and acceptable contract in Islam. It refers to a contract carried out between two or more people whereby the investors act as *ṣāhib al-māl* (capital suppliers) and the others act as *muḍārib* (business operators/entrepreneurs). In this contract of Islam, the *ṣāhib al-māl* acts as a silent or sleeping partner, while the other party, the *muḍārib* will endeavour in the business. The profit will be shared according to the proportion agreed and any loss occurred is also to be shared in different degrees. While the investors will lose some of their capital invested, the business operator/s will suffer loss of time and energy. For further details on the discussion of this concept, refer to the writing of Siddiqi, M.N., *Partnership and Profit-Sharing in Islamic Law*, Leicester, The Islamic Foundation, 1987. The whole book was devoted to discuss the framework and viability of the two contracts as prescribed in the *sharī'ah*.

⁴ Udovitch, A., *Partnership and Profit in Medieval Islam*, Princeton, Princeton University Press, 1970, pp. 174-5. See also his paper entitled "At the Origin of the Western Commenda: Islam, Israel, Byzantium?" in *Speculum*, No. 37, 1962.

⁵ Samuelson, P.A., *Economics: An Introductory Analysis*, New York, McGraw-Hill Book Company, Inc., 1958, p. 88.

⁶ *Ibid.*, pp. 93-4.

⁷ For practical purposes, the right to voice and to vote in the real business world of corporations is non-existent. This is based on facts and a few assumptions of the investors:

1. Investors own only a tiny fraction of company's stock.
2. Investors' blind knowledge of business operations and policies.
3. Investors receive good dividend, which is the main purpose of buying shares.
4. Investors' unwillingness to travel to attend annual general meetings of the company.

revealed that 85 per cent of the companies' control was exercised by the management without involving the share holders and ongoing trends move towards this concentration of power⁸. In explaining the reason for this power concentration and this break up between the ownership and the control of a company, Samuelson stressed the aspect of the vast diversification of company ownership among thousands of investors. He mentioned that a study made in the USA had revealed this separation and that astonishingly, the management control group in some of the companies was as small as 3 per cent of the companies' ownership⁹.

This moving trend towards power concentration as a result of neglecting the share holders rights, will ultimately jeopardise their economic well being. This is because the situation will lead to the break down of the free competitive market and replace it by the emergence of the monopoly market. The monopoly market as acknowledged by economists, will cause various negative consequences such as price increases, misdistribution of income and wealth and misallocation or wastage of resources. The changing process from a competitive to a monopoly market can take place through various monopolistic devices¹⁰ which are advantageously adopted out of power concentration by greedy capitalists.

In the above the share holders are gradually being denied their right to be involved in the future planning and running of the company, especially the small investors. Though legally the right is there, it does not exist in the practical implementation in the conventional company. Everything is decided by the Board of Directors without subsequent consultation with the investors. The members of the Board of Directors in today's conventional companies usually consist of those who possess the greatest amount of the company's shares¹¹. This situation could easily lead to power abuse by

5. The permission of appointing proxy and

6. Most of the investors have little interest in the subject.

For further details refer to Bach, George Leland, *Economics; An Introduction to Analysis and Policy*, Prentice-Hall Inc., New Jersey, 1974, p. 41.

⁸ Ibid., pp. 41-2.

⁹ Samuelson, P.A., *Economics; An Introductory Analysis*, Op. Cit., p. 93.

¹⁰ Monopolistic devices refers to a few steps implemented which gradually change a competitive market into a monopoly. According to Samuelson the usual steps taken are mergers of competing firms, the establishment of cartel, trustees who coordinate pricing policy, holding company control, trade association action and government sponsored 'commodity agreement'. Ibid., p. 96.

¹¹ See *A Dictionary of Economics and Business*, Op. Cit., under the entry "directors". See also Man, Z., "Share and Investment in Share Market...", Op. Cit., p. 14.

vested interests among the members of the Board of Directors¹². As pointed out by Samuelson, they may legally or illegally take advantage of material gain out of the company for themselves, their relatives and cronies, and certainly this is done at the expense of the share holders¹³.

The above prevailing situation as regards power sharing in the conventional company does not conform with the concept of *shirkah* in Islam which is very concerned with the voice and right of every investor to participate in the company's business operation¹⁴. The *sirkah* contract promotes a genuine co-operation between the partners in the business activity, thus power sharing is guaranteed as one of the important aspects in this Islamic business contract¹⁵. This important principle is stated in the definition of the word;

"*Shirkah* means participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profit and loss in specified proportion"¹⁶.

The above discussion on power sharing reflects that by neglecting this aspect, the conventional company is not compatible with the *sirkah* contract . By denying power sharing from one party while the other party takes charge of the company's daily business activities, the basic principle of *shirkah* is being neglected.

5.2.1.2 The Implementation of Profit-Loss Sharing.

However, the present writer may deduce from the above discussion that this conventional business contract, as far as the question of power sharing is concerned,

¹² Bach, G.L., *Economics; An Introduction to Analysis...*, Op. Cit., p. 14.

¹³ Samuelson, P.A., *Economics; An Introductory Analysis*, Op. Cit., p. 95

¹⁴ In the *shirkah* contract, the question of each party's right to participate in the business operation of the company is the basic principle. However, by a mutual agreement one party may not actively be involved in the daily business operation which is to be carried out by the other party an entrepreneur. See Siddiqi, M.N., *Partnership and Profit-Sharing...*, Op. Cit., p. 16. But the situation in the existing modern business world is that the small investors have not been given any right to be involved in the decision making of the company. The prime investors possess the final say and control the whole company and they usually steer the whole affairs of that particular company as members of the Board of Directors.

¹⁵ Man, Z, "Share and Investment in Share Market...", Op. Cit., p. 14-5.

¹⁶ Siddiqi, M.N., *Partnership and Profit-Sharing...*, Op. Cit., p. 15.

is similar to the *muḍārabah* contract, another type of business contract in Islam. This is because in the *muḍārabah* contract, one party called as *ṣāhib al-māl* (capital supplier) acts as a silent partner and the other party called a *muḍārib* (business operator) takes care of the entrepreneurship. By definition *muḍārabah* refers to;

"one party provides capital and the other utilises it for business purposes under the agreement that the profit from the business will be shared according to a specified proportion"¹⁷.

In other words, the business contract of the *muḍārabah* is established through the participation of investors who own different "forms" of assets¹⁸.

The *ṣāhib al-māl* will invest his/her assets in the form of capital while the *muḍārib* will invest their assets in the form of business expertise and professionalism to manage the company. While the *ṣāhib al-māl* will concentrate on providing capital, the *muḍārib* is responsible for the daily business operation. This practical separation gives a clear boundary concerning the duties of both; the *ṣāhib al-māl* (capital supplier) who acts as a sleeping partner of the company and the *muḍārib* (entrepreneur) who will manage and be responsible for every aspect of the business operation of the company. This pro-active *muḍārabah* business contract¹⁹ as far as the aspect of power sharing is concerned is similar to the present conventional company.

However, a problem arises from the existing conventional company if it be scrutinised in further detail from the *muḍārabah* contract point of view. In the conventional company profit or loss is not to be shared between the two parties involved. Regardless of the company's performance, getting a remarkable profit or badly losing in the business, the entrepreneurs will always receive their remuneration

¹⁷ Ibid., p. 15.

¹⁸ Izzī Dien, M.Y., "*Sharika*" in *The Encyclopedia of Islam*, Vol. 9, No. 155-6, Leiden, Brill, 1997.

¹⁹ It seems that the *muḍārabah* is a pro-active and dynamic business contract. Pro-active because during the period of pre-establishment of the company, the *ṣāhib al-māl* has to study the personality and credibility of his/her potential partner. Since in any event of business losses, he/she will be the only one affected financially, the entrepreneur to be selected as a partner must be good in these two characteristics. Dynamic because the entrepreneur will work very hard to make the company successful. This is because he/she realises that higher profit for the company means higher earnings for him/her. This is materialised since the remuneration received by the entrepreneur is based on the percentage of the company's total profit as agreed between him/her and the capital supplier.

in terms of fixed and predetermined wages or salaries. Occasionally, bonuses²⁰ are given to them as an additional reward for their contribution towards the success of the company. Since one of the basic requirements for the validity of the *muḍārabah* contract is the aspect of profit and loss sharing between the parties involved, the act of giving fixed salaries or wages to the entrepreneurs, invalidates the *muḍārabah* contract. Another question arises here, by remunerating a fixed salary to the entrepreneurs instead of sharing the profit, with whom does the *ṣāhib al-māl* sign the *muḍārabah* contract?

5.2.1.3 Fixed Remuneration vs Profit-Loss Sharing.

Further analysis of the contemporary practice of fixed remuneration being given to the entrepreneurs, the profit and loss sharing as is prescribed in the *muḍārabah* and *shirkah*, seems to be more attractive and fairer to both parties. In the contemporary conventional practice only the *ṣāhib al-māl* (investors) will get double profits in terms of dividend and capital profit²¹ while the *muḍārib*, business operators or the entrepreneurs will get their fixed remuneration. In the event of the company incurring loss, the investors alone will bear the burden of loss while the entrepreneurs would still be getting the same fixed rewards.

Scrutinising the above contemporary practice, fixed remuneration causes injustices to the entrepreneurs as well as to the capital owners. The practice does not 'fully' recognise the contribution of the entrepreneurs in the event of the company's success. This is because the capital owners will seize all the profit gained from the company's

²⁰ Bonuses are usually given to the employees as a kind of recognition of their contribution towards the good achievement of the company. Even then, the bonus given is usually only a small fraction of the total profit that is received by the company owners.

²¹ Capital profit is gained by investors and is usually reflected in the increase of share prices. The value of shares appreciates as the company shows a good performance. A good performance with a bigger profit attained by the company leads to company business expansion. Providing there is a viable future plan, investing the company with new assets leads to a higher estimation of share value among the investors and hence the share price appreciates. This is a real capital profit which is based on economic fundamentals in contrast to the capital profit attained by the speculators which usually involves short term transactions and is based on market sentiment and rumours. Hence, capital profit when used to indicate speculators' gain is detached from the reality of the company. For further details on the discussion refer to chapters 6, 7, 8 and 9 of this research. Inflation, demand over supply and undepreciated assets are also factors that are realised in capital gain. See A Dictionary of Economics and Business, Op. Cit., under the entry "Capital gain"

business success while the entrepreneur will only get the same amount. This could lead the entrepreneur to give a 'mediocre' performance because regardless of the company's achievement, they will take the same amount of remuneration.

The contemporary practice of giving fixed remuneration in business partnership is also seem to cause injustices to the capital owners. The practice does not take into consideration any business failure. As the entrepreneurs are the ones who are fully responsible for the running of the company business, they must also be responsible and liable for any loss incurred by the business operation. When the capital owners lose part of their capital, the entrepreneurs should not be entitled to any remuneration. By giving fixed remuneration to them (the entrepreneurs) during business loss it means further loss to the capital owners, because beside business losses, another part of the capital has to be spent to reward the 'failing' entrepreneurs. This is seems to be a clear injustice which prevails in the present system.

In view of the above aspect, the business contract in Islam as prescribed in the *shirkah* and *muḍārabah* seems to offer a better alternative to the present practice of fixed remuneration, which is unanimously agreed by all four schools of Islamic Jurisprudence as unlawful²². The profit gained from the business success as stated in the contracts, must be divided between the two parties, *ṣāhib al-māl* (capital owners/suppliers) and *muḍārib* (business operators/entrepreneurs). Higher company profit means higher income obtained by the entrepreneurs, and vice versa, lower profit attained reflects a lower income for them. This practice can motivate the entrepreneurs to work harder and be more energetic, because the success of the business will result in higher earning.

While in the event of business losses, in contrast to the contemporary conventional practice, the Islamic business contracts prescribe that the loss must also be shared between the parties involved in the business venture. The Islamic contracts make certain that the *muḍārib* (entrepreneur) has to be partly accountable for the business losses since they are the party who is fully responsible for the daily business operation of the company. This is in order to safeguard the interest of the *ṣāhib al-māl* (capital

²² Siddiqi, M.N., *Partnership and Profit-Sharing...*, Op. Cit., p. 22.

suppliers). When the *ṣāhib al-māl* face mandatory losses in terms of financial assets (capital), the *muḍārib* is not entitled to any benefit or remuneration, and he/she loses assets in terms of his/her time, effort, energy and labour²³.

From the above discussion, the present writer may summarise that the establishment of the modern conventional companies that participate in the stock market does not conform to the type of company that is permitted in the *sharī'ah*. Regarding the aspect of power sharing, today's conventional company does not correspond to the framework of the *shirkah*, a partnership company in Islam. Although in the aspect of power sharing, the conventional companies are in accordance to the *muḍārabah* contract, nevertheless, they do not conform to the *muḍārabah* contract concerning the aspect of profit-sharing, the basic principle in this Islamic business contract. As also has been pointed out above, the profit-loss-sharing that is practiced in *shirkah* and *muḍārabah* seems to be more attractive than the conventional system of fixed remuneration.

5.2.1.4 The Issue of Liability.

The different understanding of liability in conventional company and the *shirkah* and *muḍārabah* contracts is also a major distinctive feature between them. This difference affects the validity of the modern contract as viewed from the Islamic perspective²⁴. Although both companies are concerned with the aspect of limited liability in their contracts, the understanding of limited liabilities in both situations seem to be differently interpreted. While limited liability in the conventional company is only concerned with the paid up capital²⁵, limited liability in *shirkah* or other Islamic contracts is based on the total capital accumulated²⁶.

²³ Khan, W.M., *Towards an Interest-Free Islamic...*, Op. Cit., p. 31. See also Izzi Dien, M.Y., "*Sharika*" in *The Encyclopedia of Islam*, Op. Cit.

²⁴ Dail, A.R., "*Konserp Syarikat Saham Bersama menurut perhatian Islam*", (The Concept of Joint Stock Company from Islamic Perspective) a paper presented in the seminar series on Islamic Economics, National Productivity Center Hotel, Petaling Jaya Malaysia, April 26-27, 1994, p. 8.

²⁵ Paid up capital is refers to the total amount of money capital accumulated through the shares subscribed by the share holders. The shares are paid at the full amount of the share prices. It does not include money capital accumulated through the loan sources. See *A Dictionary of Economics and Business*, Op. Cit., under the entry "paid up capital" and "Limited Liability".

²⁶ In *shirkah*, the liability and responsibility are upon the whole capital acquired, regardless of whether it comes from investors or loans because in Islam the act of borrowing does not intervene the

In conventional practice the separation between a company and the share holders as different legal entities took place in the 19th century²⁷. After this separation, the liability of the share holders of the company is limited and based on the paid up capital, the share subscribed by the share holders²⁸. This implies that if the total paid up capital of the company is 1 million, the liability of the ownership of the company is also 1 million. Although the company as a separate legal entity is liable for every capital borrowed in the event of business loss or bankruptcy, the share holders as the owner of the company cannot be assessed further, beyond their capital invested. In other words, however big is the debt to be paid by the troubled company, the share holders are not responsible to pay the debt using their private property. If the company is not able to meet the commitment to pay the creditors, the available assets of the company have to be liquidated to fulfil some of the creditors' demands. The liquidation will then be divided among the creditors on a prorata basis²⁹ without having to bother whether the liquidation of the assets manages to settle all the debts or not. This could lead to injustices to the lender, and could also encourage power abuse³⁰ among people who are on the Boards of Directors who have vested interests³¹.

Limited liability in Islamic contracts, *shirkah* is based on the total capital accumulated and is distributed to the share holders based on the capital ratio of the share holders. If two persons participate in a partnership with the capital contributed at 100 and 50 dollars respectively, then the company and share holders' liability is spread between them at the ratio 2:1. If the company faces trouble, they are not only liable for the paid

right to the property. Once the property is secured by a borrower from a lender (interest-free loan), the right to the property and liability are also simultaneously transferred to the borrower.

²⁷ The purpose of this separation is to protect the private property of the share holders. Before the separation, the share holders were liable for the company to the extent that their private property could be used to pay the company debt. See *A Dictionary of Economics and Business*, Op. Cit., under the entry "Limited Liability". See also Smuelson, P.A., *Economics: An Introductory Analysis*, Op. Cit., p. 87.

²⁸ Before the separation took place, the share holders, as the owner of the company were fully liable for the company. If the company faced any business failure and huge amounts of debt needed to be settled, the share holders were responsible for paying the debt to the extent that their private properties were assessed. Ibid., p. 87.

²⁹ See *A Dictionary of Economics and Business*, Op. Cit., under the entry "Bankruptcy".

³⁰ Power abuse could occur where a member of the Board of Directors with a vested interest, silently moves some important assets to his or their new established company leaving the previous company to crumble down, especially when the first company does not really have a bright future.

³¹ For further details on the discussion of the topic, refer Dail, A.R., "*Konsep syarikat saham bersama menurut perhatian Islam*", Op. Cit., p. 6-10.

up capital of 150 dollars, but also for the capital loan secured from creditors (interest free loans system) at the ratio 2:1 respectively.

In the above point of view therefore, under the *shirkah* or *muḍārabah* business contracts, a distinct character of the contracts is that the *muḍārib* (entrepreneur) has to get agreement from the share holders when securing capital loan to use in the business operation³². It is important to get this agreement as it is connected directly to the question of the share holders' liability for the company. Under the business contract of Islam, capital secured from loans is regarded as part of the liability to be held by the *ṣāhib al-māl* because the act of borrowing will consequently transfer the right of ownership of the property to the borrowers. Hence it is considered as a component of paid up capital as far as the *sharī'ah* is concerned and the borrowers are fully liable for such capital. In this respect, a business contract in Islam offers an attractive alternative to all the parties involved³³, especially to the lenders or creditors which are often victimised by the event of business failure and company bankruptcies in the contemporary business world.

5.2.1.5 The Issue of Withdrawal from the Partnership.

In the question of an investor's withdrawal from the company, Islam looks at the matter quite differently. In the conventional company, any investor can withdraw at any given time that he/she wishes to leave the company. The decision is taken by the individual without prior permission or consultation with the other members of the company. This reflects that in the practice of the conventional company, the ties between the members in the company are not so strong. Any member can leave the company that they have jointly agreed to establish, with the intention of carrying responsibility for achieving further success in the future. In this respect the decision

³² Siddiqi, M.N., *Partnership and Profit-Sharing...*, Op. Cit., pp. 16-8.

³³ This alternative business contract offered by Islam seems to be more attractive as compared to the conventional practice. The Islamic practice would not provide so much room for the entrepreneurs which, in the conventional system, can lead to the misuse of power and business manipulation by the entrepreneurs. This is especially in relation to their easiness in securing the capital loan. Under the Islamic contract, the entrepreneurs will not be pressurised unnecessarily as the liability of the company is spread among the share holders. While the greatest relief is for the creditors, because the Islamic contracts provide them more chances to regain their capital lent to the company through the wide understanding and applicability of the liability concept in the Islamic practice.

to leave the company will actually affect the smooth running and stability of the company, especially when the member who is leaving is the one who possesses large amount of shares and has a strong influence on the operation and running of the company³⁴.

Although to withdraw themselves from the company through selling their shares is allowed in Islam, share holders are not encouraged to do so without any good and valid reason³⁵. This is in order to ensure that the safety of other members as well as of the company is always maintained. This is especially in the case of a company handling a business activity which is badly needed by the public. In this respect the company's trouble or collapse will eventually jeopardise the welfare of the society, then the *maṣlahah 'ammah* (public interest) could be applied here. The principle of *maṣlahah 'ammah* is an important basic principle in the Islamic economy whereby if there is a contradictory interest between the public and the individual and the clash of interest can not be reconciled, the public interest is to be taken into consideration. This is not to dispute the *fuqahā'* views on the right of every individual among the business partners to withdraw from the business partnership, instead to strengthen their views so that the permissibility is not used thoughtlessly by the business partner. Accordingly if the decision to withdraw from the partnership is made, it must be done with valid reasons. This argument is more justifiable from the Islamic perspective as the purpose of establishing a business partnership in Islam is to achieve business success as well as to provide a necessary service to the public. As the decision to form

³⁴ Dail, A.R., "*Konsep syarikat saham bersama menurut perhatian Islam*", Op. Cit., p. 11.

³⁵ Reasons for withdrawal from a company by selling their shares happen in three situations. Firstly, cash is urgently needed by the investor for personal and specific purposes, secondly, the analysis shows that the particular company does not possess a very bright future as far as its operation is concerned. Hence, before it incurs any loss, the investor would withdraw his participation from the company and buy other company shares which have a bright future. Thirdly, to retire from the business world. In handling the first situation, Islam sees that withdrawal from one's membership of a company is not a good way out. There are other alternatives to serve those personal purposes such as the *qard al-ḥasan* fund (welfare fund), financing from the *zakāh* fund and other welfare funds that could be established. In the second situation, Islam discourages the attitude of always jumping from one company to another as this will further affect the efficiency and the future potential of the company. Islam sees these types of investors as irresponsible investors, as they are doing an injustice by leaving the other members of the company. As the agreement to establish the company was taken between them, hence to run the operation or to cease it (or cease as a member) should be also decided by all of them or at least with advance notice being given. For further details, refer Dail, A.R., Ibid., pp. 10-2.

a company is agreed between the parties, thus to carry out the responsibility of achieving success is the duty of every member.

This is especially condemned in the case of jumping from one company to the other only to benefit from the share price movement in the stock market, as is usually done by speculators. In this particular activity, the investors or rather speculators, do not carry out their responsibility morally as well as materially towards the company, especially when the company is established with their mutual agreement as being one of the partners. Furthermore, it leads to a negative aspect in the share market that is *'urūd al-tijārah* (sale without substance) and the emergence of other unhealthy activities in the market, such as *bay' al-gharār* (sale of uncertainty), *al-maisir* (gambling), deceit trading and speculation³⁶.

The above are some issues concerning the conventional concepts of companies that need to be further scrutinised and carefully examined in order to find a real solution for these issues from the Islamic perspective. A few of them might need a very slight technical amendment such as strengthening the existing contract law to make it conform more to the business contract in Islam. At the same time some of those issues need a more comprehensive transformation approach, regarding the basics of the contract and the establishment of the company itself. Hence, clearly it would be a great contribution to deal in detail on the conventional concept of companies in the near future to provide the Muslims a permissible place of investment for their income surplus.

5.2.2 Flow of Investment.

This is another issue with the existing companies that participate in the stock exchange. Some of the companies do not only concentrate on the business venture that they are involved in, but simultaneously they invest their available capital in other business organisations or by inventing a new venture.

³⁶ Ibid., pp. 10-2.

5.2.2.1 Business Diversification.

In today's modern business organisations, the diversification of business activity is a common phenomenon. There are various reasons for a business organisation to diversify its business activity³⁷. Whatever are the reasons given, the main objective is to maximise company profit and to minimise risks or any possibility of a greater business loss. Business diversification is done through either investing a portion of their surplus capital in the operation of other companies, or through investing in an entirely new business activity from the existing main business venture.

It seems that there is nothing wrong with the diversification of business activity as mentioned above. In fact, from the share holders point of view, the diversification of the company business activity is something beneficial to them as the move will enhance their chance to get profit and minimise the risk on their capital from any business losses³⁸. However the main concern of the Muslims regarding business diversification is that the new business created or participated in by the company may not be strictly 'pure' from an Islamic point of view. Although the main business activity of the company might be *ḥalāl* (lawful) from the *sharī'ah* point of view, the newly invested company or new business venture established might be related to *ḥarām* (unlawful) business activities³⁹. This situation is of great concern to Muslims and in fact it barricades Muslims from participating in this type of company business.

5.2.2.2 The Unit Trust.

The above situation is more visible if we refer to a unit trust, a pool of money collected from the surplus of individuals into a fund managed by a professional for

³⁷ Among those reasons for business diversification are;

- 1) To minimise the risk of only depending on one business activity.
- 2) As a means to avoid seasonal or cyclical fluctuations of the main business activity.
- 3) To increase company growth rate.

See A Dictionary of Economics and Business, Op. Cit., under the entry "diversification".

³⁸ Ibid.

³⁹ *Ḥarām* (unlawful) here refers to the understanding of the concept *al-ḥalāl wa al-ḥarām* (the lawful and the unlawful) judged by Islamic parameters and not lawful or unlawful in the understanding of the modern world which judges through the existing mundane law. For further discussion refer to the discussion of the particular subject in chapter 3 of this research.

investment purposes. In Malaysia, unit trusts are now emerging everywhere, and are established as safe places for investment. This is because the funds are created mainly for those who do not possess any investment experience, especially in the sophisticated business transactions of a stock market, including the difficult process of economic analysis and forecasting. Thus these funds are available to serve 'lay people' such as farmers, fishermen as well as from the saving of housewives. The unit trust Board of Directors will carefully monitor the appointed manager in every investing activity to ensure the capital accumulated is invested into the safest place of investment. However, the investment made sometimes does not take into consideration the *sharī'ah* aspect. The lack of *sharī'ah* awareness in the investment activity will definitely become a barrier to Muslims from having their surplus income invested in a unit trust.

In the above situation of business diversification, although the main business operation of the company is basically *ḥalāl* from the Islamic point of view, the peripheral investments that they participate in or establish are sometimes doubtful for Muslims. While in the case of a unit trust, though their major business responsibility is to invest in any profitable businesses, it should ensure that every investment to be made must be in accordance with the question of *ḥalāl* (lawful) and *ḥarām* (unlawful) in Islam. If this important aspect of Islam is being neglected, it will consequently limit Muslim participation in these types of companies and unit trusts. Accordingly, the situation will also affect their participation in the business activity of the stock market since the companies who float their shares in the stock market are the same companies.

5.2.2.3 The Need for a *Sharī'ah* Committee.

To solve the above problem which is emerging here reveals the importance of establishing a *Sharī'ah* Committee in every company, which can directly play a role as a watchdog, to inspect and endorse the business activities of the company. Alternatively, a detached and professional *Sharī'ah* Committee⁴⁰ at national level

⁴⁰ This committee must detach itself from any body such as government, organisations and others. It must also be professional in nature, with proper organisation, offices, staff and competent committee members who comprise of religious educated scholars, economists that are well versed in Islamic

might be established to serve companies in any particular country. In this respect every company is obliged to dispatch its business activities in which the company is involved, and any new activities planned. Any company who does not comply with this requirement of despatching its business activities is liable to be categorised as *ḥarām* (unlawful) for Muslims to participate in the company shares.

In Malaysia, the importance of establishing the *Sharī'ah* Committee is gradually being recognised. There are several banks and financial companies which are operating under the *sharī'ah*, who have established their own *Sharī'ah* Committees⁴¹ to govern their business activities. This trend is being imitated by some conventional companies which offer 'Islamic counters' to the Muslims as a parallel business activity to the existing conventional financial system. Simultaneously, some unit trusts also have their own *sharī'ah* committee to supervise their investment activities.

However the trend taking place in these financial institutions and some unit trust funds does not seem to be noticed by business companies. Although there is a *Sharī'ah* Commission established by the Kuala Lumpur Stock Exchange (KLSE), the contribution given is limited because the establishment of this Commission is to serve the KLSE and not to serve thousands of nation wide business companies. Furthermore, the Commission could only decide or give *fatwā* (religious ruling) based on the information given by the companies, which can easily be falsified. Hence, to establish a professional and detached *Sharī'ah* Committee to deal with thousands of companies as suggested above is significantly important.

economics, conventional economists and lawyers. This is to make the committee perform its duty efficiently and correctly.

⁴¹ The phenomena of having *sharī'ah* committees in business establishments became common in Malaysia after the establishment of the first Malaysian Islamic Bank in 1983 namely Bank Islam Malaysia Bhd. Syarikat Takaful Makaysia Bhd., the first Malaysian Islamic Insurance Company also established its own *sharī'ah* committee in order to inspect and endorse its insurance business activities. This trend of having *sharī'ah* committees in a company has been followed by the majority of banks and financial companies in Malaysia especially when they operate 'Islamic Counters' which offer interest free loans schemes, well-known as STPF, (*Skim Pinjaman Tanpa Faedah*) to the Muslims. This measure is taken to attract Muslims to invest their money in them. This is seen as a necessary step because the Islamic resurgence in Malaysia which has taken place since the early 1970's has revived Islamic awareness in the society. This awareness has led to the situation where every activity including economic, is usually viewed from an Islamic perspective.

Without the existence of such a committee in a company, it implies that the particular company does not possess any means or committee to check and approve its investment and business activities to be made within the company as well as outside the company. The existence of such a committee will impart certain beliefs to the Muslim participants on the stock market regarding the issue of *ḥalāl* (lawful) and *ḥarām* (unlawful) of the company listed.

5.2.3 Capital Accumulation.

With respect to the question of capital accumulation, a company usually accumulates its capital from two important sources; firstly, from selling the company's newly issued shares called equity capital, and secondly from borrowing, termed as loan or debt capital. There is nothing wrong as far as the *sharī'ah* point of view is concerned with the first source of securing capital, that is equity capital. However, depending on the sale of newly issued shares to the public alone always causes the problem of not getting enough capital to cater for their big plan of business operation. Therefore the available alternative of acquiring capital, through borrowing is exercised.

As the existence of the interest-free banking system is still relatively new and rare even in Muslim countries, the people's faith in the Islamic banking system is still not strong. In this respect interest bearing loans offered by the conventional banking system are still preferred compared to the interest free banking system. In addition to this as pointed by Man, one of the main purposes of floating company shares in the stock market is in order to increase their borrowing power⁴². The higher the position and the more stable company shares are in the stock exchange, the greater borrowing power they will automatically secure from the conventional banks. Hence to some companies, borrowing capital from these banks is their main way of obtaining capital to sponsor their business activities⁴³. Thus the question of *ribā* (interest) arises here

⁴² Man, Z., "Share and Investment in the Share Market...", Op. Cit., p. 17.

⁴³ A company usually prefers borrowing rather than issuing new shares to the public as this step gives a company two advantages. Firstly, the company will get tax exemption as paying interest is considered as a production cost. Thus, the higher the loan and interest to be paid the better the situation for the company. Secondly, the big share holders will avoid losing their power. The Board of Directors (who usually consist of those who possess big amount of shares in the company) will opt to borrow rather than lose their power in the company. Refer to Man, Z., "Share and Investment in the Share Market...", Ibid., p. 19.

which is the main concern of every Muslim because it is totally prohibited by Islam. *Ribā* as taught by Islam is a method that leads to great injustices in society and is condemned as a negative element in the business world. Therefore, Muslims are very sensitive to the problem of *ribā* in the economy.

At the same time, the preference for borrowing rather than issuing new shares to the public for the capital accumulation process will cause two negative consequences for the company. Firstly, the method will eventually limit investment opportunity for the individual and the public who possess surplus income. This will lead to the capital of the society being kept idle. Secondly, it will affect the stability of the share price of the company as the equity capital acquired from issuing new shares to the public would provide more stability to the price of the company shares,⁴⁴ and accordingly would strengthen the business venture of the particular company.

The method of acquiring capital through equity capital is more in conformity with the economic teaching of Islam. Besides the above two significance, namely giving opportunity to the public to invest their surplus income and increase the stability of the company's share prices, Islam discourages and to certain extent prohibits the act of keeping capital idle. Property and capital must be circulated in the society for society's benefit. Unfortunately, this is not a popular way of accumulating capital. A study conducted in Malaysia between 1975 to 1989 demonstrated that the average involvement of Malaysian companies in borrowing for their capital accumulation was quite large, especially in the financial sector⁴⁵.

There are two important reasons why the management of a company opts to increase their capital through borrowing rather than issuing new shares to be openly participated in by the public⁴⁶. Firstly, through borrowing, a company will automatically gain 'taxation profit' as the payment of interest from borrowing is considered to be a percentage of the cost of production and is exempt from government taxes. The bigger the amount of capital borrowed, the bigger the amount

⁴⁴ Ibid., p. 19.

⁴⁵ The study is done by Annuar Nassir and Sahshar Mohammad, "An Empirical Study of the Capital Structure of Malaysia Listed Firm" as quoted by Man, Z., Ibid., p. 18.

⁴⁶ Ibid., p. 19.

of interest needs to be paid, hence, the bigger amount of tax exemption can be acquired. On the other hand, equity capital (capital acquired through issuing new shares), will give a reverse effect to the profit acquired by the company as far as the question of taxation is concerned. The higher the equity capital the greater the share of dividends to the share holders and consequently the greater amount of tax has to be paid, since dividend is taxable. Hence, this situation provides a conducive environment to the flourishing of the interest based loan system which is contrary to the teaching of the Islamic system of economics and vehemently denied by Islam.

Furthermore, if the step of capital accumulation through borrowing is taken in order to avoid paying taxes to the authority, Islam totally discourages the activity. This is because Islam views that giving up a portion of a company's financial assets to the authority is a praiseworthy attitude. This contribution will provide the authority with enough funds to spend on increasing public welfare. Through the contribution, the company plays an important part in ensuring the welfare of the needy and the poor as they can be taken care by public funds. Therefore one important aspect of the Islamic economic system to be fulfilled is paying *zakāh* (obligatory charity) which is obligatory if the conditions for payment *zakāh* are being met. The amount of *zakāh* in business enterprise as prescribed by Islam is 2.5 per cent of the total profit and payable to the *bayt al-māl* (treasury of the state) which is to be spent for the needy and the poor.

Secondly, the people with a vested interest among the Board of Directors will usually opt to have borrowing as a method of the company's capital accumulation for the funding of their expansion plans. This step is taken in order to avoid power dilution among them. As mentioned before, the Board of Directors in modern business practice always consists of people who possess the larger amounts of shares in the company. If they opt to issue new company shares to the public for capital accumulation, it will consequently reduce their share percentage in the company. Hence, their power and possession of the company are also diluted as well. Therefore, the method of acquiring capital through borrowing is more popular in certain companies than issuing new shares to the public.

From an Islamic point of view, accumulating capital through issuing new shares to the public which enables them to participate in a company is more desirable as it will provide the public with direct participation in business ventures. Simultaneously, this option would greatly help in promoting the Islamic economic system as this step is encouraged by and in conformity to its teaching. This step will also challenge the dominance of the conventional interest based banking system of the modern world. Although the loan could be taken from an interest-free banking system, individual direct participation is more preferable and in line with the spirit of Islamic economics, and hence should be encouraged. This will provide great opportunity for the public to be directly involved in investment, and as pointed out above it will provide more stability to the share price and hence, to the company. Furthermore, the profit received from direct participation is always higher than the dividend from investment through an interest-free financial institution⁴⁷.

The above issues regarding flow of investment and capital accumulation are still in the realm of controversy and have become the concern of every Muslim. The important role which could have been played by the *Sharī'ah* Committee is really manifested here, because through the existence of this committee, every decision, whether to invest or to borrow and all the related issues would be under the scrutinization of the committee in order to conform with the principle of *al-ḥalāl wa al-ḥarām* (lawful and unlawful) in Islam. Hence, the existence of this committee as a core for every business entity needs to be established.

5.2.4 Issues Relating to Shares.

As the establishment and operation of a company is structured and founded on the basis of the conventional system, this fact leads to the emergence of a few other issues relating to the share holdings. Although from the conventional point of view these issues are something of a small matter, it is not the same if they are viewed from the Islamic perspective. Everything that falls under the question of *al-ḥalāl wa al-ḥarām*

⁴⁷ This is due to two factors. Firstly, direct participation will not involve the cost of the management of the fund as is needed if investors put their surplus in the interest-free banking system (cost in running the banking). Thus logically, the profit would be higher if direct investors participate in the business activity. Secondly, the increase of the share price is also a kind of profit to the real investor (for speculators this is their main target in their involvement in the share of a company).

or against the *maṣlahah ‘āmmah* (public interest) however small the issue is or seems to be, is not usually a small matter to Muslims.

5.2.4.1 Reimbursement of Profit.

There are a few issues in the conventional company concerning the question of shares if they are to be viewed from the Islamic perspective. One of those issues is concerning the aspect of the company's profit reimbursement. The value of a share is greatly dependent on the financial value of the company's properties. The reimbursement of the company's profit to the future development of the company is one factor that could affect this valuation. In the conventional point of view, the reimbursement of profit gives the company two advantages. Firstly, the move will lead to the increase of the company properties' financial value and accordingly will cause the price of the company shares in the stock market to increase. Secondly, profit acquired from the business activities in the form of dividend is subjected to government taxation. In the United States of America in the 1970s the taxes for business corporations consisted of almost 50 per cent of the profit attained⁴⁸. Hence, reimbursing some or all of the profit for future development of the company will avoid the company and share holders from being liable to pay taxes. In this respect therefore, in the conventional company, the company is not obliged to distribute dividend to the share holders though the decision to distribute could win the support of the investors⁴⁹.

Although the move is good for the company from the above two advantages point of view, it is contrary to the original purpose of engaging themselves in a business co-operation, which is to share and distribute all the profit gained according to the proportion agreed by both parties, the investors and the entrepreneurs in the form of dividend⁵⁰.

⁴⁸ See Bach, G.L., *Economics; An Introduction to Analysis...*, Op. Cit., p. 145.

⁴⁹ See *A Dictionary of Economics and Business*, Op. Cit., under the entry "dividend".

⁵⁰ In the United States of America in 1972, a total of US\$25 billion undistributed corporations' profits were plowed back into new plant, equipment and other business uses. Refer Bach, G.L., Op. Cit., p. 434.

Regarding the above move, the economic system of Islam views it as something that is not impossible if the investors involved in the co-operation agree before hand. In this respect a new contract with the same parties under *muḍārabah* or *shirkah*, using the previous available capital plus new capital accumulated from profit reimbursement could be done with the agreement of the share holders without having the profit handed to them. This is what is termed '*de jure*' capital restoration by Siddiqi and most jurists agree that this type of restoration is equivalent to the proper restoration of the capital, *de facto* restoration⁵¹.

In fact, the above is a praiseworthy move as it is good for the future development of the company and the welfare of the public. The reimbursement of some or all of the profits for the future development of the company is one way of materialising the company's function in fostering social responsibility. Through the investment of this profit, it will lead to the future expansion of the company's business operation. This will eventually create new business and job opportunities for the public. Hence, this leads to further growth and the economic prosperity of the particular country. Analysing this move from an Islamic point of view, it seems that the steps taken which lead to those good consequences reflect the company's aspiration to materialise the Islamic principle of *maṣlahah 'ammah* (public interest).

However, if the reimbursement of the profit is purposely done to avoid paying tax to the government, then it is not a good decision as it will decrease the welfare of the public. The government public expenditure would be badly affected if all companies opted to take the same measure because the government expenditure depends greatly on all sorts of taxes collected from various places including from these business companies. This is also against the above said Islamic principle of *maṣlahah 'ammah* when the move is only concerned with the achievement of the company at the expense of the public. Hence, Islam sees it as a vested interest move by the company

⁵¹ *De jure* capital possession or capital restoration is a term used to indicate that the capital is fully under the owners' control in order for them to use, to desposed, to save or for other personal usage. However the capital (in cash form or other form) is not in their hands. In contrast, *de facto* capital possession or restoration refers to a state where the capital is in the hands of the owners and they are fully in control of it. For further details on the discussion of profit reimbursement in the Islamic contract of *muḍārabah* and *shirkah* and on the concept of *de jure* and *de facto* capital possession, refer Siddiqi, M.N., *Partnership and Profit-Sharing...*, Op. Cit., pp. 34-7.

which is clearly an aspect of neglecting their responsibility towards the investors as well as towards the welfare of the public.

5.2.4.2 Discouragement of Speculative Loans.

The business of buying and selling shares and stocks in the stock exchange is very attractive, especially when loans from finance institutions are always available for those who intend to participate in the business. The availability of loans from these institutions, encourage not only the real investors to take up the facility offered but also attracts the speculators to participate in the fragile business of speculative transaction in the stock exchange. The participation of this group of 'investors' or rather speculators, with their speculative activity will contribute to the fluctuation of share and stock prices in the stock market. "Speculative activity in existing stocks on the basis of margins does not perform any useful economic function and in fact harms true investors by generating undue fluctuations in stock prices and injecting an undesirable element of uncertainty and instability in their investment"⁵².

As the above statement has been proved true by the Wall Street crash in 1929 and also when the London Stock Exchange crashed in 1972, the activity of speculative transaction for getting an easy profit in a very short period should always be checked and discouraged. Hence, the abolition of *ribā* (interest bearing loans) from the Islamic economy would play a very important and vital role in reducing speculative transactions and activities in the stock market⁵³.

As explained in chapter three of this research, the abolition of *ribā* from the Islamic economic system is paramount in importance. This is because in whatever situation and condition, the existence of *ribā* will only spread injustices to the poor and the needy. Hence, in this respect, through the existence of interest bearing loans, it makes easy capital access for the speculators in order to overcome their shortage of money to finance their speculative activities, especially in the speculative transaction of sales

⁵² Umer Chapra, *Towards a Just Monetary System*, Op. Cit., p. 98.

⁵³ *Ibid*, p. 98.

on margin⁵⁴. The bankers are not usually concerned with the possibility of negative consequences as a result of their involvement in financing the activities of speculative transactions to the speculators. As their main intention is to benefit from the loan given through receiving permanent loan repayments with fixed profits in terms of interest, the loan activity will continue.

Instead, the existence of the interest-free banking system which is based on a profit-loss-sharing business contract on every loan given, will consequently check the rampant activity of speculative transactions in the stock exchange. This is because the interest-free banking system will motivate the lenders to be more cautious in lending their money which one of the criteria is on the level of risks, bearable or unbearable. Every business transaction falls within the boundry of these two levels of risk. Islam allows the Muslims to involve themselves in business transactions that carry small or bearable *gharār* (risk and uncertainty) and disallow any transaction that carry a high level of *gharār* and are highly speculative in nature⁵⁵. Muslims have to decide the viability of business transaction which lay between this two situations. Therefore, to lend money for indulging in any business activity which prevail more risks would be the least preferred by the interest-free banking system. While there will be no loans given to the speculative activities which is usually does not based on economic fundamentals and economic analysis on the performance of a company.

The existence of the interest-free banking system would not only constantly check and restrict the activity of speculative transaction in the stock market, it would at the same time promote loans for productive purposes. This is because the objective of loans given by the interest free banking system is more parallel to the spirit of lending in Islam, that is for profit-sharing in business ventures and consequently, it increases the economic well-being of the public⁵⁶.

⁵⁴ See Yass, M., *The Great Depression*, London, Wayland Publishers, 1970, p. 21. See also Rees, G., *The Great Slump: Capitalism in Crisis 1929-33*, London, Weidenfeld and Nicolson, 1970, pp. 25-6.

⁵⁵ Refer to the discussion of this subject in chapter 8 of this research.

⁵⁶ This is true because the loans given for productive purposes will generate economic activities that can benefit the public in terms of job opportunities, consumption production and increase in facilities and amenities to the area involved in the economic development plan.

5.2.5 Issues Concerning Speculation.

The purpose of buying shares in the secondary market, is now gradually changing, no longer for the genuine investment in the company, but for the purpose of acquiring profit in the short period from the movement of the shares' prices. This speculative activity does not base itself on the real assets and the future potentiality of the company instead, most of the time it is based on assumptions and rumours. As the frequency of price movement is high and does not really imply the real assets of the company, it is something that needs to be studied from an Islamic perspective.

Furthermore, the question of the relationship between the 'investors' or more precisely speculators⁵⁷ and the company arises here. To be a member of the company through buying and holding its shares is not the main purpose of speculators. Instead, they use the investment certificate only for a stepping stone or to acquire the 'legal title'⁵⁸ of the shares in order to get a quick profit in a short period by their work of speculating on the trend of the price movement. Apparently, the speculators are not investing their money for the purpose of participating in the business activity where it entitles them to get business profit. Instead they use the legal title of ownership⁵⁹ for the purpose of making capital profit from the price movement of the shares. Therefore, can they be categorised as *ṣāhib al-māl* (capital suppliers) in Islamic economics? If they do not represent themselves as *ṣāhib al-māl* what will they be and what is the status of their contract with the company from the Islamic perspective?

Ṣāhib al-māl in Islamic economics, regardless of whether they are participating in the *muḍārabah* or *shirkah* contract, represent as the real suppliers of capital for the purpose of business activities. *Ṣāhib al-māl* in Islamic economics do not consider the profit that they might get from the price movement of the shares as their foremost hope of gaining profit. Although they might get a very high profit from the price

⁵⁷ The more appropriate word to be used here is speculators instead of investors.

⁵⁸ Davidson, P., *Money and the Real World*, Op. Cit., pp. 106-7.

⁵⁹ This legal title of ownership as pointed out by Davidson is an aspect that clearly differentiates between the speculators and the real investors. Ibid. However in certain transactions in the stock market, the legal ownership of the shares is not important as the speculators can borrow the share scripts from the brokers to carry out their speculative activity such as in the case of 'short selling'. For a detailed discussion on the subject, refer to chapter 4 of this research.

movement, it will not change their foremost intention of participating in the business venture, that is for the future economic development of the company as well as the country and receiving profit from the business activities undertaken. Any attainment of profit resulted from the price movement of shares in the market will be an additional bonus to them.

Hence, while the real capital suppliers in Islamic economics as demonstrated above, receive two kinds of profits, profit from the movement of share prices and profit from economic activities, the speculators will only, most of the time, manage to get their income from their speculative activities on the movement of share prices⁶⁰. Some of them are not concerned with and just take for granted that profit achieved by the company which materialises in the form of higher dividend given to the investors. This is because they usually hold their shares for speculative purposes which means only for a few weeks or months. If they see any chance of making profit from the price movement of the shares, they will not hesitate to liquidate their share holdings. They will repeat the same process in the shares of other companies⁶¹. Hence, the profit gained by that particular company in the form of dividend pay out to the 'real investors' would not interest them. Furthermore, dividend is always given on a yearly basis and it is not usual for the speculators to hold shares for a full year. In fact, if the shares are kept for that long a period, they are no longer speculating, instead they are investors.

The question of speculation and speculative transaction is very common in the modern business transaction of the stock market. The situation indeed makes the daily transaction of stocks and shares in the secondary capital market reach a very high volume. The existence of speculators in today's stock market transactions leads to the

⁶⁰ This is because the common practice applied and the philosophy held by the speculators is to possess the shares for a very short period and move in the market as quick as possible. In this quick and short period of share possession they usually are not concerned with having the ownership changed into their names. This is clearly seen in the transaction of 'short selling', where some of the speculators sell shares which are not in their possession. As sending scripts of shares to the new buyer is their responsibility, the speculators have to borrow share scripts from the brokers (usually their close friend or indiscriminate brokers), without having the ownership transferred. The speculators then send the scripts to the buyers and re-buy it when the price decreases as they expected. After re-buying the shares, the speculators will return the scripts to the real owners or brokers. Thus, in this process, the business profit attained by the company belongs to the real owner.

⁶¹ For further details on the discussion of the nature of speculators' activities, refer to chapter 6 of this research.

activeness of the stock market where millions of dollars are transacted daily⁶². However, the existence of this group of 'investors' and their undue activities in the operation of the stock market has become a serious and debatable issue, not only among Muslim economists but also among Western economists. A Western economist concluded that speculators contribute nothing to the progress of an economy, especially that of the stock exchange in terms of work as well as there being no additional economic value made⁶³. He further states that;

"investors are much more useful to speculators than speculators are to investors, and the stock exchange would not necessarily be any less effective if there was no speculation at all"⁶⁴.

5.3 Conclusion.

To conclude this chapter, there are many other issues on the stock market that can be discussed and scrutinised from the Islamic point of view. The above discussion on a few issues of the stock market is only a breaking through point for further research by scholars in the near future as the main focus of this research is on the last issue mentioned above, that is on the question of speculation on the stock market from the Islamic perspective. This subject is being dealt with here since the majority of Muslims⁶⁵ are now actively engaged in the business of the stock market without any prior knowledge of its permissibility. This is especially important with regards the question of speculative transaction which is rampantly practiced in today's daily business operation of any stock market.

⁶² Khan, M. Akram, *Issues in Islamic Economics*, Op. Cit., p. 87.

⁶³ Refer M.S. Rix, *Stock Market Economics*, London, Weidenfeld and Nicolson, 1970, p. 204.

⁶⁴ *Ibid.*, p. 212.

⁶⁵ This is because only a few Muslim countries have started to introduce and operate their Islamic stock market, for example Sudan and to some extent, Malaysia. In Sudan, a total reformation has been done on the framework of the stock market while in Malaysia, the government has introduced a few steps out side of the framework of the existing stock market, such as establishing a *shari'ah* committee in order to clarify the permissibility of the company to be participated in. The daily operation of the stock market in Malaysia is still mainly the conventional system. The other Muslim countries still operate their conventional stock market. For further details on the subject of Islamic Stock Market in Sudan refer to Ḥamdi, 'Abdul Raḥīm, "Khartoum Stock Exchange Spearheads Islamic Reforms" in *Islamic Banker*, U.K., October 1995.

Hence, is the existence of speculators, with their activities that lead to a rapid and high volume of stocks and shares being daily transacted in the stock market desirable in Islamic economics? Are the daily unpredictable and unnecessary price fluctuations⁶⁶ of share and stock prices that are mostly caused by their activities bringing any benefit to the secondary capital market? More importantly, is there any speculative activity which is in conformity with the spirit of Islamic economics and hence should it be practised by Muslims? Additionally, what are the elements which exist and are associated with speculative activity that cause the transaction to be labelled as something negative? If this is so, can speculation be practiced freely in any stock market after those negative elements associated with it be repudiated? All of these issues are to be discussed in the forthcoming chapters.

⁶⁶ Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., pp. 95-9.

CHAPTER 6

THE STOCK MARKET AND THE CONCEPT OF SPECULATION

6.1 Introduction.

The importance of the role played by a stock market in the economic condition of a country as pointed out in the previous discussion, is undeniable, especially the role played as an instrument for determining the economic condition of a country. An organised and stable stock market reflects an economic stability; progressive economic growth as well as reflecting the economic prosperity. In contrast, an unstable stock market indicates the vulnerable economical position of a country. Consequently, in some cases an unstable stock market has caused problems and economic crashes not only for the country in which it occurs but also affects other countries because of interdependent economies. The best example of this situation was the World Great Depression which threatened the world economy in the 1930's. As the United States was the economic power of that time, the world economic condition was also based in one way or another on the economic prosperity of the United States. However, when the United States economy went through the very real horror of a financial crash in 1929-1933, it did not only affect millions of small depositors in the United States¹, but more importantly the whole world faced a crucial economic situation.

The biggest contribution to the collapse of the economy of the United States in the tragedy of the 1930's was the crumbling down of the United States stock market, the New York Stock Exchange. Wall Street crashed and affected the world's economy, which was encountered more severely by small underdeveloped countries which based their economic prosperity on the export of raw materials. It can be clearly seen that countries which based their economic prosperity on primary sources were facing

¹ Coakley, J. and Harris, L., *The City of Capital*, Oxford, Basil Blackwell Publisher Ltd., 1983, p. 69.

very low prices for their production, while manufacturing countries were encountering very high rates of unemployment².

The main factor that led to the crash of the New York Stock Exchange was the unstable prices of the stock traded. In a very short period, the traded prices of shares rocketed to their highest levels and unexpectedly began crashing down to earth within a very short time³. The New York stock Exchange at that period fell by about 36 percent during the first stage of depression (1929) and further decreased by another 80 percent between 1930 and 1932 after stocks had recovered half of their losses from the first stage⁴. However, the worst period was in 1933 when within 3 years The United States national income sank by nearly one-half, capital investment plunged to the point where net investment was negative, one out of three laborers was forced to resign and the whole banking system collapsed⁵.

The situation of the New York Stock Exchange at the time shortly before the collapse was psychotic. The buyers and investors, as well as the speculators, were going crazy, buying everything available from the market, making the prices of stocks increase rapidly. In contrast, when the price reached its zenith, while thousands of investors, especially small investors and speculators, were still crazed on buying anything left in the market, the real, big and smart speculators had already let go of their shares. They made a very handsome profit at the expense of those investors and small speculators⁶. The small investors and speculators were being victimised by the havoc, and a chaotic situation prevailed in the New York Stock Exchange as a result of speculative activities done by the larger, smarter speculators. millions of dollars was wasted in this economic tragedy of the early 20th century⁷.

² Hanson, J.L., *A Dictionary of Economics and Commerce*, Op. Cit., p. 231.

³ Samuelson, Paul A., *Economics; An Introductory Analysis*, Op Cit., pp. 426-7.

⁴ Soros, G., *The Alchemy of Finance*, N. York, John Wiley & Sons Inc., 1994, p. 345.

⁵ Ransom, Roger L., "Great Depression" in *Encyclopedia of Economics*, Op. Cit., p. 460.

⁶ Teweles, R.T. (et al.), *The Commodity Futures Game*, Op. Cit., p. 299.

⁷ Coakley, J., and Harris, L., *The City of Capital*, Op. Cit., p. 69.

What was behind the irrational fluctuation of the stock market prices which ended with the Crash? The foremost reason according to economists, was the speculative activity which steered the whole market of the New York Stock Exchange at that time, and which consequently led to its downfall⁸. These activities led to the insane fluctuation of share prices. Within a few days, the prices of stocks and shares reached their highest point and then all of a sudden, the prices fell to their lowest level. The unchecked speculative activities made the New York Stock Exchange crumble down and the whole world was in one way or another, experiencing the agony of the worst ever United States economic condition. Since then, speculative activity in the stock market has been taken more into consideration and has been more seriously discussed. In the words of Galbraith "since 1929 we have erected numerous laws designed to make securities speculation more honest and it is hoped more readily restrained"⁹.

6.2 The Definition of the Word Speculation.

The word speculation is generally synonymous with words such as hypothesis, theory, postulation, surmises, supposition, opinion, thinking, cogitation, meditation, contemplation and even gambling, wagering or taking chances or risks¹⁰. However these words are categorised into two large groups that result from two important faculties that human beings possesses i.e. the power or faculty of seeing, especially intelligent or comprehending vision, and the use of the faculty of reason and contemplation¹¹. Hence to speculate means to form a theory or conjecture especially

⁸ Galbraith, J.K., *The Great Crash 1929*, Middlesex, Penguin Books Ltd., 1969, p. 26.

⁹ *Ibid.*, p. 28. See also Born, K.E., *International Banking in...*, Op. Cit., p. 250.

¹⁰ Urdang, L., *The Oxford Thesaurus, An A-Z Dictionary of Synonyms*, Oxford, Clarendon Press, 1993 under the entry "speculation".

¹¹ Although the word has various and wide understanding of at least 10 diversifications in meaning, it can generally be divided into two main groups as far as the use of one's ability is concerned. See Simpson, J.A., and Welner, E.S.C., *The Oxford English Dictionary (2nd. Ed.)*, Vol. 16, Oxford, Clarendon Press, 1989, under the entry "speculation".

without a firm factual basis¹². On the other hand, the word speculative also has two groups of meaning. As referring to the power of one's intellect, it refers to the notion of being intellectual, inventive, abstract, unrealistic and so on. As referring to situations and states, it suggests the meaning of risky, hazardous, uncertain, unreliable, doubtful and untrustworthy¹³.

It is clearly understood from the above that the word speculation has a very wide scope of usage. In whatever condition or situation that the word is to be used, the word will always refer to something that is possible and uncertain and needs further discussion or research, and even proof of its truthfulness, in the future. However, the concern of this study is not about understanding the word in its general usage but is about the technical application of the word in the world of economics and business.

The word speculation is a noun which refers to a risky deal that may produce a short term profit¹⁴. In the economic world it refers to an act of buying something at a low price and then selling it later when prices are higher. The act of buying is accompanied by the instinct of hope as it is said, "speculation is buying at a low price in the hope of selling later at a higher one"¹⁵.

Aubrey in one of his writings, gave a combined definition of the word literally and technically by saying "speculate is to meditate; to consider a subject by turning it over in the mind and viewing it in its various aspects and relation; to purchase articles of commerce in the expectation of gain from a rise in price. This involves forethought, comparison, judgement on a variety of circumstances and possibilities and a willingness to run a certain hazard over the undermined issues of a set contingency

¹² Allen, R.E., *The Concise Oxford Dictionary of Current English*, (8th. Ed.), Oxford, Clarendon Press, 1990, under the entry "speculation".

¹³ Urdang, L., *The Oxford Thesaurus*, Op. Cit., under the entry "speculative".

¹⁴ Collin, P.H., *English Business Dictionary*, Middlesex, Peter Collin Publishing, 1986, under the entry "speculation".

¹⁵ Seldon, A., *Everyman's Dictionary of Economics*, Op. Cit., under the entry "speculation".

whereby without this no business could be carried on; and the same applies to financial transactions"¹⁶.

However, the word does not only imply that the act of buying or selling is taking place whenever the price is expected to rise, but it could also materialise when the speculators are expecting a fall of price in the market¹⁷. However, to make profit while the price is declining requires shrewdness and prompt reactions in anticipating and acting upon the course of events likely to influence the prices. This could be done through careful study of daily newspapers and other written or oral material before making sound deductions based on that correct information¹⁸.

Hence, from the above discussion, it can be deduced that the definition of the word as is understood in the world of economics, is "an act of buying or selling goods or securities in the hope of making profit on the price movement"¹⁹. One important point to be noted here is that the application of speculative judgement is not only limited to the act of selling or buying shares and goods, but it also involves land and other properties that might offer the chance of making great or 'unusual' gain out of risk taken²⁰.

¹⁶ See Aubrey, W.H.S., *Stock Exchange Investments*, Op. Cit., p. 44.

¹⁷ One of the best examples for these two cases whereby speculators would gain profit, is that either they buy with the expectation of the price going up or falling down. This is shown clearly in two important terms that correlate to the world of the stock market i.e. 'bull' and 'bear'. 'Bull' is a term used for a buyer who buys 'long' on any shares that he himself does not intend to hold, except in the hope of or for the purpose of making an offsetting sale at a higher price. While 'bear' means a buyer who sells 'short' shares that are not under his possession, or that he might possess but has no intention of delivering to the buyer, with the hope that the price will fall down so he could make an offsetting purchase in order to gain profit. In each case a speculator would benefit from the price difference, either by buying the shares whenever the price is expected to fall (in the case of bear) or when it is raised (in the case of bull).

¹⁸ Aubrey, W.H.S., *Stock Exchange Investment...*, Op. Cit., p. 48.

¹⁹ Simpson, J.A., *The Oxford English Dictionary*, Op. Cit., p. 172.

²⁰ Spencer, Milton H., *Contemporary Economics*, New York, Worth Publishing Inc., 1974, p. 671.

6.3 Speculation in Economics.

As has been discussed above, the word speculation is closely related to the world of economics. It is related to economic activity that involves in it a financial risk as well as the chance of getting unusual profits, or sometimes it might incur losses. Whatever amount involved in that financial risk, large or small, the application of speculative judgement is still playing its role. This implies that whatever a person intends to buy or sell, there is involved in this, some aspect of speculative judgement, such as how the transaction would benefit him/her tangibly or intangibly.

Obviously from the above explanation we could infer that every economic transaction involves in it some aspect of speculative judgement when using the wider application of the word speculation. Thus, in the words of Aubrey "every business venture has to be made more or less in a spirit of speculation"²¹ and "commerce is mainly carried on as a matter of speculation"²². These statements are quite right, as human's activities in this world cannot really be separated from making judgements of a speculative nature. Thus a famous speculator, Keene replied when he was asked about his practice of continuous speculating, "the spirit of speculation is born with men"²³. However, in the ongoing discussion, the focus will be on the position and nature of speculation and speculative judgement as well as the negative ways these things can effect the economic world.

6.3.1 The Existence of Speculative Judgement.

In every economic transaction there is involved some aspect of speculation and speculative judgement. Because the word itself suggests something of undependable future benefit non-guaranteed from the transaction that has taken place. Even in transactions using a barter system whereby 'things' exchange things', there would be some rather speculative judgement in the exchange. Otherwise, ancient people would

²¹ Aubrey, W.H.S., *Stock Exchange Investment...*, Op. Cit., p. 43.

²² *Ibid.*, p. 88

²³ See Teweles, R.J. (et al.), *The Commodity Futures Game...*, Op. Cit., p. 3

not have had their own systems for measuring those things that had been transacted. Having their goods transacted among themselves implies that they also expected some benefits from the goods received.

In the modern world, speculative judgement is being applied in every economic activity from very simple to very complicated economic transactions, from a traditional farmer in a very rural area to a successful businessman in a large city, from a very traditional of funding a business activity to a very complicated and sophisticated method as is practised in a stock exchange. This is to emphasise that speculative judgement is something very special and important in the world of economics.

6.3.2 The Nature of Speculation.

There are a few things which can be seen in the process of exercising speculative judgement. Some of these characteristics are bound to be found in every business transaction, while others are mainly practised in more sophisticated transactions, such as in a stock exchange, commodity exchange or in in the foreign exchange. The existence of speculation and speculative judgement in these exchanges can hardly be denied. They are operating under certain rules and regulations and are restricted on certain types of transactions. Furthermore, the transaction being carried out are always closely watched by the exchange authorities²⁴.

6.3.2.1 The Element of Hope and Luck.

While the existence and the usage of speculative judgement in every business transaction is something unavoidable, in the more complicated transactions the usage of speculative judgement is sometimes infused with the element of 'luck' and 'betting' which simply represents another kind of gambling²⁵. Therefore, it is not unreasonable

²⁴ See Emery, H.C., *Speculation on the Stock and Produces Exchanges of the United States*, New York, Ams Press, 1968, p. 32.

²⁵ Samuelson, Paul A., *Economics; An Introductory Analysis*, Op. Cit., p. 429.

of Cobbett to describe speculation as 'commercial gambling' and as 'the most miserable nonsense'²⁶.

The element of hope and expectation are two important elements in every business transaction, hence, the importance of speculative judgement. Regardless of whether it is something that is a large transaction or small, every businessman hopes and expects that all transactions, in what ever type of property and business dealings carried out, will be good and will maximise their profit and benefits received. All of these transactions would be based on how accurately they manage to speculate the business dealing. Hence, what emerges here is the importance of how a person could speculate successfully in order to expect a future successful and profitable return for their endeavours.

6.3.2.2 Rational and Pure Speculators.

We could categorise people involved in business activities into two large groups²⁷ as far as the question of speculating, expecting or analysis of future potential of shares is concerned. The first group consists of careful investors who will eventually invest and inject their capital after a careful assessment has been made. They will analyse the strength of the company, based on reliable sources of the fundamental factors, including real assets and property as well as the performance of the company in the past. The result of the study will lead them to ascertain the future potential of shares through forecasting the future achievements of the company. This is what has been

²⁶ Simpson, J.A., *The Oxford English Dictionary*, Op. Cit., under the illustration number 9 of the word, under the word 'speculation'.

²⁷ Samuelson categorised people involved in the business of the stock exchange into 4 different categories depending on their motive for injecting their money into the market. Refer Samuelson, Paul A., *Economics; An Introductory Analysis*, Op. Cit., p. 428. However, these categories could be grouped into two big categories based on their way and method of investing money. The first group will invest their money after carefully study or at least after a little bit of homework had been done, on the company he intended to invest his money in. While the second group will invest their income surplus without bothering to analyse. This latter group, base their investment on the trend of price movements in the market.

termed as 'rational speculation'²⁸ and its existence is good for the development of the future economy of a country.

While the second group consists of those people who want to acquire fast and easy profit without exerting 'real' effort. They sometimes manage to make profit, which is termed 'capital profit' and at other times they suffer losses in their 'business'. This group is termed by Samuelson 'hour-to-hour, day to day ticket watchers', and it is their work of buying and selling, selling and buying, which makes the market move so actively²⁹. They do not make any study or analysis of the shares they want to buy. At most they study the trend of price movements and market sentiment, and sometimes they base their decisions to buy on 'rumours' whispered in the market³⁰. In this research, the present writer shall call this group 'speculators'. The real investors can easily liquidate their shares into cash at any time they want as this group of speculators will always be there, although the price may not be to their advantage.

The above situations would be more clearly seen in sophisticated business dealings such as in the stock and commodity market and in the business of foreign exchange. In fact, Aubrey suggested that beginners and ordinary people in a stock market, should divide their available capital for the venture into three different uses. The first third should be channelled to what he termed as 'permanent investment' for a guaranteed return at the rate prescribed. The second allocation might be used in 'permanent speculation' which refers to stocks where an increase in value is certain within the reasonable time stipulated. The last portion could be properly and

²⁸ 'Rational speculation' is something beneficial to the development of the future economy of a country as it will generate capital accumulation at a national level, because everybody's investment is based on the achievement of a company. In contrast, 'blind speculation' would lead to the existence of unwanted elements in the world of share markets such as the element of gambling, uncontrollable uncertainty and hoarding of ownership, as well as power abuse by certain vested interest leaders. Man, Z., "Management System of Islamic Share Market...", Op. Cit., pp. 18-20. See also Hussin Salamon, "The Speculative activities in the Stock Exchange from the Islamic Perspective", Op. Cit., pp. 9-16.

²⁹ Samuelson, Paul A., *Economics; An Introductory Analysis*, Op. Cit., pp. 428-9. See also Khan, M.A., *Issues in Islamic Economics*, Op. Cit., p. 87.

³⁰ Man, Z., "Share and Investment in Share Market...", Op. Cit., pp. 22-24

advantageously used for speculative activities which he termed as 'temporary operations', that may give small but instant profit³¹.

The main purpose for dividing the capital into these three categories is to ensure that their limited capital is being protected and invested in a safe manner. This is because all these operations encounter different levels of risks. However the reality of the situation appears in any stock market is that the second group seem to be more dominant than the first in modern transactions in a stock market³². Hence, this is the situation of present transactions in a share market where the involvement of speculative judgement is used profusely.

6.3.2.3 High Frequency of Shares Transaction.

The rapid and quick movement of stocks and shares from one hand to another is a common feature in the world of the shares market. The 'pure' speculative activities demand that a player should hold the shares as short a time as possible. The more quickly and frequently they buy and sell, the more they gain the opportunity to make money, with one condition that their expectations and calculations about the trend of price movements are correct and accurate. This is what has been categorised by Aubrey as 'small profits and quick return'³³.

In this pure speculative activity, although the price movement might be very small, the frequent repetition of the process is the main factor in accumulating considerable

³¹. For detail discussion on the aspect of dividing available capital into three different categories, see Aubrey, W.H.S., *Stock Exchange Investment...*, Op. Cit., p. 44-5 while for the discussion of how the third portion could be used in 'temporary operations' in order to get quick and prompt profit see *Ibid.*, p. 111-5.

³² In the modern world, the great amount of shares transacted in a stock market are not free from the hands of speculators. They are the main and dominant group that are present at any stock exchange. They are the ones who make the market move very actively. Millions of dollars have been transacted daily in a stock exchange and the biggest contributors to the activeness of the market are the speculators. Refer Khan, M.A., *Issues in Islamic Economics*, Op. Cit., pp. 87-8.

³³ Aubrey, W.H.S., *Stock Exchange Investment...*, Op. Cit., p. 112

gain for the speculator. This could be done successfully after careful choice of stock has been correctly chosen and the correct movements of price and the surrounding environment are advantageously used. Hence to buy promptly when the prices are cheap, to sell quickly when the prices are falling and to go on repeating the process *ad infinitum* is the secret of success³⁴.

There are no rules for guidance in this type of business. It is based on the conditions of the hour, relative circumstances, temperament and the courage of the operators, the state of the market and experience and correct judgement based on common sense as well as on attentive assessment and analysis of the market. Thus, it is said that "it is safe to advise flying a kite with a short line so that it may be easily and quickly drawn in"³⁵.

6.3.2.4 Quick Small Profit.

Therefore, in connection to the above, a philosophy that successful speculators should be aware of and practice in contemporary share market trading, is the philosophy of 'let us make profit all the time and as frequently as possible, even though this is not a big profit, rather than making a big profit only once in a while'³⁶. Hence, this philosophy would encourage the speculators to be active all the time, buying and selling. They will sell anything available from their possessions as well as 'borrowing' certificates of securities from others, in order to materialise an expected profit from an anticipated price movement. As mentioned earlier in this chapter, this is done not only in situations where the prices of shares are moving upwards but also when prices are falling down as in the case for example of 'bearish' position.

³⁴ Ibid., p. 114.

³⁵ Ibid., p. 112.

³⁶ Ibid., p. 111

6.3.2.5 Aiming to Achieve Capital Profit.

The other nature of speculation is the kind of profit that people acquire from the 'business'. Whether in the case of 'rational speculation' or 'blind speculation', the profit gained is from the price difference of the shares between the time of buying and selling and that is termed the capital profit. A speculator would not concern on dividend, the business profit gained by the company in which he/she holds shares in. As long as the price of the shares move from one point to another and signals profit to them, they will sell without any delay. To gain profit from the price movement is their main intention and any profit gained from business activity is just a bonus for them. This is more apparent in the case of the 'blind speculator' whose sole purpose is to buy and sell shares in order to gain profit from the fluctuations in price, without any prior intention of making any investment³⁷.

The profit gained from such activity is called 'capital profit' and is in contrast to the profit intended by a real investor which is 'business profit' or dividend. While real investors participate in the real business undertaken by a company in which they have invested their capital, the participation of speculators is only in a capital market to make the market more active and the shares liquidate. Therefore, it is said that "a speculator seeks to gain exclusively from price differences, buying and selling something he/she cannot consume or use in his/her business, upon which he/she performs no work, and to which he adds no value"³⁸.

³⁷ This activity of speculating which is termed by Rix as 'simple speculation' is done with greater judgement, in the choices of stocks and shares as well as in forecasting the direction of the price movement. However, it is only forecasting the price movement based on the trend and sentiment of share prices in the market of that particular time. In some cases, speculators also exercise their ability to predict by how much the price will move. Refer Rix, M.S., *Stock Market Economics*, Op. Cit., p. 208.

³⁸ *Ibid.*, p. 204.

6.3.2.6 Spending the Profit Elsewhere.

As has been mentioned above the profit attained by speculators is called 'capital profit' and usually they intend to withdraw this profit from the market with the intention to spend it in other places. This is another prevailing nature of speculation. Hence, with regards to this understanding and interpretation Rix's opinion that whoever buys and exchanges one security for another with the purpose of holding more quality security, would fall out of the definition and scope of the word³⁹.

6.3.2.7 Association with Other Malpractices.

Another very important feature of speculation worth noting here is that the existence of speculation is always related to the other mal-practices existing in the world of securities and the commodities markets, as well as in the foreign exchange. Whenever someone discusses speculation in those markets, it is not possible to avoid discussing the negative elements of speculation, especially the element of gambling. This is so since the word 'speculation' does not equate with the word 'investment' in the business world. Consequently, the question of 'unearned income' for the speculators would obviously emerge.

The question of power manipulation is also a related issue to the word, because to speculate or calculate something uncertain in the future needs to be based on something. Hence, speculators, especially 'blind speculators' will usually make use of everything available even 'untrue factors' or 'rumours', in order to make their

³⁹ Ibid., p. 204. However, in the present writer's opinion, by excluding this group of people from being categorised as speculators, it would mean that the number of speculators would be very limited in any given stock market. This is because to exchange their holding from one security to another one of more quality and which is a more profitable one for re-selling, would be their main activity. Obviously, they would not cash their securities to spend them elsewhere as long as the market promised a good profit for them. They would only do this if the market was not suitable anymore for their task of speculating. Even a real investor would opt to cash their securities whenever the market was no longer a conducive place for investing their money.

judgement of whether to buy or not to buy company shares⁴⁰. These aspects of malpractice will be dealt with in greater detail in the forth coming chapter whereby the position of Islam will also be explained.

6.3.3 The Functions of Speculation in Economy.

There are a few functions that are undertaken by speculation and speculative judgement in the world of economics. The emergence of a speculative class as early as the 1850's⁴¹ that was differentiated from the trading and producing body was something very significant in the economic world. This is because the class which was termed 'speculator' was always ready to take over any risk from the merchants by buying from them or by selling the commodity to them.

6.3.3.1 Risks Manoeuvre.

The complete transformation in trade that took place in the early 19th century demanded the existence of this class. The advancement of transportation and communication methods as well as technological achievement led to a drastic change in the market condition, from separated and independent local markets to a global market. While supply and demand in a local independent market would always play a prominent role as price regulators, which consequently lead to speculative judgement, it is not so in the new global market which needs more than supply and demand to make any speculative decision. Hence, to bear a speculative risk in the local market as part of their business, is something usual and manageable to the merchant.

⁴⁰ 'Blind speculators' would buy securities not based on an analysis of the companies real assets (on previous achievement as well as expected future achievement). Instead, their buying is usually based on 'untrue factors' and rumours that are circulated in the market. 'Untrue factors' here refer to a situation whereby they buy securities through a very close monitoring of the price movement and market sentiment, based on the current situation of the economics and politics of a country. However rumours that usually spread in the market are caused by 'insider information' as well as statements made by politicians or influential people in the stock exchange itself. All these malpractices exist in the modern transactions of a stock market.

⁴¹ Emery, H.C., *Speculation on the Stock and...*, Op. Cit., pp. 104-9.

However, when the market changes and the knowledge of local conditions is inadequate to pass a speculative judgement, the risk becomes unbearable to the merchant and producer. So a special class of people are needed who have a good knowledge of the world wide conditions of the commodity traded, as well as knowledge about other factors related to the newly changing world of commercial revolution. The need for the existence of this class was also important as the element of speculative judgement and risks became more important and distinguishable; this in turn gave a greater burden for the merchant to carry. Hence, the emergence of a distinct body as a risk taker was appropriate and was important in order to relieve the merchants of the speculative elements of their business⁴².

6.3.3.2 Price Fluctuation Moderator.

The other function of speculation is its role in stabilising, or more accurately moderating, the range of price fluctuations⁴³. The speculators will step in as buyers when the supplies of commodity are in abundance, hence moderating the price fall. While in the instance of demand over supply, they will act as sellers and plug the commodity into the market from their storage. This will accordingly prevent the price rise from becoming too high. This also implies that speculators in certain instances would help to even out the consumption of the crop between harvest times and provide ample amounts between the seasons. In other words, the work done by the speculator contributes towards a smooth distribution of supplies as relative to changing demand over time⁴⁴.

In addition to the above, the role of stabilising price fluctuation is not confined alone between two different time limits, but it also stabilises price differences occurring simultaneously in two different markets. The action of professional speculators,

⁴² Ibid., pp. 104-9.

⁴³ Kaldor, N., "Speculation and Economic Stability", Op. Cit., p. 1.

⁴⁴ Yamey, B.S., "Speculation and Price Stability: A Note" in *Journal of Political Economy*, n.p., April 1966, Vol. 74, p. 207.

described by Samuelson as those who patiently keep their eye on the market,⁴⁵ buy at the cheaper market and then sell it at the higher market to make profits for themselves. Consequently this could stabilise the price between the two distant markets.

This activity will at the same time contribute to the pattern of consumption of the product from places where they have a lower utility to places where utility is higher⁴⁶. Through the existence of middlemen,⁴⁷ acting as speculators, who dare to take over any risks that are usually faced by the actual producers, the price of the product is to some extent stabilized. This is especially obvious in the agricultural sector.

Regardless of the outcome of the discussion about the influence of profitable or even unprofitable speculation on price stability,⁴⁸ and of its level of influence, whether it

⁴⁵ Samuelson, P.A., *Economics: An Introductory Analysis*, Op. Cit., p. 423.

⁴⁶ Kaldor, N., "Speculation and Economics Stability", Op. Cit., p. 1.

⁴⁷ What the present writer meant by middlemen here is not referring to the term 'middlemen' that is usually used in economics. That usual term refers to those who buy things (goods or services) cheaply from the immediate producer and sell it then at a higher price in order to gain profit from the price difference. It actually refers to the stockists, who buy products in large amounts from the producers at the time of 'over production' or whenever the goods are available abundantly. This kind of middleman buys things for the purpose of selling them later (whether to the small retailers or by himself to sell directly to buyers)

⁴⁸ There are different opinions on the role of speculation as a stabilising factor in a market. Friedman argued that profitable speculation plays its role as a stabilising factor as is discussed above. Friedman, M., *Essays in Positive Economics*, Chicago, 1953, p. 175. However, Baumol gave his counter argument that it is not necessarily profitable speculation that acts as a stabilising factor. In certain conditions it could also be a destabilising factor in accelerating both upward and downward movements because speculative sales take place when prices are falling and purchases are made when prices have begun to rise. This counter argument was not suggesting that profitable speculation or even unprofitable speculation will never have any influence on price stabilisation. However, it stressed that this is not necessarily the case. It is only true in the case of *ceteris paribus*. See Baumol, William J., "Speculation, Profitability and Stability", Op. Cit., p. 263. Baumol's argument that speculation to a certain extent could also be a destabilising factor on price was supported by a research finding by Aliber. Aliber concluded that profitable speculation can be destabilising because in his survey he found that speculative transactions more frequently amplified than dampened the

fully or partially affects the price stability, it is universally agreed that speculation to a certain extent contributes towards price stability. Hence, the conclusion arrived at by Kaldor that speculation does simultaneously exert a price stabilisation as well as a destabilisation influence, is a way of reconciliation between those two different opinions on the subject matter⁴⁹.

6.3.3.3 Income Stability.

As pointed out by Kaldor, speculative activity could also have an effect on income stability, and synonymously could increase investment which indicates an improvement in the general level of economic activity. However, this is so in the case of 'income-goods' as termed by him and not in the case of 'capital-goods'. The larger the amount spent on 'income-goods', the lesser the amount left for other goods which are here referred to as speculative stock, since the money spent is taken from the total income received. Hence, the amount left for other purposes is being reduced due to this acquisition. This argument is put forward however, with the assumption that the level of income is stagnant or unchanged and the entire amount of an individual's income is thoroughly spent⁵⁰.

6.3.3.4 Activator of Market Operation.

Another important function of speculation which is stated by economists is its role in making the market work and continuing function. It is a clear fact that the existence of speculators making speculative judgements leads the market to continue operating. Regardless of whether the speculator is making profit or incurring losses in their market comprehension of the price movement, their active participation in the business liquidates the market. It is not surprising therefore, that some economists

range of movement in spot prices. See Aliber, R.Z., "Speculation and Price Stability; Once Again", in *Journal of Political Economy*, Vol. 72, n.p., 1964, pp. 607-9.

⁴⁹ For further detail regarding the discussion and reconciliatory views of the subject, refer Kaldor, "Speculation and Economic Stability", *Op. Cit.*, p. 10.

⁵⁰ *Ibid.*, pp. 17-24.

believe that without the presence of the speculator, future markets could not function⁵¹.

These are some of the functions carried out by speculators in their capacity of making speculative judgements in the world of business. Although it seems to us that speculation has been playing an important function in economics, it does not imply that speculation and the speculators will continue doing favours for the economy at all times and in all conditions. In fact Rix made an important observation concerning the influence of speculation and speculators on the stock exchange, when he said, "investors are much more useful to speculators than speculators are to investors, and the stock exchange would not necessarily be any less effective if there was no speculation at all"⁵².

The above statement is something not to be taken lightly, as speculation has sometimes sent the economic condition of a country into a chaotic, unstable and even a volatile down situation. Once this happens, it can take a very long time for the economy to be restored, due to the fact that public confidence in that country as well as international confidence would be affected.

In the following discussion, the focus will be on the negative consequences of speculation. Its connection with financial and economics crashes will be dealt with first. Then examples of a few financial crises which took place before the World Great Depression of the 1930s will be elucidated. However, this chronological illustration will select only some big crises after the 18th century because the crises before that time lack monetary features⁵³.

Accordingly, after the above illustration, the discussion will focus more deeply on the role of speculation in financial crises. For this purpose, the crash of the New York Stock Exchange in 1929 will specifically be referred to because it was the world's

⁵¹ Teweles, R.J. (et al.), *The Commodity Futures Game...*, Op. Cit., p. 4.

⁵² Rix, M.S., *Stock Market Economics*, Op. Cit., p. 212.

⁵³ Kindleberger, Charles P., *Manias, Panics, and Crashes...*, Op. Cit., p. 6.

greatest economic crash. This discussion shall conclude this chapter. However, further discussion on the role of speculation and its negative consequence in economics, will be done in the next chapter. The chapter will focus on the present currency crisis and the stock market down fall in the region of South East Asia where a special attention will be given to the situation in Malaysia. By then, the discussion hope to outline the position of speculation and speculative transaction in the economy.

6.4 The Negative Consequence of Speculation.

The contribution of speculative transaction to the financial crisis of a country as well as the economics of the world is something that should not be forgotten. There have been many financial crises that have taken place throughout the history of financial economics. The history of the financial crises of Western Europe, goes back as far as the 16th century in 1522 and 1557⁵⁴. However, as the financial crises that took place before the 18th century had a lack of monetary features, which were only developed after the development of the banking system in the 18th century, the discussion on speculation and its relation with financial crashes usually starts from the 18th century⁵⁵.

There were many financial crises which took place between the 18th century and the 20th century. Amidst the early 19th century (1825) until the early 20th century (the World Great Depression-1929), there were at least 13 financial crises⁵⁶. Some of the crises did not adversely affect the economy of that particular country. However, undeniably, some of the financial crises had tremendous economic consequences, not only for the particular country involved but, unfortunately, also affected the economics of the world as a whole. This shows how remarkably strong it was and how it was due to the influence of speculative transactions in the financial markets.

⁵⁴ Kindleberger, Charles P., *A Financial History of...*, Op. Cit., p. 13.

⁵⁵ Kindleberger, Charles P., *Manias, Panics, and Crashes...*, Op. Cit., p. 6.

⁵⁶ See "Business Cycles" in *The New Encyclopædia Britannica*, Macropædia Vol. 3, Op. Cit., p. 537.

Regardless of whether they possess good skills of analysis and forecasting abilities, or whether they purely gamble their available money⁶¹ they continue as long as profit is still pouring in. This attractive economic attainment encourages many more 'alien' participants; (those who do not know enough about the business of stock exchange), to enjoy the 'sudden economic prosperity'. However, when panic comes and is followed by the crash, the chaos of the market becomes on many occasions, uncontrollable. For example, in the New York Stock Exchange crashes on 'Black Thursday', almost 13 million shares were transacted in this single day, and this was followed by a second crash, namely 'Black Tuesday' during which the shares transacted were more than 16 million. More disastrously, there were some stocks that became virtually unsaleable at any price⁶².

Regrettably, those who suffered the greatest financial loss of the Wall Street crashes were incurred by small investors and unprofessional speculators who had been allured into participating in the market without adequate resources to cover their marginal losses and with inadequate means for acquiring up-to-date information about the progression of the market⁶³. Chapra in his writings contended that no 'insider' knowledge, no forecasting capability and being carried away by rumours and impulses⁶⁴ were among the reasons for the downfall of small investors and unprofessional speculators.

6.5.1 Financial Crises and Speculation in History.

As I have already stated above, the series of financial crises started before the 18th century. In the early 17th century in the year 1636, there was Lubeck's financial crisis. While in 1636-7, the financial crisis re-occurred, (which they called

⁶¹ At the time people just 'invested' whatever amount of money available in their possession. They did not concern themselves any more on the theory of investment, that one should invest whenever there is surplus income in their hand.

⁶² Rees, G., *The Great Slump...*, Op. Cit., p. 48. See also Kindleberger C.P., *The World in Depression 1929-39*, London, Allen Lane Penguin Books Ltd., 1977, p. 118.

⁶³ Rees, G., *The Great Slump...*, Op. Cit., pp. 50-1.

⁶⁴ Chapra, M.U., *Towards A Just Monetary System*, Op. Cit., p. 97.

Regardless of whether they possess good skills of analysis and forecasting abilities, or whether they purely gamble their available money⁶¹ they continue as long as profit is still pouring in. This attractive economic attainment encourages many more 'alien' participants; (those who do not know enough about the business of stock exchange), to enjoy the 'sudden economic prosperity'. However, when panic comes and is followed by the crash, the chaos of the market becomes on many occasions, uncontrollable. For example, in the New York Stock Exchange crashes on 'Black Thursday', almost 13 million shares were transacted in this single day, and this was followed by a second crash, namely 'Black Tuesday' during which the shares transacted were more than 16 million. More disastrously, there were some stocks that became virtually unsaleable at any price⁶².

Regrettably, those who suffered the greatest financial loss of the Wall Street crashes were incurred by small investors and unprofessional speculators who had been allured into participating in the market without adequate resources to cover their marginal losses and with inadequate means for acquiring up-to-date information about the progression of the market⁶³. Chapra in his writings contended that no 'insider' knowledge, no forecasting capability and being carried away by rumours and impulses⁶⁴ were among the reasons for the downfall of small investors and unprofessional speculators.

6.5.1 Financial Crises and Speculation in History.

As I have already stated above, the series of financial crises started before the 18th century. In the early 17th century in the year 1636, there was Lubeck's financial crisis. While in 1636-7, the financial crisis re-occurred, (which they called

⁶¹ At the time people just 'invested' whatever amount of money available in their possession. They did not concern themselves any more on the theory of investment, that one should invest whenever there is surplus income in their hand.

⁶² Rees, G., *The Great Slump...*, Op. Cit., p. 48. See also Kindleberger C.P., *The World in Depression 1929-39*, London, Allen Lane Penguin Books Ltd., 1977, p. 118.

⁶³ Rees, G., *The Great Slump...*, Op. Cit., pp. 50-1.

⁶⁴ Chapra, M.U., *Towards A Just Monetary System*, Op. Cit., p. 97.

'Tulipmania'). This crisis which is considered to be the first 'bubble' and during it the price of a single tulip bulb rose as high as £20,000⁶⁵.

The above two manias, although having the lack of monetary characteristics which did not appear before the introduction of the banking system in the early 18th century, the crises did give adequate evidence regarding the contribution of speculative transactions. In both cases the word mania is purposely used to show the craziness of the society on speculative excess. Revulsion from these situations leads to panic, crash, and crisis⁶⁶. This shows and implies directly the contribution of speculation in the economic crises. Furthermore, prior to the crisis, all kinds of sophisticated transactions which actually create a conducive environment for speculative activity are being introduced, such as short selling, puts and calls, future trading and option⁶⁷.

The development of the Mississippi Bubble in Paris in 1719-20 is said to have originated from the same and common cause, that is speculative euphoria⁶⁸. The crisis was followed by the South Sea Bubble in London in 1720. Both crises are considered to be among the significant financial crises that occurred. In describing the occasion shortly before the crisis occurred, Warren wrote⁶⁹,

"In a very short space of time the fever for speculation infused itself into the blood of the whole nation".

"Everybody who had money to invest was interested in this gigantic gamble".

"The period was one of mad speculation".

The tragedy of the South Sea Bubble as demonstrated by Walpole is merely due to gambling, and through this it made people rich in a very short time. However it was a

⁶⁵ Kindleberger, C.P., *The Financial History of...*, Op. Cit., p. 215.

⁶⁶ See Kindleberger, Charles P., *Manias, Panics, and Crashes...*, Op. Cit., p. 4.

⁶⁷ Kindleberger, C.P., *A Financial History of...*, Op. Cit., p. 215.

⁶⁸ Kindleberger, C.P., *Keynesianism vs. Monetarism and Other Essays in Financial History*, London, George Allen & Unwin, 1985, p. 226.

⁶⁹ Warren, H., *The Story of the Bank of England (2nd Ed.)*, London, R.A. Everett & Sons, p. 178.

temporary success based purely on the price movement of the South Sea Company's shares, which moved from a lower level to the highest ever, shortly before the crash. Billions of pounds of capital that belonged to the society were taken away wastefully into the hands of some speculators. Suicide was a daily occurrence during the time of this British national disaster.

In Britain, after the South Sea Bubble that swept away millions of the society's capital, the other crisis closely related to the mania of transaction of a speculative nature, was the Railway Mania in 1847. The railway development in Britain as well as abroad attracted many real investors to rationally participate in the project between 1830-35 through investing their capital. Definitely, it was not one of the bubbles in the first stages of its development. The investment of the British alone in French railroads at the time amounted to a staggering figure of 25 million pounds⁷⁰.

The atmosphere of sober and rational investment did not survive very long. As correctly pointed out by Kindleberger previously, the second stage will always appear in the development of any mania. After 1835, as the prosperity of the railroads escalated, everyone from society who was 'taken by storm' participated in buying railway shares which consequently turned the share market into an atmosphere of financial insanity. As illustrated by Matthews⁷¹, the mania attracted individual from all walks of life including ladies, clergymen, widows, spinsters, retired navalmen, army officers, magistrates, charitable institutions, theologians and orphans.

One important point that is worth mentioning here is that the price of capital during the time of 1844-45 was very cheap. This eventually lead to the hyperbolising of the existing market of the time, which had already been saturated. As the price of capital only cost borrowers 2.5 percent which was affordable by everyone, it provided a good chance for every individual to participate in the game of speculative transaction.

⁷⁰ Kindleberger, C.P., *A Financial History of...*, Op. Cit., p. 221.

⁷¹ Matthews R.C.O., *A Study in Trade-Cycle History: Economic Fluctuations in Great Britain 1832-42*, as quoted by Kindleberger, C.P., in *Manias, Panics, and Crashes...*, Op. Cit., p. 31.

Consequently, the railway boom attained its zenith in 1845 and unexpectedly all of sudden, it plunged rapidly to the bottom⁷². In the words of Warren⁷³;

"England was in the hands of the surveyor, and the boom began in real earnest. As usual, everybody was to become immensely rich and as usual, most people were again bitterly disappointed..."

"Hope, after a very little while, drives out of the memory of human beings the nightmare of disaster; so in an astonishingly short space of time, they are gambling again".

However, when the disaster struck, everybody ran to the banks to have money on credit and the banks were not able to fulfil the sudden demand for money from everybody. The situation in the banks was extremely chaotic and some of the banks even closed their doors, while The Bank of England at first refused to advance against securities⁷⁴. As usual, when the chaotic situation prevailed, it indicated that things were on the edge of crisis.

In the above few examples of the past financial crises, it is clear that the crises always advanced in two stages, as stated in the early part of this discussion. In fact, the advancement of these two stages in speculative related financial crises was obvious and indisputable. In the following, attention will be focused on the New York Stock Exchange crashes which consequently led to the World Great Depression of 1930s, which gained control of economic prosperity in the early 1920s.

⁷² Morgan, E.V., *The Theory and Practice of Central Banking 1797-1913* (2nd Ed.), London, Frank Cass & Co. Ltd., 1965, p. 147.

⁷³ Warren, H., *The Story of the Bank of England*, Op. Cit., pp. 33-4.

⁷⁴ *Ibid.*, pp. 35-6. See also Morgan, E.V., *The Theory and Practice of...*, Op. Cit., pp. 147-53.

6.5.2 Speculation and the New York Stock Exchange Crash.

The World Great Depression judging by almost all economic indicators was the worst and the most severe of all economic depressions and crises⁷⁵. Moreover, it was not only the worst crisis, but also among the longest depression, which lasted from 1929 to 1939. Meanwhile, the affected countries were not only restricted to the manufacturing countries, the centre of the depression, but the crisis spread all over the world, including those countries whose income was mainly based on natural resources and agricultural products.

Indeed the above tragic financial crisis was followed by an economic depression that swept the whole of Europe was devastating. In other words, the economic depression that had been experienced by the whole world was very severe, and its severity was incomparable to any other economic disaster that occurred before or after the World Great Depression.

6.5.2.1 Prosperity on the Edge of Crash.

After the first World War, the United States emerged as a new economic power of the world. The prosperity that was achieved by the United States was staggering and had not been achieved by any nation or country before. Its economic stability was apparent, profits were very high, the cost of production was immutable, the capacity for industry was in surplus, the level of wages was soaring and stable, and the savings were plentiful.

The economic prosperity of the United States was said to depend on two major factors that were prevailing, i.e. mass production and hire purchase, which enabled Americans to live prosperously. This is so because mass production reduces the cost and increases the income and hence, more people are capable of owning more and

⁷⁵ Fearon, P., *The Origins and Nature of the Great Slump 1929-32*, London, The Macmillan Press Ltd., 1979, p. 9.

more products, especially with the introduction of hire purchase selling. Consequently, workers were able to own cars and other household items of luxury.

It is worth summing up the above prosperity achieved, by quoting a few speeches delivered by politicians in their election campaign of 1928. The Republican slogan in the election campaign was "a car in every garage and a chicken in every pot"⁷⁶ which shows that the life styles of the Americans were no longer struggling to attain basic needs or even comfortable needs, but rather needs of having a luxurious lifestyle. While Hoover, a candidate for the Presidential post was quoted as saying⁷⁷,

"We in America today are nearer to the final triumph over poverty than ever before in the history of any land. The poorhouse is vanishing from among us".

"By our energies in invention and enterprise we have raised our per capita productivity to levels never hitherto known in the world".

6.5.2.2 The Stock Market's Prosperity.

The New York Stock Exchange that had been established on July 17th, 1792 had developed as the strongest and most predominant financial centre of that time⁷⁸. The New York Stock Exchange became more important in the second quarter of 1928 which led to the cut-off of long term lending by the United States to Europe and other comparatively poor countries. This step was taken to increase financial availability to finance the sudden boom of the New York Stock Exchange, more precisely to finance the speculative activity of the market.

The above situation was correctly pointed out by an economist⁷⁹. He states that the danger that existed in the market was neither embodied by the large amount of daily transaction of shares, nor by the level and frequent change of share prices, but it was

⁷⁶ Yass, M., *The Great Depression*, Op. Cit., p. 12.

⁷⁷ *Ibid.*, p. 11.

⁷⁸ Rees, G., *The Great Slump...*, Op. Cit., p. 11.

⁷⁹ Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit., pp. 108-9.

mainly due to the precarious credit mechanism which supported and fed the speculative activity. The loans given to brokers for their speculative activities increased every year from only 2.1 billion dollars in 1926 to nearly 7 billion dollars immediately before the crash, and almost 3 billion of it came directly from the banks⁸⁰. Hence, the collapse of the New York Stock Exchange was being invited.

The New York Stock Exchange boom was an exceptional period in the history of financial advancement. Although the incredulous achievement of the New York Stock Exchange has been said to be a closely related factor of the economic strength and financial system of the United States, the significant factor that led to the "immediate economic prosperity" of the New York Stock Exchange was actually speculation⁸¹. This drastic affluence was incomparable with the previously discussed, South Sea Bubble, since the attractive game of speculative transaction infused the mass movement of American people to participate in the game. In the words of Baruch "a classic example of the madness of crowds"⁸².

In the above situation it would be more illustrating to seek explanation about the madness of the masses through the movement and participation of the crowds in the game of speculative transactions of the New York Stock Exchange. As the irrational element cropped up and contaminated the transactions of the New York Stock Exchange, the market lost its grip on reality and speculative mania began to get the upper hand over the usual rationality of society. Hence, the downfall of the market was already predetermined.

⁸⁰ Rees, G., *The Great Slump...*, Op. Cit., pp. 25-6.

⁸¹ *Ibid.*, p. 16.

⁸² His full name is Barney Baruch, a famous traditional speculator of the New York Stock Exchange, He formerly worked as an office boy. As the game of speculative transaction was affecting in the New York Stock Exchange, he participated and turned himself into a famous and respected traditional speculator on Wall Street. He then became the friend and adviser to three presidents of the United States. See Rees, G., *The Great Slump...*, Op. Cit., pp. 14-6.

6.5.2.3 Speculative Mania.

When speculative mania overshadowed the previously rational transaction of the market, everybody, as had been demonstrated in previous crashes, would rush to catch the market in order to get rich quickly. Americans, regardless of their class in society, held stock on margin during the spectacular summer of 1929. More than a million people speculated in the market, especially on stock trading on margin⁸³. Rees, in illustrating the number of participants of stock trading on margin said, "There seems to be no way of computing"⁸⁴. It does not matter whether they analysed or not, they miraculously won, so long as they got their surplus money into the market.

In the above fabulous period of the New York Stock Exchange, no one lost what the winners gained. Everybody in the market got his/her share of the instant prosperity. However, no one seemed to be aware that the instant abundance of profit that they were calculating, and that the prosperity that they were undergoing was all restricted to and attributed to paper terms only. If everyone intended to liquidate those profits into cash, they would have been frustratedly evanesced⁸⁵. In this situation of speculative mania, the bubble had to burst eventually.

6.5.2.4 Panics and Crash.

The panic situation and the crash of the New York Stock Exchange had taken place on two different days, which were known as 'Black Thursday' and 'Black Tuesday', towards the end of October of 1929⁸⁶, though the real starting point for the decline of the stock prices was earlier in the month. The value of shares started devaluate steadily until the 24th of October 1929, which they called 'Black Thursday'. This is when the New York Stock Exchange crash first occurred and everyone was unfavourably, caught out.

⁸³ Ibid., p. 25.

⁸⁴ Yass, M., *The Great Depression*, Op. Cit., p. 21.

⁸⁵ Samuelson, Paul A., *Economics; An Introductory Analysis*, Op. Cit., p. 426.

⁸⁶ Kindleberger, C.P., *A Financial History of...*, Op. Cit., p. 336.

Many efforts had been undertaken by leading bankers, financiers and the Federal Reserve Bank of New York to stop the further decline of the stock prices. Even the Federal Reserve Bank was violating its standing orders from the Open-Market Committee⁸⁷ through a 'big buy' of securities, far beyond the prescribed limits, which was 25 million dollars a week. The Federal Reserve Bank spent 160 million dollars to buy securities during the first buying in the last week of October and another purchase worth 370 million dollars in the following month.

In spite of every step that had been executed, the panic situation did not cease and the share price downfall continued undesirably. On the 26th of October, president Hoover made assurances published in the New York Herald Tribune, saying, "the stock market held up like a stone wall yesterday". This statement of assurance was followed and supported by the press which commented that "there was nothing in the country's fundamental business conditions to cause uneasiness". However, the price of shares continued to fall during the following few days.

Accordingly, as the situation worsened, the second crash of the New York Stock Exchange, which was worse than the first, eventuated unrestrainedly on the 29th, October 1929. This crash was more famously known as 'Black Tuesday'. In the first crash the 'Black Thursday' the amount of shares transacted during that particular day was almost 13 million shares, a record by then. However the second crash of 'Black Tuesday' saw a record of more than 16 million shares transacted⁸⁸. The volume transacted reflected uncontrollable panic and chaos had taken place in the market.

After the tragedy of 'Black Tuesday', the market continued to fall until it reached the lowest in history, in 1932⁸⁹. During this tumultuous period, in the words of Samuelson⁹⁰,

⁸⁷ Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit., pp. 118-9.

⁸⁸ *Ibid.*, p. 118.

⁸⁹ Samuelson, Paul A., *Economics; An Introductory Analysis*, Op. Cit., p. 427.

⁹⁰ *Ibid.*, p. 427.

"Billions of dollars of securities values were wiped out every month, taking with them not only the capital of gamblers out of speculative gains, but also the widows' mite supposedly invested for steady income. A 'blue chip' stock like United States Steel fell from a high of 261 in 1929 to a low of 21 in 1932, while less respectable securities dropped off the Board completely".

The economy of the United States during this time passed through a very real horror of a financial crisis and crash. It affected not only the speculators and gamblers, but senselessly it also troubled millions of genuine small investors in the years between 1929-33⁹¹.

6.5.2.5 Speculation Precedes the Crash.

The above discussion especially on the edge of the New York Stock Exchange crash, undoubtedly shows everyone the direct role played by speculation and speculative transactions in the market. Hence, the contribution of the game of speculative transaction in the collapse of the market, was beyond doubt of prime importance. The irrational element and the infection of speculative mania was rampant at the time of the boom between 1925-28, and in the first three quarters of the year 1929. When speculative mania overpowered the American's sanity, they were forgetting the collapse of Florida's land booms that had taken place at almost the same time, between 1926-29, which had seen the disappearance of 31 banks in the year of 1928, and 57 in 1929 in Florida⁹².

During the roaring twenties, the income in the United States soared, which subsequently increased the ability of citizen spending. Most of the spending was poured into the stock market and regrettably, was based on the gamble relating to speculative transactions. Some of the people purely participated in the market without any knowledge or skill in forecasting. Hence, they were participating in the market as

⁹¹ Coakley, J., *The City of Capital*, Op. Cit., p. 69.

⁹² Rees, G., *The Great Slump...*, Op. Cit., pp. 13-25.

gamblers did in any casino based purely on gamble and luck. Furthermore, their participation was primarily motivated by that short period of economic prosperity whereby anybody could participate and could win easily. Consequently, the dangers of speculative excesses that ruined their predecessors was again weaving the crash.

Unfortunately, those who had knowledge of the previous speculative manias did not appreciate it, as they unduly participated in the game of speculative transaction with two beliefs in their hearts; firstly, that profit was certain to be acquired from the market and secondly, that the previous incidents of financial crashes due to speculative excessiveness were inapplicable to the United States⁹³. This wild and unrestrained optimism among the public, as well as among the political leaders of the country encouraged more enthusiasts into the market⁹⁴. Even after 'Black Thursday' of the 24th October 1929, the first crash of the New York Stock Exchange, President Hoover did not acknowledge the situation, instead he gave assurances to the public that the country's economics and business remained strong and nothing should trigger uneasiness among the public⁹⁵.

As mentioned before, stock trading on margin was so rampant during the boom period of the New York Stock Exchange. Trading on margin allowed the speculators to hold securities with only part of the payment paid and the rest considered as a margin account which was handled by the brokers. If the price of shares went up, the speculators who traded on margin would get a large profit and vice versa. If the share prices went down, they would top up their loss capital, which was also a larger amount compared to those who did not sell on margin. This type of sale is greatly speculative in nature, as the reason for indulging in this kind of trading is for larger profit by speculating on an increase in share prices. Moreover, margin selling especially encourages speculators with small capital to speculate and buy shares far beyond their capability, through the help of brokers.

⁹³ Yass, M., *The Great Depression*, Op. Cit., p. 14.

⁹⁴ *Ibid.*, pp. 13-25.

⁹⁵ *Ibid.*, p. 25.

Ironically, in circumstances where the price of shares decreases continuously, speculators are forced to sell out their margin stock holding. The reason for this is due to them no longer being able to cover their margin account on the depreciating value of their securities in the hands of the brokers. This was the actual event that took place during the crash of the New York Stock Exchange on 'Black Thursday' and 'Black Tuesday' in October 1929. The failure to cover their margin accounts caused the brokers to sell the securities at whatever price that was available in the market. These circumstances caused the market to crumble down even further. Since the real investors lost one-third of their capital at the end of 1929 which then fell further down to one-sixth by 1932⁹⁶, what would be the loss of speculators who indulged in selling stock margin? This is in fact the undesirable consequence which had to be faced in the game of speculative transaction of selling stock on margin.

One important factor that initiated and fuelled the game of speculative transaction which led to the market crash was the excessively easy availability of loans for speculative purposes. The danger inherent in this credit mechanism was only understood by a few bankers and financiers. They believed that the brokers' loans, that were feeding the game of speculative transaction of the market, should have been curbed. A suggestion was made by the President of the Federal Reserve Bank of New York, to increase the discount rate from 5 to 6 per cent in order to slow the flow of loans into the speculative market. This suggestion was rejected by the Board of Governors. Finally it was permitted on 9th August 1929⁹⁷ when the crash was already looming on the edge.

Unfortunately, some of the bankers in New York were directly involved in giving loans to the customers. These steps actually fuelled the speculative transaction game that was already burning in the market. Many more 'aliens'⁹⁸ from the public participated in the market, as there was easy availability of capital funds from the

⁹⁶ Samuelson, Paul A., *Economics; An Introduction Analysis*, Op. Cit., p. 427.

⁹⁷ Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit., pp. 109-13.

⁹⁸ What the present writer meant by 'alien' here is referring to a new participant in the game of speculative transaction or a totally new face which was 'forced' to participate in the attractive profit being promised by the market.

bank. This was the danger of easy availability of credit for financing speculative activity in this particular period, and in the other previous financial crises. Market attractiveness and easy borrowing brought to the market participants who never ordinarily entered the market, and who did not really understand the existence of risks in the market they were enthusiastically seizing⁹⁹.

However, the real fact was that, the bankers were unable to resist the available profit from the market which was offered to them. Being tempted, they borrowed from the Federal Reserve Bank at 5 per cent and passed it to the brokers at 10-12¹⁰⁰ per cent with an easy profit in hand. In the instance of the bull market,¹⁰¹ the bankers were easily acquiring their share of the profit due to the insanity of the market at 5 to 7 per cent. Understandably therefore, the brokers' loans kept increasing, starting from the early 1920s, and by October 1929, shortly before the crash, the total amount of brokers' loans was nearly 7 billion dollars¹⁰². As stated by Born, in the year 1929, the proportion of brokers' loans from the United States banks was more than 35 per cent¹⁰³. This evidence shows how the purchase of securities during the boom years had played a major role in the credit system of the United States' economy, even though the demand for it had turned into a game of speculative transaction.

One point worth mentioning here, is that there were also large amounts of brokers' loans, taken from US firms as well as from other countries which were feeding the game of speculative transaction. These loans contributed to the increasing number of participants in the already 'burning' market. The easy availability of funds to the brokers meant that there were chances for them to fully utilise the given facility in order to maximise their profit. Hence, they did not only participate in the bull market

⁹⁹ Rix, M.S., *Stock Market Economics*, Op. Cit., p. 216.

¹⁰⁰ Rees, G., *The Great Slump...*, Op. Cit., pp. 24-5.

¹⁰¹ Bull market refers to a situation whereby the speculators buy shares with the expectation of a price rise.

¹⁰² Rees, G., *The Great Slump...*, Op. Cit., p. 24.

¹⁰³ Born, Karl E., *International Banking in...*, Op. Cit., p. 250.

but also in the bear market¹⁰⁴. Clearly, speculative mania had the upper hand over the market through the availability of brokers' loans. In the words of Rees¹⁰⁵,

"In normal time this was simply a matter of convenience, but during 1928-29 the enormous rise in brokers' loans was one of the best indications of the growth of speculation".

The above discussions on the crash of the New York Stock Exchange disclose the role played by speculation and the game of speculative transaction. The easy credit policy that was prevailing during the time directed the bull market into unrestrained speculation. Furthermore, over-optimistic about the continuation of the bull market and The United States prosperity, not only among individuals in society but also among the United States leaders and bankers, led to the exaggeration of speculative transactions in the New York Stock Exchange. As correctly pointed out by Born,¹⁰⁶ excessive speculation in securities is among the major factors in the collapse of the New York Stock Market and consequently, the beginning of the World Great Depression.

6.6 Conclusion.

To conclude the discussion of this chapter, the prominent role played by speculation in the financial crashes and crises is manifested. This was more clearly evident in the crash of the New York Stock Exchange, where a detailed account of the role played by speculation and speculative transaction has been illustrated. Although there were many other financial crashes that occurred before and after the crash of the New York Stock Exchange, the discussion of the United States tragedy is taken to represent the others. It represents a classic example of speculative excessiveness which was stimulated by the over-optimism of the American leaders and bankers and the rampant and greed participation of the public. Apparently, the crash of the New York

¹⁰⁴ Bear markets refer to a stock exchange whereby the speculators sell their shares for a fall in price.

¹⁰⁵ Rees, G., *The Great Slump...*, Op. Cit., p. 24.

¹⁰⁶ See Born, Karl E., *International Banking in...*, Op. Cit., p. 256.

Stock Exchange was the starting point of the worst economic tragedy, the World Great Depression.

Convincingly, the role of speculation is prominent in the past financial crises of the world, and probably will also be in the future. As far as the question of regulating speculation is concerned, there were steps taken to ensure that speculative activity would not be allowed to go beyond a certain limit. At the end of the 19th century, several bills¹⁰⁷ were implemented in the United States, with the purpose of suppressing and clamping down on speculation. Whilst in Germany, an advanced step was taken to curb speculation through establishing an Imperial Commission to investigate all aspects related to speculation. Consequently, restrictive legislation was passed in 1896 which was to be implemented one year later, January 1897¹⁰⁸.

After the crash of the New York Stock Exchange of the United States which economists believed to be 'the home of the World Great Depression in the 1930s', the problem of speculation and speculative transaction in the stock market emerged as a sensational topic of discussion. To show the seriousness of the problem in the operation of a stock market, there were numerous regulations designed in the United States after the crash. Unfortunately, the law established did not curb the problem totally but only ensured that speculative activity was carried out more conscientiously and in a law abiding way.

Those are the negative effects consequences of speculation on an economy. Whenever it lays a finger on the market, its effect will be felt intensely, and to recover from such turmoil will take a long time. Hence, as far as the question of speculation is concerned, the tragedy of 'Black Thursday' and 'Black Tuesday' of the New York Stock Exchange crash served as a turning point for the monitoring of speculative excessiveness.

¹⁰⁷ Emery, H.C., *Speculation on the Stock and...*, Op. Cit., p. 7.

¹⁰⁸ *Ibid.*, p. 8.

CHAPTER 7
SPECULATION IN CURRENT ASIAN ECONOMICS
TURMOIL WITH SPECIAL REFERENCE TO MALAYSIA:
AN ANALYTICAL OBSERVATION.

7.1 Introduction.

The contribution of speculative activity during financial turmoil and crisis is clearly evident in the previous discussion. This research has proved that speculation is one of the important reasons for the World Great Depression in 1929. The crash of the New York Stock Exchange in October 1929 led to the collapse of the US economy which was the economic power of that time, which consequently affected the world's economy in 1929. The crisis was predominantly caused by the excessiveness of speculative activities in the New York stock Exchange, the breeding ground for speculation. The problem of speculation has recurred in the history of financial crises. As long as human does not learn from history, it will repeat itself in the present day modern economic life of human beings.

The above statement is distinctively evident in the current financial turmoil and economic crisis in the Far East, in which the badly affected areas are the countries in South East Asia, specifically Thailand, the Philippines, Indonesia and Malaysia. These countries, once considered to be among the 'Asian Tigers', are now facing the most grievous economic challenge of all time, with the value of their currency devaluing drastically and constantly. At the same time share values in their stock markets are plummeting continuously.

7.2 The Crisis Region.

The problem started with the downfall of the Baht, Thailand's currency, which devalued very rapidly. In the words of Serrill, "like a wounded satellite", the baht

dropped by more than 12 per cent of its value during a single day, July, 2, 1997¹. The problem then proliferated speedily to the neighbouring countries who were in the Association of South East Asia Nations (ASEAN), the Philippines, Indonesia and Malaysia. All these countries, except Malaysia sought help from the International Monetary Fund (IMF) in order to steer their devaluing currency back on to the right position. Malaysia on the other hand opted not to apply for support from the IMF but concentrated on its own well-planned strategies to check the problem. The IMF in its statement praised the Malaysian approach and strategy as comprehensive and proactive in handling the crisis².

However, the 'infection' has unexpectedly disseminated across the borders of the ASEAN countries. Countries with stronger and bigger markets are being infected by the current ASEAN financial turmoil. The well-known Asian power house countries such as Hong Kong, Taiwan, Japan and South Korea, are struggling to maintain their markets although the challenge facing them is not as severe as the one faced by the ASEAN.

7.3 The Crisis in Asia.

The economy of Hong Kong, which is considered among the strongest in Asia, faced an economic ordeal starting on the October, 23rd, 1997. This country with a foreign reserve of US\$88 billion, among the highest in the world³, was battling to protect its currency from being manipulated by speculators. Using its strong foreign reserve, the Hong Kong Central Bank dipped into Hong Kong's foreign exchange coffers to sell US dollars and support the currency. This measure was taken to prevent speculators who borrowed Hong Kong dollars and sold them for US dollars in the hope of re-buying the Hong Kong currency at a cheaper rate to make a profit⁴. Additionally,

¹ Serrill, M.S., "Catching the Asian Flu: The Sickness that put the Tigers in the Tank causes a big sneeze in the US Market", in *Time Magazine*, Vol. 150, No. 18, November, 1997.

² This statement was mentioned by the IMF Executive Director for ASEAN region, Zamani Ghani as quoted by *Berita Harian*. See "*IMF anggap pakej Malaysia proaktif*" (IMF reckons Malaysian package is proactive) in *Berita Harian*, Kuala Lumpur, April 29, 1998.

³ Khaidir A. M. and Mutazar A.G., "*Menjejak Dalang Spekulator Kewangan*" (Tracking Down the Financial Speculators) in *Berita Harian*, Kuala Lumpur, October 25, 1997.

⁴ "Questions and Answers about the Markets and Thursday's Scare" in *Nando Times*, October 23, 1997.

continuing the process, the interest rate was raised by the Hong Kong Central Bank, especially for short-term interbank loans, from 7 per cent to 150 per cent. At the same time the interest rate for overnight bank loans increased to as high as 300 per cent as a result of the Hong Kong Monetary Authority draining liquidity from the economy. This was followed by the rise of prime rate interest from 8.75 to 9.5 per cent⁵. All of these things were designed to head off the borrowing for speculative purposes which attacked the Hong Kong dollar⁶.

Although the implemented steps succeeded, the price paid was considerably big. This is because the interest rate hikes led to the worst down fall, the biggest drop in points in the market's history, of the Hang Seng Index of the Hong Kong Stock Exchange. The falls of 10.4 per cent on the first day of the crisis (October 23, 1997), followed by three days continuous unavertable falls, made altogether 16.4 per cent shaved off from the market, amounting to US\$42 billion⁷. The Hong Kong market has lost more than 40 per cent of its value since reaching its highest point of 16,673.27 on August 7, 1997⁸. Even though the Hong Kong market is regaining stability, it monitors closely any new development of its counterparts in the ASEAN because this could affect them. For example as a result of civil unrest and continuing clashes between the government and the people of Indonesia recently, Hang Seng's Index was affected and 126 points were shaved off from the market to a new low of 9,411.97⁹.

The crisis that took place in the Hong Kong Stock Market and which threatens their dollar, the only currency in Asia that is still pegged to the US dollar, is affecting not only the market of the neighbouring countries but also the international market, including New York, London, Paris, Tokyo and Australia¹⁰. This is because traders and investors all over the world have lost confidence in Hong Kong's market and currency, and in its immunity to the troubles annihilating its neighbours¹¹.

⁵ Serrill, M.S., "Catching the Asian Flu...", Op. Cit.

⁶ "China-ruled Hong Kong faces first financial crisis" in Associated Press (AP), Hong Kong, October 23, 1997.

⁷ Serrill, M.S., "Catching the Asian Flu...", Op. Cit.

⁸ "China-ruled Hong Kong faces first financial crisis", Op. Cit.

⁹ Coyle, Diane, "Fears over US rates unsettle exchanges" in *The Independent*, U.K., May 19, 1998.

¹⁰ "*Krisis Hong Kong belum reda*" (Hong Kong's crisis has not subsided) in *Berita Harian*, Editorial, Kuala Lumpur, October 25, 1997.

¹¹ "Questions and Answers...", Op. Cit.

The crisis in Taiwan¹², the country with foreign reserve of US\$100 billion¹³ was started by speculative transaction of Taiwan's Futures in the Singapore Monetary Exchange (Simex). Taiwan's Securities and Futures Commission (SFC) believed that Taiwan Stock Index Futures (Taiex) had been under pressure due to short selling on Simex. The pressure led to the Taiex gaining a record high of 5,815 points. The situation sparked panic selling among investors in Taiwan's Stock Market which caused the index to fall 4 per cent in 3 consecutive days from October 17th to 19th, 1997. Consequently, 2,800 points were shaved off the market, eliminating almost all of its stunning achievement earlier in the year.

Concurrently, the Taiwan currency dropped more than 4 per cent in the first day of the turmoil to NT\$29.50, its lowest level in 10 years. This was followed by another two days of currency devaluation, until it reached a new low of NT\$30.45 against the US dollar. Interestingly, the SFC and Taiwanese Authority have had the same idea as the Malaysian Prime Minister (PM) as regards the cause of the crisis. They are now investigating the direct involvement of the Soros Quantum Fund in the speculative activity that led to the hiccup in the Taiwanese economy¹⁴.

In Japan, the financial crisis led to the crash of some of its strongest banking systems. The collapse of the Yamaichi banking company, Japan's fourth biggest investment firm, and one of their largest banks, at the end of November 1997, could jeopardise the entire banking system in Japan¹⁵. Banks in Japan were already hit by a series of company bankruptcies caused by the sharp reduction of share values that they had heavily invested in. In the middle of November, Hokkaido Takushoku, the tenth largest bank in Japan crashed. As Japanese banks invested huge amounts in the UK and US stock markets, worth an estimated hundreds of billions of pounds, the crises

¹² For the illuminating description on the Taiwanese crisis refer to an article written by Cheesman, Bruce from Taipei entitled, "Taiwan blames Soros for panic selling of stocks" as appeared in the Msm-Net, October 22, 1997. This article was written a few days after the crisis that started on October 17, 1997. All the data mentioned were taken from this article.

¹³ "*Mengekang Spekulator Kewangan*" (Intercept Financial Speculators) in *Berita Harian*, Kuala Lumpur, October 28, 1997.

¹⁴ See Cheesman, B., "Taiwan blames Soros for panic selling of stocks", Op. Cit.

¹⁵ Husband, J., "Tokyo-yo Effect: Crash in Japan can make Britain's markets bounce", in *The Mirror*, UK, November 24, 97.

eventuated are expected to have a serious effect on the stock market of both of these countries¹⁶.

The above analysis should not be taken lightly as it has been manifested recently. After the collapse of the Yamaichi banking company in Japan, £16 billion worth of British shares were wiped out on November 24, 1997. This directly followed the collapse of the Japanese finance house in London, Yamaichi Securities. As announced by the company president, Shohei Nozawa, Yamaichi Securities would close owing £15 billion, and all of the 320 workers in the firm's London office would be among 7,500 world wide company workers to lose their jobs¹⁷.

One point worth noting is that Japan's economy is the second largest in the world after the USA and four times bigger than Britain's economy. It also holds large investment interests in, as well as imports a large amount of goods from Britain and America. As a result, an economist has stated that if Japan sneezes, Britain and America will catch Asian flu¹⁸.

In early April 1998, Japan's economic crisis became more severe when the value of their currency, the Yen, dropped as low as 135 to the US dollar, its lowest point for 7 years. This was the result of a few negative factors. Two of these were related directly to an economic analysis report which stated the loss of business confidence in Japan, which had reached its lowest position in 4 years, and the depreciation of Japanese currency¹⁹. The instability of Japan's economy worried other neighbouring countries, since should anything bad occur in Japan it could trigger multiple consequences in the countries with the least economic strength. This situation was clearly demonstrated during these recent events. The devaluation of the Yen has affected the already

¹⁶ Japanese banks possess a big holding in Britain's 100 largest companies listed in the London Stock Exchange and also in banks, insurance companies, defence and electronics businesses. While in the US, their holdings are mostly in shares and bonds. So if all these holdings were sold off, the effect to these two countries would be tremendously felt. See Ibid.

¹⁷ Reily, K., "Shares plunge £16 billion as Japanese firm Crashes", in *The Mirror*, UK, November 25, 1997.

¹⁸ Husband, J., "Tokyo-yo Effect...", Op. Cit.

¹⁹ "*Yen jatuh ke paras paling rendah*" (Yen fell to its lowest point) in *Berita Harian*, Kuala Lumpur, April 6, 1998.

devalued currency of Indonesia by 0.3 per cent, Thailand by 6.2 per cent, Malaysia by 5.9 per cent and affected the stability of the Hong Kong dollar²⁰.

The Japanese economy, according to their analysts, faced a real threat of deflation as a direct effect of the ASEAN and South Korean crises. Furthermore, Japan is already under pressure from economic deflation caused by price decreases of their productions, which has led to a reduction or even to a cessation of business. Consequently the unemployment rate has increased considerably. The deflation pressures have been made worse by the abundance of products from other Asian countries, which are much cheaper than theirs. Yuji Shimaka, Chief of the economic analysts at Sanwa Bank, predicted that the deflation to be faced would be the most grievous since the 2nd World War²¹.

South Korea, the Asian economic power next to Japan, has also been affected by the crisis in the region. South Korea is one of the countries beside Thailand, the Philippines and Indonesia, under the International Monetary Fund (IMF) bail out package. The country has had to slow down their economic progress plans because the crisis has hit many investment projects, both inside and outside the country, which have had to be cancelled. For example, the Daewoo Electronics Company of South Korea has cancelled its plan to build a US\$280 million electronic factory in Eastern France. The plan was supposed to have provided more than 700 job opportunities for the local people of Thoinville, where the unemployment rate is 11 per cent²².

7.4 The Crisis in ASEAN.

In the ASEAN, the speculators' activity on the currency started in Thailand where the baht was badly affected by the assault. The situation led to political chaos and instability, which consequently overthrew the existing Thai government, replaced it

²⁰ Ibid.

²¹ See "*Tekanan Deflasi ancam ekonomi Jepun*" (Deflation pressure threatens Japanese Economy) in Utusan Malaysia, Kuala Lumpur, March 9, 1998.

²² "*Barat turut rasai kegawatan ekonomi*" (The West are being affected by the Asian economic crisis) in Utusan Malaysia, Kuala Lumpur, February 2, 1998.

by a new one. The new Thai government had to seek IMF assistance in overcoming their economic problems and it received an IMF package of US\$17.2 billion²³.

However, according to some analysts, the package from IMF in August 1997²⁴, is a failure since capital is still flowing out from Thailand's markets continuously and steadily. The analysts listed a few reasons for the failure. Firstly, there is no confidence in the Thai government's capability of implementing the IMF policy for rehabilitation. Secondly, the Thai government have failed to give a strong assurance to foreign lenders and investors. Thirdly, the main target of the IMF package is an economic rehabilitation programme through reforming financial institutions, especially where the bad debts amounted to more than US\$40 billion. This target has not been successfully achieved. This is undeniably reflected in the ambiguous future of 58 of Thai's financial institutions which are still under suspension²⁵.

Since the crisis began in Indonesia in July 1997 it has been continuously affecting the political stability of the country²⁶. The rupiah, (Indonesian currency) has already devalued devalued more than 75 per cent compared to the US dollar. Also the Jakarta Stock Exchange has been badly affected due to the devaluation of the rupiah. The price of basic goods has rocketed and the percentage of unemployment has increased steadily²⁷. Instead of resigning from the top post in the Indonesian government, as was demanded by the public, Suharto was elected for the 7th consecutive term, after 32 years in power, to lead the force of economic stabilisation. Unexpectedly, he chose his daughter and a close golf course friend as ministers in the new cabinet. A few

²³ Serrill, M., "Catching the Asian Flu...", in *Time Magazine*, Vol. 150, No. 18, November 3, 1997.

²⁴ "*Kedudukan 58 firma Thailand ditentukan 3 bulan lagi*" (The future of 58 of Thailand's financial firms is to be decided in three months) in *Berita Harian*, Kuala Lumpur, October 31, 1997.

²⁵ *Ibid.*

²⁶ After 32 years in power, most Indonesians believe that it is time for him to retire and give the power to new blood and a more energetic leader to bring changes in Indonesia. Egotistically, he ignored the people's demand for him to retire. Instead he continues to be the Indonesian president for another 5 years and selected his friends and one of his daughters the new Indonesian cabinet of ministers. Meanwhile the first demonstration of people's anger as the price of basic food kept increasing erupted in 10 main towns on the island of Java where violence and anger claimed 3 lives. See "*3 korban pertama rusuhan di Indonesia*" (First 3 victims in Indonesian riots), in *Utusan Malaysia*, Kuala Lumpur, February 15, 1998.

²⁷ "*Sokong Indonesia keluar daripada krisis*" (Supporting Indonesia in overcoming the crisis) in *Utusan Malaysia*, Editor, Kuala Lumpur, March 18, 1998.

faces were withdrawn from important posts including Mar'ie Muhammad, the Finance Minister, who was replaced by Dr Fuad Bawazier.

In order to save their economy, Indonesian flashed an emergency 'S.O.S' to the IMF in October 1997 as the crisis faced became too intense. At the end of October '97, Indonesia managed to secure an IMF package of US\$43 billion. As the IMF believed that Indonesia did not fully implement the package agreement, a new agreement had to be signed by Suharto, on January 15 1998, for the package to be continued. Consequently, under great pressure from the IMF, on April 4, 1998, Suharto drastically suspended the operation of 7 banks, while 7 others were under close government observation. This step was taken to revive the Indonesian banking system which was already critically ill. Ironically, 3 out of 7 suspended banks belonged to his relatives,²⁸ who are usually under the protection of the president. Preceding this banking suspension, 16 private banks were closed down in November 1997²⁹.

In the process of maintaining the rupiah's value, banks in Indonesia, including the government banks, offered a very high interest rate for any permanent investment to the bank. Exim Bank, Tabungan Negara Bank and Dagang Negara Bank offered the highest interest rate, 67.5 per cent for a one month long permanent investment, while Negara Indonesia Bank and Rakyat Indonesia Bank offered 56 per cent and 50 per cent interest respectively for the same period of permanent investment. This step is believed to reduce the rupiah circulation in the public. Consequently this measure will protect the currency from further devaluation as the public turn away from their usual practice of buying US dollars. Instead, they will start investing their money in the banks to receive the high rate of return offered³⁰.

Although this step successfully attracts people to invest their money, it does no favours to the entrepreneurs who are struggling to save their businesses. Since the previous interest rates which charged between 19 to 30 per cent were already considered too high for them to secure assistance, the new interest rates indirectly

²⁸ "*Kegawatan sudah berakhir; IMF*" (The crisis has come to an end; IMF) in *Berita Harian*, April 7, 1998.

²⁹ "*Perang bunga bank semakin hebat*" (Interest rate war has intensified) in *Utusan Malaysia*, March 30, 1998.

³⁰ *Ibid.*

suggest them to go elsewhere for help. Nevertheless, the move is praiseworthy because beside reducing the rupiah circulation, it could favourably recapture public confidence in the Indonesian banking system, which is on the edge of collapsing. This could be the reason behind a silent endorsement by the Indonesian Central Bank on the procedure applied. After one week of its implementation on April 6 1998, the rupiah gained strength and reached Rp8,000 to one US dollar from only Rp10,500 the previous week³¹. This clearly demonstrates that the measure taken is helping them in their process of economic re-stabilisation.

However, as the actual outcry of the public is for a total reformation of Indonesian economics as well as politics, the above small achievement in maintaining the rupiah did not impress the people. The mass movement led by students continues to gather momentum. Peace demonstrations burst into public riots in 10 main towns in Java on February 14, 1998 and claimed the lives of 3 innocent people³². The latest news of stormy clashes in May that claimed more than 500 lives caused the rupiah to slip further down to its lowest value of Rp11,500 on May 14 1998. It was followed by another crash to a historic low of only Rp17,000 against US dollar, in the morning of May 19 1998, the day on which the reformation plan was announced by Suharto. However, after the announcement, the rupiah bounced back to Rp12,500 on May 20,³³ which means it has had shaved off 80 per cent of its value since July last year. Simultaneously, its stock market fell more than 75 per cent and distressingly, only 12 out of 290 listed companies were trading on May 15, 1998 in the civil unrest interval³⁴. After the civil unrest, the movement trend of the rupiah and Jakarta stock market is downwards amidst fears of a new phrase of 'people's power' movement. However, since President Suharto stepped down from power on May 21 1998, the rupiah shows the trend of appreciating movement.

³¹ Ibid.

³² See "*3 korban pertama rusuhan di Indonesia*", Op. Cit.

³³ "*Rupiah naik semula selepas menjunam*" (Rupiah appreciated after nose-diving) in *Berita Harian*, K.L., May 20, 1998.

³⁴ Higgins, Andrew, "Brokers pray as economy collapses", in *The Guardian*, UK, May 19, 1998.

7.5 The Crisis in Malaysia.

Whereas the 'Asian Tigers' in the SEA especially Thailand, Indonesia and the Philippines have been badly affected by the crisis, other countries, especially Singapore and Brunei are being affected only to some extent. While Thailand, Indonesia, the Philippines and South Korea sought assistance from the IMF, Malaysia, among the countries which were badly affected economically, opted not to seek help from the IMF for an economic rehabilitation programme. This implies that the crisis faced by Malaysia is not as bad as other neighbouring countries. Simultaneously, it suggests that the position of the Malaysian economy before the crisis was fundamentally strong,³⁵ and this enabled the country to defend itself from this unexpected economic crisis. Furthermore, the country has achieved nearly 9 per cent economic growth for the 9th consecutive year, which has transformed the economy into an economic power house,³⁶ and gained the reputation as one of the strongest 'Asian Tigers'.

However, since the crisis attacked the currency exchange and share market, Malaysia's estimated loss is RM600 billion (US\$200 billion) in the Kuala Lumpur Stock Exchange (KLSE) as the value of shares were nose-diving. The Composite Index (CI) of KLSE fell to the lowest point in history, below 500 in January, 1998. Since then the CI fluctuates around the same points and on May 19, it was 549.99. Meanwhile, the currency exchange also fell to its lowest point in Malaysian history when it started to reach a sensitive level of 3.00 as compared to US dollar in early September 1997³⁷. This amounted to a 20 per cent fall since July of the same year. According to an economic analysis, many business entrepreneurs have fallen apart and their status as billionaires have been relegated to millionaires in just a few

³⁵ In his statement, Prof. Muhammad Ariff, Executive Director of the Malaysian Institute of Economics Research (MIER) mentioned that as the economic fundamental of Malaysia is strong, it supported the country from the economic turmoil of the region. *Berita Harian*, Kuala Lumpur, September 6, 1997.

³⁶ Ressa, M., "Malaysia: Achieving Lofty Goals by Thinking Big" in CNN report on Malaysia, October 11, 1997.

³⁷ "*Billioner paling rugi dalam kemerosotan pasaran saham*" (Billionaires are the most affected in the share market downfalls) in *Berita Harian*, Kuala Lumpur, September 8, 1997.

months, as their shares plummeted from an alluring RM22 in July to only a fraction, RM5, in September 1997³⁸.

However, in the banking sector, one of the sectors that was badly affected besides the stock exchange, an admirable profit had been acquired amidst the crisis in the sector. According to the Malaysian Central Bank's report³⁹, in the year 1997, the total profit before tax of the banking sector was RM7.9 billion, 66.8 per cent of which was gained in the first-half of the year. Amazingly, compared to the other banking systems in Indonesia, Thailand and the Philippines which were collapsing as the crisis struck in July, the banking sectors in Malaysia were still attaining a profit of RM26 billion (33.2 per cent) in the second term of a gruelling period of business operations.

To maintain the stability and operatability of the banking system in Malaysia in order to face a more challenging future, the Malaysian government has initiated a meritorious manoeuvre, which could be named the 'umbrella' banking system in the financial sector. Under this system, 39 small and scattered financial companies were amalgamated under 8 formidable institutions which acted as the umbrella's companies⁴⁰. The move is under the supervision of the Malaysian Central Bank⁴¹. The step taken is being courageously supported by Michel Camdessus, the IMF Managing Director, who commented that the step implemented will not only maintain Malaysian economic growth, but more importantly it could contribute towards the stabilisation of the Asian economy as a whole⁴².

³⁸ Ibid.

³⁹ The Malaysian Central Bank's report was released under the title "*Sektor perbankan catat untung RM7.9b*" (Banking Sector attains RM7.9 billion profits) in *Berita Harian*, Kuala Lumpur, March 26, 1998.

⁴⁰ "*39 firma kewangan setuju bergabung*" (39 financial firms agreed to be amalgamated) in *Berita Harian*, Kuala Lumpur, April 1, 1998.

⁴¹ See the speech of the Malaysian Finance Minister, Mr Anwar Ibrahim in his presentation on the steps to be taken in facing Malaysia economics crisis. This speech was delivered in the Malaysian Parliament on March 23, 1998. The full text of his speech was published in *Berita Harian*, Kuala Lumpur, March 25, 1998.

⁴² "*IMF sambut baik langkah Malaysia*" (IMF endorsed Malaysian approach) in *Berita Harian*, March 28, 1998.

7.5.1 Causes of the Crisis.

There are many possible reasons which could be analysed on the downfall of the 'Asian Tigers'. For the purpose of this discussion, focus will remain on a few possibilities that led to the crisis in Malaysia. However, as this paper is purely based on an analytical observation by the present writer on the crisis which is still happening, the analysis in the following discussion is subject to any research that might be done in the future.

7.5.1.1 Substantial Expenses on Unproductive⁴³ Mega Project.

In the process of achieving a fully developed country by the year 2020, Malaysia launched its ambitious economic plan that was spurred by the leadership of Mahathir Muhammad. The economic growth of the country at almost 9 per cent for 9 consecutive years is the envy of western economies. However the economic boom seems only to be reflected in building up the world's tallest buildings, Petronas Towers, the largest flag in the world, the longest bridge in Asia, the biggest mosque dome and the new neo-modernised international airport which is replacing the old yet capable international airport. These are all not of prior importance for the future development of the country. These non-productive investments under the classification of the Malaysian Central Bank, were burning extensive amounts of capital since raw materials as well as the consultation services were imported. The massive importation of the material from outside led to the trade deficit for Malaysia in 1997, which might actually be one of the causes which led to the crisis. As warned by economists before the crisis, the prevailing trend of spending capital could lead to

⁴³ The Central Bank of Malaysia discouraged banks and other financial institutions from giving unproductive loans to individuals or companies. Any loan to be given must be towards financing something productive to the country. The definition of productive and unproductive used here is the definition given by the Central Bank of Malaysia (Bank Negara Malaysia) as mentioned by its Vice Gavenour, Mr Abdul Murad Khalid. What the Central Bank of Malaysia classifies as productive are export based industries, manufacturing goods for import replacement, industrial sectors, service sectors, small and medium sized industries and buying transport for business usage. While unproductive sectors include land property, houses above RM150,000 thousands, condominium, sky high office buildings and shopping complexes. See "*Gubal definisi produktif atau tidak*" (Giving definition of productive and non-productive) in *Berita Harian*, April 29, 1998.

the situation of economic over heating⁴⁴. The crisis could be the real proof of the warning.

Courageously, in the midst of the crisis, the government of Malaysia through the Deputy Prime Minister Anwar Ibrahim as Minister of Finance, announced the postponement and cancellation of some other mega projects. The planned mega projects such as the gigantic Bakun Dam in the jungle of Borneo (Serawak), the futuristic electronic city, the world's longest building, the world's longest bridge connecting Malaysia to Sumatra Island of Indonesia could have burned billions more dollars. It would be a disaster to the country if this mega project is carried out as is planned because the estimated cost on paper is US\$65 billion. Meanwhile the planned high-tech government city centre alone will cost a staggering US\$8 billion⁴⁵. Hence, unsurprisingly, the move by the Finance Minister of Malaysia in stopping these extravagant projects is cheerfully welcomed by economists and the public.

The spending spree, responsible for building these unproductive mega projects is expected to contribute only marginally to the future economic development of the country. The highest possible contribution is the creation of temporary jobs on the construction sites. Sadly, the majority of the workers on the construction sites are not local people. They are imported mostly from Indonesia and Bangladesh, and a small number from countries such India, Mynmar, the Philippines, Thailand and Kambodia. Even more surprisingly, this cheap and abundant labour is also present in the agriculture and manufacturing industries housewives' helpers as well as other handy jobs such as patrol station boys. However, their presence has lead to moral and cultural problems as well as to increased criminal activity. The new stance of not renewing their work permits by the Malaysian government is a big relief to the public. The first batch of around 200,000 foreign workers in the service and construction sectors, who are mainly from Indonesia will be sent home starting from August 15, 1998⁴⁶.

⁴⁴ Taken from the CNN report by Maria Ressa, "Malaysia: Achieving Lofty Goals by Thinking Big", October 11, 1997.

⁴⁵ Ibid.

⁴⁶ This number was announced by the Malaysian Immigration Executive Director, Aseh Che Mat, in one of the most famous TV programmes, "Malaysia Hari Ini" (Today Malaysia) aired by TV3. The number only covers a proportion of foreign workers present in those sectors; construction and service

Besides importing cheap labour from neighbouring countries, the mega projects are also heavily dependent on imported construction materials as well as capital. Hence, to finance these projects, public and private sectors have had to secure foreign loans. This is possibly one of the reasons that led to the tremendous increment of the total foreign loan acquired in 1997. In this year, the total foreign loan of the public sector increased by 23.7 per cent (RM13 billion) while the private sector had a staggering increase of 82.6 percent (RM61.1 billion)⁴⁷. In total the Malaysian foreign loan in 1997 amounted to US\$ 42.7 billion⁴⁸.

Understandably, some analysts see that this staggering amount of foreign loan, accumulated through unlimited credit from the world's bankers,⁴⁹ and added to by massive import of materials for construction of mega projects from as early as 1990, could disastrously affect the country's economy especially when the crisis struck. The massive loan and import of construction materials, will certainly contribute to the deficit in the balance of trade. This could be the reason that made the Malaysian surpluses in 1994 turn to deficit in 1995 and 1996. Although in 1997 Malaysia managed to get surpluses of RM424 million in the balance of trade, this was not sufficient to eliminate the current deficit account of 5.1 per cent⁵⁰. The Malaysian total trade deficit in the first 7 months of 1997 was RM3.61 billion (US\$3760 million) which was more than double the increase of RM1.3 billion in the same period of 1996⁵¹. When the deficit situation is not properly handled, it will lead to the depreciation of currency.

sectors. Service sectors mentioned include, working in hotels, small restaurants, laundries and entertainment. The permits of the other foreign workers such as in the agricultural, manufacturing, construction and service sectors are possibly to be renewed in accordance with demand and circumstances. See "*200,000 dihantar pulang 15 Ogos*" (200,000 foreign workers will be sent home in August 15) in *Berita Harian*, March 26, 1998.

⁴⁷ This amount was mentioned by the Malaysian Deputy Prime Minister who is also the Finance Minister, Mr. Anwar Ibrahim during his speeches at Malaysian Parliament on March 23, 1998. His full speeches were published in *Berita Harian*, Kuala Lumpur, March 25, 1998.

⁴⁸ "*Strategi Urus Hutang Luar*" (Managing Strategy of Foreign loan) in *Berita Harian*, Kuala Lumpur, March 26, 1998.

⁴⁹ Serrill, M.S., "Catching the Asian Flu...", Op. Cit.

⁵⁰ Refer to the Malaysian Finance Minister's speeches in the Malaysian Parliament, Op Cit.

⁵¹ See Kynge, J., "Malaysia: Mahathir tries to reassure foreigners" in the *Financial Times*, September 8, 1997.

7.5.1.2) The Domino Theory in the Economy?

The Domino theory is a very remarkable conjecture in the political arena. The theory implies that in the rapid spread of a new political theory, for example Communism (during its early development), the capitulation one of country to the new idea will be followed by the capitulation of neighbouring countries in sequence, one by one. How far this theory is applicable in the economic sphere, with respect to the crisis in the ASEAN, has yet to be seen. In 1994 in the Mexican crisis, Mexico was predicted to be the first domino to fall in Latin America, which would be followed by many others⁵². Thus could Thailand, where the crisis first occurred, be considered to be the first domino to fall, followed by the other members of the ASEAN?

A fundamental requirement of the Domino theory in politic is for a completely new system to be installed after the failure of the old. The economic turmoil in ASEAN cannot really be said to be a total failure of the economic system, demanding a new system to be installed. Nevertheless, the movement of the crisis from one country to another, is a clear phenomenon of the Domino theory. The currency crisis which started in Thailand on July 2, 1997 accelerated rapidly to the neighbouring ASEAN countries. The Philippines, Indonesia, Malaysia, and to a small extent Singapore and Brunei were affected by the heat of the crisis. Ironically, the crisis also spread to other countries that were economically more powerful, such as South Korea, Hong Kong, Taiwan and Japan.

Considering the above theory, it would be interesting to ask if the crisis that took place in Malaysia could possibly have been affected by the weaknesses of the economic fundamentals of the neighbouring countries, especially Indonesia and Thailand? As these countries and Malaysia are closely related to each other, not only in the economic sphere, but politically as well as socially and culturally, any problem that occurred in one of these countries could easily affect Malaysia. Hence, firstly, is there such a thing similar to the political Domino theory in economics? If there could be something similar, is it applicable here? The following are a few reasons that may

⁵² This was the prediction of George Soros, the man that has been accused of causing the current far east economic crisis, in his book "Soros on Soros". Refer Soros, G., *Soros on Soros*, N. York, John Wiley & Sons, Inc, 1995.

suggest that the crisis happening in Malaysia was the equivalent of the Domino theory in economics.

As was acknowledged by the economists mentioned earlier, the economic fundamentals of Malaysia were strong enough before the crisis. This is an important asset that made Malaysia defend itself well without the IMF bailout which the other three SEA counterparts needed, though admittedly the struggles for Malaysia have been very painful. Additionally, the banking sectors that were badly affected in the crisis witnessed the failure of 58 financial firms in Thailand⁵³ and 30 private and government banks in Indonesia⁵⁴. All of these institutions were already critically ill before the crisis.

However the prevailing situation of the same sector in Malaysia is totally in contrast to their counterparts in Indonesia and Thailand. In the report issued by the Malaysian Central Bank⁵⁵, the three groups of banking institutions in Malaysia; commercial banks, finance companies and merchant banks are all defended well from the regional financial crisis. Instead of losing money and closing down their business operations, as many of their counterparts did in Indonesia and Thailand, they accumulated a total profit before tax of RM7.9 billion. Interestingly, RM2.6 billion profits (33.2 per cent) were acquired in the second terms of 1997, in the *ne plus ultra* of the economic crisis. There were only four banks and financial institutions which failed in Malaysia; the Sime Bank lost RM1.2 billion and was unable to pay its debts, while Bank Bumiputra, Abrar Finance and Cempaka Finance needed capital injection to support their business operations. Nonetheless, as the financial institutions faced the severe crisis as was shown by the decrease of profit for the second term in 1997, the Malaysian government has had to initiate the amalgamation of financial institutions, in order to strengthen and stabilise the sectors⁵⁶.

⁵³ "Kedudukan 58 firma Thailand ditentukan 3 bulan lagi", Op. Cit.

⁵⁴ "Perang Bunga Bank semakin hebat" (Interest Rates War has intensified) in Utusan Malaysia, Kuala Lumpur, March 30, 1998.

⁵⁵ As reported by Berita Harian under the title, "Sektor Perbankan catat untung RM7.9 billion" (Banking Sector gaining RM7.9 billion), March 26, 1998.

⁵⁶ "39 firma kewangan setuju bergabung", Op. Cit.

An additional point to elucidate the strength of the Malaysian economy when facing the crisis is demonstrated by the government's readiness to give an additional amount of money to help Indonesia to get out of the crisis. This unmentioned amount is to be given as an addition to the last year's amount of RM1 billion⁵⁷. This is to help Indonesia to continue carrying out their programme of economic rehabilitation while waiting for the balance of the IMF package money.

These three pieces of evidence suggest that the Malaysian economy was strong before the crisis and is still capable of facing the crisis without the IMF handout. Instead, the Malaysian government, in the middle of the crisis was able to assist its neighbouring country, Indonesia, which was far more seriously affected by the crisis. As their economic fundamentals are strong, Malaysia will continue to defend their economy themselves, and will struggle to get out of the crisis through various steps and measures implemented from time to time. During his visit to the crisis region, the President of the World Bank, James Wolfensohn, courageously said that the Malaysian crisis would be successfully handled by the Malaysian government. He commented that Malaysia was not among the countries he was mainly concerned about because its condition was not as critical as that of the other countries in the crisis region⁵⁸. Hence, because of the reasons mentioned above, the Domino theory could be the possible cause of the Malaysian economic turmoil.

The common phenomenon of the Domino theory in the political arena is the changing from the old to the new political system, whether through revolution or evolution, and usually with the support of the people in the society. In other words, they are the ones who materialise the changing. However, in this 'economic Domino theory', in the case of current affairs in Malaysia, it is not being started by the people in the affected countries but there seems to be a 'selective machine' behind the crisis. The Malaysian Prime Minister, supported by some of his ASEAN fellow leaders as well as the Asian-Pacific Economic Co-operation (APEC)⁵⁹, believes this to be the work of

⁵⁷ "*Malaysia beri pinjaman kepada Indonesia*" (Malaysia gave a loan to Indonesia) in *Berita Harian*, Kuala Lumpur, May 4, 1998.

⁵⁸ "*Tindakan Malaysia berkesan: Bank Dunia*", (Malaysian move effective: The World Bank) in *Berita Harian*, Kuala Lumpur, February 3, 1998.

⁵⁹ The Malaysian Prime Minister's suggestion of regulating currency trading is supported not only by his counterpart in the ASEAN but also by the leaders of APEC. In the 5th APEC meeting held in

unscrupulous international financial speculators who intentionally did their work on a carefully selective basis. Therefore, when the Malaysian Prime Minister was asked how long it would take for the economic recovery of the region, especially for Malaysia, he firmly replied, the period will greatly depend on them (the speculators) because the ASEAN currencies are in their hand⁶⁰. In the following discussion, the focus will be on the possible contribution of these speculators to the Malaysian crisis, and the consequences to the Malaysian economy.

7.5.1.3 Speculation Behind the Crisis.

Undeniably in many economic crises in the past, speculators' contribution to the crisis has been later proven true⁶¹. Unquestionably, in all crises, the same pattern takes place; firstly economic prosperity leading to excessive speculative activity, then a chaotic (mania) situation, and finally, inevitably, a crash. As also pointed out in many writings, the New York Stock Exchange (NYSE) crash in 1929 which eventually led to the World Great Depression 1929-39,⁶² was also preceded by these common symptoms. After the first world war, as the United States achieved a high level of economic prosperity, overtaking England as a new economic power, people started to forget the previous bad experience of economic tragedies. At this point, there was no

Vancouver Canada on November 23, 1997, all 18 leaders of APEC agreed to pass a declaration that asked the IMF to look into the possibility of regulating currency trading as a measure to minimise speculative activity in the trading. "*Kewangan: ketua negara sepakat*" (Financial: APEC leaders in agreement) in *Berita Harian*, November 27, 1997.

⁶⁰ This reply was given by him to a group of German businessmen in his meeting with them in Hannover, Germany on March 20th, 1998. See "*Krisis ekonomi pulih ditangan speculator*" (Economics recovery in the hand of speculators) in *Utusan Malaysia*, March 21, 1998.

⁶¹ There were well-known financial crises in the past such as the Lubeck crisis (1636), Tulipmania (1637) The Mississippi Bubble in Paris (1719-20), The South Sea Bubble in London (1720), Railway Mania (1847) and the New York Stock Exchange crashes (1929) (just to mention a few) where the contribution of speculative transaction was very obvious. There are quite a number of references on the subject, to mention some of them such as by Kindleberger, C.P., *Manias, Panics, and Crashes: A History of Financial Crises*, London, The Macmillan Press Ltd., 1978; Kindleberger C.P., *A Financial History of Western Europe*, London, George Allen & Unwin, 1984; Born, K.E., *International Banking in the 19th and 20th Centuries*, Warwickshire, Berg Publishers Ltd., 1983; Lechner, A., *Street Games: Inside Stories of the Wall Street Hustle*, N.York, Harper & Row Publishers, 1980; Rees, G., *The Great Slump: Capitalism in Crisis 1929-33*, London, Weidenfeld and Nicolson, 1970.

⁶² Besides some of the books mentioned in the footnote above, there are some other writings that are specifically written on the NYSE crashes and the consequences following such as Fearon, P., *The Origin and Nature of the Great Slump 1929-32*, London, The Macmillan Press, 1979; Galbraith, *The Great Crash 1929*, Middlesex, Penguin Books Ltd, 1969; Kindleberger, C.P., *The World in Depression 1929-39*, London, Allen Lane Penguin Books Ltd., 1977 and Yass, M., *The Great Depression*, London, Wayland Publishers, 1970.

getaway from speculative excessiveness, especially in margin trading in the NYSE. The second stage of speculative mania took over the sanity of the market,⁶³ which consequently made worse the already poor situation of the market. This caused the unsustainable market to crumble further down more drastically⁶⁴. The same symptoms seem to be taking place in the current Asian crisis, particularly in Malaysia we shall focus on this in the following discussion.

a) Malaysian prosperity.

Malaysia was considered to be one of the fastest developing countries among the 'Asian Tigers'. This claim is supported by clear evidence when economic growth indicators are examined. The country's achievement of nearly 9 per cent economic growth in 9 consecutive years⁶⁵ has put Malaysian economic growth among the top in the world. This prosperity has also been demonstrated by the fact that the Malaysian per capita income has increased by 25 per cent in 10 years from RM12,000 (US\$4,000) to RM15,000 (US\$5,000)⁶⁶. In fact, in the first two quarters of 1997, before the crisis, Malaysian economic growth was being maintained at 8.45 per cent⁶⁷.

During those 10 years of encouraging economic growth, there were many mega projects constructed such as the Penang Bridge, Petronas Towers (the world's tallest building), Kuala Lumpur International Airport (to replace the existing Subang International Airport) and the manufacturing of the National car, Proton. A gigantic Bakun Hydroelectric Dam in Sarawak and Multimedia Super Corridor are under construction while the first futuristic electronic city and the world's longest building

⁶³ What is meant by the second stage of speculative mania is a phase where the rational investors turn their back on the principles of investment and get carried away by the market craziness and irrationality that over takes market sanity and investor's rationality. In this situation, real investors will change their cause and indulge themselves in speculative activities which are so attractive. Refer Kindleberger, C.P., *Manias, Panics and Crashes: A History...*, Op. Cit., p. 30.

⁶⁴ Samuelson, P.A., *Economics; An Introductory Analysis*, N. York, Mc Graw Hill, 1965, p. 427.

⁶⁵ Ressa, M., *Malaysia; Achieving Lofty Goals by Thinking Big*, Op. Cit.

⁶⁶ This data was given by the Malaysian Prime Minister to the Associated Press News Agency and Dow Jones newspaper in an interview with them as reported by *Berita Harian*, Kuala Lumpur, September 19, 1997.

⁶⁷ "*Pembaziran Membawa Muflis*" (Extravagant spending leads to bankruptcy) in *Berita Harian*, Kuala Lumpur, October 14, 1997.

are planned to be constructed⁶⁸. While mobile phones and luxurious cars such as the Mercedes which were considered as 'dreams on the light of the day' in the 1970's, are emerging recently even in shanty towns⁶⁹. Many Malaysian students who study overseas especially in the UK, import luxurious cars, mainly Mercedes and BMWs⁷⁰.

Besides all of the above indicators of Malaysian prosperity, another notable indicator is the emergence of many new billionaires or at least millionaires among the Malaysian citizens. Though, there were a few millionaires in the 1970's, the number of millionaires has increased tremendously while quite a number of them have moved a step further to reach the status of billionaires. The billionaires 'club' has received more numbers of applicants from people wanting to become a member of the exclusive club.

The above offers clear evidence of the economic prosperity of Malaysia before the crisis. During the 9 years when economic growth was stimulated, people in Malaysia, as happened to the people of the US⁷¹ before the crash of the NYSE in 1929, started to forget the experience of the previous financial tragedies. They were wildly confident in the flourishing Malaysian economic development, without having suspicious regarding the possibility of a crash as the economy was so prosperous. Hence, they borrowed and continued borrowing to finance unproductive investment as well as investing in the Kuala Lumpur Stock Exchange (KLSE) which predominantly comprises of property companies - considered to be non productive investment⁷². The people as well as the leaders of the country were ignoring the

⁶⁸ Ressa, M., "Malaysia; Achieving Lofty Goals by Thinking Big", Op. Cit.

⁶⁹ Lockwood, C., "Gang of Four Nations on the Bamboo Rack" in *Electronic Telegraph*, October 23, 1997.

⁷⁰ However, when the economic crisis struck, the Malaysian government tightened the regulations for students importing cars and the import tax was raised. Many students opted not to bring a car back home to Malaysia since the tax is unaffordable, and the recent Malaysian currency crisis made the import tax soar even higher. They sold their cars at a loss as everybody rushed to the market to sell their cars. For each car sold, they lost thousand of pounds in only a few months, and some of them were ready to sell their cars at whatever price was available in the falling Mercedes market.

⁷¹ The Americans believed that the previous incidents of financial crashes due to speculative excessiveness were inapplicable to the United States. Hence, they continued to excessively speculate in the NYSE and that led to the market crashing unrestrainedly. See Yass, *The Great Depression*, Op. Cit., p. 14.

⁷² Lockwood, C., "Gang of Four Nations on the Bamboo Rack, Op. Cit. For the definition of productive and non-productive, refer to the earlier discussion on the sub-topic 'Substantial expenses on unproductive mega projects, where the definition is given by The Malaysian Central Bank.

warning of economic overheating cautioned by economists⁷³. Hence, this implies eventually, the economy of Malaysia will burst.

b) The contribution of speculative activity in the crisis.

The economic crisis that is occurring in the ASEAN (Association of the South East Asian Nations) countries began with the devaluation of their currency, starting with the Thailand baht on July 2, and soon followed by the Philippines, Indonesia and Malaysia. When the currencies of those countries devalued, it consequently affected their stock market and the whole economic progress was impoverished.

In the Malaysian crisis, when the ringgit first devalued, the Malaysian PM, Mahathir Muhammad, pointed his finger at the speculative activities of international financial institutions in currency trading. One of those involved was Soros, a well-known American billionaire, philanthropist, financier and a renowned speculator⁷⁴. The Malaysian PM strongly believed, since one of the speculators admitted it,⁷⁵ that there were people manipulating the ringgit and the KLSE to make profits at the expense of less fortunate people of other countries. This is clearly evident in the case of Malaysia, where the economic growth of almost 9 per cent in 9 consecutive years was supposed to be closely followed by currency appreciation. Strangely, despite this overwhelming economic progress with strong economic fundamentals, the ringgit and the stock exchange were still plummeting badly. This devaluation could not have taken place on its own, there must have been something or somebody behind it.

At first, the above Malaysian PM's perception was only firmly supported by the Malaysian Finance Minister, Anwar Ibrahim⁷⁶. However, the remarks did not go

⁷³ Ressa, M., "Malaysia; Achieving Lofty Goals by thinking Big", Op. Cit.

⁷⁴ "*Spekulator umpama penjenayah*" (Speculators are the culprits) in *Berita Harian*, Kuala Lumpur, July 28, 1997.

⁷⁵ The Malaysian PM has a strong conviction about the involvement of George Soros in the market manipulation of the region because Soros himself admitted it. His participation in speculative activity in currency trading depressed the value of the ringgit. Damagingly, as Soros is a renowned speculator, his move has allured other funds to take the same position as his. Consequently, the ringgit further devaluated and the KLSE was simultaneously affected. Refer "CNN's Q&A with Dr Mahathir" as published by *The Star*, Kuala Lumpur, September 3, 1997.

⁷⁶ "*Komplot spekulatif gugat RM*" (Speculative complot threaten RM) in *Berita Harian*, Kuala Lumpur, July 16, 1997.

unnoticed, and were judiciously supported by the leaders of many other countries. The Malaysian PM's suggestion and ideas about regulating immoral currency trading have been agreed internationally,⁷⁷ including indirectly by the IMF⁷⁸. Having been accused of being a menace to his own country, the Malaysian PM is prepared to provide evidence of the international institutions' involvement in speculative activities, which consequently led to the regional economic crisis, especially in Malaysia.

The involvement of international speculators in the Asian crisis including in Malaysia, is also acknowledged by investors as well as economists. Kevin Watkins of Oxfam, UK⁷⁹ believes that the impoverishment of the 'Asian Tigers' magic economic achievement in the last two decades has been caused by speculators' activity in currency trading. He says that the prolongation of the crisis in the far east indicates the failure of the World Bank and the IMF to provide enough assistance for rehabilitation.

The suggestion that the Soros' Quantum Fund played a negative part in the Asian crisis, and especially in Malaysia is supported by economists as well as by investors. William Shawcross indirectly inferred that Soros's participation in the ASEAN financial and economic turmoil led to its downfall⁸⁰. This is also manifested in the Taiwan financial crisis. In the middle of October 1997, the speculative activity by the

⁷⁷ 18 leaders of the APEC countries (Asian Pacific Economics Cooperation) agreed to the PM Malaysia suggestion on regulating immoral currency trading. The agreement was achieved in the Vancouver meeting and the declaration was announced by Canada PM, Chretien after the meeting on November 26, 1997. Previously, the suggestion had been accepted by three other government organisations; CHOGM (Commonwealth Head of Government Meeting) leaders in their meeting held in Edinburgh UK, ASEAN and G15 meetings, both held in Malaysia. See "*Kewangan: Ketua negara APEC sepakat*" (Financial: APEC Leaders in agreement), Op. Cit.

⁷⁸ Enthusiastically, the IMF which is in its statement at the beginning of the crisis stated the accusation by the Malaysian PM on the involvement of international speculators in currency trading that led to the region's economic crisis as purely absurd, at last agreed to study the problem and suggestion had been put forward by Malaysia. This step taken by IMF after Malaysian government willing to provide the evidence of the international financial institutions participation in the speculative activity in the region currency trading which involving a staggering amount of fund, RM1,888 billion (US\$500 billion). See "*AS\$500b untuk spekulasi*" (US\$500 billion for speculation) in Utusan Malaysia, Kuala Lumpur, April 16, 1998. See also "*Spekulasi matawang sukar dikawal*" (Currency speculation difficult to control) in Utusan Malaysia, Kuala Lumpur, April 17, 1998.

⁷⁹ "*Malaysia mampu tangani spekulasi mata wang*" (Malaysia capable of handling speculation in currency trading) in Berita Harian, Kuala Lumpur, September 16, 1997.

⁸⁰ Shawcross, W., "The Saint George (Soros)" in Time Magazine, UK, Vol 150, No. 9, September 1, 1997.

Soros fund, as mentioned before, led to a panic selling which caused the Taipei Stock Market's Index and its currency to plunge deeply, unexpectedly⁸¹.

Peter Brooke, the founder of Advent International, the first global firm in the investment industry, had strong words to say about the direct role played by Soros in the crisis. Without any hesitation Brooke named Soros as the real menace to the crisis and considered him the greatest villain of all⁸². He disapproves of the involvement and reckons that the speculation activity by Soros went too far for the vulnerable developing countries.

As the stability of a currency is a vital point for the success of an economy, its instability will reverse the effect; it will badly affect the economy of a country. This implies the importance of checking any possibility of market manipulation, especially through speculative activity, in the currency trading as well as in the transaction of the stock market.

The above situation is eventually taking place in the Malaysian economic turmoil. Its devaluing currency, caused by speculative activity in currency trading led to the economic downfall. While in the KLSE, speculative activity was rampantly participated in. In an interview with the Asiaweek magazine, Daim Zainudin, the former Malaysian Finance Minister, who is also currently the government's economic advisor, admitted that there was speculative excessiveness in land property as well as in the KLSE⁸³. His statement was true since the value of companies especially those who were listed in the stock market were nose-dived accordingly as the price of their shares plummeted. According to an economic analyst, the share value of a company in the KLSE has plunged from RM22 in July to just RM5 in September 1997 and it changes the status of the owner from a billionaire to just a mediocre millionaire⁸⁴.

Furthermore, the unstable currency and stock market will drastically erode the new investors' confidence in the investment viability in the country. Disastrously, the

⁸¹ Cheesman, B., "Taiwan blame Soros for panic selling of Stocks...", Op. Cit.

⁸² Warsh, D., "The Greatest Villain" in *The Boston Globe*, January 13, 1998.

⁸³ As quoted by *Berita Harian*, "*Daim akui spekulasi berlebihan dalam hartanah dan saham*" (Daim admits speculative excessiveness in land property and stocks), Kuala Lumpur, November 8, 1997.

⁸⁴ "*Bilioner paling rugi dalam kemerosotan pasaran saham*", Op. Cit.

situation is also grinding down the confidence of the existing investors. As the ringgit plunged to its lowest level in 24 years, the loss of confidence in the stock exchange, led foreign investors to liquidate their holdings, and caused unrestrainable capital outflow from the market⁸⁵. Although the Malaysian PM accused foreign investors deliberately of causing the crisis in the Malaysian economy and the KLSE crashes, they should not be blamed. Any investor in any country will opt to do the same, because the theory of investment stresses clearly that it is important to invest safely, at the same time getting the highest return. Hence, to keep capital away from unstable markets is a prior requirement in the principles of investment.

From the above point of view therefore, it is unsurprising that the same step was taken by local depositors and investors. An estimated RM20 billion of capital belonging to local depositors was transferred from local banks to foreign banks and financial institutions, especially in Singapore⁸⁶. Although, they are labelled as traitors and unpatriotic to their own country, from the economic point of view, they are doing the right thing because this step is required by the basic knowledge of investment in capitalism. The only business ethic which can be expected from capitalists is that they maximise their profit in an economic boom and minimise any losses when the boom bursts. Thus, the decision taken and the procedure followed to withdraw their capital is lawfully done⁸⁷. Interestingly, as claimed by the Malaysian Finance Minister, the move to withdraw their capital and invest it in foreign banks was done due to their speculative judgement on the weaknesses of the local bank⁸⁸.

⁸⁵ "*Serangan spekulator musnahkan pencapaian Malaysia*" (Speculators' attack destroyed Malaysia's achievement) in *Berita Harian*, Kuala Lumpur, September 19, 1997.

⁸⁶ "*Dedah identiti syarikat*" (Uncover the company's identity) in *Utusan Malaysia*, Kuala Lumpur, March 13, 1998.

⁸⁷ Here there is a clear border between the conventional system and the Islamic system of economics. In Islam, the issue will be viewed differently because the Islamic system of economics is strongly based on human values and ethics in business. Hence, in the Islamic system, if there exists a contradictory interest between private (individual) and public (society), the contradictory interest must be reconciled. If there is no way of reconciliation, the interest of the public (*maṣlahah 'āmmah*) must be given priority. See Aḥmad Muḥammad Assal, *Al-Niẓām al-Iqtisādī fī al-Islām...*, Op. Cit., pp. 25-30. Therefore, 'Islamic patriotism' could be advantageously used to save the country's problem before the individual.

⁸⁸ In his statement in the Malaysian Parliament, the outflow movement of local capital to foreign banks which amounted to RM25 billion was based on rumours that the local banks were on the brink of collapse. See *Berita Harian*, April 22, 1998.

The move by local investors to invest their capital in the foreign market means they have given the cold shoulder to the government call for them to re-invest their capital in the local market. Instead, they continue investing their capital in the foreign market. An unnamed local multinational company is being investigated for investing RM8 billion in buying hotel chains in the US in February 1998⁸⁹. Simultaneously, the Malaysian company MUI Group, injected £44 million for a 40 per cent stake in the Laura Ashley business, in what UK analysts conclude as a shock move to save the UK company from the brink of disaster⁹⁰. At the edge of the Malaysian economic crisis, to invest in the foreign market is seen by the government as unpatriotic and should be condemned. Furthermore, to invest in a collapsing foreign business like Laura Ashley, is seen to be imprudent⁹¹ and indeed insulting to the Malaysian government as there are around 20,000 companies, big and small waiting to be rescued⁹².

The above are possibly the foremost reasons that led to 99 out of 120 companies listed in the KLSE facing a total loss of RM977.1 million in the financial year ending December 1997, though the total profit of the same companies in 1996 was RM3.99 billion⁹³. While, the crash of the KLSE was unavoidable, Malaysian economic growth will slow down and slump will start to have charge of the economy. This really shows how important it is to regulate speculative activities in currency trading as well as in the stock exchange.

c) Margin trading in the KLSE.

Trading on margin is one of the famous speculative devices in most stock markets in the world. This transaction allows customers to give only a small fraction of the total

⁸⁹ "*Dedah Identiti Syarikat*" (Uncover the company's identity) Op. Cit.

⁹⁰ "Laura 's £44 million lifeline" in *The Mirror*, UK, April 18, 1998.

⁹¹ The decision to invest in Laura Ashley seems to have been mistakenly done. This is because the company faced a £41 million slump; a £25 million loss in 1997 from an amazing profit of £16 million in the previous year. Furthermore, £20 million of the new injected capital is to be used in rebuilding its US business and not for the expansion programme. Devastatingly, the rest of the capital is only to be used to cut down its £30 million debts. An analyst believes that the recovery road is too long for the company to get back on its feet and profit will only be possibly gained after several years. Ibid.

⁹² "*Bank diminta bantu 20,000 syarikat nazak*" (Banks are encouraged to rescue 20,000 collapsing companies) in *Utusan Malaysia*, March 16, 1998.

⁹³ "*99 syarikat di BSKL rugi*" (99 listed companies on KLSE loss) in *Berita Harian*, April 7, 1998.

buying price to their brokers and this is called 'margin'. The shares bought in this transaction are usually kept by the brokers as a collateral since the rest of the payment is secured through the brokers' loan. Thus the transaction gives more room to the speculators, allowing them to utilise their available capital in speculative activity. With the same amount of capital, the speculator can buy more shares using this transaction, to gain greater profit and at the same time with a risk of a greater loss.

This transaction is commonly practiced in the bull market, where the trend of the price movement goes upwards. If the price of the share increases as expected, the speculators will get a bigger profit than the profit they could have attained without indulging in this transaction. However, if the share's price decreases unexpectedly, the losses faced are also bigger than would have been incurred without being involved in this type of trading. In the event of loss, the speculators have to top up the margin amount to maintain the minimum requirement for the continuation of the account.

However, a disastrous consequence usually takes place in the event of a heavy loss caused by a sharp falling in share prices. In this situation, the speculators have to find the means to make up the margin that had been shaved off their account or otherwise they have to relinquish their account with total capital loss. Abandoning margin accounts reflect that the speculators were painfully affected by the market. This circumstance rampantly occurs during the time of an economic burst or crisis. A good example of this is the crash of the NYSE in 1929. Malaysia is unavoidably, facing the same occurrence in the current economic crisis⁹⁴.

In both crises, the crash of the NYSE and the KLSE, speculative transaction, especially through margin trading was clearly observed, although in the case of Malaysia, there should definitely be conclusive research carried out to discover all the causes of the KLSE downfall. In 1929, when speculative euphoria was infecting everyone in the market, many others from outside participated. It is said that more

⁹⁴ These two examples are mentioned as to represent other similar crises that took place in the history of financial crises. The downfall of the NYSE in 1929 led to the World Great Depression between 1929-39. Most economists agree that the Depression of this period was the most severe. See Fearon, P., *The Origin and Nature of the Great Slump 1929-32*, Op. Cit., p. 9. See also Kindleberger, *The World in Depression 1929-39*. The current crisis in Malaysia is being singled out here since this paper is focusing on the country.

than one million people regardless of their status in society held stock on margin in the NYSE⁹⁵. In this fabulous period, everyone won as long as they put their surplus money into the market. However, if everyone intended to liquidate those profits into cash at the same time, the profits would rapidly disappear. This was actually the situation which happened when panic struck the people, and everyone was caught out. Speculators unwillingly had to let go of their 'margin' accounts as they were not capable of topping up the margin call. Ruinously some stocks disappeared from the board completely while others were unsaleable at any price⁹⁶.

The same occurrence is taking place in the current Malaysian economic crisis. Some investors, or rather the speculators, indulged in margin trading on the KLSE during the economic boom starting at the end of 1980's. The KLSE index was continuously moving upwards except for a small hiccup at the end of 1993. This bull market attracted speculators to participate actively in speculative activities including in margin trading. However a sudden disturbance caused the boom to be replaced by crisis in July 1997 and affected the previous admirable performance of the KLSE and thus, the index started to decline. Speculators were caught in the crisis. As the crisis continued, they had no alternative except to pump in more money to save their margin accounts with the hope that the crisis was only another temporary market hiccup. As the hiccup continued, they realised that it was actually not a market hiccup, instead, it was a crisis which was hitting not only the KLSE, but also the other sectors of the Malaysian economy. By the time they acknowledged the crisis, the market had already devalued extensively and they were unable to comply any longer with the margin call. This situation was admitted by the Malaysian PM⁹⁷.

The Malaysian PM and his government's decision to spend RM60 billion defending the KLSE from market manipulators, especially from speculators is a commendable initiative. It could help to bring the diving market into stability,⁹⁸ and could

⁹⁵ Yass, M., *The Great Depression*, Op. Cit., p. 21.

⁹⁶ See Samuelson, P.A., *Economics: An Introductory Analysis*, Op Cit., p. 427. See also Rees, G., *The Great Slump: Capitalism in Crisis 1929-33*, London, Weidenfeld and Nicolson, 1970, p. 48; and Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit., p. 118.

⁹⁷ "*RM60 billion pertahan BSKL*" (RM60 billion to defend KLSE) in *Berita Harian*, Kuala Lumpur, Sept 4, 1997.

⁹⁸ *Ibid.*

consequently restore investors' confidence in the market. However the inclusion of speculators, specifically the margin account holders, in the government bailout programme, is conflicting with the Malaysian PM's main idea of putting a limit on speculators' activity. Possibly the Malaysian PM considered these people to be investors since he used the word investor in his statement. Therefore, he urged financial institutions who financed margin holders, to be patient with their clients by giving more time or even postponing their margin call⁹⁹.

The above call by the Malaysian PM could suggest to us that directly or indirectly, he is protecting these speculators. Ironically, he is the Asian leader who strongly opposed and blamed the activity of speculators, and considered speculative activity to be an unethical business transaction that should be regulated or banned forever¹⁰⁰. His idea here is worthy of support, however his double standard approach towards speculators by the bailing out programme for the local speculators of margin sellers, shows his disorientated and confused approach.

In reality, those who hold margin accounts in any stock market are the real speculators. They are merely interested in utilising the legal title as a store of wealth which will increase their financial claims in the future¹⁰¹. In fact, as illustrated by an economic dictionary, margin trading is closely related to speculative activity. In explaining the word margin, Stiegeler connected margin trading to the activity of speculators who take loans from stockbrokers at a certain percentage in order to add up their margin payment¹⁰². As pointed out by Chapra, margin selling by speculators can cause many unnecessary elements which can disturb the market stability¹⁰³.

⁹⁹ "*Tindakan jika terus bantu spekulator:PM*" (Retribution for continuing assisting speculators:PM) in *Berita Harian*, K.L., August 30, 1997.

¹⁰⁰ "Malaysian Official Defends Premier's Anti-Semitic Remarks" in *Agence France-Presse*, Paris, October 15, 1997.

¹⁰¹ Davidson, P., *Money and the Real World*, London, Macmillan Press Ltd., 1978, pp. 106-07.

¹⁰² Stiegeler, S.E., *A Dictionary of Economics and Business*, Op. Cit., under the entry 'margin'.

¹⁰³ Among these unnecessary elements are:

- a) Making large purchases with smaller capital could result in a market crash.
- b) It could bring about unnecessary market expansion or contraction in the value of transactions and stock prices because there is no addition in stock supply.
- c) Variations in margin requirements and interest rates tends to increase uncertainty and market instability.
- d) Lowering the margin requirement generates unnecessary heat in the market
- e) Raising of the margin requirement (react to point b) leads to the liquidifying of speculators' holdings. This could cause unnecessary problems for the market.

Clearly trading on margin is greatly speculative in nature since the holding of shares is only for the 'legal ownership' for greater profit as speculated in the bull market. Hence, the Malaysian government's KLSE bail out programme should exclude those who are actively participating in the trading on margin. The serious effect of margin trading is reflected in the steps taken by the NYSE after the crisis in 1929 and the LSE. The NYSE through the US Federal Reserve Board has introduced minimum margin requirement for every speculator in margin trading, while the LSE implemented 'knock out' measures by banning this type of transaction¹⁰⁴. Why is Malaysia and its PM willing to sacrifice their idealism for the sake of local speculators by a bailing out programme which includes margin traders?

d) Short selling in the KLSE.

Short selling is another device that is commonly used by speculators in gaining a quick profit in the stock market. This mechanism is usually implemented in the situation of a bear market, which is a market where the trend of share prices moves downwards. This transaction is highly speculative in nature since the position taken by the speculators is to sell securities which are not in their possession, or if they do possess them, they do not intend to deliver them to the buyers. The speculators' purpose of executing the transaction is to make an 'off-setting' purchase when the price decreases as expected. The speculators would make a profit in the event of share prices decreasing as they sold the shares at a higher price than the repossession price. Hence this type of transaction is not only immensely speculative in nature but also could destructively drag further down the ill-starred market especially at the edge of an economic crisis.

This is what has happened in Malaysia where the KLSE has been dragged further down by the short sellers' activity among local and international speculators. They borrowed scripts from brokers' firms as well as from banks in order to exercise their speculative activity. As a result, the share prices have constantly decreased since July

See Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., pp. 95-97.

¹⁰⁴ The New Encyclopaedia Britannica, Micropaedia, Vol. 6, Chicago, Encyclopaedia Britannica Inc., 1977 under the entry 'margin'.

1997. According to an economic analyst, the share value of one company in the KLSE has plummeted from RM22 in July to a mere RM5 in September 1997¹⁰⁵. This critical situation has also been clearly manifested by the constant decrease of the Composite Index of the KLSE. One period of short selling activities took place in the KLSE between August 25 - 28, 1997, and the index dived an average of 20.12 point in 4 consecutive days, and this also affected the ringgit¹⁰⁶. As was admitted by the Malaysian PM, obviously the speculative transaction of short selling was damaging the Malaysian Economy¹⁰⁷. Therefore the stern step of banning this type of transaction was introduced by the Malaysian government on August 28, 1997 in order to stop this destructive market manipulation. Unfortunately, the ban is only applicable on some shares and the 'blue chips' shares can still be short traded¹⁰⁸.

Additionally, the Malaysian government has interceded in the market by ensuring the local banks and brokers' firms do not lend scripts to the speculators. A stern reminder was given to them on their lending scripts to the speculators. The government stance of forbidding the activity remains applicable to counter speculators' market manipulation¹⁰⁹. This government move is being earnestly implemented and various local financial institutions are under government probation for continuing to lend scripts to the speculators to enable them to engage in the speculative transaction of short selling. These financial institutions are labelled as traitors to the country's economy and if they are found guilty, their business licence will be revoked and their business will also be suspended¹¹⁰.

7.6 Conclusion.

From the above discussion, it is clearly shown that although there are many other possible reasons contributing to the Asian economic crisis, especially in Malaysia, the

¹⁰⁵ "*Bilioner paling rugi dalam kemerosotan pasaran saham*", Op. Cit.

¹⁰⁶ "*BSKL tunjuk tanda pemulihan*" (KLSE shows sign of recovering) in *Berita Harian*, August 30, 1997.

¹⁰⁷ "CNN Q&A with Dr Mahathir", an interview between the CNN and the Malaysian PM as published by *The Star*, Kuala Lumpur, September 3, 1997.

¹⁰⁸ "*Tindakan jika terus bantu speculator: PM*", Op. Cit

¹⁰⁹ "*Syarat skrip masih berkuat kuasa*" (Script's restriction is still implemented) in *Berita Harian*, Kuala Lumpur, September 6, 1997.

¹¹⁰ "*Tindakan jika terus bantu speculator: PM*", Op. Cit.

contribution of speculative activities in currency trading and the stock markets is highly significant. The writer strongly believes that the speculative activities in these two sectors of the economy are just an iceberg in an open sea. With proper research, the validity of this analytical observation could be revealed and the contribution of speculative activity to the crisis could be clarified in a more concrete and acceptable form.

If the above analysis proved to be true, how should the ASEAN governments, especially the Malaysian government, react to prevent the same occurrence in the future? This question is important, because as is witnessed in the history of financial crises, economic crisis recurs, even though after every crisis, new preventive measures are introduced. It seems that nothing can stop crises from recurring. This suggests that there could be some defects in the capitalist economic system, the system which strongly believes in creeds such as profit motive, profit maximisation, cost minimisation and free enterprise.

There seems to be nothing wrong with the above creeds provided that they are carried out by individuals who do not have those creeds as their sole objective in their business activity. However, as the temptation in the business world is too immense, it tends to carry people away from their ideals of being good and responsible human beings. In this situation, people would manipulate all the available means in a stock market to achieve the paramount goal of business activity, profit maximisation. Therefore from this point of view, the Islamic model of a stock market would take into consideration this vital aspect. The model of an Islamic stock market would exclude any instruments that could lead to any market manipulation, would clear future uncertainty and other malpractices under humanistic values as perceived by the Muslims. In the following, the discussion will focus on a model of an Islamic stock market that could be viable in the future.

CHAPTER 8

SPECULATION IN THE ISLAMIC PERSPECTIVE: ON THE ASPECT OF *AL-MAISIR* (GAMBLING).

8.1 Introduction.

As discussed in the previous chapter, the existence of speculative judgement is something ineluctable. In every business transaction, even in an ancient barter system, there is present to a certain extent some aspect of speculation and speculative judgement. This is because the nature of a human being is to always strive for the betterment of their future life. Since they possess the faculty of intellect that was bestowed upon them, they should use this priceless bounty to their utmost for their best living.

To continue from the previous chapter, the present writer will devote this chapter to discussing the understanding of Islam on speculation. Elements in speculation that are denounced by Islam will be discussed in order to give a clear picture and understanding to the readers of the subject under study. Henceforth, the discussion will focus on the Islamic perspective on the question of speculation in the stock exchange.

8.2 Speculation in Islam and the Life of Humankind.

As illustrated in chapter six, the general and wider understanding of the word speculation always refer to something that is probable and uncertain concerning the future. This uncertainty concerning the future has to be dealt with through the use of intellectual power using the faculties of seeing, reasoning and contemplating. Human Beings are the only creatures on earth who possess and are empowered with the ability to think, ponder, contemplate and make decisions. From this point of view, Islam believes that the existence of speculative judgement originated with the first humans evolved on earth.

Adam, as the first human being created, was honoured with intellect and emotion. The endowment of these abilities made his status higher than the angels¹. These qualities are essential as they will steer him through the life of this world. Worldly life is totally different from the previous life that he experienced. In this world, he has to be more self-initiated, pro-active and independent to accomplish his duty of vicegerency on earth². Hence, through their *'aql* (intellect) and physical capabilities, human beings can explore and utilise everything on earth for their benefit³. In other words, all of these *ni'mah* (bounties) are purposely provided to make human beings capable of carrying out his *amānah* (responsibility) in this world. No one can deny his/her personal action, and this will be asked about in the day of judgement.

Nonetheless, though human beings possess intellect and the faculty of choice, they always need guidance from The Creator. The faculty of choice could be influenced by two enormous adversaries of human beings, Satan⁴ and Desire⁵. Adam and Eve's descent to this world were caused by the Evil Spirit. The situation faced by them in choosing whether to eat or not to eat required the speculative process, since it involved the faculty of thinking and contemplating. Their speculative judgement in choosing the best for them proved wrong. Noticeably here, the process of making speculative judgement had taken place.

8.3 Speculation: The Nature of Human Life.

As cited above, human beings honoured with *'aql* (intellect) have to speculate in their life. However, the correctness of the decision taken varies, based on at least two things; their status as well as their competency in analysing things. In referring to status, all the prophets as believed by Muslims are grouped differently to ordinary human beings since they were *ma'sūm* (infallible) and *faṭānah* (clever). Since they

¹ The Qur'ān, 2:34-5.

² The Qur'ān, 2:30.

³ The Qur'ān, 14:32-3, 16:12-4, 22:65, 45:13 and others.

⁴ Iblis is a word that is deduced from the understanding of the feeling of desperateness and rebellion while satan reflects the notion of perversity and enmity. See 'Alī, 'Abdullāh Yūsuf, *The Holy Qur'ān: English Translation...*, Op. Cit., foot note no. 52. There are many verses in the Qur'ān concerning the Evil Spirit (*shaiṭān*) as an enormous enemy of humankind among others are; 2:168, 2:208, 4:92 and 7:22.

⁵ The Qur'ān, 12:53, 79:40 and 91:8.

were prophets, the guidance of God was always with them. In this situation, their decision was supreme when compared to ordinary human beings. However, their 'ordinary speculative judgement' in a few cases was proven to be only as good as ordinary human beings⁶. Human being's competency in analysing things and consequently drawing correct conclusions from them, depends on various factors such as brilliancy, talent and skill, information available as well as his/her willingness to take the risk of being wrong⁷.

The above discussion demonstrates the teachings of Islam, that to make a decision through speculative judgement is something needed to be done by everyone in their life. It is a nature of human life in this world that people always have to make decisions. Since every decision made is expected to attain a good result while there is no guarantee of its correctness, hence, this is the speculative nature of decision making. As life in this world is full of uncertainties, to make speculative judgements in order for life to continue is the nature of human life.

8.4 Speculation in the Stock Market in the Islamic Perspective.

The existence of speculative judgement is important in human life as it had a close relation with the faculty of intellect. As far as the question of speculative judgement in economy is concerned, it happens, and takes place in almost every business transaction⁸. Even in the wider application of the word, to hold wealth in whatever form is impossible without having to speculate on the future changes in its value against other assets. Hence in this respect, money is held on a speculative basis⁹. There was even a famous speculator who dared to say that "the spirit of speculation is born with men"¹⁰. Hence the connection between speculative judgement and human's

⁶ One instance of 'ordinary speculative judgement' by the prophets is shown by Prophet Muḥammad. His decision to defend Madīnah from inside the city in the battle of *Badar* was discussed and finally rejected. Instead the idea of one of the companions to defend Madīnah from outside the city, was taken and implemented.

⁷ One important factor for the success in making judgements in Islamic understanding is the help from God. For Muslims believe that they make plans and descisions but God also makes plans and decisions and He is the best planner and decision maker. See the Qur'ān, 8:30.

⁸ Aubrey, W.H.S., *Stock Exchange Investments...*, Op. Cit., p. 43. See also page 88.

⁹ Dow, Sheila C. and Earl, Peter E., *Money Matters; A Keynesian Approach to Monetary Economics*, Oxford, Martin Robertson, 1982, p. 101.

¹⁰ Teweles, R.J. (et al.), *The Commodity Futures Game...*, Op. Cit., p. 3.

life is inevitable and people unavoidably have to exercise it as good as possible. In this point of view, therefore speculation in its basic literal understanding and application is allowed under the Islamic framework¹¹.

However the question emerges here on the extent of its permissibility. Are all kinds of economic judgements that are speculative in nature acceptable to the Islamic economic system or should they all be rejected? Is there any way of reconciliation between both extremes? This is particularly in relation with the speculative business transactions that take place in the stock market, the main subject of this research.

The existence of element *al-maisir* (gambling), *al-gharār* (uncertainty), malpractices, unethical activities and 'unearned income' in the speculative transaction of a stock market, as we will see in this and the following chapter, is undeniable. In this chapter, the discussion will focus on the element of *al-maisir* which is closely related to the speculative activity in the stock market which shall shed the light in clarifying the above question. The element of *al-gharār*, the problem of malpractices, the question of unethical activity and the question of 'unearned income' will be discussed in the next chapter. Although some of these elements are obviously seen in the speculative transactions in the stock market, nevertheless, some are not. Hence a detail discussion on the presence of every element in the speculative activities in the stock market will be given.

8.5 *Al-Maisir* (Gambling) and Speculative Transaction in the Stock Market.

There are a few elements in the speculative transactions of the stock market that seem to be similar to the elements present in the activity of gambling¹². In some types of gambling, these elements are sometimes present, and in some other, only some of these elements are present. Some of them can easily be recognised as gambling elements but some others are indistinguishable from a business transaction. However,

¹¹ Khan, M.A., "Commodity Exchange and Stock Exchange in Islamic Economy" in *The American Journal of Islamic Social Science*, Vol. 5, No. 1, 1988, p. 101.

¹² The present writer has already discussed these elements in the early part of this chapter which touched on the elements denounced by Islam in speculative activity. The presence of these elements suggest to us that the activity of speculation in the stock market resembles the act of gambling.

before a detailed account on these elements is discussed, the present writer shall first give the definition of the word gambling and a concise background of the practice.

8.5.1 The Definition of *Al-Maisir* (Gambling).

Gambling and other words such as gaming and games of chance are derived from the Anglo-Saxon 'gamen' and 'gamon', which means sport or play¹³. The general usage of the word gamble is to denote any decision executed in any transaction or pursuit involving risk and uncertainty¹⁴. Hence, gambling is to play a game of chance for money or to take a risk for some advantage or a risky venture¹⁵. Risk and uncertainty are faced since the outcome of the decision taken is unknown but a good outcome is always expected. Therefore, it is said that politics in fact are 'a big gamble'¹⁶, since the judgements passed in this area are always uncertain and risky.

The usage of the word usually refers more specifically to economic activity which is very concerned with the aspect of gain, loss, risk and uncertainty relating to the game of chance. Economically, therefore to gamble is "to play games of chance for money especially for unduly high stakes; to stake money (especially to an extravagant amount) on some fortuitous event"¹⁷.

However this definition is too narrow because the words 'to play games' does not accommodate all types of gambling. There are business transactions which are certainly gambling in their nature but could not be included under this definition of games. Furthermore, there are many kinds of gambling which are not based purely on chance, such as betting on horse races, boxing or any other sporting events, even though their outcome is unpredictable. In addition, the words 'for money' in the above definition do not suit all kinds of modern gambling. Although, money gain is still the main objective of much gambling, it is not anymore the sole purpose of a game of chance. There are various alternative prizes to be won including political power,

¹³ "Gambling" in *The New Encyclopædia Britannica* (1977), Macropædia Vol. 7, Op. Cit.

¹⁴ *The Oxford English Dictionary*, (Ed. by Simpson J.A. and Weiner E.S.C., 2nd Ed.), Vol. 6, Op. Cit., under the entry "gamble", p. 342.

¹⁵ *English Dictionary*, Scotland, Geddes & Grosset Ltd., 1996 under the entry "gambling".

¹⁶ *The Oxford English Dictionary*, Op. Cit., p. 342.

¹⁷ *Ibid.*, p. 342.

leadership and to a certain extent, women. As mentioned by Cohen and Hansel in their writing, among the Scythians, they staked not only their teeth, eyebrows, their wives, their families and their freedom, but also risked their lives on a single throw of the dice¹⁸.

Green in his work 'Betting and Gambling' suggested a definition which he claimed was a more comprehensive definition. He defines 'to gamble' as "an agreement between two parties, whereby the transfer of something of value from one to the other is made dependent on an uncertain event, in such a way that the gain of one party is balanced by the loss of another"¹⁹. Accordingly, this definition comprises all types of gambling such as playing games of chance, betting on horse racing and other sporting events, between clients and bookmakers or between individuals, all kinds of sweep stakes, lotteries and other similar enterprises. Furthermore, the definition given includes certain business transactions²⁰.

The above definition, though claimed to be comprehensive, excludes however a few important aspects which prevail in any gambling or games of chance, such as gambling risk,²¹ hope of gain and the element of chance. The latest definition that represents the nearest meaning of gambling says, "gambling is the betting or staking of something of value, with consciousness of risk and hope of gain, on the outcome of a game, a contest, or an uncertain event, the result of which may be determined by chance or accident or has an unexpected result by reason of the bettor's miscalculation"²².

If we analyse this definition, it will show us that the definition has excluded sophisticated business transactions which embody in them the element of gambling, such as business transactions taken by the stock market as well as the foreign

¹⁸ Cohen, J. and Hansel, M., *Risk and Gambling: The Study of Subjective Probability*, London, Longmans, Green and Co., 1956, p. 136.

¹⁹ Green, P., *Betting and Gambling*, London, Student Christian Movement Press, 1930, p. 17.

²⁰ *Ibid.*, pp. 17-9.

²¹ This term from now on should be well understood to differentiate it with business risk. In every business activity, there will be certain inevitable risks involves as soon as the venture is undertaken. In contrast to this, the risk in games of chance is purposely created for the game to operate and therefore its existence is very dominant.

²² "Gambling" in *The New Encyclopædia Britannica* (1977), Macropædia Vol. 7, Op. Cit.

exchange. In my opinion, there are at least two important gambling elements embodied in these sophisticated business transactions that are excluded from the definition²³ i.e. the element of economic fundamentals and reality, and economic manipulation. Hence the present writer suggesting here a new and fresh definition of gambling as "the betting of something of value²⁴, with unnecessary risk²⁵, hope of gain based on the elements of chance and uncertain events, that involves to a certain extent economic manipulation and on occasion, loss of context of economic reality"²⁶.

8.5.2 A Concise Background of Gambling.

Gambling or games of chance are believed to have existed in all civilisations and are as old as human beings. This is because gambling of a sort was used to decide various life events such as in laws, military operations, ceremonies, liturgies²⁷, as well as in the economy. According to Paton, these things were possibly decided by various methods of divination in the primitive era, in order for people to know and decide their future²⁸. Hence, the primary objective of the device was originally for decision-making. However, to give zest to the game, it has been 'secularised' through putting or staking some possession on the turn of chance²⁹.

In ancient cultures, gambling was very significant as it took on religious significance in connection with myths and rituals. In other words, it was not regarded as gambling in the specific usage of the word today. The casting of lots is said to have been carried out purposely to end disputes, to divide or distribute property as well as to divine

²³ These two elements were discussed in the early part of this chapter with the other elements denounced by Islam in speculation. However, while the other elements are included in the definition of gambling, these two elements are ignored.

²⁴ The connotation of the word 'value' here is not solely concerned with material gain in terms of money or property but it could be power or leadership as well as to gain love.

²⁵ The usage of the term 'unnecessary risk' is to represent a gambling risk in contrast to a business risk. Business risk is a risk faced by business entrepreneurs in their undertaken business venture. See also the footnote no. 21 above.

²⁶ Hereafter, this definition will be used and referred to as a new definition of the word gambling in the on going discussion. To really appreciate this definition, refer to the discussion on the elements of gambling in the speculative transaction of the stock market in the later part of this chapter.

²⁷ Morgenstern, Oskar, "Game Theory" in Dictionary of the History of Ideas (Ed. by Philip P. Wiener), Vol. 2, N. York, Charles Scribner's Sons, 1973, pp. 263-4.

²⁸ Paton, J.L., "Gambling" in Encyclopædia of Religion and Ethics, Op. Cit., p. 163.

²⁹ Ibid., p. 163.

God's Will³⁰. However, not enough studies have been made on the cultural and religious significance of gambling as is claimed by deffusionists³¹.

In addition, findings by archaeologists all over the world strongly suggest that the origin of religious gambling as claimed by deffusionists are irrefutable. This is because the painted pebbles, dice, board games, astragali and other artefacts dating as early as 3500 B. C. are all gambling implements³². Since a large number of astragali has been discovered in many pre-historic site excavations, it has been suggested that people were tossing these bones in games of chance as long ago as 40,000 years³³. While some of the ancient games of chance still continue to be played today by the people in the area of the archaeological findings, many other modern implements and methods of gambling have been created to 'entertain' human wants and desires.

8.5.3 The Elements of *al-Maisir* in the Speculative Transaction of the Stock Market.

As discussed above, the game of chance has already been practiced by tribes from ancient times. The practice was widely used as an important way of solving various life events encountered by them. However, as the time goes on the game of chance had been secularised through putting or staking money or other valuable possessions for the purpose of securing property or other valuable possessions from other people. In today's modern world, when the words' game of chance is used, it will solely refer to the 'secularised' version of the game of chance mentioned above. However the more familiar words used are gambling or betting. The following are a few elements that are embodied in the speculative transactions of the stock market which are simultaneously present in the game of chance or gambling.

³⁰ "History of Gambling" under the entry "Gambling" in *The New Encyclopædia Britannica* (1977), *Macropædia* Vol. 7, Op. Cit., p. 866.

³¹ A deffusionist perspective viewed that games of chance or gambling are derived from various method of divinations and religious rites. See "Gambling" in *Encyclopædia of Religion and Ethics*, Op. Cit., p. 163.

³² See Hildebeitel, Alf, "Gambling" in *Encyclopedia of Religion* (Ed. by Mircea Eliade) Vol. 5, N. York, Mac Millan Publishing Co., 1987, p. 469. See also "Gambling" in *The New Encyclopædia Britannica*, Op. Cit., p. 866.

³³ *Ibid.*

8.5.3.1 The Element of Pure Hope and Luck.

These two elements of hope and luck are inescapable when exercising speculative judgement in any business transaction. Islam views these two elements as something that do not contradict its teachings. Nevertheless, Islam holds a very clear stance on the point that the elements of hope and luck must be associated with tireless work to be carried out before the decision is exercised. This is termed as *al-tawakkul*³⁴ in Islam and it has been distinctly prescribed in the Qur'ān where God says;

"...then, when thou hast taken a decision, put thy trust in *Allāh*, for *Allāh* loves those who put their trust in Him"³⁵.

From the above verse, clearly God does not only state that human beings have to do *al-tawakkul* (fully surrender to God) but that He loves those who surrender to Him after work is performed tirelessly. The hope is certainly directed to God and the luck is certainly from God.

On the contrary, Islam does not agree with the idea of *al-tawakkul* without any onerous work done before it, as is understood by some Muslims. This 'blind *tawakkul* is rejected in Islam and the correct concept used is *tawākul*³⁶. Those who depend purely on hope and luck without carrying out their responsibility to work hard are judged by God as ones who have no faith. This is because to surrender without doing any work is the same as giving up the hope of God as He says;

"O my sons, go ye and enquire about Joseph and his brother and never give up hope of *Allāh*'s Soothing Mercy, truly no one despairs of *Allāh*'s Soothing Mercy except those who have no faith"³⁷.

³⁴ For further elaboration refer to the discussion of this concept in chapter 3 of this research.

³⁵ The Qur'ān, 3:159. See also 4:81, 11:123 and 33:3.

³⁶ *Al-Tawakkul* is to rely upon God after an onerous effort and work are done towards achieving the objective. *Al-Tawākul* is a blindly rely upon God without any work done to achieve the objective targeted. See *Al-Mu'jam al-Wāsiṭ* (ed. by Ibrahim Anis (et al.), 2nd ed.), Vol. 2, Cairo, Dār al-Fikr, 1973, p. 1054.

³⁷ The Qur'ān, 12:87.

More specifically, the element of luck must be viewed from the Islamic perspective. The element of luck is connected with the idea of *al-qadar*³⁸ (a due proportion) in Islam. While in the conventional economic point of view, luck is something purely accidental or by chance³⁹, Islam taught that luck is something pre-destined by God as the knowledge of God is unlimited. Everything which happens to each individual is already stated in *lauḥ al-maḥfūz*⁴⁰ (the protected tablet). Hence, to accept the idea of luck in Islamic economics, its conventional understanding should be replaced by the Islamic exposition.

The above explanation sums up the idea of *al-tawakkul* and *al-qadar* in Islam. The acceptability of the elements of hope and luck depends on these illustrations. Furthermore, the implementation of these elements must be in accordance with the teaching and spirit of Islam. Hence, to be involved in speculative judgement, as far as the elements of hope and luck are concerned, in any business venture, including the stock exchange, is basically acceptable. This stance remains valid as long as the understanding and spirit of Islam about these two elements are correctly appreciated. This is to ensure that the business transactions undertaken would not include more serious elements which are prohibited by Islam, namely betting, or more precisely, gambling.

8.5.3.2 The Element of Betting⁴¹.

An acceptable speculative transaction must also be free from betting which has the element of gambling. In Islam, the validity of any business transaction, require it to be free from such an element. There are some business or welfare organisations in

³⁸ *Al-qadar* has various meanings. As this discussion focuses on the economic point of view, *al-qadar* here refers to the situation whereby everything that a man receives for his life is a due proportion which God has mentioned in *lauḥ al-maḥfūz*.

³⁹ The conventional economic understanding of this term is that it means purely accidental or by chance because the word itself is used interchangeably with the action of gambling. The prevailing nature of gambling is to depend purely on luck for the outcome of the betting. See Samuelson, Paul A., *Economics; An Introductory Analysis*, Op. Cit., p. 429. See also Rix, M.S., *Stock Market Economics*, Op. Cit., p. 205.

⁴⁰ *Laūḥ al-maḥfūz* refers to a tablet preserved by God whereby the knowledge of everything is stated and preserved by Him. See 'Alī, 'Abdullāh Yūsuf, *The Holy Qur'ān...*, Op. Cit., footnote no 6066. See also the Qur'ān, 7:154, 15:9 and 85:22.

⁴¹ By the word 'betting', the present writer refers to the action of injecting money without any work done. The next thing for the person involved is to purely wait for the outcome of his betting.

today's modern world, who hide their betting business behind all kinds of good names. It does not matter what names they use or what the purpose of the organisation is, it will not nullify the prohibition of the business as prescribed in the Qur'ān⁴². The prohibition is based on the gist of the transaction and not on the name and purpose of the managing organisation or government. As long as it involves the element of betting, it is forbidden by Islam.

The prohibition of gambling is clearly stated in the Qur'ān⁴³ and it will stand forever. The prohibition is not only limited to the activity of gambling to acquire money, it is also applicable to games of chance or gambling for the purpose of entertainment and recreation⁴⁴. If to involve in the game of chance for relaxation is forbidden in Islam, hence the prohibition must be more easily understood in the case of gambling to attain profit at the expense of other people. Hence, the application of this stance would also be extended to the process of passing speculative judgement on the speculative transaction in the stock market.

Further analysis on the speculative transactions of the stock market, we shall see that the element of betting is clearly embodied in the transactions. Since the speculators injecting their surplus income in the market, based on imaginative factors such as rumours and the trend of the price movement in the market, the element of betting is certainly there. This is because in contrast to the real investors who buy shares based on a real analysis of the economic fundamentals of the company, the speculators buy shares based on the sentiment of the market and detach themselves from the reality of the economy. Hence the element of betting is present as in the words of Bach,

"The market price of stocks is determined by thousands of other people who are all guessing. Many of them are in the market as speculators, looking for a quick dollar on the price rise rather than for a long-pull investment...

⁴² There are many form of lottery and toto syndicates run by governments or private organisations to collect money for the purpose of charity as well as for business. This 'betting business' for charity is being carried out by many countries, including Muslim countries, although some of these Muslim countries have now forbidden it. Regardless of who run this business, the stance of Islam on its prohibition is still valid and will continue as such.

⁴³ The Qur'ān, 2:219 and 5:90-1.

⁴⁴ Qaradāwī, Yūsuf, *The Lawful and the Prohibited in Islam*, Op. Cit., p. 304.

so you are betting on what other people will bet on and they in turn are betting on what you and others will bet on"⁴⁵.

The above situation of betting surplus money through participating in the speculative transactions in a stock market is manifested clearly in the crash of the NYSE in 1929. As mentioned in the previous discussion, in chapter six of this research, millions of people involved in the speculative transactions on the NYSE especially in the margin trading. During the peak period of the speculative mania in the NYSE, no one lose as the 'bull' market in the stock market continues. As testified by Fred Fantasy, in describing the NYSE, "this market has been like a money machine. I have now taken six straight profits on the short side"⁴⁶.

However, as correctly pointed out by Teweles, "In any game in which probabilities are involved the longer you play the more certain it becomes that a series of losses will occur"⁴⁷. This was manifested in the crash of the NYSE whereby small and unprofessional speculators and investors became the victims of the large speculators as prevailed in the Rockwell and Blair studies carried out after the crash of the NYSE⁴⁸. The existence of gambling in the securities transaction is further acknowledged by Warren where he mentioned that the investors always become the victim of the speculators through the 'bulls' and 'bears' if they do not fully understand the market mechanism⁴⁹.

One point worth noting here is that, the game of speculative judgement in the stock market as proven in the crash of the NYSE was not only been participated by the real speculators or investors turned speculators. In the period where the speculative euphoria seems to be overpowering everybody, the brokers were also attracted and consequently associated themselves in the mania⁵⁰. Hence not only the real speculators were betting their money in the market, the brokers were also betting their

⁴⁵ Bach, George L., *Economics: An Introduction to Analysis...*, New Jersey, Prentice-Hall Inc., 1974, p. 426.

⁴⁶ Teweles, R.T. (et al.), *The Commodity Futures Game*, Op. Cit., p. 280.

⁴⁷ *Ibid.*, p. 281.

⁴⁸ Refer to the related discussion in chapter 6 of this research.

⁴⁹ Warren, H., *The Story of the Bank of England*, Op. Cit., p. 160.

⁵⁰ Refer to Lechner, A., *Street Games: Inside Stories...*, Op. Cit., p. 48.

money for instant profit from the 'bull' market. Thus in the heat of the speculative mania where large speculators win handsomely, it attracted everyone to indulge in the speculative transaction in the stock market. To show that gambling on the speculative transaction in the stock market was attractive, some of the players participated in the game without being aware of their participation. As has been admitted by Lechner, he did bet US\$3,300 in the 100 Bally shares in the NYSE. He said,

"I told my broker to sell it if it fell to \$30. I did not know what I was doing, other than I was gambling on gambling. And since I never walk into a Casino with more than \$100 in my pocket, I figured that play in a casino stock was worth only at \$300 loss"⁵¹.

8.5.3.3 The Element of Taking Advantage.

There are elements of taking advantage by the speculators on other participants in the market. These elements of taking advantage do not conform to the Islamic teaching regarding economics. The fact is that Islam disallows any action of taking advantage or taking other's property falsely. The Qur'ān clearly mentions this as follow;

"O ye who believe, eat not up your property among yourselves in vanities but let there be amongst you traffic and trade by mutual good-will..."⁵².

From the above, it is understood that to take advantage of another person is denounced by Islam. The denouncement of taking advantage is applicable in both situations i.e. taking advantage of the weaknesses of the speculator as well as of the investor, and taking advantage of the 'real' or 'artificial' inefficiency of the market.

The activity of taking advantage is rampantly undertaken in today's stock exchange by the professional speculators. These people usually manage to earn quite a handsome amount of profit at the expense of the small, new and unprofessional speculators. The sad, prevailing fact is that the greedy professional speculators earn

⁵¹ Ibid., p. 50.

⁵² The Qur'ān, 4:29.

their profit not only at the expense of small speculators, but also small real investors are also senselessly victimised⁵³. According to Chapra⁵⁴ the weaknesses of new, small and unprofessional speculators include no inside knowledge or information, no basic forecasting ability as well as acting on the basis of rumours and impulses.

This situation of one party (professional speculators) wins the game consistently at the expense of the unprofessional speculators⁵⁵ lead to the emergence of another important related element of gambling, the element of one party gain and the other party loss⁵⁶. As manifested in the betting game, the profit gained by one party usually coincides with the loss of the other party. This is what exactly takes place in the game of the speculative transactions. As proven in the crash of the NYSE in the 1929 and the current crisis in Asia, the speculative transactions are always make someone rich while the rest of the participants suffer from losing. In the words of Lechner,

"...the stock market tail spinned and crashed...individual fled the market with what little left, vowing (as he had before) never to return"⁵⁷.

"...as long as the game might still make someone rich, it will have its participants"⁵⁸.

In addition, taking advantage also materialises in a situation where inefficiency of a market prevails. The professional speculators step in and take advantage of the inefficiency of the market. This leads to unnecessary disturbances of the price fluctuation of the free market⁵⁹. This situation will lead to price and market instability as pointed out by Aliber. The result of his survey indicated that when a speculative

⁵³ The Rockwell and Blair Studies conducted separately in the US showed that 75% speculators lost their capital to the professional speculators. See Teweles, R.T. (et al.), *The Commodity Futures Game*, Op. Cit., pp. 296-302.

⁵⁴ Chapra, M.U., *Towards A Just Monetary System*, Op. Cit., p. 97.

⁵⁵ As stated by Teweles, studies revealed that the large speculators (professional) win consistently at the expense of the small and unprofessional speculators. Refer Teweles, R.T. (et al.), *The Commodity Futures Game*, Op. Cit., pp. 299-302. This situation is true as pointed out by Kindleberger, the professional speculators have an advantage over the small and unprofessional speculators. This is because the large or professional speculators usually have more opportunity to get inside informations compared to the small speculators whereby it could lead to the market and price manipulation. See Kindleberger, C.P., *Manias, Panics, and Crashes...*, Op. Cit., p. 32.

⁵⁶ Refer to Green, P., *Betting and Gambling*, Op. Cit., p. 66.

⁵⁷ Lachner, A., *Street Games: Inside Stories...*, Op. Cit., p. xii.

⁵⁸ *Ibid.*, p. xiii.

⁵⁹ Rix, M.S., *Stock Market Economics*, Op. Cit., p. 212.

transaction occurs, it frequently causes amplification rather than dampening the range in spot prices' movement⁶⁰. This price disturbance of a free market is contradictory to the economic teaching of Islam since it is a kind of price manipulation⁶¹ by the speculator. Accordingly, price interference in the free market is forbidden so as to safeguard the public interest⁶² rather than the interests of this small group of speculators. Hence, it can be deduced that taking advantage in any business activity does not conform with the teaching of Islam.

8.5.3.4 The Element of Fundamental.

The element of fundamentals of a company is an important aspect for investor to know prior to making an investment. This step is very vital for every investor as it helps them to invest their surplus money in something sound and reliable in the economy and not in something imaginative and unrealistic. Evaluation is based on current asset, previous performance, viable future plan and all its elements related to the company. Thus, viewed from the economic perspective, to invest based on, in the words of Kindleberger, "a lost contact of reality"⁶³ will bring 'de trop' consequences to the economy.

To take the above measure is to make sure that the economic stability of a company, as well as a country, continues to flourish. Investing money in business ventures by properly analysing their strengths and weaknesses is a great help. The investment that is based on the fundamental aspects of a company would not be much affected by changes in the economic situation, especially changes that take place due to untruthful information and rumours. Hence, there would be no need to worry about the investment that had been made, since the investment was based on something fundamental which 'exists'. What the present writer means by 'exists' here is that the

⁶⁰ Aliber, R.Z., "Speculation and Price Stability...", Op. Cit., pp. 607-9.

⁶¹ Qaradāwī, Yūsuf, *The Lawful and the Prohibited in Islam*, Op. Cit., p. 255.

⁶² Ibid., p. 258.

⁶³ The usage of this phrase by Kindleberger is to indicate the peak position of price in a stock market whereby profits are substantial and there is a tremendous daily turnover of shares. However, the situation does not reflect the real economic strength of the particular country. It is more based on wild assumption and non-sensical prediction of continuous economic prosperity. Precisely, it is a bubble, a mania or any term used to denote a loss of contact with reality. Refer Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit., p. 109.

fundamental assets of the company are there. If ever the company closes down, the investor can expect to receive something from them.

However, the above is not the situation in the case of speculators who invest their surplus of money blindly. As the injection of their money surplus is based on profit expectation and highly imaginative in nature, they will find that if there is a changing economic situation, the value of their shares could be easily affected. This is because the basis of speculative investment is based on something which does not really equate to how it is being valued. A slight change in the economic situation would be enough to cause huge changes because the changes will gain momentum while spreading. From something small they become large and then, accordingly are accepted as a reason for selling or buying shares by the speculator. As imaginative investment is part of their life, they tend to be very responsive to any change in economics, even to a small change. Suicide occurred daily as billions of dollars were burnt in the 'game of speculative transaction' that took place in the US during the New York Stock Exchange crashes in 1929⁶⁴ and in the UK, during the tragedy of the South Sea Bubble in 1720⁶⁵.

In the tragedy of the South Sea Bubble, the work carried out by speculators caused the value of the South Sea Company shares to rocket from £100 to £1,000 within a month. Suddenly, a few days later, after the peak point, this unrealistic valuation of the company's worth started to fall down and consequently almost returned to its real and original value of £175⁶⁶. This tragedy truly indicates that the price of shares undergoing speculative manipulation does not usually represent the real value of the company. This was stated by Boughton and Wicker, "to be sure that market value depends primarily on what prospective stock purchasers think the stock is worth, there is no precise linkage between a company's current profits and the price of its stock in the open market..."⁶⁷.

⁶⁴ Yass, M., *The Great Depression*, Op. Cit., p. 26.

⁶⁵ Warren, H., *The Story of the Bank of England*, Op. Cit., pp. 177-80.

⁶⁶ *Ibid.*, pp. 177-80.

⁶⁷ Boughton, J.M., and Wicker, E.R., *The Principles of Monetary Economics*, Illinois, Richard D. Irwin Inc., 1975, p. 181.

In the above cited tragedy, the genuine investors theoretically should not have been affected by the down fall of the South Sea Company shares in the market. They invested based on the real valuation of the company which was £100. When the price started to rise, the speculators began to step in and made the price of the South Sea Company soar. Although the speculative valuation of the company's shares had risen to £1000 within one month and suddenly fell to only £175, the investors' shares were still valued at £75 above the price they bought earlier in the month i.e. £175 - £100. However billions of pounds (£1000 - £175 x number of shares) of capital belonging to the society who were being tempted were wasted by the imaginative and speculative game of the South Sea Bubble.

Rationally, it is impossible for shares of a company to rise to more than ten times of their original value within that short a time. It only happened due to imaginary valuation which was detached from the real world. In the words of Kindleberger,

"The additional rise above the true capital will only be imaginary; one added to one, by any stretch of vulgar arithmetic will never make three and a half, consequently all fictitious value must be a loss to some person or other first or last. The only way to prevent it to oneself must be to sell out betimes, and so let the Devil take the hindmost"⁶⁸.

Hence, while the speculators suffered a great loss to their surplus income, the real investors should have been keeping their shares happily.

The above assumption on the happy position of the investors is based on their determination not to be carried away by those very attractive games of speculative transaction. If they manage to hold to their principle of putting their money to the purpose of real investment and not for the game of speculative transaction, then they succeed as real investors.

However, this might not be what happens to all the investors in every financial crisis, because of the gigantic temptation caused by the game of speculative transaction. As

⁶⁸ Kindleberger, C.P., *Manias, Panics, and Crashes...*, Op. Cit., p. 34.

stated by Kindleberger⁶⁹, speculation usually develops in two different stages. First, everyone who possesses surplus income will invest in the company of their choice, holding tightly to the principles of investment. They invest their money after careful knowledgeable analysis of the performance of the company, as well as the market. When speculation starts to affect the market due to the effort of speculators, especially big speculators, within a limited and controllable environment the real investors start to re-think the principles of investment that they hold. As the speculative price rises further because of price manipulation, the second stage could take place at any time. At this stage, irrationality overcomes rationality, their interest in business gain is overpowered by their interest in capital gain, and through selling their principals, sober investors turn into greedy speculators.

In the above case, the investors would be likely to face the same consequences as the speculators if any economic event or disaster struck the market. This is because they would have already changed their role from being real investors into 'part time' speculators. As was mentioned before, two studies were made subsequent to the event of the New York Stock Exchange crashes. The Rockwell and Blair Studies have proved that the large and professional speculators win constantly at the expense of the small and unprofessional speculators.

The two tragedies cited above give a clear indication to everyone that investment in business ventures, must be based on the fundamental and realistic asset of the company. A proper analysis should be made and to invest based on purely imaginative and unrealistic elements should be avoided. The disastrous consequences of being purely imaginative in investing money would not only be faced by individual investors, but would also be likely to cause economic disaster to that particular country, as well as to the world's economic achievement. This was testified in the World Great Depression of the 1930s. Accordingly, to inject surplus money based purely on speculative and imaginative principles is contradictory to the economic teachings of Islam.

⁶⁹ Ibid., pp. 30-2.

8.6 Conclusion.

The present writer shall now conclude the above discussion regarding the elements of gambling that present in the speculative activity in the stock market. Islam holds that to speculate in various economic events is permissible, nevertheless speculation should not be incorporated with the elements denounced by Islam such as pure hope and luck, betting, taking advantage and unrealistic economic fundamentals. This is genuinely important, as the embodiment of these elements would undermine and jeopardise man's ability for rational speculation. Furthermore, if these elements are allowed to creep into the decision making of business transactions in the stock exchange, it will lead to the economic situation described by Kindleberger as 'loss of contact with reality'⁷⁰. If this economic scenario goes unchecked, it will cause problems to the economy of a country as well as to the world as demonstrated in the World Great Depression in the 1930s.

The above discussion showed that the existence of element *al-maisir* (gambling) in the speculative business transactions in the stock market is clearly manifested. In fact as testified by Lechner, the authority of the market is the 'promoter' of gaming in the stock market by creating new games to replace the old abandoned game with new promises to the participants. Games continue with different names and different players and it will always attract players from the public as long as it managed to make someone rich⁷¹. As the presence of these elements brings disturbances to the rational speculators or professional investors, therefore they are renounced by Islam. Hence, the existence of these elements in the speculative transaction of a stock market needs to be reviewed, restricted and even abolished, so as to make the business of the stock market participatable for every Muslim and more just and equitable for non-Muslims.

⁷⁰ See footnote no. 63 of this chapter.

⁷¹ Lechner, A., *Street Games: Inside Stories...*, Op. Cit., pp. xi-xiii

CHAPTER 9

SPECULATION FROM THE ISLAMIC PERSPECTIVE: ON THE NEGATIVE ELEMENTS IN THE SPECULATIVE TRANSACTIONS OF THE STOCK MARKET.

9.1 Introduction.

Apart from the element of *al-maisir* (gambling) in speculative transactions in the stock market which is denounced by Islam and discussed in the previous chapter, there are a few other elements associated with the speculative business transactions in the stock market which have become the concern of Islam. Elements such as *al-gharār* (uncertainty), malpractices, unethical activity and unearned income are always seen to go together with speculative activity in the stock market. In this chapter, the present writer shall focus on the presence of these elements and correspondingly, any consequences caused by them during speculative transactions in a stock market. This discussion will further justify the aspect of permissibility or rejectability of the speculative business transactions in the stock market.

9.2 The Presence of *al-Gharār* (Uncertainty).

The presence of *al-gharār* in speculative transactions of the stock market is apparent. In fact the general definition of the word speculation as discussed in chapter six of this research, denotes the situation as unreliable, doubtful and untrustworthy¹. Hence, speculative transactions in the stock market represent the situation of business dealings where their certainty or reliability is still not clear. Hence, this is actually *al-gharār* happening in the particular business transaction.

¹ Refer to the discussion of the definition of the word 'speculation' in chapter 6 of this research.

*Al-Gharār*² literally means danger, hazard, peril and other words that provide a similar connotation³. In other words it refers to an uncertain, unpredictable, situation concerning business transactions or business dealings. The word is usually translated into English as 'uncertainty'.

The theory of uncertainty was first developed by Professor Knight⁴, whose interest in the theory of profit led to the development of the uncertainty theory. He concluded that profits are earned in business transactions because the entrepreneurs are willing to bear the risks of uncertainty. The existence of uncertainty results from the lack of knowledge which is necessary for the entrepreneurs to maximise profits and to minimise losses. This situation leads to a process of guessing and estimating which consequently affects the precision of the decision implemented⁵.

However, in the business world, some uncertainties can be calculated and hence avoided through research activities and information gathering, while some others cannot be avoided completely⁶. From this perspective therefore, Hanson states that the word 'uncertainty' which is borne by the entrepreneurs refers to the second situation, uncalculated and unexpected risks⁷. Therefore in the business world, the usage of the word infers the meaning of "to undertake anything blindly without

² For further details on the discussion of the word, refer to al-Jawzīyyah, Ibn Qayyim, *I'lam al-Muwaqqi'īn* (Vol. 1), Beirut, Dār al-Fīkr, n.d., pp. 357-61, al-Qurafi, A.I., *al-Furuq* (Vol. 3), Cairo, Dār Iḥyā al-Kutub al-'Arābiyyah, 1965, pp. 265-6, Ṣāliḥ, Nabil A., *Unlawful Gain and Legitimate Profit...*, Op. Cit., pp. 49-85 and Hassan, 'Abdullāh A., *Sales and Contracts in Early Islamic Commercial Law*, Islamabad, Islamic Research Institute, 1994, pp. 47-75.

³ *Mu'jam al-Wāsiṭ* (Vol. 2), Turki, Dār al-Da'wah, 1986, p. 648.

⁴ Seldon, A. and Pennance, F.H., *Everyman's Dictionary of Economics*, Op. Cit., under the entry "uncertainty".

⁵ Ibid.

⁶ See Koutsoyiannis, A., *Modern Microeconomics* (2nd Ed.), London, The Macmillan Press Ltd., 1978, p. 395.

⁷ Hanson divided risk into two, calculated and uncalculated risks, where the first is insurable and hence be avoided while the second is not. Therefore to him, the second is the real application of the word "uncertainty" in the business world. See Hanson, *A Dictionary of Economics and Commerce*, Op. Cit., under the entry "uncertainty".

sufficient knowledge, or to risk oneself in a venture not knowing exactly what the result will be, or to rush headlong into a peril without regard for the consequences"⁸.

As was pointed out in chapter three of this research⁹ the definitions of *al-gharār* given by *fuqahā* are varied. However from their definitions, the present writer shall deduce here a precise definition of *al-gharār* which is the uncertainty that is present in the 'aqd (contract) in business transactions and which is concerned with the unclarity and ambiguity concerning the time, price, quantity, quality, and security of the article transacted as well as an act of taking advantage by one party who is involved in the transaction, over the other party¹⁰. The writer shall conclude here that *gharār* refers to uncertain circumstances surrounding a business venture or business transaction due to imperfect knowledge of the market which is closely related to the party and the article involved.

9.2.1 The Prohibition of *al-Gharār*.

The prohibition of *al-gharār* is rooted in the *aḥādīth* (traditions) of the Prophet Muḥammad. However, one verse of the Qur'ān that is usually quoted by Muslim scholars when discussing the subject is verse 29 from *sūrah al-nisā'* (the chapter of the women) which says,

"O ye who believe, eat not up your property among yourselves in vanities; but let there be amongst you traffic and trade by mutual good-will, nor kill (or destroy) yourselves; for verily *Allāh* hath been

⁸ Sanusi, Mahmood M., "*Gharār*" in the International Islamic University Malaysia Law Journal (IIUM Law Journal), Petaling Jaya Malaysia, IIUM Press, p. 102.

⁹ Refer to the brief discussion of the subject in chapter 3 of this research under the subtopic 'other mal-practices in the business world'.

¹⁰ The aspect of taking advantage in the business transaction through, saying or acting by one party to the other party who is involved in the business transaction, is also a definition of *gharār* given by *fuqahā*'. In this respect, they define *al-gharār* as an act of falsely acting or saying by one party with the purpose of attracting the other party to conclude and accept the business transaction. See Ngadimon, N. and Rusly, S.A., "*Konsep-konsep Pelaburan, Spekulasi, Ghurmi, Gharār dan Perjudian dalam Islam*" (The concept of Investment, Speculation, *Ghurmi*, *Gharār* and Gambling in Islam) a paper presented in Seminar series on Islamic Economics at the National Productivity Center Hotel, P. Jaya Malaysia, April 26-27, 1994.

to you most Merciful".

According to Asād, if taken literally, this verse could imply that to profit from mutual business agreements is also forbidden. However he added that most of the *mufassirūn* (commentators of the Qur'ān) comment that the particle *illa* used in this particular verse means "but" instead of "not"¹¹. Hence the permission to do legal trade, by stressing the words "mutual agreement" in the above verse in order to profit between one another, implies that there must be no *bay' al-gharār* involved in the transaction¹². This is because legal trade with mutual agreement in Islam connotes that the validity of the transaction undertaken is certain, and that no uncertainty or ambiguity is present whether in terms of its *'aqd* (contract), goods transacted (quality and quantity) and price agreed, as well as the business obligation of the parties involved.

The Islamic injunctions on the subject of *bay' al-gharār* are abundantly available in the *ḥadīth* (tradition) of the Prophet Muḥammad. Many contemporary Muslim scholars had pointed out a number of *aḥādīth* that directly prohibit the transaction involving *gharār*¹³.

One important *ḥadīth* reported by Muslim,

"Abu Hurairah (r.a) reported that Allah's Messenger forbade a transaction determined by throwing stones and the type which involves some uncertainty"¹⁴.

¹¹ See Asād, Muḥammad, *The Message of the Qur'ān*, Gibraltar, Dār al-Andalus, 1980, refer to the foot note no. 38 of *sūrah al-nisā'* (chapter of the women).

¹² See Hussin Salamon, *The Concept of Takāful in Islam and its Applicability in Malaysia*, unpublished M.A. dissertation, Kulliyah of Islamic Revealed Knowledge and Human Sciences, International Islamic University, Malaysia, November 1991, p. 82.

¹³ Refer to al-Nawawī, Muḥy al-Dīn Abū Zakariyyā Yahyā, *Ṣaḥīḥ Muslim bi Sharḥ al-Nawawī*, Vol. 10, Cairo, al-Maṭba 'ah al-Miṣriyyah, n.d., under '*kitāb al-buyū'*', Al-Zarqā', M.A., '*Aqd al-Ta'mīn wa Mawqīf al-Sharī'ah al-Islāmiyyah*, Damascus, University Press, 1962, p. 45, Hassan, 'Abdullāh A., *Sales and Contracts in Early Islamic...*, Op. Cit., pp. 47-75 and Ṣāliḥ, Nabil A., *Unlawful Gain and Legitimate Profit...*, Op. Cit., pp. 49-85.

¹⁴ Al-Nawawī, *Ṣaḥīḥ Muslim bi Sharḥ al-Nawawī*, Op. Cit., pp. 156-7. For the English translation, refer to Siddiqi, A.Ḥamīd, *English Translation of Ṣaḥīḥ Muslim*, Vol. 3, Beirut, Dār al-'Arābiyyah, 1992, p. 798, *ḥadīth* no 3614.

There are many other *aḥādīth* of the Prophet Muhammad regarding *bay' al-gharār* and as pointed out by Hassan in his research, there are more than 26 types of business transactions that involve *al-gharār* mentioned by the Prophet¹⁵. All these *gharār's* transactions are forbidden by the Prophet as they have embodied in them uncertainty, risks and speculation¹⁶.

However, one point worth noting here is that the prohibition does not absolutely affect every sale that incorporates *gharār* (uncertainty). This is because in every venture, there is always a small unavoidable element of risk and uncertainty. What is prohibited in Islam is the transaction or selling of something that involves an obvious and clear element of *gharār*. The prohibition of *sharī'ah* on *bay' al-gharār* is based on probability that this type of transaction or sale may lead to future dispute and conflict between the parties involved. It may also lead to the unjust possession of the property of other people.

From the above discussion, the writer shall condense and simplify the prohibitions of *al-gharār* in business transactions into a few important points as follows;

- a) uncertainty in terms of goods or articles transacted which is concerned with the aspect of ambiguity aspect of its quality, quantity, price and the existence of the substance.
- b) uncertainty concerning the circumstances surrounding the transaction, which are concerned with the aspect of the time factor and safety.
- c) uncertainty with respect to the *'aqd* (contract) itself which is concerned with the matter of mutual agreement that based on 'sincere full information'¹⁷ regarding the article transacted and circumstances related to the goods.

¹⁵ Hassan, 'Abdullāh A., Sales and Contracts in Early Islamic..., Op. Cit., pp. 47-75.

¹⁶ Ṣāliḥ, Nabil A., Unlawful Gain and Legitimate Profit..., Op. Cit., p. 85.

¹⁷ This aspect must ascertain that there are no unbecoming factors that can invalidate this principle of 'mutual agreement' such as the existence of *ikrāh* (compulsion) on one of the parties by the other. Simultaneously, sincere full information must prevail in the business contract. What the present writer means by 'sincere full information' refers to the information on the article or the subject of the business

d) uncertainties that are concerned with the parties involved in the transaction, whether one of the parties involved have advantageously influenced the other party, resulting in the conclusion of the business contract.

It is clear from the above that the existence of those uncertainties may cause dispute in the future and an unjustifiable method of wealth possession. However, if the existence of *gharār* (uncertainty) is something small, common and bearable and it involves a needed item, then Islam shows its *rukḥṣah* (flexibility) by allowing the transaction to be carried out¹⁸. However, to take this *rukḥṣah*, some Muslims scholars add two additional conditions. The first is that the *gharār* is not to be practised intentionally and the second, it must be in accordance to the principle of *ḍarūrah* (emergency) prescribed in the teaching of the *sharī'ah*¹⁹.

Unfortunately the above conditions for *rukḥṣah* (flexibility) which lead to the permissibility of *bay' al-gharār* provided by the *sharī'ah* are not present in the daily speculative transactions carried out by speculators in the stock market. Some of these speculative transactions contain a very distinctive feature of the *gharār* contract which means that under the standard judgement of Islamic Law, they are still beyond the boundary of a lawful business transaction. Therefore, many Muslim economists argue in their writings concerning the unpermissibility of the transactions,²⁰ and *fatāwā* (religious rulings) forbidding these contracts have been collectively passed by the *fuqahā'* in their religious council meeting²¹.

contract. This information is on the things that the party has the right to know, especially about the bad side of the article or the contract which is in today's business transactions are often concealed.

¹⁸ Al-Qaradāwī, Y., *The Lawful and the Prohibited...*, Op. Cit., pp. 253-5. See also Siddīqi, M.N., *Insurance in an Islamic Economy*, Leicester, The Islamic Foundation, 1985, pp. 40-3.

¹⁹ See Hussin Salamon, "The Concept of Takāful in Islam and its Applicability in Malaysia", Op. Cit., p. 84.

²⁰ Examples of Muslim Economists who wrote on the aspect are Chapra, M.U. in one of his writings, *Towards a Just Monetary System*, Op. Cit., pp. 95-101, Khan, M.A., "Commodity Exchange and Stock Exchange in an Islamic Economy" Op. Cit., pp. 47-50 and Elgari, Mohamed, "Towards an Islamic Stock Market" in *New Horizon*, London, October 1994.

²¹ An example of such a religious council is The Council of the *Fiqh* Academy, based in Jeddah and comprising of 46 member countries of the Organisation of the Islamic Conference (OIC). In their 7th meeting to discuss questions of *fiqh* (jurisprudence) relating to a number of Islamic financial transactions and products in 1992, the Council passed a few rulings including the unpermissibility of currencies

9.2.2 *Gharār* in the Speculative Activities of the Stock Market.

There are various transaction instruments present in the modern stock market that are speculative in nature. These transactions which involve clear *gharār* contracts are not in conformity with the *sharī'ah* and hence forbidden by Islam. For the purpose of this discussion, the present writer will briefly present some of the speculative transactions in the stock market which are involved in aspects of *al-gharār*. These contracts, namely short selling, margin selling, option and future markets will only be viewed in respect to the existence of *al-gharār*, though there might be other negative elements in them. The existence of other negative elements in these contracts will be dealt with in further detail in chapter ten of this research²².

9.2.2.1 *Al-Gharār* in Short Selling.

As pointed out in the previous discussion, short selling is a transaction that is highly speculative in nature and operates in a modern stock market. One aspect that is apparent in the operation of short selling is that the speculators who sell short are usually selling shares which are not in their possession, or if they possess them, there is no intention for the shares to be delivered. In the first situation, they usually borrow the share scripts from brokers, friends or somebody that they know. They take this position with the expectation of price decreases so they can make an 'offsetting' purchase to gain quick speculative profit on the price difference (selling price minus price of 'offsetting' purchase). Since the shares they are selling are not theirs', the *gharār* in this transaction is present with respect to the possession of the shares. *Al-Gharār* can be clearly seen in two aspects, firstly the speculators who sell the shares are not the owner of the shares. Secondly, the '*aqd* carried out in this

trading and short selling, margin trading and trading in the futures in the stock market. Refer to "Latest Islamic Fiqh Academy Rulings on Finance" in New Horizon, UK., March 1993.

²² For a detailed discussion concerning the subject of *gharār* in the speculative transaction of the stock market, refer to chapter 9 of this research under the sub-topic of 'unnecessary elements existing within the stock market'.

particular transaction is not valid as the buyers are not buying the shares from the owner, especially in the case where the owners are not being told regarding the transaction involving their possession.

In the second situation, though the speculators possess the shares they are selling, there is no intention to deliver them. This is another position taken by the speculators in short selling. This type of transaction clearly invalidates the *'aqd* (contract) carried out as there is no mutual agreement between the parties involved in the transaction. As was noted earlier, the present of *al-gharār* in the contract is one important aspect that could lead to the unpermissibility of the transaction. The ambiguousness of the *'aqd* leads to the existence of *al-gharār* and hence, to the prohibition of the transaction.

Another *gharār* that exists in the speculative transaction of short selling is related to the aspect of deceit trading of those particular shares. The speculator, with his/her vast knowledge and information on the market (regardless of the source of the information whether through economic analysis or rumours and 'insiders' information) more or less knows the position of the shares that he/she is selling. The price of the shares is going downwards and he/she is advantageously using the situation of the market by selling 'devalued' shares to the 'potential victim' among the market participants. This is also an aspect of clear and prohibited *gharār* as mentioned above.

9.2.2.2 *Al-Gharār* in Margin Selling.

Margin trading is another type of business transaction in the stock market which is highly speculative in nature. The transaction gives more room for the speculators to gain a larger profit with the same amount of capital (simultaneously larger loss in the event of a miss-speculation). As the speculators only pay a small fraction of the price and the rest is secured from the brokers' loans, the shares are in the hands of the brokers as collateral.

The existence of *al-gharār* in this transaction is distinctively manifested in the aspect of the possession of the shares, between the brokers (the lenders) or the margin holders (speculators). Let us assume that the loan secured from the brokers by the margin account holders is permissible from the *sharī'ah* point of view²³. Under the *sharī'ah* point of view, any loan secured by a person will automatically secure him/her the right of ownership of the wealth²⁴. Correspondingly the transaction of the trading on margin is also bound to settle the problem of share entitlement in accordance to the above *sharī'ah* view point. The brokers (lenders) have to hand over the ownership of the shares to the margin holders and they must not keep the share script as collateral, as is practiced in today's transaction of trading on margin. Unless the possession of the share script is handed over to the real owner (the margin holders) after the conclusion of the business contract, there is a clear element of *gharār* present in the transaction of margin trading.

Another element of *al-gharār* that is present in the transaction of margin trading is with regards the aspect of full payment for the shares by the margin holders. The *gharār* (uncertainty) exists here as the transaction does not take into consideration the full payment of the share prices. There is no indication that the margin holders will complete the payment of the whole share prices²⁵. The activity that is repeated all the time is the process of profit withdrawal by the speculators from the brokers in the event of share price increases. While in the case of price decreases, the speculators have to pay the 'margin call' to the brokers (lenders) to ensure the margin account is always at the level of minimum requirement. The *gharār* appears here with respect

²³ This assumption is used here to simplify the discussion that there is no *ribā* bearing transaction in the loan secured, and hence in the margin trading itself. The assumption is that the loan is secured within the boundary of the *sharī'ah* permissibility (under *muḍārabah* or *shirkah* contract).

²⁴ For further details refer to the discussion of the subject in chapter 5 of this research under the sub-topic 'the Issue of Liability', where the Islamic account on the question of loans secured is discussed.

²⁵ The settlement of the business transaction of trading on margin usually takes place when the margin holders do not intend anymore to continue their holding on the margin account. They can settle the account by liquidifying the shares or through fully paying the outstanding amount to the brokers for the total possession of the shares.

to the settlement of the full buying price of the shares, as well as to the aspect of the time duration of the price settlement.

The other element of *gharār* which exists in margin trading is related to the aspect of the margin holders' capability with respect to the question of capital possession. As this instrument provides much room for speculators to deal with large speculative transactions using relatively small capital, it usually tempts the small speculators to get involved in large dealing in margin trading. With small capital in hand they will participate in a large dealing of this transaction with the expectation of making profit. A slight downwards movement in share prices, will eventually give greater effect to the margin holders (speculators). Hence the *gharār* exists here with respect to the question of their capability in coping with the situation with their small available capital. This *gharār* of gaining or losing by using relatively small amounts of capital compared to the large dealing they have participated in is in fact condemned by the Qur'ān as it says, "Do not throw yourselves in the valley of destruction"²⁶.

9.2.2.3 *Al-Gharār* in the Option Market²⁷.

As discussed in chapter four, options in a business contract is speculative in nature because it allows the participants to pay a price on the right to buy or to sell securities in a stock market²⁸. The speculators in the option market can profit or lose from the contract done in the current time for something in the future, without taking into consideration any economic changes that may take place within the period of the contract. There are a few *gharār* present in the option market.

²⁶ The Qur'ān, 2:195.

²⁷ For the discussion on the other negative elements existing in the option market, refer to chapter 9 of this research under the sub-topic 'the omission of the option market'. The discussion leads to the conclusion that the option market practiced in the conventional stock market needs to be omitted from the alternative model of a stock market in Islam.

²⁸ For further details on the business operation of an option transaction which is speculative in nature, refer to chapter 4 of this research on the sub-topic 'Options; Puts and Calls'.

The aspect of *al-gharār* is present in this type of transaction with regard to the question of uncertainty of the future position of the participants. As with other speculative transactions in the stock market, the speculators who participate in the option market usually indulge in a short term business transactions. In the option market the standard and common period for share holdings are three and occasionally six months²⁹. Their purpose is only to gain profit caused by the price movement in the market as expected by them. The decisions to participate in the market, as are usually made by the speculators, are not based on the economic fundamentals, instead they are based on the sentiment of the market based on rumours and the trend of the price movement, in order to gain a quick capital profit in a short period. This aspect of detaching themselves from the economic reality or economic fundamentals is in itself *al-gharār* and hence the result to be achieved by them in the future is apparently uncertain.

The above situation is more visible when the speculators pay options for both rights, the right to buy and the right to sell. This position certainly represents a clear *gharār* in the transaction of an option market because the speculators who pay these two rights are unsure of the sentiment of the market. Firstly, they are not sure concerning the 'information' or more precisely the rumours gathered, and secondly they are not able to predict the trend of the price movement in the future. Hence to be on the safe side, they pay for both options in the hope that they can make profit on either direction of the price movement; upwards or downwards. Hence, the uncertain position of the speculators regarding the sentiment of the market which results in paying the two options, is itself a clear and non-allowable *gharār* from the Islamic point of view.

The other aspect of *al-gharār* in the transaction of the option market is seen with respect to the question of the 'option cost', the option money paid to the dealers or brokers. The position of the money is also uncertain. If the expectation of the option

²⁹ Elgari, M., "Towards An Islamic Stock Market", Op. Cit., p. 4. See also A Dictionary of Economics and Business, Op. Cit., under the entry "option", p. 304.

holders materialises, the option money will remain in their possession with the profit gained from the business transaction. However in the case of 'miss-speculation', the speculators are allowed to abandon their contract and the option money will be forfeited by the dealers or brokers. This is a clear *al-gharār* involved in the business transaction of the option market.

What is more important, in this particular aspect, is that the way option dealing is carried out is similar to the operation of betting or gambling; if the expectation is correct, they will gain profit, and if it is not, they will lose their 'betting money'. This is actually one of the main reasons behind the prohibition of gambling by the *sharī'ah*, the presence of unnecessary risk in the transaction, which is considered as unbearable and hence unpermissible *gharār* in Islam³⁰.

9.2.2.4 *Al-Gharār* in the Future Market.

The future market is a common activity in the commodity market. In the stock market, the activity of future trading is quite a new business transaction instrument³¹. The operation of future trading in the stock market is the same as the one operated in the commodity market. However while in the commodity market, the contract is for the transaction of commodity, in the stock market, it is concerned with stocks and shares.

Transactions of the future market are highly speculative. According to Khan³², there are two types of speculators present in the market namely the 'permanent speculators with large stake, long-standing and wider network' and 'temporary speculators' who are usually the victims of the permanent speculators. As the involvement of the

³⁰ For a general discussion on the prohibition of *al-maisir* (gambling) in Islam, refer to chapter 3 of this research under the sub-topic 'the prohibition of *al-maisir*'. For a specific discussion on the aspect of *al-maisir* in the stock market and its prohibition in Islam refer to chapter 8 of this research.

³¹ Cox, J.C. and Rubinstein, M., *Options Market*, New Jersey, Prentice-Hall, 1985, p. 500.

³² Khan, M.A., "Commodity Exchange and Stock Exchange...", *Op. Cit.*, pp. 40-1.

speculators in the market is common, hence the question of *al-gharār* seems to be simultaneously present.

The existence of *gharār* in the transaction of future trading in the stock market is apparent. In this type of business transaction, as the transaction is for the future, the commodity or shares are non-existent and hence, there is no physical transfer in the transaction. Furthermore, as pointed out by Khan, the transaction usually takes place without any one of the parties involved owning the substance and the physical delivery hardly ever takes place³³. According to him, only about one per cent of the whole commodity future trading's contract materialises into physical delivery when it reaches the maturity date³⁴. In the provocative words of Kamali "it is only a paper transaction and not a genuine sale"³⁵.

As mentioned earlier in the discussion of *al-gharār*, the non-existence of substances in the transaction is a kind of *al-gharār*'s transaction which is disallowed by Islam. Some may similarise this transaction with *bay' al-salam*³⁶. The above future trading is not the same as the legally binding Islamic business transaction of *bay' al-salam* in many aspects. One of these aspects is the question of bearable *gharār* in the business transaction of *bay' al-salam* and unbearable *gharār* in the business transaction of future trading.

Bay' al-salam is a kind of business transaction allowed by Islam though it involves an aspect of *gharār*. In this transaction both parties agree to conclude a business

³³ Ibid., pp. 40 and 49-50.

³⁴ Ibid., p. 39. According to Muftī Taqī Usmānī, there are two reasons behind the prohibition of futures contracts in Islam. Firstly, from the *sharī'ah* point of view, sale or purchase cannot be affected for a future date. Secondly, in most of the futures contracts, physical delivery is not intended and usually end up with the settlement of the price difference. See "Futures, Options, Swaps and Equity Investments" in New Horizon, London, Institute of Islamic Banking & Insurance, June 1996.

³⁵ See Kamali, M. Hashim, "Islamic Commercial Law: An Analysis of the Futures" in *The American Journal of Islamic Social Sciences* (Vol. 13, No. 2), 1996, p. 199.

³⁶ *Bay' al-salam* refers to a transaction contract whereby the payment is made in advance by the buyer. The article of the transaction is to be delivered in the future at the stipulated time. The Prophet approved this type of transaction. See Rayner, S.E., *The Theory of Contracts in Islamic Law*, London, Graham & Trotman, 1991, pp. 134-7.

transaction where the buyer has to pay the full amount of the buying price at the time of the contract concluded and the seller is obliged to deliver the substance later in the future. Although the substance is to be delivered in the future, the details of the substance i.e the quality, quantity and time is stipulated clearly in the contract. Hence, the existence of *al-gharār* in this type of transaction is something bearable as the seller is legally responsible to fulfil the contract obligation. While in the contract of future trading, though the substance is also to be delivered in the future, the price, in contrast to the *bay' al-salam*, is also to be paid in the future. As the aspect of delivery and payment are both deferred, it is not the same as the *bay' al-salam* contract, where only one aspect is deferred, that is the delivering of the substance. As the *sharī'ah* allows only one aspect to be deferred and not both³⁷, the future contract is not valid from the *sharī'ah* point of view.

9.3 Speculation and Malpractices in the Stock Market.

As discussed in chapter three, wealth in Islam is considered as an *amānah* (responsibility) that God trusted upon human beings. Since human beings are accountable to this *amānah* and will be asked about it in the day of judgement, Muslims have to carry this responsibility in accordance with God's Will, to attain His *riḍā* (pleasure). With respect to this view point therefore, Islam has ordained its followers to ensure that their method of acquiring, possessing and spending wealth must always be in accordance to the teaching of the *sharī'ah*. There must be no *ḥarām* (unlawful) ways associated with Muslims in obtaining, possessing or spending wealth such as *al-ribā* (interest), *al-maisir* (gambling), *al-iḥtikār* (hoarding), *al-gharār* (clear uncertainty), deceit in trading, market manipulation and

³⁷ Kamali in his writing mentioned that the stance of *sharī'ah* in respect of disallowing both aspects to be deferred is clear, as stated in the prohibition of *bay' al-kāli' bi al-kāli'* (sale of one debt for another). However, he made a very provocative argument that this future trading is a new phenomena in the business world which does not have a parallel situation in the traditional *fiqh al-mu'āmalāt* (jurisprudence of transaction). Hence according to him, a new and different interpretation on the subject must be done since the new phenomena needs a new and different set of rules. To some extent, his writing gives a new interpretation on the subject. For further details refer Kamali, M. Hashim, "Islamic Commercial Law:...", Op. Cit., p. 198-9.

exploitation of labour³⁸. While the existence of market rigging, market cornering and inside trading is illegally practiced in the business transaction of the stock market it is also prohibited in Islam as it is being used to manipulate the market for the benefit of the speculators at the expense of the small unprofessional speculators and investors.

In chapter four of this research, we have already discussed the existence of malpractices in the stock market. What the present writer meant by malpractices refers to a situation where the speculators use illegal methods to influence the market stability especially with regards to share prices in order to attain profit. Therefore the price of shares in the market is said to be susceptible to manipulation and rigging and though there were steps taken to protect the market from the practice, it was unsuccessful³⁹. In the words of Lechner,

"...while selling booze was a crime against the state, stock manipulation, market cornering, selling shares in non-existent companies, and issuing false or misleading statements about corporations were all considered standard business practices"⁴⁰.

Based on the apparent existence of these practices in Wall Street therefore, Sage considered the market "the greatest playground in the world"⁴¹. Among these malpractices are market manipulation, market cornering, market rigging, inside trading and rumour spreading⁴². In addition to the these malpractices, the above quotation included the practice of selling shares in non-existent companies, which is a clear business deceit. This sadly happens in modern business transactions in the stock market especially during the economic boom of a country. Lechner illustrated a good example during the NYSE boom where a man pretending to be the president

³⁸ Refer to the discussion of these aspects in chapter 3 of this research.

³⁹ Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., P. 97-8.

⁴⁰ Lechner, A., *Street Games: Inside Stories...*, Op. Cit., p. 57.

⁴¹ Sage, M., *Street Fighting at Wall and Board: An Insider's Tale of Stock Manipulation*, New York, Macmillan Publishing Co. Inc., 1980, p. i.

⁴² For details discussion on the subjects, refer to chapter 4 of this research.

of a company which was actually non-existent, was holding a meeting with the investors⁴³. Whatever way the malpractices take place in the market, this illegal and unethical method of attaining profit has led to the victimisation of a large number of shareholders, especially through the practice of insider trading⁴⁴. Therefore in this respect, Kindleberger⁴⁵ divided the speculators into two distinctive groups, namely the insiders and the outsiders⁴⁶. As the insiders have more opportunity to get inside information and possess the skill of economic forecasting, they can manipulate the market and the price in order to get profit at the expense of the outsiders, which eventually become the victims of the market game of speculative transaction. As concluded in one research, "insiders can predict stock price movement up to six months subsequent to trading"⁴⁷.

The above malpractices bring more harm than good, specifically to the stability of the stock market and generally to the economy of a country as a whole. In addition, as these malpractices are also carried out illegally by the speculators, the activities are unjustifiable from the economic point of view. As these practises are unjustifiable in the conventional system, hence the stance of Islam on this subject is quite clear, that is *ḥarām* (unlawful). This is clearly discussed in chapter three of this research. In pursuing wealth, Muslims must not involve themselves in any activities that could have a negative effect on themselves, other individuals or the public, as well as on the economic prosperity as a whole. Hence, Islam regards these activities as unethical and any income generated from such activities is considered as *ḥarām* (unlawful) or 'unearned income'.

⁴³ Lechner, A., *Street Games: Inside Stories...*, Op. Cit., pp. 52-3.

⁴⁴ Stenberg, E., *Just Business: Business Ethics in Action*, Little, Brown and Company, 1994, p. 194.

⁴⁵ Kindleberger, C.P., *Manias, Panics and Crashes...*, Op. Cit., p. 32.

⁴⁶ This division is actually similar to the division given by Chapra. Kindleberger used the word insiders and outsiders to denote the sophisticated (larger) and less sophisticated (small) speculators used by Chapra and Teweles respectively. Refer Chapra, M.U., *Towards a Just Monetary System*, Op Cit., p. 97.

⁴⁷ Jaffe, Jeffrey F., *Security Regulations, Special Information and Insider Trading*, A dissertation submitted to the Faculty of the Graduate School of Business in Candidacy for the Degree of Doctor of Philosophy, University of Chicago, March 1973, p. 1.

9.4 Speculation: Unethical Economic Activity and Unearned Income.

The role played by the speculators in the stock market, as discussed in the previous chapters, is obviously seen. As pointed out, their domination of the market through their speculative activity makes the business transactions in the market take place actively. They bring liquidity into the market as is required and make the market carry out its main function smoothly, as a place of trading stocks and shares. However, further evaluating the role of speculators from the Islamic perspective, two moral considerations emerge. The first is on the question of speculative transaction as unethical economic activity and the second is regarding the question of 'unearned income' that results or is gained from this unethical activity.

In the process of acquiring quick capital profit, the speculators will manipulate the prevailing situation of the market to its fullest capacity. If there is any loophole for them to make profit, they will advantageously manipulate it, though the step may lead to unnecessary share price fluctuations and cause trouble to a company, the stock market and the economy of a country as a whole. They will employ all conventionally legal business instruments available in the market to attain profit from their speculative activity, such as options, trading on margin and short selling, even though some of these instruments are banned or restricted in some countries. At the same time, as discussed above, some malpractices such as market rigging, market cornering, rumour spreading and inside trading are also carried out illegally⁴⁸.

Regardless of whether these instruments are legal or illegal from the conventional economic point of view, Islam regards them as unlawful and unethical business activities since the transactions involve elements that are prohibited by Islam. Consequently, Islam considers the profits gained from these transactions as unlawful, 'unearned income' because they are gained from the speculators' market

⁴⁸ For a detailed illustration on the way that the transaction of these modern speculative business instruments is carried out, refer to the discussion of these aspects in chapter four of this research.

manipulation, at the expense of other market participants, especially the investors and small unprofessional speculators.

The above issues of unethical business transactions and unearned income could be more clearly illustrated through viewing the negative consequences of the speculative transactions practiced by the speculators. As discussed in the previous chapters these excessive speculative transactions led to economic crashes, including the crash of the NYSE in 1929 and the current economic crisis in Asia. As the prime concern of the speculators is to attain profit for themselves, any negative consequences resulting from their activities becomes secondary. As long as they manage to get a profit, all available instruments in the market will be exploited and every chance appearing will be seized. The speculators' unethical activity through these speculative business transactions in the stock market will consequently have a negative affect on the investors, the small and unprofessional speculators, the stability of the stock market and on the economic condition of the country. Hence, these speculative activities are considered by Islam as unethical, and the income received is consequently considered as 'unearned income'. This is because the profit is attained at the expense of other participants, the market and the economy as a whole. In the following, the present writer will discuss the negative consequences caused by the speculators' unethical activity in the stock market that leads them to attain 'unearned income'.

9.4.1 Speculative Transaction: Unethical Activity Causing Victimization of Investors and Small Speculators.

As far as the question of victimisation of the investors is concerned, it usually takes place in two different situations. Firstly as mentioned by Kindleberger⁴⁹, when the second phase of speculative mania takes place, vulnerable investors, 'forced' by the prevailing situation of that time turn their original investment objective into

⁴⁹ See Kindleberger, C.P., *Manias, Panics, and Crashes...*, Op. Cit., p. 30.

speculative activity. They become speculators or more precisely, unprofessional speculators, who usually become the victims of large and professional speculators due to market adjustment. Secondly, when the market crashes, the real investors will be badly affected and victimised as their share prices devalue steeply. As illustrated by Rees⁵⁰, during the NYSE crashes in 1929, investors had to sell their shares at any available price and some of the shares eventually were unsaleable at any price. The crash of the NYSE affected millions of small investors⁵¹ in the United States which consequently lead to the economic depression of 1929-33. To show that the speculators are really taking advantage of the investors, the present writer will quote the writing of a western economist which states, "investors are much more useful to speculators than speculators are to investors"⁵².

Regarding the victimisation of the small and unprofessional speculators, two studies⁵³ were made after the crash of the New York Stock Exchange in 1929 which proved the disaster which happened to them. While the Blair Study revealed that 75 per cent of the speculators lost their principal in the game of speculative transactions, the Rockwell Study concluded that professional speculators gained consistently at the expense of the small and unprofessional speculators. The small and unprofessional speculators usually become the victims in the game of speculative transactions, since they lacked forecasting ability, based their decisions totally on rumours and impulses and did not have the same inside information as the professionals have⁵⁴.

9.4.2 Speculative Transactions: Unethical Activity Towards Market Stability.

The game of speculative transactions in the stock market can turn the market stability into a chaotic situation. This is because speculative transactions bring

⁵⁰ See Rees, G., *The Great Slump...*, Op. Cit., p. 48.

⁵¹ See Coakley, J. and Harris, L., *The City of Capital*, Op. Cit., p. 69.

⁵² Rix, M.S., *Stock Market Economics*, Op. Cit., p. 212.

⁵³ See Teweles (et al.), *The Commodity Futures Games*, Op. Cit., pp. 299-304.

⁵⁴ Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., p. 97.

unnecessary price fluctuations in the market. As stated by Chapra, out of many factors that leads to unhealthy price fluctuations in the stock market, the destabilising speculation that is caused by forward purchases, trading on margin, short selling and long buying is the prime cause⁵⁵. He further added that the situation is shown more clearly in margin selling where the stability of the stock market is very responsive to any adjustment on the margin requirement and the interest rate. Any amendment to the margin requirement or adjustment to the interest rate can bring unnecessary heat and instability to the stock market⁵⁶. In fact, in the downfall of the NYSE in 1929 and the current crisis in Asia, speculative business transaction trading on margin was among the main activities of the speculators in the stock market. In both crises, the role of speculative excessiveness was clearly manifested⁵⁷.

In addition to the above, the common practice of the speculators in buying shares is based on the sentiment of the market (trend of the price movement and rumours) which leads to the price expectation, whether it rises or falls. As their basis for buying or selling is based on the same factors, the tendency of the speculators to go in different directions in the market is quite small. Instead the reality of the market is that the speculators usually move in the same direction, which consequently leads to an exaggeration of the range of the price movement in the market. Therefore Chapra again argued here that in respect to this tendency, the claim which says speculation can lead to the share price stability in the market is incorrect⁵⁸.

The above unhealthy situation of price fluctuation is sometimes purposely created by the speculators in order to gain profit. They can increase or decrease the price of

⁵⁵ Ibid., pp. 95-6.

⁵⁶ Any amendment in the margin requirement or/and interest rate can bring chaos to the market. Lowering the margin requirement or/and the interest rate will invite many new and many participants into the market. This will lead to price increases as many new participants rush into the market to be involved in margin selling. Meanwhile, by increasing the margin requirement or/and the interest rate, the margin holders will react negatively through liquefying their holdings, and accordingly the price of the particular shares will decrease. See Ibid., p. 97.

⁵⁷ Refer to the discussion on the related topic in chapter 6, on the crash of the NYSE, and in chapter 7, on the Asian crisis with focus on Malaysia, in this research.

⁵⁸ Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., p. 97.

particular shares with the purpose of attracting others to participate in the transaction of the same shares. This activity can be materialised through market manipulation, market rigging and market cornering. In these three situations, the speculators possess the ability to influence the share prices in the stock market, sometimes artificially, with the intention of making profit later. In these three unethical activities of attracting other participants into the transaction of the same shares, the transaction that takes place does not usually involve any genuine sales. The main purpose is to create a temporary situation of the activeness of the shares transacted in the market, whereby it will create chances for the speculators to make profit especially at the later stage⁵⁹. These unhealthy activities will create unnecessary fluctuations of the share prices which will jeopardise the sanity of the market.

Although there were arguments stated that speculation can play a role as a price fluctuation moderator in two different situations⁶⁰, the argument seems to be more applicable in the commodity market with respect to the demand on 'consumption goods'. This is because the function of moderating price fluctuation by the speculators in the commodity market takes place based on the interaction of real supply and demand of the 'consumption' goods. Therefore with respect to dealing in the commodity market it is said that it "necessarily contains a speculative element; but in the markets of securities, speculation overshadows all else"⁶¹. However, the same situation does not prevail in the stock market. This is because, as discussed above some of the transactions carried out in the stock market are illegally done. In these transactions, the demand for the shares is 'being created' by the speculators to attract the other participants, in order for the speculators to make profit in the later stage. As the demand and supply in the market are temporarily created by the speculators, no 'real' adjustment in the share prices is actually needed in the market.

⁵⁹ To understand further the discussion of these four methods of gaining profit by the speculators, refer to chapter 4 of this research under the sub-topics 'market manipulation', 'market rigging', 'market cornering' and 'inside trading'.

⁶⁰ Speculation can play a role as a price fluctuation moderator on two different occasions. It can stabilise the price fluctuation between two different time limits and also in two different markets. For the discussion, refer to chapter 6 of this research under the sub-topic 'price fluctuation moderator'.

⁶¹ "Market" in *Encyclopædia Britannica* (1997), *Macropædia* Vol. 11, *Op. Cit.*, p. 513.

In addition, the main idea of speculative transactions such as margin trading, short selling, long buying, options and future trading, is forecasting the price movement of shares in the future. Thus the buying activity of the speculators will be detached from the issue of price stabilisation in the market. In fact their activity could lead to accelerating the price movement, upwards or downwards. This is because the speculative transactions taking place are based on the sentiment of the market, where the price movement is the main consideration. Speculative sales of shares take place when the price starts to decrease and speculative purchases usually take place when the prices start to increase. Hence in this situation, as pointed out by Baumol, the activity of the speculators does not suggest any contribution to the process of price stabilisation, instead it contributes to an acceleration of the movement of the share prices, upwards or downwards⁶². According to Aliber, speculative transactions can be destabilising. This was proved in his survey where the activity led to a more frequent amplification rather than dampening of the range of movement in spot prices⁶³.

9.4.3 Speculative Transaction: Unethical Activity Relating to the Economic Stability.

The effect of excessive speculation on the economy, as illustrated in chapter six and seven of this research, is devastating. The effect of speculation is not only restricted to the particular country where the excessive speculative activity takes place but it spreads to other countries. The collapse of the NYSE in November 1929 led to the collapse of the United States of America's economy, which was a starting point of the World Great Depression in 1930's. As acknowledged by many economists, the main and immediate factor leading to the collapse of the NYSE was the contribution of speculative excessiveness in the market⁶⁴. As correctly pointed out by Galbraith,

⁶² See Baumol, W.J., "Speculation, Profitability and Stability", Op. Cit., p. 263.

⁶³ See Aliber, R.Z., "Speculation and Price Stability...", Op. Cit., pp. 607-9.

⁶⁴ For a detailed discussion on the aspect of excessive speculative activity as the immediate factor in the crash of the NYSE, refer to the last part of chapter 6 of this research.

"The Stock Market crash (NYSE) and the speculation which made it inevitable had an important effect on the performance or rather the mal-performance of the economy in the ensuing months and years"⁶⁵.

The collapse of the United States of America's economy, the main economic power of that time, caused a massive blow to the economy of other countries, industrial countries as well as under developed countries⁶⁶. The under developed countries which based their prosperity on the exporting of raw material to the industrialised countries, faced the problem of low prices for their produce. This situation made these under developed countries suffer more severely than others, since low prices means a low income for the people and the country. This results in a low standard of living especially with regards to the aspect of education and health. While the industrial countries faced the problem of high rates of unemployment. These rates of unemployment increased since the demand for their production goods nose-dived as the result of the economic depression. Reducing their production to meet the new low demand resulted in the increase of the rates of unemployment.

The most current event of economic turmoil which to a certain extent was started by speculative activity in the foreign exchange and was followed by the same activity in the stock exchange, is the ongoing economic crisis in Asia⁶⁷. As was pointed out in chapter seven, it seems that the contribution of speculative transactions to these two exchanges in the Asian crisis cannot be denied, though the existence of other factors has also been shown.

The Asian crisis first began in Thailand, where speculative activity in currency trading first took place. The baht, Thailand's currency, was badly victimised by the speculators' activities and these activities quickly spread to the neighbouring

⁶⁵ See Galbraith, J.K., *The Great Crash 1929*, Op. Cit., p. 26.

⁶⁶ Hanson, J.L., *A Dictionary of Economics and Commerce*, Op. Cit., p. 231.

⁶⁷ For the discussion on the ongoing economic crisis occurring in South East Asia, refer to chapter seven of this research where a detailed analytical observation is made.

countries, the Philippines, Indonesia and Malaysia, and other economically stronger countries in Asia such as South Korea, Taiwan, Hong Kong and Japan. The same speculative activity that had occurred in the foreign exchange spread to the stock market of the South East Asia countries. The combination of speculative activity in currency trading and on the stock market led to a double blow to the economic position of the countries involved, firstly the devaluation of their currencies, mostly to their lowest level in history, and secondly to the devaluation of the share prices, also to their lowest new record⁶⁸.

These countries which had previously been labelled as the 'Asian Tigers' are now struggling to restore the confidence of investors to get them to invest their capital in their countries. Disastrously, the loss of confidence was not only among the foreign investors but also among the local investors who withdrew their deposits from the local banks and invested them in the banks outside the crisis region. The economic turmoil has negatively affected the life of the people in the region, as the price of goods has soared and the rate of unemployment increased. Restoring the investors' confidence takes time⁶⁹ hence to fully recover from the crisis takes even longer. While it took decades to develop the economic prosperity in these countries, the destruction only took a short period, and their current stage is almost at the same as it was decades ago when they were just starting to climb the 'ladder' of tremendous economic achievement. This is the negative consequence of the speculative activity. It was one of the main factors in the Asian crisis, effecting the economic position of the countries involved as well as effecting the rest of the world.

⁶⁸ Ibid.

⁶⁹ This section of the research was written in early July 1998 and there is no sign of economic recovery in the Asian crisis. After one year of the crisis that started on the 2 July 1997. In fact, recent development shows that the crisis in Asia has turned into a new negative phase with new negative development taking place in the economy of Japan, the largest in Asia and the second largest in the world after the United States of America. Under the economic globalisation, the current crisis in Asia has started to spread all over the world and it could cause world economic depression if there is no cooperation between nations to stop the crisis.

The discussion on the effects of speculation to the economy demonstrates that speculative activity in the stock market can contribute adversely to the economic position of a country. As was pointed out by Kindleberger⁷⁰, the introduction of various modern and sophisticated speculative transactions such as short selling, 'puts' and 'calls', future trading and option, from as early as in the 17th century, has contributed to economic crisis. Lubeck's financial crisis in 1636 and Tulipmania in 1636-37 are two good examples showing the contribution of these speculative activities in the market that led to the crises. The crash of the NYSE in 1929 and the current crisis in Asia, where speculative transactions of margin selling were rampantly practiced, further justify the Islamic stance of prohibiting this unethical business activity which leads to unearned income.

The above discussion on the unethical activity and unearned income of speculative transactions shows us that speculative business transactions from the Islamic point of view are incontestably an unethical approach towards achieving profit in the stock market. This is because their activity is carried out without considering the negative consequences that the activity may cause to individuals, the market and the economy of a country. This stance of Islam on speculative activities is well supported by the fact that these activities do not contribute any good to the economy. In illustrating the work of the speculators, Rix stated that the speculator is "buying and selling something he cannot consume or use in his business, upon which he performs no work and to which he adds no value"⁷¹. He further criticised the speculators in another place by stating, "the stock exchange would not necessarily be any less effective if there was no speculation at all"⁷². As Islam views speculative activities as unethical activities in acquiring profit, consequently the profits acquired are also unlawful and considered 'unearned income'.

⁷⁰ Kindleberger, C.P., *A Financial History of...*, Op. Cit., p. 215.

⁷¹ Rix, M.S., *Stock Market Economics*, Op. Cit., p. 204.

⁷² *Ibid.*, p. 212.

9.5 Conclusion.

From the above discussion on speculation in the stock market from the Islamic perspective, the writer shall conclude here that Islam regards human beings as *khalīfah* (God's representatives) in this world. The Creator gave *amānah* (responsibility) to them to make the life of this world peaceful and harmonious. To carry out this *amānah* properly, God honoured human beings with '*aql* (intellect) to enable them to ponder, think, choose and find the best solution for any problem or any expected event in the future. In general therefore, to indulge in speculative decisions for the betterment of future life is allowed in Islam since a better life means a better opportunity to be a good servant of God. Hence, to speculate concerning future events of human life is a nature of their life in this world and for that purpose God has bestowed upon them a powerful tool, that is '*aql*.

However, the '*aql* they possess must be used with regards to the aspect that is ordained by God in order to gain His *riḍā* (pleasure). '*Aql* must not be used in order to spread mischief in society or to cause any possibility of dispute in the future, including in the economical life of human beings. In this respect therefore, Islam has clearly prohibited business transactions that could lead to future dispute such as *al-maisir* (gambling), *al-gharār* (uncertainty), any unlawful or unethical economic activity that leads to the income received being considered as unlawful or 'unearned income'. The prohibition of such economic activities is clearly proclaimed by Islam as they can cause disturbances to the peaceful life in society.

At this juncture, the permissibility of speculative transactions in the stock market from the Islamic perspective appear, because they are dominantly practised in the stock market by Muslims, in the Muslim world. Since any kind of transaction that is comparable to gambling or could lead to future disputes such as *gharār* or transactions which are unethically transacted, are all forbidden in Islam, hence the speculative transactions in the stock market are likely to fall in the same category as

far as the aspect of their permissibility is concerned. This is because, as discussed in this chapter, the speculative activities in the stock market carry with them the elements of *al-maisir*, *al-gharār*, mal-practices and unethical business transactions that lead to unearned income for the speculators. However, the immediate question which emerges here is how the business transactions in the stock market should be done, since the available speculative business transactions do not conform to the teaching of the Islamic economy? In other words, how should a stock market under an Islamic economy be operated and how could the institution be viable without the presence of those speculative activities? All these questions will be discussed in the next chapter where an alternative model of a stock market in Islam will be presented.

CHAPTER 10

AN ISLAMIC APPROACH TOWARDS SPECULATION: A PROPOSAL OF AN ALTERNATIVE STOCK MARKET.

10.1 Introduction.

As this research concludes that speculative transactions in the stock market do not conform with the teachings of Islam, the participation of Muslims in the stock market is seriously affected. Therefore, in this chapter, the present writer will conclude this research by giving a proposal as regards to the Islamic approach towards the problem of speculation, by formulating an alternative model of stock market¹.

10.2 An Islamic Alternative Model of a Stock Market.

The framework of the alternative model is not totally detached from the existing stock market. As far as Islamic economics are concerned, there is nothing wrong with the conventional framework. The main concern here is to retain the fundamental functions of the stock market and the permissible transactions practised in the existing conventional stock market². Simultaneously, a real effort is needed to keep the speculative business instruments that are commonly practised in the conventional institution out of the alternative model. Thus, in this alternative model, the present writer would suggest a major modification of the functions of a conventional stock market in order to make it more presentable in Islam as far as the question of obliterating speculative transactions is concerned. Accordingly, the alternative model will be more sustainable in the event of economic crisis. Reasons and advantages behind this major alteration of the functions of a conventional stock market will also be presented.

¹ In this research, the present writer prefers to use the phrase 'the alternative model' rather than 'the Islamic stock market'. Hereafter, the phrase 'the alternative model' will be used through out this chapter and the following concluding chapter.

² Elgari, M., "Towards An Islamic Stock Market", Op. Cit., p. 4.

10.3 The Functions of the Alternative Model.

In the operation of the modern stock market, there are many functions that the market has to carry³. The functions of a stock market in the modern economy have increased to more than double as compared to the functions of the institution when it was first established. In the writer's point of view, these 'overflowing' functions lead to the 'overburdening' of the responsibility to be carried out by the institution. This overburdening of functions and responsibility leads to the emergence of a few negative elements especially with respect to the aspect of speculative transactions, which affect market sustainability. In the following, the present writer proposes that the alternative model of the stock market returns to basics and concentrates on the fundamental functions.

10.3.1 Return to the Fundamental Functions.

The alternative model of the stock market must fulfil the main functions as are carried out by its predecessors. The establishment of '*courratier de change*' or '*agent de change*', the first recorded institution with a similar type of operation in the 12th century, was to create a proper place for stock trading among the merchants where they could discuss their daily business activities⁴. Even the similar institutions which emerged later such as The Royal Exchange at the end of 17th century in England, LSE in 1773 in London and NYSE in 1792 in New York, were originally based on the same ideas⁵. Hence, it is clear that the main purpose of the institution in its early days was to serve two important functions, firstly as a meeting place for the merchants to discuss their daily business activity and secondly, as a place of genuine buying and selling stocks and shares among them.

The alternative model of a stock market which the present writer proposes here is supposed to concentrate and maintain these two important functions without

³ To understand some of these functions, refer to the illustration on the functions and the importance of a stock market in the modern economy as discussed in chapter 4 of this research work.

⁴ "Securities Trading" under "Markets" in *The New Encyclopædia Britannica* (1991), Op. Cit., p. 559. See also to the discussion of the subject in chapter 4 of this research.

⁵ Poley, A.P., *The History, Law, and Practice...*, Op. Cit., pp. 5-6. See also "The New York Stock Exchange: History, Organisation, Operation and Service", Op. Cit., p. 5.

neglecting the other functions that could have appeared naturally out of these two main functions. This is because through accomplishing these two main functions it will correspondingly reduce the 'overburdening role'⁶ that a modern stock market carries. By adding new functions to the existing stock market, initiates the market authority to create unnecessary elements to make the market look more attractive to the participants. This will invite more speculators to the market rather than inviting real investors and this surely makes the market move more actively, unnecessarily. As pointed out by Khan⁷, the prevailing reality in the modern transactions of any stock market is that the presence of speculators seems to be more dominant than investors.

10.3.2 The Functions as an Economic Indicator: the Negative Consequences.

One good example to explain the above situation is the function as an economic indicator where it leads to the presence of more speculators. In today's modern business era, the function of a stock market as an economic indicator of a country is important. Economists agree that the economic position of a country is well indicated by the condition and progress of its stock market. An inactive and slow progressing stock market, indicates that the economic achievement of the country is not encouraging, while the fast progressing and active stock market, reflects the strong economic position of that particular country.

The above is a standard measurement in the modern economic life of a country. Therefore as stated by Khan, there are economists who believe that a modern economy cannot exist without the existence of a well-organised stock market⁸. Hence to reflect that the economy of a country is flourishing and prosperous, the stock market must be active and actively participated in. From this point of view the tendency of the market authority to make the market active is great. The market operations must be organised in such a way that they are attractive enough to allure

⁶ What the present writer means by 'overburdening role' in the stock market refers to the 'business' activities that have to be carried out by the stock market in order to achieve additional functions. For example, one of these additional functions carried by the modern stock market is as a country's economic indicator. This function seem to be one of the reasons that leads to the creation of a few unnecessary transaction instruments that make a stock market more vulnerable in response to any drastic economic adjustment in a country. This aspect will be discussed in the continuing discussion.

⁷ Khan, M.A., *Issues in Islamic Economics*, Op. Cit., p. 87.

⁸ *Ibid.*

new participants into and prevent the existing participants from relinquishing the market, especially among the speculators, who play the role of the market activators. To facilitate market activeness, the authorities have to be more tolerant about the policies as well as the business instruments, than when viewed from the Islamic perspective. This is the reason behind the different approaches and policies imposed on the market of different countries. In other words the more lenient the policies, the more attractive is the stock market⁹, locally as well as internationally.

10.3.2.1 Policy Leniency.

One good example about a policy of leniency is the regulations concerning the margin requirement in margin selling. These vary from one market to another. After the crash of 1929, the authority of the NYSE passed a law of minimum requirement for margin selling in order to minimise the use of loans for excessive speculation¹⁰. This step was implemented after they had experienced the detrimental effects of 'free' margin requirements that led to the immediate crash of the NYSE. Stock markets of other countries imposed the same law to protect their market from the manipulation of speculators. However the minimum margin requirements between those stock markets are not the same. A low percentage of minimum requirement for margin selling reflects leniency in that particular aspect, and hence, provides a more attractive market. Vice versa, a high percentage implies a more strict regulation and consequently reduces the market participatability¹¹.

A good example of this issue concerning policy leniency is to do with the transaction of short selling. This transaction was banned in the LSE although it is commonly practiced in the NYSE¹². In Malaysia, allowing it and banning it has recurred since 1992¹³. The latest position of the Malaysian government on the transaction is allowing some shares to be traded by short selling while not allowing others¹⁴. This

⁹ This argument must be understood in a free and competitive market. In this situation, the establishment of two stock markets that operated under different regulations of leniency with '*ceteris paribus*' are compared. Naturally people choose to participate in the more lenient market.

¹⁰ See Galbraith, J.K., *The Great Crash 1929*, Op. Cit., p. 12.

¹¹ See Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., p. 97.

¹² Lechner, A., *Street Games: Inside Stories...*, Op. Cit., p. 57.

¹³ Refer to Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 35.

¹⁴ Refer to the discussion on the subject of short selling in the KLSE in chapter seven of this research.

was prescribed amidst the present Asian economic crisis, which was discussed in chapter seven, and which badly effected the KLSE.

From the above, it is obvious that while the LSE and the NYSE authorities have taken opposite ends of the spectrum, by banning and freeing respectively, the Malaysian market authority, the KLSE, seems to be taking the middle approach by banning some shares from short selling while some others are allowed to be short sold. Though Malaysia is now facing economic turmoil caused by speculative activities¹⁵, the KLSE authority still shows policy leniency in short selling to make the market attractive.

The above two examples of policy leniency on the margin requirement and short selling shows us different levels of leniency being imposed. The different approaches implemented in handling the same subjects imply different levels of leniency about them, hence different levels of attractiveness, at least in those two particular aspects. The permission to indulge in short selling will invite more customers among the short sellers into the NYSE instead of the LSE. While the uncertain policy on the same practice in the KLSE will only attract some short sellers as compared to the NYSE but certainly more than LSE, who has banned the transaction.

10.3.2.2 Invention of Sophisticated and Attractive Speculative Business Instruments.

Market authorities have invented other sophisticated practices of business transactions in order to make the market be actively participated. As the invention of these mechanisms leads to the high liquidity of the securities, the transaction of securities based on the perceptions of buyers and sellers, makes the securities highly susceptible to speculation¹⁶. Hence, the invention of some sophisticated transaction mechanisms

¹⁵ Refer to chapter 7 of this research.

¹⁶ The valuation of a company is based on two sets of factors. Firstly, all the factors that are directly related to the company, such as profit earned, earning potential, real assets, previous and expected future performance and debt-equity ratio. Secondly, the perceptions of buyers and sellers of the company are related closely to the psychology of the market. See Qureshi, D.M., "The Role of Stock Exchange in the Islamic Financial System" in *Journal of Islamic Banking and Finance*, Vol. 5, No. 1, Karachi, The International Association of Islamic Banks, 1988, pp. 9-10. The second set of factors are usually the factors that are always the concerns of the speculators.

in order to use the institution of the stock market as an economic indicator, is indeed an important measure taken by the market authority.

However, a point worth noting here, the activeness of today's business activities that are taking place in any stock market is not as a result of genuine transactions by the investors but is due to market manipulation by the speculators. The speculators act as the market activators, and it is this which leads to the magnificent amount of daily transactions. They seem to dominate the modern stock market,¹⁷ especially where very attractive business instruments are available in the market. This reality consequently leads to the market failing to function properly as an economic indicator for a country. This is because the speculative activities by the speculators do not accurately represent the real economic position of the country, because their activities are detached from the economic reality of the country. The situation threatens the country's economy as it makes the market more vulnerable to any market adjustment, as was proved in the NYSE crashes in 1929 and the KLSE in the current Asian crisis¹⁸.

In the history of financial crashes, as pointed out in the previous discussion, the role of speculators was shown to be distinctly apparent in the crash of the NYSE¹⁹. This is because more than a million speculators were said to be indulging in the transaction of margin selling²⁰. The same situation happened in 1972 when the NYSE crashed when in only a few days the Dow Jones Industrial Average nose-dived to only 580 from 1,000 points²¹.

In the most recent tragedy, the Asian economic crisis, it seems that the contribution of speculative activity in currency trading, followed by speculative activity in the

¹⁷ As stated by Khan, this situation is the main factor that leads to the activeness of all stock markets in today's business transactions since the speculators seem to be more dominant than the real investors. See Khan, M.A., *Issues in Islamic Economics*, Op. Cit., p. 87-8. See also Samuelson, P.A., *Economics; An Introductory Analysis*, Op. Cit., pp. 428-9.

¹⁸ Refer to chapter 6 and 7 of this research for the discussion on the subject.

¹⁹ As pointed out by Born, 3 out of 5 main factors that led to the NYSE crashes were related to the problem of speculation. While Kindleberger strongly believed that excessive speculative activities contributed greatly to the crumble down of the NYSE. Refer to the discussion on the subject in chapter 6 of this research under the sub-topic 'speculation and the NYSE crash'.

²⁰ Refer to the discussion on the subject in chapter 6 of this research under the sub-topic 'speculative mania'.

²¹ Lechner, A., *Street Games: Inside Stories...*, Op. Cit., p. 75.

regional stock markets steered the crash. In Malaysia as pointed out in the previous discussion, the KLSE Composite Index (CI) depreciated steeply and continuously from more than 1,000 points before the crisis in July 1997, to the lowest of below 500 points in January 1998. The current point of the CI (July 1998 - the completion of this writing) is still fluctuating around 400 to 420 points and the trend is moving downwards. The prevailing CI points show us that shares have been devalued detrimentally as compared to the situation before the crisis. As the activities of margin trading (the activity that led to the crash of the NYSE in 1929), and short selling were admittedly practised in the KLSE²², this seems to suggest that the force behind the fall of share value is the speculative activities of margin trading and short selling.

10.3.2.3 The Alternative Model as an Economic Indicator.

From the above discussion, it is clear that unless regulated properly, the leniency prevailing in the market can cause trouble to the market itself. This is because the more lenient the market, the more loopholes are present for the market players to manipulate for profit maximisation. Hence as an alternative model to the current stock markets, the stock market in Islam will concentrate on the basic functions of the secondary market; a meeting place to discuss daily business activity and a place for genuine selling and buying stocks or shares. This is in order to limit the involvement of the speculators, hence protecting the market from market vulnerability. However, if there are functions that materialise out of these fundamental functions, they will naturally happen²³ by themselves.

²² The existence of these two activities in the KLSE was admitted by the Malaysian Prime Minister when he mentioned in his statement that the government programme of KLSE bailing out would include the margin holders while the regulation on short selling in the KLSE was to be tightened by the Malaysian government. Refer to the discussion of this subject in chapter 8 of this research.

²³ What the present writer means by naturally here refers to the natural process that leads to the outcome of any new function of the stock market. In the conventional system, the function of the stock market as an economic indicator is being helped by the existence of many unnecessary elements in share transactions. The more elements that exist, the more active is the market. As seen in the above discussion, on many occasions, these elements will lead to an inaccurate representation of a country's economic position and can disturb the market unnecessarily. See Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., pp. 95-100. The market disturbances can lead to market crashes as witnessed in the history of financial crashes. In the alternative model, as the trading taking place is based on genuine transactions (with the omission of those unnecessary elements in share transactions), the market will genuinely indicate the real progress and condition of the country's

For example, in carrying its two main functions, the alternative model could instinctively accommodate the important function as an economic indicator for a country. As the alternative model detaches itself from unnecessary sophisticated elements in business transactions, (the burden of the conventional model) and indulges only in genuine transactions, the model will represent the indicating system which is closest to economic reality. Consequently, the model will be more sustainable towards any economic adjustment in the market as compared to the conventional system,²⁴ because it is based on the reality of the economy.

10.3.3 Image Projection for Capital Accumulation.

Capital accumulation is another important function of the conventional stock market. By floating their shares in the stock market, companies' chances to acquire capital are better. However, the chance for capital accumulation does not directly come from the investors or speculators who spend their money in the stock market. Through the listing of the companies in the stock market, there will be the opportunity for the companies to accumulate capital through loans from financial institutions²⁵. The higher the position of the company on the board of the stock market, the more opportunities it has to obtain capital loans from the financial institutions.

10.3.3.1 The Problem of Speculative Valuation.

The problem will arise in this system whenever a company's share position in the stock market does not represent the company's real assets and good performance, but is only the result of the speculative activity and market manipulation that took place in the market through the existence of unnecessary elements. In this situation the market becomes very vulnerable and responsive to any market adjustment. The worst

economy. Consequently, the alternative model will be more sustainable as trading is based on the reality of the economy.

²⁴ As pointed out by Kindleberger, a loss of contact with reality in business activity especially in a stock market will contribute significantly to the collapse of the market as happened in the previous crashes. See Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit., p. 109.

²⁵ In this respect therefore all listed companies aim to get into the highest position in the stock market as this good image will further enhance their chance of getting not only easy loans but also larger loans.

case is when the unscrupulous company owner will advantageously use this opportunity to continue borrowing capital without considering the reality, using the secured loan for further speculation in the stock market or investing in an unproductive area.

10.3.3.2 False Information to Attain Higher Valuation.

Furthermore, in order to stimulate the good image of their company in the stock market, which can lead to easy borrowing, there are usually two unethical approaches carried out by desperate entrepreneurs, despite the present of the law. Firstly, they will present false information on the performance or the real assets of the company to the exchange authority. Thus, the image projection of the company on the exchange board is based on an untrue situation, and the investors will buy shares of the company, finding that their value is not as was expected. Secondly, the company itself, or through proxies, can manipulate the company share prices in the market in order to suggest to the market participants that the company is in a good position and has great potential.

In the above situations, if any disaster strikes the economy of the country, the market will respond negatively and drastically as was witnessed in the previous economic crises. In the crash of the NYSE, a 'blue chip' share, priced at US\$585 a share, devalued badly to a mere US\$17 during the World Great Depression²⁶. While in the tragedy of the South Sea Bubble, the share prices of the South Sea Company dived from their speculative value of £1000 to only £175 a share in just a few days²⁷. The same problem is contributing to the current Asian crisis especially in the drastic falls of the KLSE. Some of the companies' owners listed in the KLSE continue borrowing against their property to provide more capital to enable them to participate in speculative transactions in the KLSE as well as to finance their unproductive investment²⁸.

²⁶ Lechner, A., *Street Games: Inside Stories...*, Op. Cit., pp. 57-74.

²⁷ Warren, H., *The Story of the Bank of England*, Op. Cit., pp. 177-80.

²⁸ For a detailed discussion on this subject, refer to chapter 8 of this research. See also Lockwood C., "Gang of Four Nations on the Bambo Rack" in *Electronic Telegraph*, October 23, 1997.

10.3.3.3 Capital Accumulation in the Alternative Model.

In the alternative model of a stock market, the possibility of the same situation occurring seems to be lower than in the existing conventional system. There are two main reasons behind this claim. Firstly, companies under the Islamic framework do not encourage any operation based on capital loans but more on equity capital²⁹. This is due to the fact that the economic system of Islam encourages many investors to participate in business ventures as to keep capital idle is unlawful³⁰. As was discussed in chapter five of this research, accumulating capital through equity loans will lead to the stability of the company and indirectly of the stock market. Indirectly, this approach will reduce the activity of accumulating capital through loans and will limit the activity of image projection in the stock market.

Secondly, as the business contract of companies in Islam is based on profit-loss-sharing, it provides ground for financial institutions to thoroughly study the viability of the business venture in which the company is indulging in, previous and expected future performance, real assets owned, profit in the past and expected in the future and other important considerations, before injecting their capital. This is an important step because they realise that profit-loss-sharing will not give them an automatic return on their investment, but rather a profit or a loss. Hence, to really study the status, performance and future viable plan of the particular company is to ensure that the capital is being properly used and resource allocation in Islam is being carried out.

In contrast to the above, in the interest bearing loan which is based on a fixed return, the tendency of financial institutions to study carefully is less than in the above system. This is because regardless of the company performance, whether the

²⁹ Suggested reading on the importance of equity capital in Islam see *Towards a Just Monetary System* by Chapra, Op. Cit., *Partnership and Profit Sharing in Islamic Law* by Siddiqi, Op. Cit., and a paper written by Man, Z., "Share and Investment in the Share Market", Op. Cit.

³⁰ The Qur'ān, 9:34. In this verse, God threatens those who hoard and keep their capital idle with grievous punishment. The circulation of the property will encourage further economic development of a country, while keeping the capital idle will not have any benefit for the society and economy of the country. This situation shows the purpose of property in Islam, for the betterment of human life and to make people better servants of God.

company gains profit or incurs loss, the lender will definitely receive their portion in terms of interest.

From the above discussion, the alternative model of the stock market in Islam will not function as a place of capital accumulation, as is the case in the conventional model. Also it is not the place for the company to indulge in 'image projecting' for their further borrowing activities. As Islam promotes a business venture based on equity capital that can be widely participated in by the public, the proper place for capital accumulation is in the primary market, through issuing new shares. This can be done even in a stock market at a special counter. While in the aspect of 'image projecting' in the stock market, besides a thorough study by a special committee in charge of the aspect (this committee needs to be established), the interest free financial institutions will also make a thorough study on the company before injecting their money, because the venture is based on profit-loss-sharing. However the good image of a company will accordingly emerge on the stock market board, and will be based on real and thorough assesment by the market authority and the financial institutions.

The above is the alternative stock market in Islam. Its operation is to focus mainly on two basic and fundamental functions of the stock market, while modifications are needed for the other functions. The model seems to be more sustainable than the vulnerable conventional stock market. However, as its framework is taken from the conventional stock market, a few unnecessary elements that are much practiced in the existing system must be excluded from the alternative model. This is to ensure that the proposed model can function as properly and effectively as expected.

10.4 The Exclusion of Unnecessary Elements from the Alternative Model³¹.

The exclusion of elements from the alternative model of the stock market is in order to ensure the sustainability of the proposed model and the economic stability of the country. The discussion of this subject will be divided into two sub-topics. Firstly, the exclusion of a few speculative business instruments that are commonly practiced in the conventional model which will focus on margin selling, short selling and option contracts. Secondly, the exclusion of other market manipulations from the alternative model through introducing a few measures to be implemented. The presence of these unnecessary business instruments in the stock market as proved in the previous discussion, will directly or indirectly affect the market. These elements are generally one of the following; elements which have been given *fatwā* (religious ruling) as unlawful under the *sharī'ah* (Islamic Law) or secondly, elements which have no *fatwā* of unlawful, but are morally not in conformity with *maṣlaḥah 'āmmah* (public interest).

10.4.1 The Exclusion of Speculative Business Instruments.

There are a few unnecessary business instruments present in the conventional stock market. As proved in the previous discussion the existence of these business instruments in the market transaction mechanism has seriously disturbed the markets³². Hence the existence of these elements that are rampantly practised in the modern stock markets is deplorable and they are to be excluded from the alternative model proposed.

³¹ The points to be discussed in this section are not all new. To the best of the present writer's knowledge, there are a few writings by Muslim economists on the subject of how to establish an Islamic stock market. Some of the points are fresh from the present writer and some are discussed in their writings which will be noted where the point is taken from. However the present writer will try to present all the points systematically. The present writer has benefited a lot through reading their writings because they injected into the present writer to do further research in this aspect. These writings will be the present writer's constant reference for the following discussion.

³² See chapters 6 and 7 of this research where the contribution of the unnecessary elements to the collapse of the stock market is discussed.

10.4.1.1 The Exclusion of Margin Selling³³.

The history of financial crises has shown that margin selling contributed to the collapse of some of the stock markets³⁴. Taking a lesson from those tragedies, the practice of margin selling is not to be allowed in the alternative model proposed here. This is because as pointed out by Chapra³⁵, margin selling can cause unnecessary havoc in the stock market since the mechanism leads to superfluous expansion or contraction in the volume of transactions in the market. As there is no real addition to the quantity of the stocks, the practice will directly affect the price of the particular shares and stocks.

a) Margin selling causes market uncertainty and instability.

Chapra further stated that the variation of interest rate and margin requirement can lead to further uncertainty and instability of the market³⁶. Through lowering the interest rate or/and the margin requirement unnecessary heat will be created in the market. This is because it will cause 'sudden massive participation', especially by speculators into the market. This leads to a rapid increase in demand for the shares which consequently increases the price because there is no additional supply of the particular shares. Professional speculators can advantageously manipulate the situation by liquidating their position in order to grab the profit presented by the market instability quickly, before the price decreases. As the professional speculators leave the market through selling their large holdings of margin account, the price starts to decline as there is an abundance of shares available. This is the chaotically fluctuating situation caused by margin selling.

³³ Refer to the illustration on this business instrument in chapter 4 of this research. For the discussion on the subject of margin selling and its connection with the question of *al-maisir* (gambling) and *al-gharār* (uncertainty), refer to chapters 8 and 9 of this research respectively.

³⁴ Margin selling contributed greatly to the collapse of the NYSE. More than one million people held stock on margin before the NYSE crash. After the panic situation began, they frantically rushed to the market to liquidate their holdings. This caused further and more drastic falling down of the market. See chapter 6 for the discussion. While in the current Asian crisis, especially in the Malaysian KLSE, the contribution of margin selling seems to be apparent. Refer the discussion on the subject in chapter 7 of this research.

³⁵ Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., pp. 96-7.

³⁶ *Ibid.*, p. 97.

Increasing the interest rate or/and the margin requirement will force speculators to liquidate their holdings. This move will affect the stock market, especially the small speculators as well as the investors. The situation will be worsened if all the speculators rush to the market to sell their margin holdings, hence creating further unnecessary market chaos. In this market chaotic situation, as concluded in two studies carried out in the USA, the small speculators and investors were always victimised by the professional large speculators, who consistently 'won'³⁷. In this situation, as the price of shares rapidly decreases, it gives a good opportunity to the professional speculators. After leaving the market for a while to cool down the market, they return to the market, buying stocks at the lower price so they can gain a quick speculative profit.

b) The *fatwā* (religious ruling) on margin selling.

The above discussions show the reality of the market business operation of margin selling, and show how the practise can disturb the sanity of the market, and hence must be excluded from the alternative model of the stock market in Islam. However, if the mechanism of margin selling is to be scrutinised under the Islamic view point, there will be no doubt about its non-permissibility. The Council of the Islamic Fiqh Academy³⁸ gave a *fatwā* (religious ruling passed by the Muslim Jurists) on the non-permissibility of margin selling by stating, "It is not permissible to borrow money with interest from a stockbroker or other party, and then buy shares in a company with the loan, and deliver the share certificate to the lender as security for the repayment of the loan, as the transaction is interest bearing". The unlawfulness of margin selling as stated in the *fatwā* is because of the existence of the interest bearing loan. Does it mean that the *fatwā* will no longer be valid if the loan is taken from the interest free banking system?

³⁷ The two studies were the Rockwell and Blair Study, and the conclusions of the studies stated that large/professional speculators win consistently at the expense of small speculators and investors, and that around 75 per cent of speculators lost in their speculative activity. See Teweles (et al), *The Commodity Futures Game*, Op. Cit., pp. 296-9.

³⁸ The Council of the Islamic Fiqh Academy is an organisation established by 46 nations of the Organisation of Islamic Countries (OIC) which is based in Jeddah. The purpose of its establishment is to handle any question on *fiqh* (jurisprudence) relating to Islamic financial transactions or products. The *fatwā* on margin trading was passed in their seventh meeting in Jeddah in 1993. See "Latest Islamic Fiqh Academy Rulings on Finance", in *New Horizon*, United Kingdom, March 1993, p. 13.

The present writer intends to present his views on the above question so as to support the proposal that the alternative model of the stock market must exclude margin selling. Although the loan acquired for margin selling can be taken from the interest free banking system, there are a few other considerations to ponder upon about the mechanism of margin trading.

c) The essence of margin selling's resemblance to *al-maisir* (gambling)³⁹.

The essence of the margin transaction itself, if it is scrutinised, resembles the spirit of *al-maisir* (gambling). Margin trading which is only practiced in the bull market, a market where the trend of price movement is upwards, is comparable to the act of gambling. Nothing needs to be done except to put their money surpluses in the market, the profit will certainly pour in. This was what happened in the NYSE before the crash. After the first World War, the United States emerged as the new economic power and generally the NYSE was in a 'bull' position for a very long time until the crash in 1929. The sudden boom was more clearly witnessed in the second quarter of 1928 and led to the cutting-off of long term lending to Europe and other relatively poor countries. This measure was implemented in order to finance the local market booms which were actually created by speculative activity in the NYSE⁴⁰.

The bull market in the NYSE not only attracted speculators, but at the same time turned the investors into speculators,⁴¹ speculating for certain quick profit. People started to 'gamble'⁴², and miraculously everyone received their portion as long as they put their money in the market. They did not need to make an analysis of the real economic performance of the country. The most attractive 'gambling' mechanism was through margin selling. It is said that more than one million people opted to choose

³⁹ Refer to the discussion on the elements of *al-maisir* in the speculative activities in the stock market in chapter 8 of this research.

⁴⁰ Kindleberger, C.P., *The World in Depression, 1929-39*, Op. Cit., pp. 108-9. See also Rees, G., *The Great Slump...*, Op. Cit., p. 11 and pp. 25-6.

⁴¹ Kindleberger, C.P., *Manias, Panics, and Crashes...*, Op. Cit., p. 30.

⁴² See Samuelson, P.A., *Economics: An Introductory Analysis*, Op. Cit., p. 427. See also the discussion on the crash of the NYSE in chapter 6 of this research.

this mechanism to obtain a quick profit⁴³. It is apparent here that margin selling is similar to gambling which is clearly prohibited in Islam⁴⁴.

d) Margin selling: Business instrument for speculators.

It seems apparent that those who participate in the activity of margin selling are not committing themselves in the business venture as investors. The purpose of having a margin account is to obtain a quick profit on the movement of share prices in the market. If they really intended to make an investment, why do they not fully commit themselves financially? As the mechanism allows them to put in only a small portion of their capital, they usually fully utilise their available capital by spreading it over various margin accounts, in order to minimise risk and maximise profit out of the market inefficiency. Hence, holding a margin account is not a kind of investment because their concentration is purely on capital profit alone and not on any dividends from the business. The availability of this business instrument in the stock market is only to cater for the need of the speculators.

e) Margin selling and its negative consequences.

In addition to the above, Islam is always cautious about things carried out by individuals. If a person takes steps which can jeopardise him/herself, the public, as well as the country in the future, even though some rewards are expected, the steps become not permissible. In this respect, as the margin holders are allowed to buy shares far beyond their capacity, which can badly affect their future life in the event of a market catastrophe (as witnessed in the previous crashes especially the crash of NYSE in 1929 and KLSE recently), the Islamic principle of "do not throw yourself into the valley of destruction"⁴⁵ is applicable here. Since this *sharī'ah* principle is to safeguard people from self destruction, hence the transaction becomes *ḥarām* (unlawful) in Islam.

⁴³ See Rees, G., *The Great Slump...*, Op. Cit., p. 25. See also Yass, M., *The Great Depression*, Op. Cit., p. 21.

⁴⁴ The Qur'ān, 5:90-1.

⁴⁵ The Qur'ān, 2:195.

In addition to the this, as discussed in chapter six and seven of this research, speculative activity in the stock market has a negative effect on the public and the economic stability of a country. As demonstrated in those two chapters, professional and large speculators win consistently from the market at the expense of small and unprofessional speculators, as well as at the expense of the real investors. The negative consequences towards the economy of a country are also manifested in the previous discussions⁴⁶. In this respect, the principle of *maṣlaḥah ‘āmmah* (public interest) in Islam is applicable, whereby in the situation of an interest clash between the individual and the public (including the government) in which a reconciliation is not possible, the interest of the public and the government must be prioritised⁴⁷.

10.4.1.2 The Exclusion of Short Selling⁴⁸.

The practice of short selling and long buying are devices used by speculators to attain profit regardless of the price movement. If the share prices move upwards, speculators will indulge in 'long buying' while in the downwards trend of price movement, they will use short selling. In both situations, they speculate to achieve profit. This is another mechanism of share transactions that needs to be eliminated from the alternative model of the stock market in Islam. These mechanisms do not have any real economic function in the stock market, merely a negative contribution of causing price fluctuation⁴⁹.

a) The *fatwā* on short selling.

The Council of the Islamic Fiqh Academy in its seventh meeting held in Jeddah⁵⁰ has passed *fatwā* (religious ruling) on the unlawfulness (*ḥarām*) of short selling because the transaction involves uncertainty regarding the owner of the shares. As the sellers borrow the share scripts from the brokers, then they are not the owner of the shares,

⁴⁶ Refer to chapters 6 and 7 of this research.

⁴⁷ Al-Assal, M. (et al.), *Al-Niḡām al-Iqtiṣādī fī al-Islām...*, Op. Cit., pp. 25-30.

⁴⁸ For the illustration on the mechanism of this business instrument, refer to chapter 4 of this research. While for the Islamic view point on this transaction, relating to the element of *al-maisir* and *al-gharār*, refer to chapters 8 and 9 of this research respectively.

⁴⁹ Refer to Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., p. 95-6.

⁵⁰ "Latest Islamic Fiqh Academy Rulings on Finance" in *New Horizon*, Op. Cit., p. 13.

hence the transaction becomes unlawful. The transaction becomes more seriously prohibited if the payment money received is deposited in the account of an interest based banking system.

One important aspect which distinguishes between speculators and investors is their intention when investing their money. Investors will invest their money with the intention of investment to get business profit and for future saving, while speculators place their money for speculative purposes to get quick capital profit in a short term transaction. From this view point it is clear that both short selling and long buying are not from an investment motive. This is because by definition short selling means the speculators sell shares which they do not possess or if they possess them, they do not intend to deliver them. In fact analysing the short selling transaction, the element of deceit trading is present since they conclude the contract using another person's share script borrowed from the broker, or if the share script is theirs, the prior intention is not to deliver the shares to the buyers. Deceit in trading is universally an unethical and unlawful business activity and in Islam it is *ḥarām* (unlawful)⁵¹.

b) A short seller is just another market player.

The above connotation of short selling clearly implies that the short sellers are just a category of 'market players' who participate in the game of the market. To sell something they do not possess or do not intend to deliver is not the activity of investors. This is because if investors decide to sell their shares, they really mean it and hence will definitely deliver their shares⁵². That short sellers are involved in a transaction without actually possessing shares in their hand, and that they usually borrow share scripts from brokers, or if they do possess them they have no intention to deliver them, indicates that they are 'market players'. They are involved in the market only to get a quick capital profit through the share price movement, which they term as the 'inefficiency of the market' and the 'market adjustment'. Hence their

⁵¹ Refer to the discussion on the unlawfulness of deceit trading in Islam in chapter 3 of this research.

⁵² This is because since the factors that usually force an investor to sell his/her shares are genuine factors the shares need to be delivered. The factors which make an investor decide to sell his/her shares are; the need for urgent cash for his/her immediate use, to liquidify shares for personal leisure use (this is not usual) and discouraging performance of the company participated in which led to the withdrawal of his/her capital in order to invest it in another potential company.

presence makes no contribution to real economic development except by causing market uncertainty and instability due to them betting their surplus money through the mechanism of short selling.

A longer holding reflects more of an investment motive, while a short holding implies a speculative motive, the shorter the greater is the motive⁵³. If this point is to be taken into consideration, then the mechanism of short selling and long buying are speculative in nature. This is because, as defined by economists⁵⁴, the mechanism is used by market participants to gain a quick capital profit through price differences in short term transactions. Both the short sellers or the long buyers need only a short duration to materialise their profit expectation, which can happen between the signing of the contract and the date of delivery or maturity. Therefore, indulging in this sort of transaction purposely for quick capital profit is an activity that fits in with the characteristics of speculators.

c) Further depression of the unstable market.

A point worth noting here is that the mechanisms of short selling and long buying give an opportunity to speculators to gain capital profit from both situations, in the bull market where the trend of the price movement is continuously increasing and vice versa in the bear market where the price is continuously depreciating. Regardless of the economic position of the country, the speculators will continue to speculate. Their activity in the bull market will contribute to the continuation of the bullish market and their activity in the bear market will cause further depression to the market. As the chances of making profit are available in these two positions, the mechanisms become very attractive, and this encourages more speculators into the market and hence, can further disturb the market.

The above arguments justify that the activities of stock market participants when they are involved in short selling and long buying are comparable to and resemble the activity of gambling. As the existence of this group of market players does not

⁵³ Rix, M.S., *Stock Market Economics*, Op. Cit., p. 204.

⁵⁴ Chapra, M.U., *Towards a Just Monetary System*, Op. Cit., p. 95.

contribute to real economic activity for the further economic advancement of a country, and instead contributes further towards stock market uncertainty and instability, their presence is not needed in the alternative model of the stock market in Islam, and hence they must be excluded.

10.4.1.3 The Exclusion of Option Contracts⁵⁵.

a) Option contracts is not comparable to the *bay' al-salam*.

In discussing a few main business techniques which do not conform to the teaching of the *sharī'ah*, Khan considered option as one of them⁵⁶. The option contract, which gives the right to buy or to sell shares in a stipulated time in the future at the current price, is not comparable to the Islamic law of *bay' al-salam*⁵⁷. This is because in the *bay' al-salam* the payment is fully paid in advance, while the object of sale is to be delivered in the future at the stipulated date. In this contract only one aspect is being deferred or non-existent at the time of the contract and that is the delivering of the product. However in the option contract the deferment takes place with both aspects, the payment and the delivering of the substance. In other words, both aspects are non-existent at the time of contract, and this does not conform to the teaching of the *sharī'ah* as stated in the *bay' al-salam*⁵⁸.

b) Bring into the market additional uncertainty.

Besides the above non conformity to the *sharī'ah*, the option contract also brings to the market an additional uncertainty⁵⁹ caused by 'put' and 'call' options⁶⁰. Everybody tries to avoid risk by spreading the risk to other participants, but it actually gives them

⁵⁵ Refer also to the discussion of option contracts and its relation to *al-gharār* in chapter 9 of this research.

⁵⁶ For further details on the discussion of option from Islamic perspective, refer Khan, M.A., "Commodity Exchange and Stock Exchange in..." Op. Cit., pp. 48-50. See also Elgari, M., "Towards An Islamic Stock Market", Op. Cit., pp. 4-7.

⁵⁷ *Bay' al-salam* is a kind of future contract in Islam. The transaction allows the sellers to deliver the object of sale in the future while the buyer pays a full payment for the transaction.

⁵⁸ Khan, M.A., "Commodity Exchange and Stock Exchange in...", Op. Cit., pp. 48-9.

⁵⁹ Ibid., p. 49.

⁶⁰ A put option gives the buyer of the option the right to sell while a call option gives the buyer the option to buy shares in the future at the current price.

unexpected additional risks and uncertainty. As they eagerly pass the risk to others through exercising a put or call option, it will cause a chain of transactions which give speculators an opportunity to make profit. In this situation where they try to spread the risk to others, and speculators attempt to gain a good profit from the prevailing uncertainty, the tendency for market manipulation becomes enormous⁶¹. Hence, the professional speculators are the beneficiaries of the situation as they usually have got enough experience and means of market manipulation.

c) Option contracts is for speculator.

In reality, an option contract is a contract created to serve the speculators, giving them more room to play in the stock market. This is clearly seen because the contract is usually carried out in a short time which is usually three months⁶². This short time of share holding reflects a strong motive of speculation rather than investment. Rix states, "the shorter the time the security is intended to be held, the less strong is the investment motive"⁶³. As in margin selling, this option contract allows the participants to indulge in the contract though they only have a small amount of capital to spend, since only a fraction of the whole price needs to be settled on the day of the contract the option money. This situation causes more participants among the speculators to join the market, and hence leads to more market uncertainty and instability.

d) Option contracts and gaming.

The present writer intends to further examine the practice of option contract and to make a comparison with the activity of gaming or gambling⁶⁴. As stated by Stiegeler, this option contract is actually a form of speculation activity and is closely related to

⁶¹ Khan, M.A., "Commodity Exchange and Stock Exchange in...", Op. Cit., p. 49.

⁶² Elgari, M., "Towards An Islamic Stock Market", Op. Cit., p. 4. The same usual practice of option holding for only six month is also implemented in the London Stock Market. See A Dictionary of Economics and Business, Op. Cit., under the entry "Option".

⁶³ Rix, M.S., Stock Market Economics, Op. Cit., p. 204.

⁶⁴ In this illustration, my assumption is that the participants are speculators who are involved in an option contract with the expectation of price increase or decrease based on rumours and pure speculation on the market uncertainty.

the work of speculators in obtaining a profit⁶⁵. This is because the participants will indulge in an option contract if they expect a price movement upwards or downwards. Also if they are unsure about the direction of the price movement, they can pay for a double option, the right to buy and the right to sell. As speculators participate in the market basing their decisions on rumours and market sentiment, or in the words of Qureshi⁶⁶, 'on the psychology of a market' that has totally lost contact with the reality of the business world and the economic strength of a company, hence this is comparable to the betting mechanism. This argument is well supported by the situation of forfeiting the option money if the option holders abandon the contract, another aspect that is not in conformity with the *sharī'ah*⁶⁷.

Speculation based on rumours and the sentiment of the market, which is divorced from reality, is similar to an act of betting. Speculators bet their money on the expectation that their chosen options will materialise and hence that they will profit from their economically baseless judgement. While in the converse situation where their economically baseless speculative judgement does not materialise, they will lose their option money. In other words, the practice of getting profit through the correctness of their economically baseless speculative judgement, or total loss of their option money or 'betting money' if their speculative judgement does not materialise resembles betting.

10.4.2 The Exclusion of Other Market Manipulations.

As discussed previously, there are a few other activities in the stock market which are illegally practiced by the speculators and other market manipulators such as market

⁶⁵ See A Dictionary of Economics and Business, Op. Cit., under the entry "option".

⁶⁶ Qureshi, D.M., "The Role of Stock Exchange in...", Op. Cit., p. 10.

⁶⁷ This forfeiting condition of the option money if the contract holders abandon the contract is forbidden in Islam as this is equivalent to the contract of *bay' al-'urbān* which is clearly prohibited by the Prophet in his *ḥadīth*. Refer Malik b. Anas, *Muwatta'*, Egypt, Maṭba'ah Muṣṭafā al-Bābī, 1951, *kitāb al-Buyū'*, p. 1. *Bay' al-'urbān* refers to a transaction in which deposit paid is non-refundable. For further details refer Hassan, 'Abdullāh A., Sales and Contracts in Early Islamic..., Op. Cit., pp. 60-2. The condition of paying fee for indulging in option contract as seen by contemporary scholar as a main factor for the prohibition of an option contract. See "Futures, Options, Swaps and Equity Investments" in *New Horizon*, London, Institute of Islamic Banking & Insurance, June 1996, pp. 10-11.

rigging, manipulating, cornering, inside trading and rumour spreading⁶⁸. These activities are generally practiced to support their speculative activities in the market. As the speculative transactions are usually based on the psychology of the market and not on the economic reality, the implementation of these malpractices is to influence the sentiment of the market, especially the movement trend of the share prices. As the process of attaining profit becomes very competitive, speculators have to employ whatever method is available at their disposal including these unfair dealings. As mentioned before these methods of attaining profit are commonly used in the operation of the modern stock market⁶⁹.

It was also pointed out in the previous discussion that these activities do not give any benefit to the market, or to the economic stability of a country. Instead they could cause economic instability as has been discussed in chapter nine of this research⁷⁰. The present writer intends to stress again that by scrutinising these activities from the economic point of view, they are unjustifiable. Furthermore, as the activities are illegally deployed and income is attained at the expense of other participants through victimising them, morally speaking they are unacceptable. Therefore these activities of market manipulations must be excluded from the alternative model. However, it is impossible to exclude these activities from the alternative model because they are already illegally practised. The only way to curb them is through introducing new regulations into the market which will 'tighten-up' procedures. This approach is also applicable to limit the legal speculative instruments practiced in the market as discussed above⁷¹. The introduction of these regulations is to be discussed in the following section.

⁶⁸ For the illustration on the mechanisms of these mal-practices, refer to chapter 4 of this research where each aspect is illustrated. While for the Islamic point of view on the same subjects, refer to chapter 9 of this research. In this chapter, the discussion on the aspect of mal-practices in speculative activities is given.

⁶⁹ Lechner, A., *Street Games: Inside Stories...*, Op. Cit., p. 57. Refer also to chapter 9 of this research under the sub-topic 'Speculation and Mal-Practices in the Stock Market'.

⁷⁰ Refer to chapter 9 of this research under the sub-topic 'speculation: Unethical Economic Activity and Unearned Income'.

⁷¹ Legal speculative business instruments here refer to margin selling, short selling and option contracts practiced in the conventional system. The introduction of few 'tightening-up' regulations into the alternative model of the stock market will assist the market in the process of limiting speculative activities.

10.5 The Introduction of a Few 'Tightening-up' Regulations.

The introduction of these few tightening-up regulations into the alternative model is really needed. This is to make sure the speculative activities that are commonly practiced in the conventional stock market are effectively checked. This is because to depend on the above step of excluding speculative business instruments from the alternative model alone is not sufficient. This is so, as the speculators can turn other business instruments in the stock market into speculative activity. Furthermore, there is always possibility that the market's authority will create new business instruments which are speculative in nature. Hence the procedure of implementing new regulations is needed. These regulations are to be adhered to by all participants in the market. Any participant who breaks these regulations is liable to receive an unsparing penalty. In the following discussion, the present writer will put forward a few suggestion on these regulations⁷².

10.5.1 Higher Tax for Speculative Activities.

To introduce higher tax for any profit attained through speculative activities is another measure which needs to be implemented in the alternative model⁷³. This is because through imposing a higher tax on those who are involved in speculative activities will directly suppress the activity of speculative transactions in the market. However, the question of the time duration for shares to be considered as holding for speculative motive emerges here. This is because the shorter the time the share is intended to be held, the lesser the motive of investment on the transaction⁷⁴. Hence, what is a suitable time duration to consider the holding as a non-speculative activity? In the following, we shall discuss the period of share holding for speculative activity.

⁷² Some of the points suggested here up to the present writer's knowledge are fresh from his idea. The opinions taken from other writers will be acknowledged accordingly.

⁷³ Al-Harran, S., "The Islamic Stock Exchange" in *Leading Issues in Islamic Banking and Finance*, (Ed. by Saad al-Harran) Shah Alam Malaysia, Pelanduk Publications, 1995, p. 149.

⁷⁴ Rix, M.S., *Stock Market Economics*, Op. Cit., p. 204.

10.5.1.1 Share Holding Period for Speculative Activity.

As mentioned in chapter six of this research⁷⁵, the nature of speculative activities varies. However, with regards to the question of time, two important characteristics of speculative activities emerge. The first is on the aspect of the 'high frequency of share transactions' and the second, on the aspect of 'quick small profit'. In relation to these characteristics therefore there are many principles which need to be adhered to by speculators in carrying out their speculative activities. Two of them are, 'to go on repeating the process *ad infinitum* is the secret of success' and 'let us make profit all the time and as frequently as possible, even though it is just a small profit, rather than making a big profit only once in a while'⁷⁶.

The above philosophies require the speculators to hold shares for as short a time as possible. The speculators will not wait a long time to get a big profit, but on a slight movement in the share prices, they will liquidate their positions. Though it seems to us that they gain just a small profit for every unit of share, eventually the accumulating profit would be a handsome amount as they usually buy or sell in bulk. Hence to act quickly in the shortest possible time is their main method. Therefore, the period of share holding for speculative transactions, in some cases is a matter of hours, days or weeks especially in short selling when it takes place during the 'bear' market. Therefore, the writer suggests here that the appropriate time duration for share holding is at least six months. It would be ideal if a one year period could be considered.

The above idea of shares holding at least for six months will undeniably interrupt the idea of marketability and liquidity of the shares. However, this alternative model will continue its original function as a place for the transaction of shares though the activeness of the model will not be the same as the conventional model. This is an acceptable situation as we will see in the later part of this chapter, the main focus of the alternative model is to provide a conducive and sustainable market to the real investor and simultaneously to suppress the present of the speculators. Hence the

⁷⁵ Refer to chapter 6 of this research under the sub-topic 'the nature of speculation'.

⁷⁶ Ibid.

question of market sustainability will always be foremost consideration in the alternative model as compared to the question of shares' marketability. In fact, all new suggestions and modifications of the alternative model as discussed in this chapter is directed towards achieving this important goal.

Nevertheless, the aspect of liquidity and marketability are also considered as two important aspects in the alternative model. The establishment of a special committee which will be discussed later on in this chapter, shall serve towards the alternative model activeness and shares' liquidity and marketability. This is so as one main function of this special committee is to be fully responsible to quickly verify concerning genuine shares selling⁷⁷ under the shares holding period of less than six months. The rapidity of such verification is an important factor for such a committee. In the present writer's opinion a decision is ought to be provided within less than two days. This step will protect shares' liquidity and marketability and will ensure that the investors intention to sell their shares are a genuine one. Simultaneously, it will protect the market from scrupulous speculators.

This is because in the alternative model, the main consideration in participating in the market is to invest surplus money in business ventures for profit in the future, and this money at the same time functions as savings. People must be responsible on their participation and be considerate to the other investors. Though, it is allowed to withdraw one's participation from the business venture, but Islam discourages this attitude as the step may jeopardise the venture⁷⁸. As the market participants in an alternative model commonly participate out of a real investment motive, so emerges the question of time for share holding. They will keep their investment to get business profit as well as capital profit and contribute to the economic development of the country and the prosperous life of the society. However a question emerges here, what happens if the investors genuinely need emergency cash for one reason or another? Should they also be 'punished' through the higher amount of taxation that is designed to curb the speculators?

⁷⁷ As previously mentioned, there are 3 genuine reasons for selling shares. First, emergency need for cash, second, to invest in other potential company and third, to retire from the business world. See footnote no. 35 in chapter 5 of this research.

⁷⁸ For the discussion on this subject, refer to chapter 5 of this research under the sub-topic 'the issue of withdrawal from the partnership'.

10.5.1.2 Special Treatment for those who Need Emergency Cash.

As suggested by an Islamic economist and mentioned in chapter five of this research, an urgent need for cash by genuine investors for their personal spending could be met through various welfare funds operating within the Islamic environment such as from the *zakāh* (compulsory charity) *bayt al-māl* (treasury of the state) and *qarḍ al-ḥasan* (welfare) fund⁷⁹. As an alternative to the above funds, the setting up of a company could possibly be accompanied by the establishment of a fund to cater for the welfare of the investors who have an emergency need for cash. This fund should be handled professionally⁸⁰ in order for it to work efficiently.

If the above welfare funds that operate in the Islamic environment do not exist or exist but are not active,⁸¹ or the companies do not organise their own welfare funds, then the authority of the alternative stock market in Islam is responsible to verify the genuine nature of the investors' need. If the authority (or a special committee which could be established by the market authority to handle such a problem) of the alternative stock market, find that the investors' need for cash is genuine, then the investors should be allowed to liquidate their shares without having to pay the tax that is imposed on the speculators. By imposing a higher tax, it will suppress and limit the activity of the speculators as their activities are mainly financed by loans. They already have to pay all the commissions and interest charged, as well as handle the market risk. With this additional measure imposed on them, the speculators will have to re-consider the profitability of their activity.

⁷⁹ See Dail, A.R., "The Concept of Joint Stock Company from the Islamic Perspective", Op. Cit., pp. 10-2. Refer also to the related discussion in chapter 5 of this research under the sub-topic 'the issue of withdrawal from the partnership'.

⁸⁰ The fund should operate professionally, where workers are employed to handle the whole operation of the fund, including investing its accumulated capital in financing small business activities. This could be done by a big corporation and the fund could be treated as one of its subsidiaries. The fund officers would also be responsible for verifying that the need for urgent cash by the investors is really a genuine one. This is in order to ensure no vested interest investors take advantage of the fund.

⁸¹ This is a common phenomenon in most states in Malaysia where the Islamic welfare fund such as *zakāh* and *bayt al-māl* are not actively utilised. The understanding of the usage of these funds is still very narrow minded and limited. Consequently, the majority of these states keep the accumulated hundreds of millions of capital idle in the bank and feel satisfied when they receive profit from the Islamic bank where they save their money. Nothing much is done by a such amount of money as far as the economic point of view.

However, another related question may arise, which is about the problem of market 'activeness'. By imposing a higher tax, it could drive away the market participants as the step leads to the less marketability and liquidity of their holdings, the two main functions of the market. Are these accusations true? This question will be dealt with in the later part of this chapter in the discussion concerning market activeness in the conventional market vs. market sustainability in the alternative model.

10.5.2 Full Payment for Shares Bought.

In order to avoid the alternative stock market from being manipulated by speculators, the implementation of this aspect is badly needed. The introduction of this full payment requirement on every purchase of shares in the market can bring at least two significant consequences to the market. The first is that the measure will have an effect on the participation of speculators in margin trading and option selling. This is easily understood because in the practice of these two transactions the participants are required to pay only a small portion of the total price of the shares bought. This measure will directly effect their participation in these two transactions as they will have to pay the full amount of the purchasing price.

Secondly, through implementation of this measure, the speculators are being 'forced' to participate in the business transaction in the stock market according to their capability. As mentioned in the previous discussion,⁸² in margin trading, it requires only a small amount of payment to be given to the brokers. This loose requirement on payment directly encourages the speculators to participate further in this speculative activity in two ways. Firstly, the speculators with large or small capital will spread their capital into various margin accounts. This step is taken in order to maximise the possibility of gaining profit and to minimise the risk of loss. Secondly, this easy requirement will enable the speculators to participate in a larger transaction than they could really manage with their small capital. In these two situations, margin trading encourages the speculators to participate in speculative activities which are beyond

⁸² Refer to chapter 9 of this research under the sub-topic '*al-gharār* in the margin trading'.

their means. Through the implementation of this full payment requirement therefore, the room for speculators to participate in transactions beyond their means is restricted.

10.5.3 The Introduction of Price Fluctuation Range (PFR)⁸³.

Price fluctuation is a common phenomenon in a stock market. The problem is very difficult to control as it depends on various factors. However in certain cases, price fluctuation is caused by the speculators' activities in the stock market. In this respect, the price movement does not reflect anymore the correct position of the company and the economy of a country. This is what economists term 'forecasting the psychology of the market'⁸⁴. In this respect, Keynes has already warned that the excessive speculative activities will cause serious problems to the economy by stating:

"Speculations may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done"⁸⁵.

This serious situation is demonstrated in many financial crises as has been discussed previously and the South Sea Bubbles in 1720 and the crash of the NYSE are good examples for this situation⁸⁶.

Therefore in the alternative model of a stock market, there must be a maximum⁸⁷ and a minimum share price to be introduced, termed as PFR. This will directly restrict and

⁸³ The term PFR is introduced here by the present writer in order to differentiate from the proposal on the same aspect by Metwally. Metwally used MSP=Maximum Share Price to indicate the importance of stating the highest valuation of the share prices allowed in the market so that the share would not be traded above the MSP. However the present writer used Price Fluctuation Range=PFR to indicate the range of price fluctuation allowed in the market. Shares are allowed to be traded within the limitation of this range. Anything beyond this PFR is considered as speculative in its nature. While MSP is only concerned with the maximum price, the PFR is also concerned with the minimum price of the share should be traded.

⁸⁴ Metwally, M.M., "The Role of the Stock Exchange...", Op. Cit., p. 22. See also Qureshi, D.M., "The Role of Stock Exchange...", Op. Cit., p. 10.

⁸⁵ Keynes, J.M., *The General Theory of Employment, Interest and Money*, New York, Harcourt, Brace and World, 1936, p. 151 as quoted by , Metwally, M.M., Op. Cit., p. 23.

⁸⁶ Refer to chapters 6 and 7 of this research for the discussion on the subject of excessive speculation in financial crises.

limit the activity of speculation in the market. Regardless of how much effort that the speculators put into manipulating the price movement in order to benefit from it, this effort will not effect the market price much. This is because the PFR will protect against the excessive speculative valuation on the market whether upwards or downwards. Hence the introduction of PFR is among the important measures to be implemented in the alternative model.

10.5.4 Other Required Elements to be Implemented.

There are a few other elements that should be applied to the alternative model of a stock market in order to restrain the activity of speculation in the stock market. These elements could be very helpful in the process of curbing speculation effectively. Each of these elements will be explained briefly in the following.

Ownership is an important aspect in Islamic contracts. Without having the proper ownership, the *'aqd* (contract) for the business transaction will be null and void. Therefore to settle this *gharār* (uncertainty) concerning share ownership is important and can control transactions involving speculation in the stock market. Hence in the alternative model, the transfer of title must be completed before the next transaction is allowed to be carried out. This will directly control the activity of short selling whereby a seller does not usually intend to deliver his/her sold shares to the new owner as he/she intends to make an offsetting purchase when the price has decreased as expected. At the same time, the step will protect against the practice of borrowing shares from the brokers in order to engage in short selling. As they are required to transfer the script into their name and thus sell something owned by them, then it will automatically stop the activity of share borrowing. Hence to fully transfer the ownership of shares bought immediately after the transaction is proposed in the alternative model.

⁸⁷ In this respect the present writer disagrees with the proposal put forward by Metwally which is only concerned with the aspect of maximum price of the share to be considered under the Price Fluctuation Range (PFR) (termed by Qureshi 'MSP'=Maximum Share Price). As speculative activity could take place in both ways of the price movements, upwards and downwards, hence the minimum PFR is also needed. See footnote no 82 above. See also Metwally, M.M., "The Role of the Stock Exchange...", Op. Cit., p. 24.

Thus, the alternative model of the stock market should disallow the activity There are also elements which need to be prohibited as compared to the existing practise. of script borrowing by the speculators from the brokers. As speculators and brokers benefit from short selling, the speculators will not hesitate to borrow while the brokers are more than willing to lend their scripts, which usually belong to their customers. By introducing this measure, the real owners of the shares who entrusted the scripts to the brokers would not be being jeopardised by the unscrupulous speculators and brokers.

In order to monitor market manipulation, market rigging, market cornering and inside trading, transactions of the same shares on the same day should be disallowed. This step has actually been introduced in the KLSE in order to avoid market manipulation by the speculators⁸⁸. Harsh penalties are to be given to those who do not want to follow the market laws and regulations prescribed in the alternative model.

10.5.5 The Establishment of a Special Committee.

The establishment of a special committee is very important in order to make sure that the alternative model operates as efficiently as expected. This committee should function as a market facilitator, to facilitate the smooth running of the alternative stock market. This special committee would be responsible for ensuring all the laws and regulations prescribed in the alternative model would be strictly adhered to. In short the functions of this committee are as follows;

- a) To ensure all regulations prescribed in the market are strictly adhered to, such as the requirement for a full payment, transfer of title and speculative activity.
- b) To monitor the daily operation of the alternative market especially in relation to the question of malpractices in the market.
- c) To give suitable penalties for every kind of wrongful activity as far as the alternative market is concerned.
- d) To be responsible for the fixing of the Price Fluctuation Range (PFR) of the alternative model.

⁸⁸ See Ismail Ibrahim, *Saham dan Pasaran Saham*, Op. Cit., p. 46.

e) To be responsible for verifying the genuine share selling within the time period of six months, the time limit for the speculative holding of shares.

10.6 Few Important Outside Elements for Implementation.

In curbing speculative activities in the stock market, the approach of prohibiting the existing speculative stock market business instruments is not sufficient. This is because of two reasons as mentioned in the previous discussion. Firstly, though the existing sophisticated speculative transactions can be barred from the market, the possibility of creating new business instruments that are speculative in nature is always there. This is because the nature of some human beings is to get easy and quick profit. Secondly, the speculators can still manipulate the stock market through the existing 'less' speculative business instruments practiced in the market. In this respect therefore, the exclusion of those speculative business instruments from the alternative model of the stock market in Islam needs to be supported with the implementation of a few other elements from outside the market. From the present writer's point of view, there are a few outside elements which need to be implemented in the market besides tightening-up measures discussed above. In the following discussion, the present writer will touch on these elements which can ensure that the process of curbing the speculative activities in the market is a success.

10.6.1 Elimination of *Ribā* (Interest Bearing Loan) from and Introducing Profit-Loss Sharing into the Economy.

From the present writer's point of view, in order to help the process of tracking down the speculative activities in the stock market, there are a few outside elements which need to be implemented. The first is regarding the prohibition of *ribā* from the market or more 'radically' from the economic structure of a country as a whole. As testified in the financial crises, especially in the crash of the NYSE and the current crisis taking place in Asia, especially in Malaysia, the easy availability of interest bearing loans have contributed to the problems. This is because the *ribā* system does not take into serious consideration the viability of the project before giving loans to the borrowers. The main consideration of the lenders is to gain a fixed profit through the interest

charged to the borrowers, regardless of the business achievement of the business venture. It would be worse if the capital loans secured were being used to finance the borrowers' speculative activity in the stock market.

It can be disastrous if the lenders are willing to directly finance speculative activity in the stock market, especially margin trading, which is greatly based on capital loans from the brokers. This usually takes place during economic booms such as in the 1920s in the United States of America and in Malaysia, in the 1990s⁸⁹. As the economic prosperity during the economic booms demonstrates that any amount of capital injected in to the stock market, will usually attain a sure profit, the lenders are tempted to lend their money. By lending their capital to the speculators, the lenders can get their share of the economic prosperity quickly rather than investing in the real economic activity⁹⁰. The lenders are unable to resist the profit offered by the market. This act of feeding speculative activity makes the market become very responsive towards any market adjustment, and it was this that eventually led to the crash of the NYSE and KLSE.

Hence, to discourage the activity of securing loans to finance speculative activity in the stock market, the *ribā* system of finance must be limited or abolished. The abolishment of *ribā* from and introducing profit-loss sharing to the market will help to greatly reduce, the speculative activities in the stock market. This is because the attitude of lenders and borrowers under a profit-loss sharing system would not be the same as their attitude in the *ribā* system. The lenders would scrutinise the viability of the projects planned before committing themselves. In the case of business that is already in operation, the previous performance, the profit gained, and the viability of the future projects planned would be the main consideration before investing their money. This is because the profit to be attained by the lenders would depend on the success of the business venture. If the business failed, the lenders would lose their capital while the entrepreneurs would lose their energy and time. As the capital

⁸⁹ Refer to the discussion of the subject under the sub-topic 'Speculation and the NYSE crash' in chapter 6 and 'Margin Trading in the KLSE' in chapter 7 of this research, respectively.

⁹⁰ Refer to the discussion on the subject of speculative loans in the crash of NYSE in chapter 6 of this research under the sub-topic 'Speculation Precedes the Crash'. For the discussion on the same subject in the Malaysian crisis, refer to chapter 7 of this research under the sub-topic 'Speculation Behind the Crash'.

responsibility is on them, the lenders must really analyse the viability of the business venture and choose the lowest risks with the highest return. In this respect therefore no lenders would be willing to commit themselves to the high risk activity of speculative transactions in the stock market⁹¹.

In addition to the above, the lenders in the profit-loss sharing system would always be aware that to be involved in business transactions that were highly speculative in nature is morally wrong and legally prohibited in Islam. In an economic boom where profit from speculative activities in the stock market is usually almost certain, the lenders in the profit-loss sharing system could be involved in speculative transactions if they wished by giving out loans to the speculators. In this situation, the profits offered by the 'bull' market are irresistible and hence overshadow the risky and unlawful speculative transactions in the stock market. Even if this is the case, the profit-loss sharing system is not tempted by the 'profit over-flowing' as the people would be bound to the ethical and business principles prescribed by Islam.

10.6.2 Detachment from Irresponsible Statements by Politicians, Decision Makers and Economists.

This aspect is quite important as the political influence on the stock market could disturb the smooth running of the market. This issue is most important in a country where the politician is free to participate in business ventures as the directors of various companies. This is especially important with relation to the stocks and shares transactions in the stock market. The influence of politicians who have self-interest in the business transactions in the stock market can jeopardise the stability of the market and victimise the market participants. One good example to illustrate the influence of a politician in the business operation of the stock market was a case which took place in the KLSE of Malaysia in early 1994. At the end of 1993, the economy of Malaysia was booming and this was reflected in the higher point of the Composite Index (CI) of the KLSE (almost 1,400). The prosperity of the KLSE continued to the early part of 1994. However through the statement of a politician that the level of the CI was

⁹¹ For further discussion on the question of how profit-loss sharing offers a better alternative than the *ribā* system, refer to the discussion of the subject in chapter 5 of this research under the sub-topic 'The Implementation of Profit-Loss Sharing' and 'Fixed Remuneration vs Profit-Loss Sharing'.

well above the real economic position of the country, the CI of the KLSE suddenly nose-dived to a lower point. Many speculators as well as investors were victimised by the statement of that politician in the above occurrence⁹².

Although in the above example, there is no evidence to prove that the particular politician had a vested interest,⁹³ motive behind his statement. However, the same occurrence could take place in the future in the KLSE and it could be done by a politician with a vested interest, who might be desperately trying to gain something from the speculative activity in the stock market. Therefore to maintain the sanity and the smooth running of the market, politicians must not irresponsibly release any statement concerning the economic condition of the country, especially regarding the stock market, before the information is first referred to the authority in charge of the matter i.e. the Minister of Finance or any special committee who really deals with the matters.

This committee would also deal with the irresponsible statement given by an influential economist in a particular country. This is because an economist could trigger the same negative consequences to the sanity of the market. For example the statement given by Greenspan⁹⁴ on the economic outlook for the United States of America triggered stock markets tumbling down all over the world, especially in Europe. In this respect, the special committee could make a free inquiry into the motive of the statement and any possible vested interest by the speaker behind the release of the statement⁹⁵.

⁹² Refer to Hussin Salamon, "Speculation in the Share Market...", Op. Cit., p. 15.

⁹³ In this respect, the general opinion of the public believed that the particular politician who had previously been the Finance Minister of Malaysia had a self interest in his statement. This seems to be true because during the event, he was the Economic Advisor of the Malaysian Government and a very active and successful businessman in the country. Most importantly, he has his company listed in the KLSE.

⁹⁴ Alan Greenspan is the chairman of the US Federal Reserve. On the July 21, 1998 in his semi-annual testimony, he stated that there would be a 'significant' stock market correction and mentioned that the US interest rates would be raised if the economy continue to develop. His statement led to the tumbling down of stock markets in Europe and the whole world on the following day. The LSE was shaved-off by 143.1 points on its FTSE 100 Index directly after the statement. See the report by Paterson, L., "Greenspan 'correction' hint shakes stock prices" in *The Independent*, U.K., July 23, 1998.

⁹⁵ The example on the statement given by Alan Greenspan here, does not at all reflect that he had a vested interest on giving the statement. The example taken here only illustrates how the statement of an economist could directly effect the market.

10.7 Marketability vs. Sustainability.

Apart from introducing various regulations to be implemented in the alternative model, the model had also excluded all speculative business instruments. Hence, an important question may be asked, would the alternative model be as attractive as the conventional system? In this section, the present writer will respond to this possible question that the alternative model does not attractive enough for participation. The exclusion of many attractive elements such as margin selling, option selling and short selling and also the introduction of very tight regulations and a few other restrictions into the market could, discourage the investors from investing their capital in the market. In addition, that all the above mentioned steps that are to be implemented in the alternative model would actually repudiate the important function of a stock market as a place for share liquidity and marketability. If these two important aspects of shares are absent from the market, surely no one would be willing to take the risk of investing their money in the market.

First of all, the above statements are more likely to come from a feeling of frustration among the speculators. This is because all the elements that are excluded from the operation of the alternative model are the ones suitable to the activity of the speculators. The exclusion of margin selling, option selling and short selling besides the abolishment of interest bearing loans means a lot to the speculators. Without all of these elements in the alternative model, the speculators' opportunity to participate in the alternative model has been reduced. While the restrictions planned for the alternative model, such as introducing a requirement for full payment, an immediate title transfer, a higher tax for speculative transactions, a price fluctuation range and strengthening a few existing regulations, further reduced their already slim opportunity in the market. Therefore, the speculators are the ones who are really not happy with the approach of the alternative model in handling the problem of speculative transaction, which is rampant in the conventional model.

Secondly, in the present writer's point of view, the real investors in the alternative model should not worry about their investment. For the real investor, the problems of

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As to the claim that the alternative model is not attractive enough, and no investors would be willing to take the risk of investing their money in this 'strict' model. This situation could lead to an 'inactive' market operating without many participants. Undeniably, the claim that the alternative model is not attractive enough, and that this could effect the activeness of the market, to a certain extent is true. The exclusion of the speculative elements from the market will certainly make the speculators turn away from the alternative model. As they are the group who make the modern market move actively⁹⁷, their absence will certainly make the market look inactive. Therefore inactive in the alternative model understanding is 'inactive' from the participation of the speculators.

Concerning the aspect of 'no investor' being willing to invest their surplus money in this strict model. Any newly developed model will face the same problem, especially when it refers to the Islamic system of economics. This is because the Islamic system is a relatively new system developed recently. The Islamic banking system which has been operating for only a few decades, still faces the same problem, not only among non-Muslims but sadly, also among Muslims. The writer fully believes that if this alternative model is implemented, it will climb the ladder of success steadily though it might be slower than any conventional system. However, when the alternative model has been established even if it is surrounded by the conventional system, it will still offer an attractive place for real investors. This is because the element of sustainability of the alternative market is there, since there are not many speculative activities in the market which could make the market crash as testified in the crash of NYSE in 1929 and in many other modern financial crashes. As the aspect of genuine marketability, liquidity and sustainability are all there, the alternative model should provide a competitive place for investment.

10.8 Conclusion.

From the above discussion, the present writer will conclude that the alternative model of the stock market in an Islamic economy should carry the most basic functions of the earlier stock market, that is a place of meeting among business entrepreneurs and

⁹⁷ Khan, M.A., *Issues in Islamic Economics*, Op. Cit., p. 87.

a place of genuine transactions stock and shares. The main focus on these two functions does not mean that the alternative model throws away the other functions of the modern stock market, but because these two functions are well carried out, the other functions will naturally appear. At the same time, any function that can be carried out by the alternative model of a stock market without having to show leniency or toleration when it comes to the laws and regulations prescribed in the alternative model, would be welcome.

As the main problem of the existing system is on the presence of speculators and speculative business instruments, the alternative model focuses on abolishing the presence of the group of market manipulators, and on protecting the market from all kinds of business transactions that are speculative in nature. This is because the alternative model of a stock market is more concerned with the market sustainability rather than the activeness of the market. However, it does not imply that the alternative model rejects the possibility of an active market in its operation. The activeness of the alternative model could be achieved after a long period and not in the very short period of activation caused by the involvement of the speculators. The active market which could be achieved by the alternative model would be a genuine active market and not tempered by speculative activity. Consequently, the stability of the alternative market is believed to be sustainable.

CHAPTER 11

CONCLUSION.

In this concluding chapter, the present writer will precisely summarise the discussions of the previous chapters of this research. The important conclusions for each chapter will be restated. Simultaneously the outcomes of this research will provide us with a clear resolution of the subject of speculative transactions in the stock market from the Islamic perspective.

To conclude the discussions of the previous chapters, the present writer will again emphasise that ethics in the business world, as viewed by Islam, are the core components when searching for the bounties of God. This is because the primary objective of Muslims in doing business is to achieve *marḍātillāh* (the pleasure of God). This is more important than the business profit, which is also important in this mundane life. However, the motive of material attainment must not override the foremost aim of attaining *marḍātillāh*. Even the material gain which is viewed as an *amānah* (responsibility) must be spent in such a way that the final achievement is also the *riḍā* (pleasure) of God¹. If a Muslim struggles at his/her very best capability to attain *riḍā* of God in his/her business activity and simultaneously attains success in the business world, then this is the real *falāḥ* (success) that every Muslim is intended to achieve.

From the above point of view therefore, Islam prescribes clearly the basic principles to be adhered to by Muslims in all spheres of life. For business activities Islam prescribes the decree of *al-ḥalāl wa al-ḥarām* (the lawful and the unlawful), the prohibition of *ribā* (interest), the prohibition of *al-maisir* (gambling), the denouncement of *al-iḥtikār* (hoarding), the prohibition of *al-gharār*, the importance of *‘aqd* (contract) and the prohibition of other malpractices which are rampant in today's business operations. Every individual Muslim is bound to follow these basic principles of Islamic business ethics including in the business transactions in the stock market, in order to achieve the *riḍā* of God and the real *falāḥ*.

¹ The Qur’ān, 28:77.

The business of the stock market is a new phenomenon in Islamic economics. There are many aspects that worth studying from the Islamic perspective in the business operation of the market. Nevertheless the question concerning the business of speculative transactions overshadows the other aspects. Islam views that speculation in its general understanding and application of the word is permissible because human beings are given the power of intellect to think, ponder and speculate for the betterment of their life in this world. However, the specific application of the word, in the business of speculative transactions in the stock market, needs justification. This is because the stock market is now being 'unofficially' turned into a place to gain quick profit or to lose capital in a short time, without knowing the status of its permissibility. This is as a result of speculative transactions.

Analysing thoroughly the speculative transactions in the stock market from the Islamic perspective, there are three important factors which can be deduced from this research, and which have led to the prohibition of speculative transactions in the stock market in the conclusions of the present writer. The first is the negative consequences that speculative activity can cause to the stock market in particular, and to the economy as a whole. The second is the presence of elements of gambling in the business of speculative transactions in the stock market. The third factor is the existence of clear *gharār* and other unethical and malpractices in the transaction. The presence of all these factors in speculative transactions cause them to be incompatible with the spirit and teaching of Islam.

The presence of the first factor, the negative consequences of speculative activity is clearly demonstrated in the later part of chapter six and the whole discussion of chapter seven of this research. The excessive speculative transactions that took place in the New York Stock Exchange were believed by economists to be among the main factors that led to the crash in 1929². Consequently, not only the economy of the

² Speculative activities in the NYSE had started in the early 1920s when the United States of America's economy emerged as a new super power after the first World War. However the speculative mania overpowering the sanity of the NYSE during the period 1925 up to the first three quarters of 1929 eventually contributed to the crash in November 1929. Refer to the discussion in the later part of chapter 6 of this research. As pointed out by Born, the speculative excessiveness in securities trading in the NYSE was among the major factors causing the crash of the market which

United States of America was affected but the whole world faced a long and dreadful experience of economic depression from 1930-1939³. While the current crisis that started in South East Asia in July 1997, due to speculative activity in currency trading and the stock market, has spread to different parts of the world. The crisis, as illustrated in chapter seven of this research, is not only affecting small and developing countries in the crisis region, but also the economic powers of today such as Japan, the United States of America, Britain, Germany and France⁴. These are among other examples of the negative contribution of speculative activities. When this level of economic severity is caused by speculative activities, the prohibition of the transactions by Islam seems appropriate.

The second factor is the embodiment in the transactions of a few elements comparable to the activity of gambling. The element of pure hope and luck, the element of betting, the element of taking advantage and the element of speculators detaching themselves from economic fundamentals, make speculative transactions comparable to the activity of gambling. As gambling or games of chance are forbidden in Islam, business activities which have involved in them these elements of gambling are to be treated as gambling. This is probably what is termed by Corbett as 'commercial gambling' when he was describing the word speculation⁵.

In addition to the above elements that are obvious in gambling activity, speculative transactions in the stock market also have embodied in them the element of *al-gharār* (uncertainty), malpractices and unethical activity where these elements lead to the question of 'unearned income' being received by the speculators. Although

consequently led to the World Great Depression in 1930s. Refer to Born, Karl E., *International Banking in...*, Op. Cit., p. 256.

³ Kindleberger, C.P., *The World in Depression 1929-39*, Op. Cit.

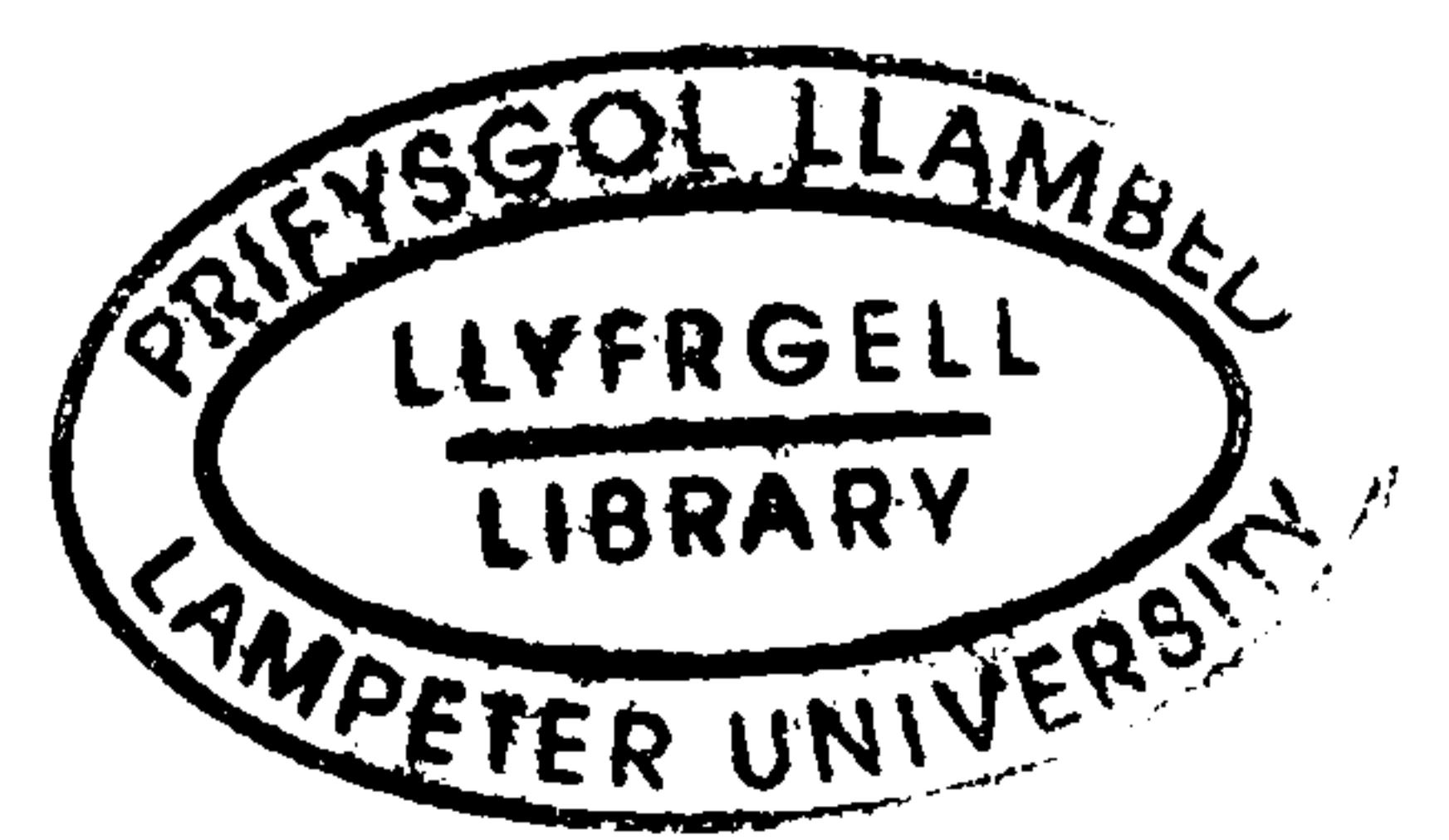
⁴ The crisis in South East Asia is effecting the economy of these countries. The effect on the Japanese economy is really challenging while the effect on the rest of these countries is felt to a certain extent. This is because the economy of Japan is the second largest in the world after the United States of America. Refer to the discussion of the subject in chapter seven of this research. However, while this research came to this concluding chapter in late July 1998, the negative effect of the crisis in Japan has entered into its new phase. The Yen (Japanese currency) has continuously devaluated and the country's economy is moving towards deep recession. Thus the crisis taking place in Japan is now almost as severe as the rest of the South East Asian countries. While the effect is also being more seriously felt by the rest of the world including Russia and South Africa where their currencies are badly affected.

⁵ The Oxford English Dictionary, Op. Cit., in the illustration no. 9 under the entry "speculation".

transactions which include small and unavoidable aspects of *al-gharār*, especially during the transactions of necessary goods, are permitted in Islam, this permissibility is not applicable in the business of speculative transactions in the stock market. As was discussed in chapter nine, the element of *al-gharār* in the speculative activity in the stock market in which speculators participated, does not conform to the requirement for permissible *gharār*. The other elements mentioned in chapter nine all contradict the basic principles of Islamic ethics in business, as discussed in chapter three. The existence of these elements further strengthens the stance of Islam on the prohibition of speculative transactions in the stock market⁶.

As the prohibition of speculative transactions in the conventional stock market is clear, hence Muslims need an alternative model of a stock market to enable them to participate in this particular business activity. The alternative model presented in chapter ten of this research shows that Muslims can still participate in the business transactions of the stock market. However the alternative model of the stock market in Islam as presented here is a modification of the conventional stock market. There are a few elements of the conventional system which clearly are not suited to the spirit of Islamic economics, and which are excluded from the alternative model. While a few other elements have been injected into the alternative model to make the model operate more effectively than expected. These modifications, by subtractions from and supplements into the existing stock market, are purposely done to make the market more in conformity to the teaching of the *sharī'ah*. Accordingly, the alternative model does not only offer a conducive place for investment which is free from speculative activities, but also a sustainable stock market for the participants.

⁶ The present writer intends to stress here that the conclusions reached in this research only affect the business activities in the stock market which are involved with speculative transactions. The participation of Muslims in the business transactions of the stock market as real investors are unaffected by the conclusions of this research. However, these real investors must always consider the issues in the stock market from the Islamic perspective discussed in chapter 5 of this research before they participate in the market.



GLOSSARY OF ARABIC TERMS.

Al-‘Adālah : Justice; To put something into its right place.

Ādhān : Call for prayer.

Aḥādīth : Traditions of the Prophet Muḥammad (saw). Plural for *ḥadīth* (tradition).

Akhlāq : Ethics, morals, manners.

Allāh : God.

‘Amal : Action.

Amānah : Responsibility and accountability.

Anṣāb : Idolatry; sacrificing animal for idols.

‘Aqd : Contract.

‘Aql : Intellect.

‘Aqīdah : Faith, belief.

Azlām : Divining by arrows; Arrows without head which is used in divination.

Badar : The first war had been faced by the Prophet Muḥammad (saw) after the migration to Madīnah.

Bay‘ al-gharār : Sale of uncertainty.

Bay‘ al-kāli’ bi al-kāli’ : A prohibited sale of one debt for another.

Bay‘ al-ribawī : Interest based transactions.

Bay‘ al-salam : A transaction contract whereby the payment is made in advance by the buyer and the article of the transaction is to be delivered in the future at the stipulated time.

Bay‘ al-‘urbān : A prohibited transaction in Islam in which deposit paid is non-refundable.

Bayt al-māl : Treasury of the state.

Daman masfūḥan : The running blood.

Ḍarūrah : States of emergency or difficulties in the society.

Al-Dīn : The way of life that includes every aspect of human activity.

Al-Falāḥ : The real success achieved in both worlds, in this world as well as an absolute success in the hereafter.

Farā'id : Law of inheritance in Islam.

Faṭānah : Clever; an attribute which is only belong to the prophets.

Fatāwā : Religious rulings; plural for fatwā.

Fatwā : Religious ruling.

Fiqh : Islamic jurisprudence.

Fiqh al-Mu'āmalah : The Islamic jurisprudence of transaction.

Fir'aūn : Pharaoh.

Fuqahā: Scholars of Islamic Jurisprudence.

Al-Gharār : Risks and Uncertainty; an uncertain, unpredictable situation concerning business transactions or business dealings.

Ḥadīth : Tradition of the Prophet Muḥammad (saw).

Ḥadīth Ṣaḥīḥ : Authentic tradition.

Al-Ḥalāl wa al-Ḥarām : The lawful and the unlawful.

Hāmān : Pharaoh's right hand man.

'Ibādah : Every human's activity that is carry out within and in accordance to the teaching of *sharī'ah*, with right intention of attaining *maqāṭillāh*.

Iḥsān : To do good; To worship God as though we see Him, if we do not see Him, indeed He always sees us.

Iḥtikār : Hoarding.

Ijmā' : Consensus of the Muslim scholars.

Ikrāh : Compulsion.

Infāq : Voluntary charity.

'Īsā : Prophet Jesus.

Jahīliyyah : The period of ignorance.

Kaffārah : Compensation for repentance.

Kalimah : Word or expression.

Kalimah al-tawḥīd : The expression of there is no God except *Allāh* and Muḥammad is the messenger of God.

Khamr : Alcohol.

Khalīfah : The term used to indicate human being as God's representative or vicegerent on earth.

Laḥma al-khinzīr : Swine flesh.

Māddī : Material.

Māddiyyah : Materialistic

Maisir : Gambling.

Mardātillāh : Pleasure of God.

Maṣlahah ‘āmmah : Public interest.

Ma’ṣūm : Infallible; an attribute which is only being honoured to all the prophets.

Muḍārabah : Profit-loss-sharing; a contract carried out between two or more people whereby the investors (*ṣāhib al-māl*) act as capital suppliers and the others act as entrepreneurs (*muḍārib*). The capital supplier acts as a silent partner, while the entrepreneur will endeavour in the business.

Muḍārib : Business operator/entrepreneur.

Mufassirūn : Commentators of the Qur’ān.

Mūsā : Prophet Moses.

Lauḥ al-maḥfūz : Refer to a tablet preserved by God whereby the knowledge of everything is stated and preserved by Him.

Naṣārā : Christians.

Ni‘mah : Bounties bestowed by God, material as well as non-material things.

Al-Qadar : A situation whereby everything that a human being receives for his/her life is a due proportion which God has mentioned in the preserved tablet (*lauḥ al-maḥfūz*).

Qarḍ Ḥasan : Welfare fund to serve the needy.

Quraysh : The tribe of Prophet Muḥammad (saw).

Rahbāniyyah : Ascetic; searching for success in hereafter by neglecting this worldly life.

Ribā : Interest or usury.

Ribā al-faḍl : Interest imposed on barter transaction of identical commodities.

Ribā al-nasī'ah : Interest imposed on financial transactions.

Riḍā : Pleasure.

Rukḥṣah : Flexibility in Islamic Law which is applicable at the time of difficulties.

Ṣadaqah : Voluntary charity.

Ṣāhib al-māl : Capital supplier.

SAW : An abreviation for *Sallā Allāh 'Alaih wa Sallam* which means peace be upon him, being used after the name of Prophet Muḥammad is mentioned.

Shahīd : Martyr.

Al-Shaiṭān : Satan; the evil spirit.

Sharī'ah : The Islamic Law prescribed in the teachings of Islam.

Shirk : Polytheism; to put partner or associating a companion with God.

Shirkah or *Sharika* : Partnership; participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profit and loss in specified proportion.

Slm : Peace, fully surrender; the root word for the word Islam.

Sunnah : The detailed account of the Prophet Muḥammad's (saw) life.

Sūrah al-nisā' : The chapter of the women.

Al-Takāful : Mutual co-operation; to perform good deeds and help others.

Taqwā : Righteousness.

Al-Tawḥīd : Belief in the Oneness of God.

Al-Tawākul : To surrender and rely upon the only Creator blindly, without any effort being carried out.

Al-Tawakkul : To fully surrender and rely upon the only Creator in any activity carry out after an effortful endeavour is done.

'Urūd al-tijārah : Sale without substance.

Waṣāyā : Law of inheritance in Islam (related to Will of dead person).

Yahūd : Jews.

Zakāh : Obligatory charity.

Zinā : Adultery.

Ẓulm : Transgress.

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