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The *Voices from Central Asia* series is a platform for experts from Central Asia, Afghanistan, Azerbaijan, Mongolia, and the neighboring countries. The local point of view is often forgotten in Western-centered analysis; at best, only the official, state-level position is known. The series promotes the diversity of opinions expressed by Central Asians and is a venue for researchers, senior officials, opposition figures, and civil society activists.

## **The Politics of Islamic Finance in Central Asia and South Caucasus**

**by Fuad Aliyev**

Started as a small grassroots initiative in Egypt about forty years ago Islamic finance has been growing in the number of countries, proposed Islamic banking services, and areas of finance and assets ever since. In late 2011 the global market for this industry was worth around \$1.3 trillion, with assets having grown by 150% since 2006.<sup>1</sup>

Islamic finance represents a system of financial intermediation that avoids interest-based transactions in accordance with Islamic law. The major principle is the avoidance of interest (*riba*), the avoidance of preventable contract uncertainty (*gharar*) and ambiguity (*meysir*), not funding immoral activities (*haram*), as well as ensuring social justice and transparency. Thus an Islamic financial institution is a financial intermediary whose objectives and operations, principles and practices conform to the principles of Islamic Law.<sup>2</sup> A major feature of Islamic finance is profit and loss sharing (PLS) transactions. However, in reality many other modes like leasing, and sale in installments are also used.

### **Key Points**

- Kazakhstan is the most welcoming towards Islamic finance in the region, and plans to become a regional hub linking Central Asia to the Islamic world by 2020.
- Uzbekistan has the best potential market for Islamic financial institutions in the region, but is cautious in participating in the activities of the Organization of Islamic Cooperation and the Islamic Development Bank.
- Islamic finance is viewed not as a commercial activity, but as Islamic activism by most of the Central Asian and Azeri regimes, and therefore considered as part of the "Islamic threat".

### **Bio**

Fuad Aliyev has served as lead analyst at the Center of Economic Reforms under the Ministry of Economic Development of the Azerbaijan Republic and Executive Director of Azerbaijan Marketing Society. In 2011-2 he was a Fulbright Scholar at the Central Asia-Caucasus Institute, School of Advanced International Studies at Johns Hopkins University, Washington DC.

Seemingly a commercial activity at first sight, Islamic finance has always been partially political. There is indeed a complex history between Islamic financial institutions and the political regimes or authorities in the Muslim states where it was implemented. It has never been seen by respective governments as a purely financial institution, and has thus been closely intertwined with politics.

The Islamic Revolution in Iran and the *islamification* of Sudan's polity immediately resulted in the full and total *islamification* of their financial-banking systems. On the other hand, secularized and even non-secularized Muslim countries have been cautious and sometimes hostile to Islamic finance for a long time. Thus, all other things being equal, introduction and development of Islamic finance has depended heavily on the politics in the specific countries. The Central Asia – South Caucasus region is a good example of this rule.<sup>3</sup>

This paper explores the political aspects related to the ongoing attempts to introduce Islamic finance in the predominantly Muslim, but secular countries of the Central Asia – South Caucasus region, namely Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.

According to Clement M. Henry, "Islamic banks would seem to have better opportunities to compete and to expand their shares of market in relatively open, liberal economies than in closed ones."<sup>4</sup> The trend of last decades towards more openness and globalization has indeed created a fertile soil for growth and expansion of this industry. For example, the liberalization of the national economy helped Islamic economic institutions in Turkey become an important sector of the economy.<sup>5</sup> Liberalization of politics in Turkey and to some extent in a few Middle Eastern countries has also immediately helped Islamic activists get their momentum.

Although the majority of the population in Central Asia and in Azerbaijan is Muslim, Islamic finance has been almost non-existent there, and there have been problems in incorporating interest-free banking operations into the countries current legislative systems. However, the current

state of things is very different throughout the region with an almost fully-fledged system in place in Kazakhstan and no signs of any genuine Islamic finance on the horizon in Turkmenistan and Uzbekistan.

Although Azerbaijan was the quickest among the post-Soviet Muslim states to join the Islamic Development Bank (IDB) in July 1992 and has the largest amount of its funding (more than \$1.2 million), it has not become a regional leader in introducing Islamic finance. Most of this funding was used to finance huge infrastructural projects in form of concessional loans and grants. In fact, the legislation in Azerbaijan does not recognize Islamic finance, Islamic banking or their modes as legally acceptable. Post-Soviet Azerbaijan has on the contrary a history of "Guerilla Islamic finance," i.e. banking activities "hidden" under the forms of conventional banking.<sup>6</sup>

Following a different route Kazakhstan has the most welcoming policies towards Islamic finance in the region. After joining the IDB in November 1995, it started active cooperation with this institution. It was the first country of the region to welcome the equity fund International Company for Investment in Central Asia in 1998. In 2000-1 an IDB line of financing in accordance with the Sharia was opened to three Kazakh banks through installment sale/leasing and import trade financing operations. The law "On introducing amendments and addenda to some legislative acts of the Republic of Kazakhstan on issues of organization and activities of Islamic banks and Islamic finance organizations" was approved in February 2009. It officially allowed banks to conduct operations in accordance with the principles of Islamic finance. Furthermore, related provisions of the Civil Code, laws "On Banks and Banking Activity," "On Investment Funds" and "On the securities market" were amended accordingly.

At the moment, only the Islamic bank Al-Hilal Bank operates after receiving a license in 2009. According to specialists, within a few years, Sharia-compliant financing will be more than five percent of Kazakhstan's total banking services market.<sup>7</sup> It is worth mentioning that President Nazarbayev has encouraged and even initiated the process of introducing Islamic finance. He personally persuaded Al-Hilal to come to the

country during his visit to the United Arab Emirates.<sup>8</sup> The overall goal of the Nazarbayev government is to turn Kazakhstan into a regional hub linking Central Asia and the Commonwealth of Independent States (CIS) to the Islamic world by 2020.<sup>9</sup>

In 2006, a Memorandum of Understanding was signed between the IDB, the Kyrgyz Republic, and OJSV EcoIslamicBank concerning the introduction of Islamic banking and finance. The rapid introduction of Islamic finance in Kyrgyzstan can be explained by the personal support of the president at the time, Kurmanbek Bakiyev, and his good personal relations with the Chairman of EcoBank Shamil Murtazaliyev, a Kyrgyz Islamic finance enthusiast. The second “revolution” in April 2010 that resulted in the collapse of Bakiyev’s regime has not stopped this process. The post-Bakiyev authorities continued his policy and cooperation with the IDB, under the supervision of now Prime Minister Omurbek Babanov.<sup>10</sup>

In November 2011, Tajikistan and the IDB signed a Technical Assistance agreement on Islamic banking.<sup>11</sup> It is aimed to develop legal, regulatory, and supervisory frameworks required for this banking sector. Through these measures Tajikistan is becoming the third country in the region to start the legalization of Islamic banking activities. According to expert evaluations, the draft legislation is underway and expected to be adopted by the end of 2012. There is currently strong support from the country’s leadership, thereby explaining this policy acceleration in favor of Islamic finance. Indeed, according to some sources, one of the largest banks in the country has agreed to be supported by the IDB but on the condition of complying with Islamic regulation. One would expect this bank to be first in line for “Islamification” once the legislation is in place, and to be ready to operate in 2013.

Little has been going on in Turkmenistan around Islamic finance. In November 2011, the IDB Islamic Corporation for Development of the Private Sector signed a Memorandum of Understanding with Ashgabat that established an investment holding company similar to the ones opened in Kazakhstan and Azerbaijan.<sup>12</sup> It will focus on the development of the private sector, especially small- and medium-size enterprises, the financial

sector, agriculture, logistics, the construction of affordable housing, as well as the services and manufacturing industries.<sup>13</sup> However, currently this institution is not operational and it is unclear when it will become so.

Unlike the other countries of the region, Uzbekistan has been extremely cautious in simply joining the Islamic Development Bank. While the neighboring countries were trying to utilize the opportunities coming from IDB funding for almost a decade, Tashkent was mainly observing before finally joining in 2003. It has had an IDB line of financing in accordance with Sharia since 2005-6. Two institutions, Ipak Yuli Bank and Uzbek Leasing International, were selected to carry these lines. In general, it is mainly the leasing operations that are used due to a relatively well-developed leasing sector in the country.

Some informal sources say there was an initiative coming from a local IDB representative to introduce Islamic finance in 2007. However, little progress was achieved due to the lack of high-level support for this idea, mainly because of perceived threats of potential terrorist financing and the additional workload needed to amend the existing legislation. Having the best potential market for Islamic financial institutions in the region given a large religious population, especially in the Ferghana Valley, Uzbekistan’s leadership paid more attention to the other side of the story – the potential for helping Islamist opposition grow and terrorism financing.

As a result Tashkent’s decision was to postpone the introduction of Islamic finance in the country. The Uzbek government’s policies towards anything related to Islam have been always suspicious, and Islamic finance is no exception. Uzbekistan is thus the only country in the region that does not actively participate in the activities of the Organization of Islamic Cooperation (OCI) and the IDB.<sup>14</sup>

### **Concluding remarks**

The main clientele of Islamic banking services are religious Muslims who want to have financial services in accordance with Sharia, and one could expect them to be loyal clients. Thus potentially Uzbekistan and the Ferghana Valley as a whole

could be a good market for these services, while in Kazakhstan the clients are mainly corporations as well as the government itself.

Having glanced at the way Islamic finance initiatives have been treated in various Central Asian republics and Azerbaijan allows one to argue that the policies towards this financial industry have taken their lead from the individual countries policies towards Islamic activism in general. Market demands and potential do not seem to have been taken into consideration at all. Thus Islamic finance is viewed not as a commercial activity, but as a part of Islamic activism. The more restrictive policies towards this kind of activism are, the less Islamic finance there will be.

Such policies emanate from the perceived “threats” associated with Islamic finance by policy makers. They can be defined as a “hidden Islamophobia” – a phobia based on the alleged threat represented by any kind of Islamic activism to secular nationalism and current regimes. Such attitudes are exemplified by the statement a public official in Azerbaijan made while meeting with a delegation of Islamic bankers several years ago: “Islamic finance is alien to the Azerbaijani mentality since we are a secular nation”.<sup>15</sup> However, the trend towards differentiation between the political and financial nature of Islamic finance, exemplified by Kazakhstan and Kyrgyzstan, to be followed soon by Tajikistan, appear to be increasing.

The opinions expressed here are those of the author only and do not represent the Central Asia Program.

<sup>1</sup> “Islamic Finance,” *The Economist*, April 10, 2012, <http://www.economist.com/blogs/graphicdetail/2012/04/focus-2>.

<sup>2</sup> Raquib, Ahmad, *Principle and Practice of Islamic Banking* (Dakha: Panam Press Ltd., 2007), p. 70.

<sup>3</sup> Clement M. Henry, *Financial Performance of Islamic versus Conventional Banks* in C.M. Henry and R. Wilson (eds.), *The Politics of Islamic Finance* (Edinburgh University Press, 2004), p. 106.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

<sup>6</sup> Fuad Aliyev, “‘Guerilla Islamic Finance’. The Azerbaijani Way,” *Azerbaijan in the world* 1, no. 13 (August 1, 2008).

<sup>7</sup> “Islamic Finance and Bank arrives in Kazakhstan,” *Global Islamic Finance*, October 2, 2009, <http://www.global-islamic-finance.com/2009/10/kazakhstan-islamic-finance-banking.html>.

<sup>8</sup> Clare Nuttal, “Support from the top for Islamic finance market,” in *Investing in Kazakhstan 2011* (Washington, DC: New Desk Media, 2011), pp. 131-133.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> “IDB, Tajikistan sign agreement on Islamic Banking,” *Trend News Agency*, November 17, 2011, <http://en.trend.az/regions/casia/tajikistan/1958198.html>.

<sup>12</sup> “IDB establishes an investment holding company in Turkmenistan,” *Fineko News Agency*, no date, [abc.az/eng/news/49129.html](http://abc.az/eng/news/49129.html).

<sup>13</sup> Ibid.

<sup>14</sup> Ernest Sultanov, *Mezhdunarodno-pravovye aspekty deiatel'nosti Organizatsii Islamskoi Konferencii*, PhD, Moscow, 2005.

<sup>15</sup> Interview conducted by the author in March 2012 with the former IDB officer.

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