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**The Logic of Financial Westernization  
in the Middle East  
(REVISED)**

**Timur Kuran**

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University of Southern California Law School  
Los Angeles, CA 90089-0071

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# The Logic of Financial Westernization in the Middle East

Timur Kuran\*  
Department of Economics  
University of Southern California  
Los Angeles, CA 90089-0253

(213) 740-2102 • kuran@usc.edu

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**ABSTRACT.** In the nineteenth century the steps taken to modernize the Middle East's financial system included the legalization of interest, the establishment of secular courts open to both actual and juristic persons, and new banking regulations based largely on Western models. Exploring why they involved the transplant of foreign institutions, this article shows that certain elements of Islamic law blocked evolutionary paths that might have generated a modern financial system through indigenous means. These sources of rigidity included (1) the Islamic law of commercial partnerships, which limited enterprise continuity; (2) the Islamic inheritance system, which restrained capital accumulation; (3) the waqf (pious foundation) system, which inhibited the pooling of resources; and (4) the Islamic legal system's aversion to the concept of juristic personality, which limited the capabilities of private organizations. Even before the financial advances of the nineteenth century, the region's non-Muslim minorities had come to dominate key economic sectors, including finance. Non-Muslim merchants and financiers improved their relative positions because, unlike their Muslim counterparts, they could operate under the jurisdiction of Western courts.

Keywords: Islam, Islamic world, Middle East, development, modernization, finance, interest, bill of credit, bill of exchange, banking, partnership, inheritance law, cash waqf, minorities.

Journal of Economic Literature Codes: N25, N23, N85, P51, O53.

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## 1. Introduction

The economic transformation that the Middle East initiated in the nineteenth century involved the emergence of banks that dealt in interest openly and unabashedly. This event is generally regarded as essential to the region's modernization. But two groups of thinkers been impressed especially by its costs. The first consists of "Islamic economists," who aim to restructure economic relations according to classical Islamic teachings; they view the banks that proliferated in the course of the modernization process as evidence of destructive Westernization (Qureshi, 1967; Siddiqi, 1973; Chapra, 1985). For their part, various dependency scholars link the advent of modern Middle Eastern banking to an imperialist thrust to make the region chronically reliant on the West (Wallerstein, Decdeli, and Kasaba, 1987; Berque, 1968; Frank, 1998).

These interpreters do not explain, at least not adequately, why the observed modernization took place in the nineteenth century rather than, say, several centuries earlier. Nor do they elucidate why diverse local players, including Muslim merchants and financiers, welcomed the institutional transformation. Focusing on changes in financial practices, this article argues that the timing of the Middle East's economic modernization was tied to the institutional evolution of Western Europe. Relative to the prevailing Islamic institutions, the new institutions of the West improved capabilities for pooling resources, and they lowered the cost of credit. They thus turned the Middle East's time-honored financial institutions into sources of competitive disadvantage. The region's financial modernization was a natural response, then, to the institutional divergence brought about by structural changes in the West.

The financial system of the Middle East did not remain literally frozen until the reforms of the nineteenth century. Several centuries earlier "cash waqfs" had emerged as major sources of credit. Conceived as part of the waqf system—the vast system of Islamic trusts—these enterprises presented some bank-like features. Capable of making multiple loans at once, they earned returns by charging interest. Unlike a veritable bank, however, the cash waqf was not a legal person. Limiting financial flexibility, this deficiency hindered the pooling of financial assets.

Among the puzzles of Middle Eastern economic history is that, starting around the eighteenth century, the region's religious minorities achieved increasing prominence in the region's financial markets, outshining the Muslim majority in most major cities. The region's Christians and Jews got

ahead, I suggest, because of the “choice of law” that Islamic law customarily granted to non-Muslims living under Muslim rule. This provision allowed minorities to litigate their internal disputes in communal courts of their own. When Western financial institutions began to offer advantages over their Islamic counterparts, that historical precedent enabled indigenous Christians and Jews to move under the jurisdiction of consular courts long in operation for the benefit of resident and visiting Westerners. So the region’s religious minorities entered modern banking sooner than Muslims, who had to wait for institutional reforms.

Nothing in the interpretation below assumes that Islam is inherently hostile to business or that the architects of Islamic institutions foresaw how the transformation of the West would eventually necessitate fundamental reforms. Rather, I show that certain old institutions blocked adaptations that might have resulted in self-propelled financial modernization. Among these institutions are the Islamic law of commercial partnerships, which limited enterprise continuity; the Islamic inheritance system, which hindered capital accumulation; the waqf (pious foundation) system, which inhibited the pooling of resources; and the Islamic legal system’s aversion to the concept of legal personhood, which enfeebled private organizations.

It is often said that Islam’s presumed ban on interest raised the cost of credit and hindered financial modernization. These two charges carry much validity. By itself, however, the Islamic prohibition of interest fails to explain why the financial capabilities of the Middle East fell so significantly behind those of the West. A millennium ago interest was as maligned in Western Europe as it was in the Islamic Middle East. Moreover, in both regions circumventing the ban absorbed resources. The key puzzle is that in the Middle East interest gained legitimacy later than in the West. The reason, we shall see, lies in the very stabilizing mechanisms that kept the Middle East’s financial institutions essentially stagnant during an extended period marked by cumulatively revolutionary changes in the West.

## **2. The Islamic interest ban and its rationale**

In its strict interpretation, classical Islamic law requires every loan, regardless of size or purpose, to be free of interest. The principal justification for this ban is that it is stated in the Qur’an. Actually, what the Qur’an explicitly prohibits is *ribā*, an ancient Arabian practice whereby the debt of a borrower doubled if he failed to make restitution on time (Qur’an 2:274-80, 3:130, 4:160-61).

*Rib~* commonly resulted in confiscation of the borrower's assets, even in his enslavement. So it was a potent source of communal tension. In banning the practice, Islam effectively prohibited enslavement for debt (Rahman, 1964).<sup>1</sup>

It is not self-evident why a ban on *rib~* should require a general and timeless prohibition of interest. After all, a modern family that purchases a house by borrowing at interest does not risk becoming the mortgage company's slave. Nor is a grave danger present when an industrialist finances its production through interest-based credit. Therefore, the promoters of a broad prohibition have endeavored to develop a rationale for banning even seemingly innocuous practices. Every form of interest, they argue, allows the lender to earn a return without giving the borrower appropriate counter-value; as such, it generates unjustified enrichment. In addition, to require the borrower to make payment even in the event of a misfortune that leaves him destitute would subject him to undue risk (*gharar*).<sup>2</sup> By this logic, the lender should always carry a share of the unavoidable risk associated with any particular loan. In situations where the borrower cannot fulfil his obligation without hardship, the lender should waive his right to repayment. If the creditor of a destitute debtor were to insist on the principal's return, he would be failing to show compassion to a brother in his time of need. And were he to insist on profiting from the deal by collecting interest, he would also be guilty of morally unjustified enrichment.<sup>3</sup>

This rationale for a general ban was developed in a society already accustomed to financial restrictions. Well before Islam, legal codes of the Middle East included stipulations to limit borrowers' exposure to risk. The code of Hammurabi capped the interest rate on grain loans at 33 percent per annum and that on silver loans at 20 percent; in addition, it restricted slavery for debt to three years. A millennium later, around 600 BCE, the laws of Solon reduced or annulled most pre-existing debts, and they prohibited slavery for overdue obligations. For yet another example, around 450 BCE the Roman Twelve Tables capped interest at 8 1/3 percent per annum and imposed

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<sup>1</sup> For critiques of past and present controversies over the meaning of *rib~*, see Wilson (1991) and Kuran (2004, chap. 1).

<sup>2</sup> For references to early Islamic sources, see Qureshi (1967, chap. 2).

<sup>3</sup> For a broad review of concerns over unjustified enrichment and lopsided uncertainty, see Saleh (1986, chaps. 1, 3).

fourfold damages on creditors who demanded more (Homer and Sylla, 1996, p. 3). Whatever their particularities, all such financial restrictions were intended to lessen the ubiquitous and socially destabilizing danger of enslavement for unpaid debt. Throughout the ancient world, including pre-Islamic Arabia, defaulters were routinely sold into slavery and often shipped to foreign lands. Such horrible consequences tainted all interest earnings, making diverse profit-reaping lenders appear as greedy exploiters. The Islamic view that interest produces unjustified enrichment was simply a re-expression, then, of an ancient prejudice common to the Eastern Mediterranean basin.

Monotheistic precedents for prohibiting interest, as opposed to capping its rate, were set by Judaism and, in stricter form, by Christianity. The Torah prohibited lending at interest among Jews (Deuteronomy 23:19-20). It also banned charging interest to the poor (Exodus 22:25, Leviticus 25:35-37). Later, but still centuries before the birth of Islam, Christian theologians condemned interest as an instrument of avarice. The blanket prohibition in Christianity rested on a Biblical instruction to avoid charging interest even to grave sinners: “Lend, expecting nothing in return, and your reward will be great” (Luke 6:33-35). It was also justified through a pagan tenet that took on a Christian hue: the Aristotelian principle that, money being barren, interest amounts to robbery (Noonan, 1957, esp. chap. 3; Langholm, 1984). Medieval Christian qualms about interest are still apparent all across Europe in church carvings of the evil usurer dragged by his purse down to hell.

All such precedents for regulating interest applied above all to consumption loans. In the overwhelmingly agrarian economies of antiquity, in the Middle East as elsewhere, loans for production or commerce were uncommon, and governments rarely borrowed. The main purpose for borrowing was to meet urgent subsistence needs. However, medieval theologians applied the Christian interest ban to both consumption and business loans. Likewise, many early Islamic leaders interpreted the ban on *rib*~as subsuming all forms of interest.

A corollary to considering interest-based production loans un-Islamic was to make commercial partnerships,<sup>4</sup> which need not involve interest, seem inherently Islamic. This was so

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<sup>4</sup> On the relevant classical rules, see Udovitch (1970); and, on their evolution, Çizakça (1996) and Kuran (2003).

even though the Qur'an is silent on the procedural aspects of economic cooperation.<sup>5</sup> Through various partnership forms, traders of the Middle East had long been accustomed to sharing both profits and losses. Gaining Islamic legitimacy, these practices underwent refinements within the purview of the religion's evolving legal system.

Whatever the merits of forbidding interest, a partnership contract offers an obvious alternative to interest-based commercial credit. A partnership based on profit and loss sharing keeps the risks of a joint venture from falling on one party alone. Consider a simple Islamic partnership to which a sedentary investor supplies capital and a traveling merchant his labor. If brigands sack the caravan carrying the partnership's goods, the investor loses his capital and the merchant's expended labor goes to waste. Neither party bears the entire loss. If instead the merchant borrows from the investor at interest, any loss from brigandage falls fully on the former—assuming, of course, that the loan agreement is enforceable costlessly.

### **3. Evasion of the interest ban**

However, not all financial transactions would fit the template of a commercial partnership. Individuals who borrowed to meet subsistence needs would not produce a profit, so consumption loans could not be based on profit and loss sharing. In principle, lenders could have been required to make interest-free loans, but that would have dampened the incentive to lend. As a practical matter, therefore, borrowers frequently agreed to compensate their creditors by means that most modern economists would characterize as interest. Notwithstanding the prevailing prejudices, borrowers did not necessarily consider such arrangements exploitative. For their part, moneylenders found the business of interest-based lending sufficiently lucrative to make it worthwhile to risk opprobrium.

As far as is known, no Muslim polity has had a genuinely interest-free economy. Nor is this surprising, for risk tolerance varies widely across individuals. Thus, Muslim communities have included credit seekers prepared to pay for the privilege of shifting their risks onto others, along with

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<sup>5</sup> The few references to resource pooling include: "... if ye mingle your affairs with theirs, then (they are) your brothers" (2:220), and "... many partners oppress one another, save such as believe and do great works, and they are few" (38:25). None provides a precise blueprint for financial activity.

credit providers willing to carry these risks for a price. In short, incentives as well as opportunities to participate in interest-based credit deals have always been present.

Evidence of the persistent appeal of interest is found even in Islam's earliest period, its canonical golden age. Not even *rib*~ itself vanished with its prohibition. As Ömer Lütfi Barkan (1966, p. 31) observes, the ban on *rib*~ is reiterated in a section of the Qur'an recorded toward the end of Prophet Muhammad's life—proof that the practice remained alive. To be sure, Islam prohibited enslavement for debt, and this ban was enforced remarkably well even as slavery itself remained legal.<sup>6</sup> But even in modern times the least developed areas of the Islamic world have seen compound interest rates of 50 percent or more (Benedick, 1964, p. 52, n. 9); like *rib*~, such rates can cause liabilities to mushroom. One may point, of course, to times and places where interest was treated as illegal. Equally easy is to cite prominent leaders who depicted interest as horribly immoral. The eleventh-century jurist Sarakhsi characterized the sin of dealing in interest as more grievous than 33 adulteries (Udovitch, 1985, p. 459). Nevertheless, rarely have offenders endured conviction or even prosecution (Gerber, 1999, pp. 128-130). Islam does not prescribe a punishment for dealing in interest.

The circumvention of the interest ban has taken two forms: compartmentalization and casuistry.

### *3.1 Compartmentalization*

The first relegates practice and ideal to separate domains of discourse, thus enabling societies to ignore the ban in daily life without rejecting it in principle. As a case in point, in most heavily Muslim contemporary communities almost all banking services are explicitly based on interest. Through religious education, many members of these communities learn that interest is un-Islamic; but almost all proceed to borrow and lend at interest, often without noticing the contradiction. In the few countries where interest is formally illegal, including Iran, Pakistan, and the Sudan, the state itself facilitates compartmentalization by treating violations as personal failings deserving divine punishment rather than as crimes subject to worldly retribution (Rayner, 1991, p. 84). The state might not enforce interest-based contracts—although it generally does—but it does not punish

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<sup>6</sup> Lewis (1990, chap. 1). Slavery ended in recent times as governments outlawed the practice, beginning with Turkey in 1830 and ending with Mauritania in 1980.



offenders. This makes it easy for people to give and take interest without reflecting on the morality of their acts.

Pre-modern Islamic history offers striking examples of compartmentalization. In the sixteenth century, an Ottoman sultan limited the annual rate of interest to 11.5 percent throughout the empire, though on transactions that satisfied the letter of the ban on interest through stratagems; this order was duly ratified by a fatwa, or legal opinion (Gerber, 1999, pp. 62-63). A study of credit practices in seventeenth-century Kayseri, an Anatolian town, shows that “the giving of money and credit for interest not only was customary ... but also was condoned, sanctioned, and certified by the *ulema* [religious scholars], *ayans* and *eşraf* [notables], and the Imperial Porte [Ottoman regime]” (Jennings, 1973, quote at p. 183). Remarkably, Kayseri’s Islamic establishment considered an annual interest rate of 20 percent a sacred commandment and, provided the mandated rate was respected, neither lenders nor borrowers were treated as impious Muslims (Jennings, 1973, pp. 184-185). A separate study of financial practices in the same century, focusing on Bursa, another Turkish town, also finds evidence of de facto legitimacy. In Bursa the customary interest rate was 10 percent—well below that of Kayseri. The difference probably reflects Bursa’s proximity to international trade routes, which enhanced its access to credit. More important, perhaps, only Bursa had a class of professional moneylenders. (Gerber, 1988, chap. 7, esp. pp. 127-29, 146-47).<sup>7</sup> In supplying credit to many people simultaneously, moneylenders diversify their risks, thereby lowering the premia necessary to keep their operations viable.

In the sixteenth and seventeenth centuries transactions involving interest were so common that courts frequently adjudicated disputes in which partners disagreed as to whether their contract involved a loan or a partnership. In the typical case, a merchant returning from a commercial voyage had informed the investor(s) in his mission that pirates or brigands had stolen his goods. The merchant would testify that they had agreed to a partnership, implying that he owed the investor nothing. For his part, the investor would claim that he had provided capital at interest, giving him entitlement to a full refund, plus accumulated interest. Gedikli (1998, esp. pp. 79-80, 183-186) identifies dozens of such cases in the judicial records of Galata, Istanbul, dating from the sixteenth

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<sup>7</sup> In the sixteenth century the customary interest rate ranged between 10 and 15 percent (Barkan, 1966, pp. 34-36).

and seventeenth centuries.<sup>8</sup> Their very existence, and especially the large number resolved in favor of the party claiming the agreement was to a loan, confirm the commonness and legality of interest-based credit.

Comparable findings have emerged from studies focused on earlier periods. According to documents found in the geniza (store-room) of a synagogue in eleventh-century Cairo (Fustat), in the Eastern Mediterranean various groups, including Muslims, often, perhaps typically, used interest-based credit. On both retail sales and long-distance trade, we also learn, payments were routinely deferred for an interest charge. The rate, which could be as low as 4 percent, varied depending on payment terms, goods transacted, and market conditions (Goitein, 1967, pp. 197-200.

### *3.2 Casuistry*

To turn now to the casuistical method for evading the interest ban, it involves legal devices that allow interest to be given and taken without violating the letter of the presumed prohibition. One such device was to conceal interest charges for payment deferrals through discounts for advance payment (Goitein, 1967, p. 199; Hanna, 1998, pp. 83-84). A less transparent device was the double sale. Here is how the double sale could be used to disguise a \$100 loan at 15 percent interest from lender *L* to borrower *B*. *L* purchases a blanket from *B* for \$100 in ready cash, then promptly returns the same blanket to *B* for \$115, payable in one year. By the end of the second transaction, the blanket has returned to its original owner; *B* has gained \$100; and *L* stands to receive \$115 in a year's time. Paired together, of course, these transactions amount to a \$100 loan at an annual rate of 15 percent. But neither involves interest when considered in isolation. Yet another common stratagem has been the loan with usable collateral. It involves the borrower giving the lender a productive object as collateral, for instance, a horse. There is nothing illicit about lending one's horse to an acquaintance. But in this particular context the purpose is to disguise an interest payment.<sup>9</sup>

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<sup>8</sup> I myself have found dozens of other such cases in judicial records of various Istanbul districts, dating from 1592 to 1708.

<sup>9</sup> These legal devices, along with many others, are described by Barkan (1966, pp. 32-36), Khan (1929, pp. 241-244), Rodinson (1966/1973, pp. 35-44), and Schacht (1964, chap. 11).

All such forms of casuistry received stamps of approval from leading jurists of early Islam.<sup>10</sup> These jurists include luminaries of the Hanafi school to which more than a third of all contemporary Muslims adhere, and of the Shafii school that struck roots in Egypt, Syria, and Iraq. Evidently, the unviability of the interest ban quickly gained wide recognition even among the religion's most influential interpreters.

The "simple and rational way" to escape the need for elaborate financial casuistry, writes Siadat Ali Khan (1929, pp. 238-239), would have been to "amend, repeal, or abrogate" all laws that treat interest as un-Islamic. But over more than a millennium staunchly conservative jurists, including ones belonging to the Maliki school centered in Arabia, precluded these options. Their resistance discouraged proponents of some form of legalization from transgressing the ban openly or directly. Consequently, liberalizers chose to meet the steady demand for giving and taking interest through financial stratagems. In refraining from challenging the ban directly, closet reformers inadvertently helped to sustain the fiction that eliminating interest is both desirable and possible.

#### **4. Costs of the interest ban**

Stratagems developed to circumvent the interest ban allowed the reallocation of risks according to variations in individual risk preferences. Nevertheless, in the pre-modern Islamic world interest was not given or taken as freely as in, say, the essentially secular economic systems of the contemporary Middle East. Just as partnership contracts could be challenged on the ground that the agreement called for an interest payment, so interest-based debt could be disavowed by alleging that the lender had agreed to a partnership. Gedikli's Galata study harbors abundant examples of *both* types of cases. Also, the persistent illegality of interest presented a constant threat to interest claims. An independent-minded judge could invalidate an interest-based contract. This danger undoubtedly raised the prevailing rates, because profit-maximizing lenders would have allowed for potential attempts to avoid restitution. So a harmful consequence of the interest ban, intended to protect impoverished borrowers, was to increase the cost of credit for everyone, including entrepreneurs seeking capital.

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<sup>10</sup> For example, both Abu Hanifa and Abu Yusuf considered it legitimate to use a double sale as a cover for interest. See Gerber (1999, pp. 103-104).

Might the interest ceilings of economically liberal localities such as Bursa and Kayseri have attenuated this adverse economic effect? We do not know how well the ceilings were enforced. They could always have been circumvented through some financial stratagem. A willing lender could have extended credit to a willing borrower at a rate above the ceiling simply through an appropriate double sale or by accepting collateral equivalent to foregone interest. Yet, such stratagems must have raised credit costs, if only because they complicated the financial transaction. The double sale required two or more documents where one would have sufficed. Besides, every stratagem required safeguards to counter the danger of the borrower or lender using one of a group of linked transactions to his own advantage, or for a purpose contrary to the whole agreement's spirit. In certain regions a common safeguard was to deposit documents in the hands of a trustworthy intermediary authorized to produce, if necessary, a side document to reverse an abused transaction (Schacht, 1964, p. 83).

Adverse consequences of the Islamic interest ban were not limited to added documentation or litigation. Over the long run, a more significant cost was that commercial, financial, and monetary matters could not be discussed honestly and openly. The resulting impoverishment of public discourse would have clouded individual understandings of the time value of money, delaying the development of a capitalist mentality.<sup>11</sup> Where the ban was enforced, and even in the face of possible enforcement, the intellectual deficit in question would also have hindered the rise of modern financial institutions. For one thing, it would have prevented the invention of modern accounting techniques, which require clarity—precisely the opposite of what financial stratagems accomplish. For another, if only because the illegality of interest discouraged record keeping, it would have blocked the emergence of durable financial intermediaries recognizable as banks. Whereas an individual, or even a small partnership, might conceal interest through unrecorded stratagems, a bank expected to maintain standardized accounts comprehensible to employees and shareholders cannot easily disguise the nature of its operations. The interest ban, even where reinterpreted as an interest ceiling, would thus have dampened the incentive to form large financial intermediaries, lest their records draw attention to illicit dealings. The paucity of open challenges to the interest ban

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<sup>11</sup> On the underlying logic, see Kuran (1995, esp. chaps. 10-11); and specifically for the case of underdevelopment in the Middle East, Kuran (1997, sect. 8).

would have compounded this discouragement.

One might have expected public opinion, including official pronouncements, to have fueled a movement to legalize interest in times and places where it was openly regulated. But even in seventeenth-century Bursa and Kayseri, authorities sought to have it both ways: though accepting interest under one name or another, they refrained from objecting to the relevant Islamic teachings. Breaking what they considered the law where convenient, and making violations more or less socially acceptable, they left the law itself intact. In the process, they kept public discourse wedded to the pre-capitalist notion that interest is somehow immoral.

The ethical status of interest remained unfavorable, then, even at times and in localities where it was tolerated. Accordingly, many interest-based contracts continued to be packaged to satisfy the letter of Islamic law. In Bursa, a common practice was to have the borrower sell his house to a lender and immediately lease it back from him; at the end of the loan period the borrower was to repurchase the house for the same amount. The fictitious rent, which was subject to the city's interest ceiling, was obviously a pre-specified interest payment, and that was known to the Islamic courts. Nevertheless, in cases where the borrower failed to repay the loan, they allowed the lender to keep the house on the ground that contracts must be followed to the letter (Gerber, 1994, pp. 74-76, 104-105).

In principle, a bank, assuming it had somehow emerged, could disguise interest charges through the same technique. In cases of default, the bank might even prefer to have title to the borrower's house, because liquidation costs would be lower than if a suit had to be filed. However, the use of this cumbersome technique would have diminished the bank's flexibility in coping with risks, thereby raising credit costs. So the net benefit of banks would have been lower than if interest were charged freely and openly.

The persistent illegitimacy of interest affected economic growth and modernization also by discouraging financial practices generally free of interest. Consider the bill of credit (*suftaja*), which a broker issues to a person seeking to transfer funds to another location. At the chosen location the bill holder would receive cash from an agent of the broker. Insofar as the broker matched customers aiming to move cash in opposite directions, the bill of credit thus eliminated the risk of losing cash in transport. Although the broker got paid for his services (Dien, 1997, p. 770), his transfer fee did not necessarily involve interest, because, in principle, it was not for the use of money. Yet, during

the period between purchase and redemption, it is the broker who enjoyed the use of funds rather than the buyer. In practice, therefore, the fee could reflect the broker's benefits. Specifically, it could be lowered by the broker's expected income from the funds. Insofar as such an adjustment was made, the contract obviously involved an interest payment to the buyer. This is one reason why the bill of credit appeared un-Islamic (D'Ohsson, 1824/2001, p. 46). That the time-value of money affected the contract is obvious from the fact that the broker paid a daily fine if he delayed repayment beyond the agreed date. Another source of religious opposition was that the agent served as an extension of the broker, whose service to the buyer amounted to elimination of a risk involving money.

On such grounds the Maliki school of law prohibited the bill of credit except in cases of grave necessity, and the Hanbali school permitted it only if no fee was charged. True, the Shafii school allowed it in places where it was already common, and the Hanafi school permitted it as long as the fee was small and not part of the contract (Dien, 1997, p. 770; Ashtor, 1973, pp. 567-570). Also, qualms about the legitimacy of the bill of credit deterred neither its widespread use nor its legal enforcement over large regions (Goitein, 1967, pp. 242-246; Ashtor, 1973, pp. 554-567; Sahillio<sup>TM</sup>u, 1975). But data from the eleventh century to the eighteenth century show that the controversy made some Muslim merchants, and perhaps most of those in North Africa, accept the risks of carrying large sums of money on trips over land and sea (Goitein, 1967, p. 245; Raymond, 1973-74, vol. 1, pp. 298-301). At a minimum, then, the interest ban diminished the use of the bill of credit in certain contexts in which it would have provided economic benefits. Insofar as frank discussion on the determinants of brokerage fees was squelched, a more serious effect over the longer run would have been delays in the advancement of economic thought, the rationalization of economic morality, and the modernization of economic practices.

## **5. How the Western and Middle Eastern experiences differed**

To readers knowledgeable about European economic history, much of the foregoing account will seem familiar. At the start of the second millennium interest was as maligned in Christian Europe as in territories under Islamic rule. In both civilizations moralists justified a ban as essential to protecting the weak from greedy exploiters. Moreover, practically identical stratagems were devised to disguise interest payments. Yet, banking arrived in the West a half-millennium before

locally-established banks opened in the Middle East. Barcelona got its first chartered bank in 1401, Genoa in 1407 (Epstein, 2000, p. 66). These banks, and those that followed, usually paid depositors interest, meeting their obligations through their returns on long-term investments. Foreshadowing the practices of a modern bank, their reserves ordinarily covered their deposits only partially, so they had to anticipate the demand for money and devise procedures for meeting unexpected withdrawals. As fractional reserves gained legitimacy, banks were tempted to invest ever larger shares of their deposits, inevitably leading to bankruptcies (Hunt and Murray, 1999, pp. 209-212). Cities responded by instituting reserve requirements. In this manner every financial innovation restructured incentives and generated new challenges, inducing further innovations.

The development of Western banking, or of its broader financial system, did not come suddenly, through a transformation completed within a year or even a century. There was a long evolution. Significantly, institutional advances went hand in hand with attitudinal changes. It had been common for financiers to suffer anxiety over the morality of interest (Delumeau, 1983/1990, pp. 220-228). Testaments of the Middle Ages offer abundant examples of instructions to return interest payments or to donate all interest-tainted wealth to the Church (Roover, 1963, pp. 12-13). Already in the thirteenth century, however, debates over interest were under way within the Roman Church. Contrary to impressions fostered by Max Weber's *Protestant Ethic and the Spirit of Capitalism* (1904-05/1958), the notion that interest and the quest for risk avoidance are inimical to Christian virtue was under fire well before the Reformation. By the fifteenth century interest enjoyed legitimacy among theologians, at least with respect to investment financing. Concomitantly, people of all walks of life were distinguishing between reasonable and unreasonable interest, reserving the term usury for the latter category. Although the Protestant Reformation did not initiate a change in economic morality, it certainly accelerated the transformation by making it acceptable to disobey Mosaic injunctions harmful to financial efficiency (Schumpeter, 1954, pp. 82-115; Noonan, 1957, chaps. 10-20). The Scottish Enlightenment of the eighteenth century, especially the works of Adam Smith, David Hume, and Bernard Mandeville, carried the process further by making interest seem moral, even compatible with the spirit of Christianity. By the nineteenth century, relatively few Western businessmen questioned the morality of interest. This ethical transformation facilitated financial modernization by broadening the license to innovate and by alleviating fears of sinning in the pursuit of higher profits.

Insofar as the Middle East took up the question of interest during this attitudinal transformation in the West, discussions were more cautious and, hence, less consequential for business. Tied to old religious interpretations and increasingly removed from the changing concerns of merchants and producers, they did little to forge a social climate hospitable to the rise of banking. So the commonness of interest-bearing credit, even the legitimacy that many courts bestowed on loan contracts involving low interest, did not lead to a reconsideration of financial morality. This failure, suggests Udovitch (1975, pp. 19-20), kept many financiers from compensating their depositors; it also restricted their ability to invest the funds they received for safekeeping. Although certain financiers managed to evade the Islamic restrictions, the net result was to limit the supply of loanable funds and the growth of lending operations. Consequently, during a half-millennium when Western attitudes toward interest underwent progressive liberalization, Islam's formal commitment to the interest ban deprived the Islamic world of a prime engine of growth.

Nothing thus far explains why interest gained legitimacy more rapidly in Western Europe than in the Middle East. Nor is it clear why the West, rather than the Middle East, led the way in developing modern financial institutions. To add to the puzzle, around the twelfth century finance was at least as sophisticated in the Middle East as in Europe. The Middle Eastern economy was served by currency changers, moneylenders, and pawnbrokers, along with merchant bankers who, in the course of their commercial activities, accepted deposits, provided credit, and intermediated payments through bills of credit convertible in distant lands, promissory notes honored locally (*ruq'as*), or direct credit transfers (*haw-la*). Such financial operations had assumed "fairly complex forms" as early as the mid-eighth century, observes Udovitch (1975, p. 6), "at least three or four centuries before anything comparable is recorded for medieval Europe."<sup>12</sup> Why, then, was the Middle Eastern torch of financial creativity subsequently blotted out, when that of the West stayed ablaze?

The answer lies in explaining the growing inter-civilizational contrast in the *organization* of credit services. Right up to the modern era Middle Eastern financiers continued to deliver services as individuals or through temporary, small scale, and generally unspecialized partnerships. These

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<sup>12</sup> See also Udovitch (1979, esp. pp. 268-270). On the uses of these instruments in later centuries, see Pamuk (2000, chap. 5).



financial partnerships could not pool the deposits of more than a few savers, undertake clearance operations beyond the simplest, or supply credit to masses of consumers and producers (Issawi, 1982a, chap. 9; Issawi, 1988, esp. p. 444; Masters, 1988, esp. pp. 52, 136; Frangakis-Syrett, 1992, esp. p. 147; Shields, 2000, esp. pp. 107-110). Another limitation of these rudimentary enterprises is that they lacked legal personhood; keeping them from being sued as enterprises, this restricted the financial transactions that others were willing to conduct with them. As late as the early nineteenth century, there was not a single Middle Eastern bank analogous to those established in the West in the 1400s, except for a few owned and largely operated by Europeans. Indigenous Middle Eastern banks were to emerge under Western influence, at a time when European banks spread their wings across the globe.

## **6. Inheritance practices and organizational evolution**

The persistent simplicity of Middle Eastern partnerships was not limited to the financial sector. All across the economy partnerships had at most a few members, and they lacked structural complexity. Prior to Western-inspired reforms of the nineteenth century, nothing akin to a joint-stock company or a corporation had emerged in any context. This stagnation had much to do with threats that inheritance practices posed for organizational continuity. Whether constituted for the purpose of ownership, production, commerce, or finance, every partnership became null and void upon the death of a member. By law, the deceased partner's share of the partnership's assets had to be distributed among his—in a minority of cases, *her*—heirs. This rule was not unique to the Middle East. In Western Europe, too, a partnership lapsed at the death of a member.

Western Europe and the Middle East did not differ, then, in regard to the immediate consequences of membership reduction. The significant disparity is that a deceased member tended to have substantially more heirs in the Middle East. This disparity stemmed from a profound difference in inheritance practices. In particular, the Islamic inheritance system was more egalitarian than most of the very diverse systems found in Western Europe. In particular, it required a decedent's property to be divided according to intricate rules among his children, parents, and often more distant relatives as well. The higher the number heirs, the greater were the costs of dissolving the partnership and the lower the chances of restarting the interrupted enterprise under a modified membership. So merchants and financiers kept their partnerships small to minimize the probability

of a premature and costly dissolution. The Islamic system was also resistant to reform, largely, no doubt, because its basic principles appear explicitly in the Qur'an. By contrast, the Bible does not specify a system for the division of estates. This is consistent with the enormous diversity of Western inheritance practices; adaptation is easier in the absence of sacred rules that constrain options.

In Western Europe, therefore, the threat to partnership continuity could be alleviated by modifying inheritance practices. An effective solution turned out to be primogeniture—the practice whereby a decedent's business concerns, if not his entire estate, accrued to his oldest son. Primogeniture facilitated recontracting at the death of a partner. Indeed, it was far simpler to reconstitute an enterprise through replacement of a deceased partner with an heir groomed to take over his father's investments than to negotiate with numerous heirs unfamiliar with the business. The consequent growth in partnership size aggravated communication and coordination problems, which then induced organizational innovations. Already in the thirteenth century Italian financiers were forming partnerships for periods of several years, rather than for a predefined venture (Roover, 1948, pp. 34-36; Usher, 1943/1967, pp. 12-14), the pattern prevalent in the Islamic Middle East. The upshot is that the scale of commercial and financial operations, as well as their organizational complexity, registered steady advances over the better part of a millennium, even as the financial system of the Middle East essentially stagnated.<sup>13</sup> The joint-stock company and the business corporation, each still in use, are among the organizational forms that eventually emerged.

The delayed emergence of Middle Eastern banks represents, then, merely one element of a broad pattern of institutional divergence in progress well before banks existed anywhere. Banks emerged in Europe in the course of a structural transformation that led to larger, more durable, and functionally more specialized organizations throughout the economy. In the Middle East banks would have been an anomaly, because all profit-oriented enterprises, including non-financial ones, remained small, simple, and ephemeral. To see why, let us step back for a moment to twelfth-century Baghdad or Florence and imagine that 100 individuals have come together to form a simple partnership intended to fulfil two basic functions of a modern commercial bank: accepting deposits and making loans. To stay within the law, this bank must disband and reorganize at the death of any

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<sup>13</sup> On the mechanisms responsible for this divergence, see Kuran (2003).

given partner. This requirement will make its costs of operation prohibitively expensive. So financiers will be reluctant to repeat the experiment until liberated from the need to live, or even appear to live, by the requirement of re-contracting at every death.

At the time, incentives against forming large partnerships were as strong in Florence as in Baghdad. So modern banking could not have emerged in Florence, or anywhere else in the West, in a single step. The road to modern banking was traversed through many small steps, beginning with renewable, and thus effectively indefinite partnerships linked through one or more common partners who coordinated their activities. Headquartered in Florence, the famous Medici financial house, which operated between 1397 and 1494, combined many partnerships, each a separate legal entity that charged the others commissions and interest. One of these partnerships controlled the rest, which served as its tributaries. In particular, the tributary partnerships reported to the controlling partnership, which made them operate like branches of a single enterprise (Roover, 1948, pp. 34-42; Roover, 1963, esp. chap. 5). Among the novel functions of the Medici headquarters was the facilitation of clearance operations (Usher, 1943/1967, chaps. 1, 4). As financial conglomerates capable of increasingly complex undertakings came to dominate European finance, their constituents became more numerous. By the fifteenth century partnerships of five to seven investors were not uncommon, and the number could be larger (Roover, 1948, pp. 39-42).

Not until the nineteenth century do we find financial enterprises with shareholders in the hundreds or thousands. As late as the 1820s, no English bank other than the Bank of England could have more than six partners, and nowhere in Europe could banks be established as joint-stock companies. Prior to these developments, major private investments were financed not by banks but through linked, and increasingly complex, partnerships (Harris, 2000, chap. 8; Landes, 1998, pp. 256-257). In the meantime, however, the ingredients of modern banking were falling into place. The spread of partnerships with growing numbers of inactive partners smoothed the transition to joint-stock banks, whose shareholders did not have to concern themselves with uses of their capital and could transfer shares at will. Another factor was the increasing acceptance of business corporations. This facilitated the recognition of rules providing financial intermediaries an existence apart from their founders and employees. Through all these developments, along with the strengthening of private property rights, interest rates declined. In England rates on long-term borrowing fell from 14 percent in 1693 to three percent in 1739 (North and Weingast, 1989, esp. p. 824).

Until well into the nineteenth century the Islamic world saw nothing comparable to these developments. As Murat Çizakça (1996, chaps. 2, 4) has shown, Islamic partnerships remained small and, with few exceptions, short-lived. Not even the financial sector saw the emergence of indigenous joint-stock companies. Equally significant, there was not a single case of mass mobilization through non-governmental channels for a major business venture. Along the way certain wealthy families made loans that were large by standards of the day, usually to individuals, occasionally to the government. However, there were no private lenders capable of financing wars—certainly none able to match the scales attained, from the 1490s onward, by the Fuggers, whose loans could alter the balance of power between princes. Nor did there exist private lenders capable of financing missions of global discovery, such as Magellan’s 1519 expedition, heavily funded by profit-seeking German merchants.<sup>14</sup> The Middle East’s failure to attain such scales resulted partly from the fragmentation of wealth through the Islamic inheritance system. Whatever its many merits, it had the unanticipated effect of limiting development in the financial sector.

## **7. The cash waqf alternative**

To solve the puzzle of why financial institutions of the Middle East did not follow the evolutionary path observed in the West is not, of course, to establish that in the absence of a Western model the Middle East would not have achieved financial modernization. In principle, the Middle East might have reached the same outcome through an alternative path, even one unavailable to the West. A possible starting point for an evolutionary process that might have culminated in a bank was the waqf. Known also as a “pious foundation,” a waqf is an unincorporated trust established under Islamic law by a living person for the provision of some service in perpetuity (Kuran, 2001). Regarded as sacred, the waqf has enjoyed considerable immunity against confiscation. Originally its assets had to be immovable, but in certain places this requirement was eventually relaxed to legitimize what gained recognition as a “cash waqf.” Could the cash waqf have metamorphosed into the modern bank?

Consider first the history of the cash waqf. This institution was developed by holders of

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<sup>14</sup> On the financial feats that Europe’s private financiers achieved in the fifteenth and sixteenth centuries, see Jardine (1996, pp. 95-99, 292).

liquid wealth. Such people, who included moneylenders, favored relaxing the waqf system's immovability requirement in order to obtain privileges originally reserved for owners of real estate. Chief among these was that the founder of a waqf could shelter some of his wealth by appointing himself its salaried mutawalli (trustee and manager) and including his relatives and descendants among the beneficiaries. Cash waqfs emerged as early as the eighth century, earning income generally through interest-bearing loans (Çizakça, 2000, chap. 3). Uncommon for many centuries, they provoked intense controversy as their numbers grew, for they violated both waqf law and the prohibition of interest. Conceding that the cash waqf clashes with classical Islamic principles, its defenders held that it should be tolerated simply because of its usefulness (Mandaville, 1979, pp. 297-300, 306-308).

Precisely because they met important needs, by the sixteenth century more than half of all new Ottoman waqfs commanded liquid capital. Measured by assets, most of these cash waqfs were on the small side, and they lent primarily to consumers rather than entrepreneurs (Çağatay, 1971; Masters, 1988, pp. 161-163; Yediyıldız, 1990, pp. 118-122; Çizakça, 2000, p. 48). If one factor that accounts for their popularity is the quest for wealth protection, another is the absence of banks. The moneylenders who supplied credit charged interest rates commensurate with the risks that they took on account of their illicitness. The cash waqf, where and when it enjoyed legal approval, allowed moneylenders to operate essentially within the prevailing interpretation of Islamic law. Equally important, the sacredness it acquired through inclusion in the waqf system insulated its interest-based activities from the charge of sinfulness.<sup>15</sup>

What turned out to be a flaw in the rules governing the waqf of immovables was the fixity of its mission. Unauthorized to adjust its operations to suit changing circumstances, it easily became dysfunctional (Kuran, 2001, pp. 861-869). The cash waqf limited one of the problems associated with static perpetuity. It could transfer capital across economic sectors simply by redirecting loans from one set of borrowers to another. Accordingly, where a waqf of immovables might have its capital tied up in an increasingly unproductive farm, a cash waqf's commitment to an agricultural pursuit was constrained only by the time-structure of its loan. Yet, the cash waqf was not free of

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<sup>15</sup> An added impetus to forming cash waqfs came from cash-rich individuals seeking to establish steady revenue streams to finance charitable services whose expenses were expected to remain roughly constant, for example, a mosque or a school.

operational constraints. Like the founder of a waqf of immovables, that of a cash waqf could restrict its beneficiaries and charges. Yediyıldız (1990, p. 122) points to the deed of an eighteenth-century waqf whose founder required it to lend at exactly ten percent and only to the residents of three particular neighborhoods. The restrictions imposed on a cash waqf typically reflected, in addition to the founder's personal tastes and biases, the interest rates prevailing at its inception. Over time, of course, the fixity of its lending rates could impede the exploitation of profit opportunities. Because of this requirement, observes Çizakça (2000, pp. 52-53), only a fifth of all cash waqfs survived beyond a century.

Why might the founders of cash waqfs have fixed the rates their mutawallis could charge? Static perpetuity being among the defining principles of the conventional waqf system, perhaps such a step was considered critical to having cash waqfs qualify as waqfs. Fixing nominal fees may have seemed the least the founder of a cash waqf should do to meet the requirement of immobilizing the waqf corpus. Indeed, requiring the mutawalli to charge a rate that appeared commensurate with the waqf's designated expenses, might have been viewed as essential to its permanent viability. Of course, such logic presupposed an unchanging economy, so in times of escalating interest rates it was bound to spell trouble. Indeed, as nominal interest rates rose in credit markets outside the waqf system, mutawallis found growing opportunities for personal enrichment through arbitrage. Borrowing money from the cash waqfs under their supervision, many Turkish mutawallis of the sixteenth through nineteenth centuries lent on their own account to the moneylenders (*sarrafs*) of localities with higher interest rates. According to data compiled by Çizakça (1995, pp. 333-350), the difference could be enormous. In the second half of the seventeenth century, when the cash waqfs of Bursa charged interest rates around 10.8 percent per annum, the moneylenders of Istanbul charged between 18 and 25 percent. The latter are known to have obtained domestic capital at 12.5 percent—a rate between the fixed rate of the cash waqfs and the market rate in Istanbul. Evidently, both mutawallis and moneylenders benefited from the flow of loanable funds to Istanbul's credit market. Had the endowment deeds of cash waqfs permitted greater flexibility, they themselves could have reaped the gains accruing to mutawallis.

It is tempting to view the cash waqf as a rudimentary bank that would have overcome its inflexibilities, if only given enough time. However, the obstacles to the necessary modifications were not trivial. In contrast to a bank that pools the deposits of the masses, a cash waqf was formed

through a single individual's savings. Moreover, as with the waqf of immovables, the rule of static perpetuity barred cash waqfs from pooling their resources. True, this rule was sometimes circumvented, and the merging of established cash waqfs was not unknown. But the requirement to follow the founder's directives exactly was enough to limit the size of the cash waqfs formed. Because each cash waqf, regardless of size, pursued risk diversification by lending to many people at once, this requirement also limited the size of the average loan. Of course, there was nothing to keep borrowers from pooling capital themselves; they were free to seek credit from multiple cash waqfs. But the transaction costs of taking many small loans undoubtedly exceeded those of taking an equivalent large loan. Unsurprisingly, evidence of demand-side pooling is meager.

To evolve into some form of bank, the cash waqf would have had to overcome an additional restriction of Islamic law: its aversion to the concept of legal personhood. Alas, it could not transcend the individualism of Islamic law, probably rooted in early Islamic efforts to unite Muslims by denying recognition to political boundaries other than those separating Muslim-ruled territories from lands under non-Muslim governance (Lambton, 1981, chap. 2; Lewis, 1988, chap. 4). Born in a legal setting lacking familiarity with the concept of a legal person, the cash waqf never became a legal entity. This limitation undoubtedly contributed to its failure to develop into a lending organization able to raise abundant capital, respond flexibly to opportunities, and refine its operations.

## **8. Westernization of the Financial System**

A consequence of the foregoing cases of institutional stagnation is that large-scale finance in the Middle East, including lending to governments, was initially provided by Europeans. By the nineteenth century Western economic institutions had developed to the point that Europe's trade with all regions of the world, including the Middle East, was undergoing rapid and sustained growth.<sup>16</sup> Moreover, the required financing was coming largely from Western organizations. In the Middle East this expansion in economic relations generated a demand for major local creditors. With the region's own financiers unable to accommodate this need, Europeans stepped in to exploit the

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<sup>16</sup> World trade grew 23-fold between 1780 and 1880. During this period, Europe's share in this trade hovered around 70 percent (Kuznets, 1966, Table 6.3; Maddison, 1995, p. 74).

emerging opportunities. The early 1800s saw several abortive attempts to establish small banks, along with a few successes.<sup>17</sup> Dozens of successful attempts followed in mid-century. The banks established in this period include the Bank of Egypt (Alexandria, 1855), the Ottoman Bank (Istanbul, 1856, became the Imperial Ottoman Bank in 1863), the Anglo-Egyptian Bank (Cairo, 1864), and the London and Baghdad Association (1864). All these major banks were largely, if not wholly, European-owned and -operated; private banks with predominantly local ownership gained importance in the 1890s, and largely Muslim-owned ones in the early twentieth century.<sup>18</sup> The foreign banks of the mid-nineteenth century lent primarily to states. But they were able to finance large commercial, agricultural, and industrial ventures of private entrepreneurs. They also accepted deposits, provided housing loans, and made advances to consumers, charging interest rates well below those prevailing in older markets dominated by local financiers (Issawi, 1988, pp. 410-411). Before long, specialized banks came on the scene, including strictly commercial banks.

These observations are consistent with the emergence of movements to have major banks open new branches. Such movements were directed at enabling farmers and merchants to escape the exorbitant rates and other draconian requirements of traditional moneylenders (Clay, 1994, pp. 592-593). In the second half of the nineteenth century, and in many places even later, peasants borrowing from moneylenders paid interest rates varying between 20 percent and 100 percent, with their crops serving as collateral. By contrast, European agricultural interest rates had fallen to around 4 percent (Fawaz, 1983, pp. 66-67; Issawi, 1988, p. 76; Kazgan, 1995, p. 173). Commercial interest rates, too, were high in traditional markets. In Lebanon and Syria they stood at 24 percent in the mid-nineteenth century. Meanwhile the silk guilds of Istanbul were paying 18 percent, as compared with

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<sup>17</sup> The earliest successful initiative was the Camondo Bank in Istanbul, founded by a Jewish-Ottoman family in 1802 (Seni, 1994). The early banks were far smaller than those that came to dominate the region's financial markets beginning in the 1850s.

<sup>18</sup> The most notable of the predominantly Muslim-financed banks were Bank Misr in Egypt and İş Bank in Turkey. On the origins of modern banking in the region, see Landes (1958), Pamuk (1987, chap. 4), Issawi (1988, pp. 410-412), Black and Brown, eds. (1992, pp. 73-77, 226-227), Clay (1994, 1999), Eldem (1999, chaps 1-2), and Tschoegl (2003). In other parts of the Islamic world Muslim-owned banks did not arise until much later. The first modern Muslim-owned bank of India, the Habib Bank, started in Bombay after World War II. See Tandon (1989, p. 50).



the 5 percent paid by their counterparts in Lyon, France (Issawi, 1988, pp. 411-412; Kazgan, 1995, p. 173). With the spread of banks to all corners of the region, an ever growing share of the population came to benefit from the availability of relatively cheap loans. The volume of lending also rose by orders of magnitude, dwarfing the supply of loans by cash waqfs. In 1908, the total capital of the Ottoman cash waqfs amounted to 90 million grüş; the following year, Ziraat Bank, the state-owned agricultural bank, advanced 563 million grüş as credit, and the Ottoman Bank advanced 1,102 million grüş (Çizakça, 2000, pp. 52-53).

The differences between the new banks and traditional financiers were not limited to scales and rates. The foreign banks enjoyed legal standing; they could sue and be sued as organizations, at least in courts operated by European consulates under centuries-old privileges. The procedures and capabilities of these courts continued to evolve in concert with Western institutional developments. The consular courts gained familiarity, for instance, with the increasingly sophisticated accounting systems of modern banks. As economic relations between Europe and the Middle East grew by leaps and bounds, they thus facilitated the diffusion of modern banking. By setting up prototypes that would be emulated by new indigenous courts, they also served as agents of renewal in the legal arena.

If one salient characteristic of the Middle East's financial sector in the nineteenth century is the emergence of foreign banks, another is the rising prominence of local religious minorities. In contrast to, say, the sixteenth and seventeenth centuries, when Muslims participated more or less proportionately in the supply of credit (Jennings, 1973; Rafeq, 2002, pp. 108-116), by the nineteenth century local credit markets had fallen under the domination of religious minorities. The imbalance became especially and increasingly pronounced in the principal centers of international commerce, such as Istanbul, Izmir, Beirut, Alexandria, and Cairo. The ascent of the minorities was itself a consequence of the institutional stagnation identified above. Whereas lawsuits involving Muslims had to be litigated in Islamic courts, from the advent of Islam to the industrial era non-Muslims were allowed to take cases among themselves to communal courts of their own. As the West came to dominate the Middle Eastern economy, and Western courts started playing an increasingly important role, it proved an easy step to extend the customary choice of law of non-Muslims to the legal systems operated by consular courts. Accordingly, hundreds of thousands of Christians and Jews—in some places the majority of all subjects—became protégés of Western powers, effectively

moving themselves outside the jurisdiction of the Islamic courts (Rosenthal, 1980, p. 243; Ba<sup>TM</sup>s, 1983, esp. pp. 17-52; Masters, 1992, pp. 579-580; McGowan, 1994, p. 616). This option, long closed to Muslims, helped the minorities advance by enabling them to participate in domestic as well as global economic activities under the umbrella of modern institutions. Although not all Christians or Jews switched jurisdiction, enough did so to build solid links between minority communities and the West. Consequently, even non-Muslims who kept doing business under Islamic law acquired opportunities that gave them an edge over the religious majority.

The advantages that the minorities obtained from their legal privileges allowed them to improve their relative economic position to the point where they controlled a noticeably disproportionate share of the region's private capital. One manifestation of this enrichment is that in the nineteenth century local moneylending fell under the heavy domination of non-Muslims, mainly Jews in some places, increasingly Christians elsewhere (Issawi, 1982b; Issawi, 1988, pp. 410-412; Kazgan, 1995, esp. chaps. 1-2, 12; Pamuk, 2000, pp. 200-204; Masters, 2001, esp. chap. 3). In Istanbul, the mostly Levantine,<sup>19</sup> Greek, and Armenian financiers known collectively as the "Galata bankers" had joined foreign banks and governments as the leading creditors of the Ottoman state. It is significant that the Galata bankers became a major force in the mid-nineteenth century, for this is when the Ottoman Empire undertook its first substantial steps toward modernizing its economic institutions.

This is not to say that the Galata bankers, or their counterparts in the region's lesser financial centers, employed business methods identical to those of Western banks. They raised capital not by pooling vast deposits but by serving as intermediaries between Western financiers and local borrowers. They accumulated fortunes partly by buying from the West on credit provided by European financiers, selling locally, and using the consequent profits to extend domestic loans (Kazgan, 1995, esp. pp. 89-114).<sup>20</sup> They also intermediated between Western financial enterprises and local governments. Borrowing money in Europe at rates of 3 to 5 percent, they advanced funds

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<sup>19</sup> The Levantines were local residents of European origin, many of whom had intermarried with indigenous non-Muslims.

<sup>20</sup> The Galata bankers also made money by financing the activities of the tax farmers, many of whom belonged to the governing class (Çizakça, 1996, pp.165-169).

to governments at rates of up to 18 percent—several percentage points higher than the rate charged to any Western government. Their profit margins were thus astronomical, partly to compensate for the high risk of government insolvency (Eldem, 1999, p. 73; Kostis, 1999, pp. 5-6). So their legendary successes did not stem solely from domestic institutional innovations. Also critical were the international networks they formed and the wealth they created by virtue of their communal legal privileges. These privileges contributed to turning the institutional transformation of the West into an advantage for non-Muslim financiers and merchants, and, concomitantly, Islamic law into a handicap for Muslims. When modern Western institutions presented themselves as alternatives to traditional Islamic institutions, the religious minorities gained tangible advantages over the religious majority because, among indigenous peoples, only *they* could take advantage of the new opportunities immediately and as individuals, without waiting for fundamental domestic legal reforms. If nothing else, they could borrow from the West. Western lenders preferred to lend through contracts enforceable through their own courts, as opposed to the indigenous court systems of the Middle East.

## **9. Conclusions**

Nothing in these interpretations relies on a presumption that Islam is inherently hostile to commerce or finance. That it has sought to regulate and even prohibit interest does not mean that it could not have gravitated, like Judaism and Christianity, to a more liberal interpretation. Vast numbers of Muslims have now made this switch, in fact, through economic modernization drives launched to catch up with the West. Although Islamic anti-interest movements exist even today, they enjoy little support. All but a handful of the 56 members of the Organization of Islamic States treat interest as legal, effectively ignoring the calls of Islamists who favor a stringent interpretation of Islam's financial prescriptions (Kuran, 2004, esp. chap. 3).

This article has invoked several institutions that blocked evolutionary paths in the direction of modern banking: the Islamic law of commercial partnerships, the Islamic inheritance system, the waqf system, and the individualism of Islamic law. None was developed deliberately to paralyze business or delay its development. As far as one can tell, each emerged for other reasons. The provision that a partnership ended with the death of a partner provided safeguards to the deceased partner's heirs. The egalitarian rules of the Islamic inheritance system dampened wealth disparities

and gave women some financial protection. Limits were imposed on the freedoms of waqf managers in order to solve a principal-agent problem; they made it difficult to depart from the founder's wishes. Finally, the individualism of Islamic law appears to have been meant to prevent factionalism. Roughly a millennium ago, as these Islamic provisions were taking shape, no one could have anticipated the evolutionary paths they would foreclose. Nor could anyone have predicted that the institutional evolution of a neighboring region, the West, would make it disadvantageous to conduct finance under Islamic law.

The financial successes that the minorities achieved in the nineteenth century formed an unintended and unanticipated consequence of yet another Islamic institution originally designed to provide advantages to Muslims. Non-Muslims were given choice of law in return for accepting, at least implicitly, higher taxes and political subordination. More than a millennium later, under very different global conditions, that legal privilege turned into an enormous advantage. Indeed, it allowed local Christians and Jews to benefit from modern economic institutions well before Muslims began doing so as a result of legal reforms.

At any given point during the historical process that culminated in European economic domination over the Middle East, opposition to interest was among the proximate causes of the Middle East's failure to modernize its financial institutions. All else equal, entrepreneurs would have felt freer to speak their minds and pursue financial innovations had the moral standing of interest not been an issue. There is no evidence, however, that this opposition hindered institutional development more seriously than, say, the anti-interest stance of the Church. Whatever barriers the Islamic interest ban posed for financial and commercial development, these could have been surmounted, as in Europe, if the scale and longevity of private enterprises had risen enough to make it critical to use credit based openly on interest. For one thing, such a transformation would have stimulated a need for standardized accounting, and the utility of legal stratagems would have fallen. For another, in allowing the preservation of successful private enterprises, it would have strengthened the commercial class, enhancing its political leverage over religious conservatives. If the impetus for financial modernization ultimately came from abroad, and specifically from the West, the fundamental reason is that Islam's traditional institutions blocked indigenous paths to financial development.

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