Islamic financing is growing rapidly and the West wants in. With a huge influx of oil dollars and expanding U.S. trade and budget deficits, are the dollar's days as the world's reserve currency numbered?

Want to buy a sukuk?

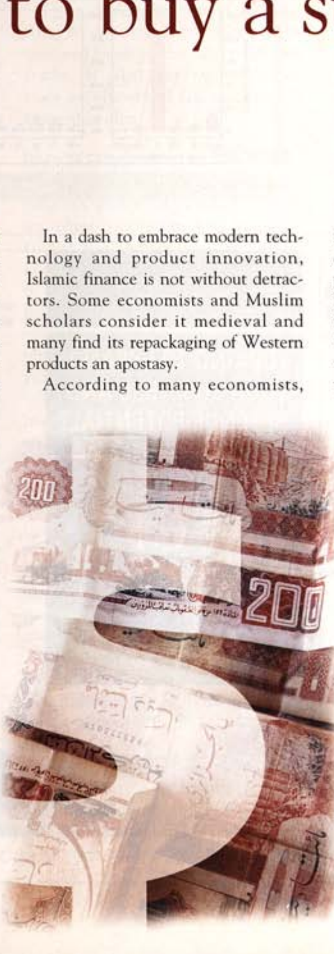
BY ANN BERG

Imagine living in a parallel financial world where bankbooks earn rents, leases procure homes and scholars vet stocks. A world where merchants divulge profit margins in advance to buyers and commodities stream as dividends from capital investments. A world whirling around an orbit of gold. You don't have to imagine — this is the world of Islamic finance.

Islamic finance is one of the fastest growing segments of global finance. Evolving gradually from 1970, when the first Islamic banks started in Dubai, it has lately swelled on the wave of globalization and the petroleum boom. Operating in 70 countries with about $500 billion in assets, it is poised to expand geometrically. Western institutions have jumped right in; Citigroup and other Western banking giants recently opened Islamic divisions and are elbowing out much of the indigenous competition. The Islamic Bank of Britain, the United Kingdom's first bank catering to a Muslim client base, listed its shares on the London Stock Exchange in 2004.

In a dash to embrace modern technology and product innovation, Islamic finance is not without detractors. Some economists and Muslim scholars consider it medieval and many find its repackaging of Western products an apostasy.

According to many economists, Islamic finance, in its objectives and operations, is based on Koranic principles (also called Shariah Law). Going beyond the tautology that Islamic finance equals "interest free" banking, it embodies three religious tenets: the avoidance of speculation (gharar), the avoidance of excessive profits (riba) and the focus on permissible activities (halal).



Underlying the system is the philosophy of risk sharing: the lender must share the borrower's risk, making the two in effect partners, injecting a strong social component into the financial system. That viewpoint separates it decisively from Western finance, which seeks to maximize profits and minimize loss through diversification and risk transfer.

At the core of Islamic finance is the sukuk. Much like a western-styled revenue bond, the sukuk returns capital from rents, royalties or user fees. According to Citi Islamic Bank, which unveiled a Citi-Dow Jones Sukuk Index at the International Islamic Finance Forum in Dubai this March, sukuk issuance for 2006 could equal about $14 billion, the combined notional value of the past four years' issuance. Revealing its sophistication level, a recent sukuk offering in the shipping sector named Venus Glory describes its structure as combining "an Islamic mezzanine tranche ... with conventional senior debt and conventional equity."

Retail products in Islamic finance run the gamut from microfinance to mortgages. Because interest-based loans are prohibited, mortgages, like other consumer products, are structured as installment or "lease to buy" arrangements, apportioning monthly payments between rent and ownership. Not amortized the conventional way, they replace the front-loaded interest payment schedule with a linear one, allowing homebuyers to acquire homes in equal parts throughout time. Mortgages are viewed as partnerships between custodian (lender) and occupier (borrower) until the home transfers to the latter. Although controversial, the Western practice of bundling and selling mortgages as asset-backed securities into the secondary market began in Dubai this past April with a $300 million offering.

As for equities, most Westerners' are shocked to see the list of industries forbidden by the Shariah Board, which include businesses engaged in entertainment, gambling, tobacco, alcohol, financial services, defense/weapons and pork production. Yet Islamic equity indexes first started in 1999 are blooming. According to Dow Jones, exchange traded funds (ETFs) also have gained acceptance. Last year, the Istanbul Stock Exchange launched two ETFs: the Turkey Titans, which comprises the top 20 blue chip Turkish firms, and the other is made up of 17 Shariah compliant companies. Another Dow Jones fund, called the Islamic Sustainability Index, lists Shariah-approved corporations focused on ethical and environmental issues, commenced in 1999.

THOSE DODGY DERIVATIVES

The field of derivatives trading draws hot debate among religious scholars. While frowning on speculation, some scholars consider hedging permissible because the activity reduces risk for both the buyer and the seller. However, leveraging a purchase or sale on margin is problematic as is the practice of "clearing," which counteracts the partnership concept. Most Islamists view hedge funds as taboo investment vehicles because they aim solely to extract money from money. An Islamic hedge fund offered three years ago misfired due to poor subscription.

Amid this controversy, three derivatives exchanges in predominantly Muslim countries have launched (or have plans to launch) since last year. The Turkish Derivatives Exchange (www.turkdex.org.tr) began in February 2005 amid much official fanfare in a country that, while a secular Republic, is 98% Muslim. Trading primarily equity indexes, currencies and conventional interest-bearing bonds, it welcomes speculators. The United Arab Emirate of Dubai has opened a gold exchange (www.dgcx.ae) and Qatar is in the process of forming an energy trading platform (www.imex.com).

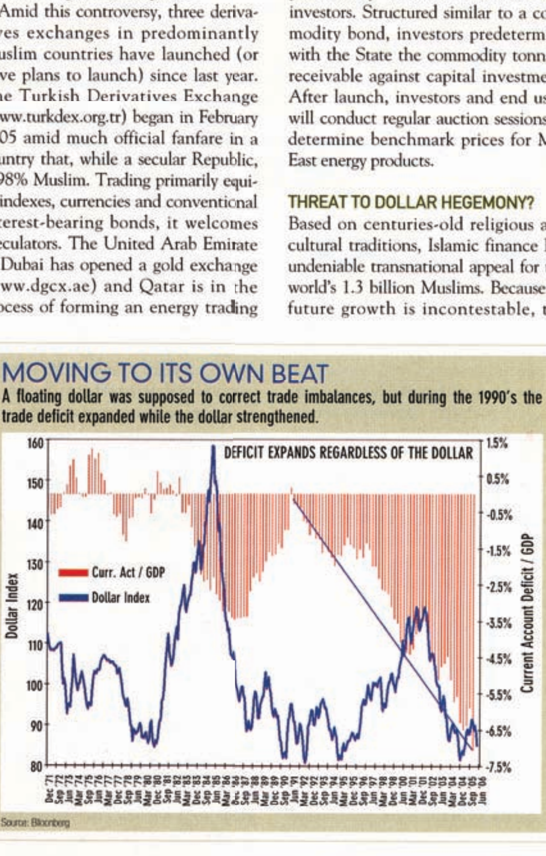
Most controversial of all is the soon to be launched Iranian Oil Bourse (IOB). Created by the former compliance director of International Petroleum Exchange, Chris Cook, the IOB plans to trade oil, natural gas and petrochemicals in euros rather than dollars, hiking the hysteria among dollar doomsayers. Although widely rumored to be a derivatives exchange, according to Cook, it is "a bilateral trading platform based on a Shariah-compliant partnership" between the State and investors. Structured similar to a commodity bond, investors predetermine with the State the commodity tonnage receivable against capital investment. After launch, investors and end users will conduct regular auction sessions to determine benchmark prices for Mid East energy products.

THREAT TO DOLLAR HEGEMONY?

Based on centuries-old religious and cultural traditions, Islamic finance has undeniable transnational appeal for the world's 1.3 billion Muslims. Because its future growth is incontestable, the

MOVING TO ITS OWN BEAT

A floating dollar was supposed to correct trade imbalances, but during the 1990's the trade deficit expanded while the dollar strengthened.



Source: Bloomberg

WHEN YOU ASSUME...

Many economists assumed large trade deficits would create higher interest rates that would eventually regulate those imbalances but the opposite has more often been the case.

Source: Bloomberg

question is: Will Islamic finance grow side- by-side with the Western financial world or threaten it? And what if the Islamic world decided to return to the gold dinar, which operated as a means of exchange for 13 centuries until the collapse of the Ottoman Empire in 1923?

Few economic topics are as hotly debated as dollar hegemony — the role of the U.S. dollar as the world's reserve currency.

As part of the world's largest economy, American consumers have run a trade deficit for 25 years, making dollars the predominant American export. The constant flow of dollars into the world's central banks then recycles into direct investment (as attempted by the Dubai Ports World in January 2006) or into purchases of U.S. securities (e.g., Treasury bonds) to help finance the twin deficits of budget and trade.

Lagging financial markets in the developing world re-enforce this cycle. By putting greater focus on manufacturing and export expansion than on creating U.S.-style banking and risk-management institutions, most emerging countries constrict credit availability in their domestic currencies. The dollar recycling also keeps their domestic currencies from appreciating, enabling them to maintain export competitiveness. Imagine what would happen to China's currency — the renminbi — if China decided to dump its estimated $600 billion USD reserves and buy renminbis. This asymmetrical economic situation and the codependency between the U.S. and exporting nations combine to sustain the dollar's status as a default world currency.

THE CURRENT SYSTEM

Between the 16th and 19th centuries, the gold standard dominated global trade, collapsing after World War I along with the global economic system. The British pound sterling rose briefly into ascendancy, but cratered under the debt burden of World War II, ceding reserve currency status to the U.S. dollar. Under the Bretton Woods agreement formulated in 1945, the dollar was officially linked to gold at $35 per ounce and to all other currencies in a quasi-fixed system. That system ended abruptly in 1971 when, during the height of the Southeast Asia conflict, President Richard Nixon shut the gold window as foreign lenders demanded specie repayment.

The current system of floating sovereign paper currencies replaced the gold-backed system in 1971. Although intended to function similarly to the gold standard by balancing trade and investment among nations, 35 years of data reveal a system that bulges with imbalances and inclines toward large revaluations.

A review of the dollar's performance shows that far from automatically correcting trade balances, it has only once correlated with declining trade balances. That was between 1987 and 1990, which was the period following a 50% free fall that occurred after global leaders orchestrated a devaluation of the dollar against the other major currencies through the 1985 Plaza Accord (see "Moving to its own beat," page 67).

During the 1990s, the deficit expanded while the dollar defiantly strengthened. Most recently, the sharp 2001-2004 dollar sell off failed to correct the trade deficit as it ballooned to record levels. And although the dollar has been declining for most of 2006, experts disagree on the size of the correction needed to significantly contract the deficit; with some saying a Plaza Accord size devaluation, particularly against the Asian bloc, is needed. A comparison between the dollar and national debt, which is approaching $9 trillion, would show a similar pattern.

Interest rates throughout the last 35 years have also failed to respond to the trade deficit. Since 1979, the United States enjoyed a multiyear trade surplus only once when interest rates (10-year note) were peaking in the early 1980's at 15%. Thereafter, the trade deficit expansion has been mostly synchronous with declining interest rates. In fact, the chart "When you assume...," above, suggests the converse to the oft-repeated theory that deficits should create higher costs of borrowing: low interest rates promote trade deficits, high ones shrink them.

WHY THE PARADOX?

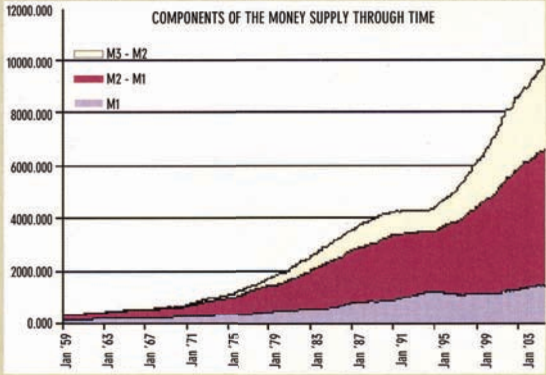
The fiat system turns the gold standard on its head. David Hume, the Scottish philosopher and colleague of the classical economist Adam Smith, observed in 1752 that prices in a country changed directly with changes in the money supply (the monetarist quantity theory of money). As net exports increased causing a nation's bullion reserves to rise, the prices of goods in that country would also rise. The increase in domestic prices due to the gold inflow would discourage exports and encourage imports, thus automatically limiting the amount by which exports would exceed imports. This adjustment mechanism was called the price-specie-flow mechanism. The stability of the system resided in gold's immutability and relative constancy of global supply.

Today, instead of trade-generated bullion supplies regulating prices, a committee poring through economic data regulates the money supply. That money supply holds the key. From the standpoint of a formal definition of inflation (increase in the money supply), barely moving between 1959 and 1971, it has swelled since the creation of paper currencies, which is an occurrence forewarned by many economists opposed to a system unanchored by gold or silver (see "Party time," above). So, a balance-of-payments system has replaced a balanced trade system.

Arguably, if you were to lay the chart of the money supply against bond prices, deficits, major equity indices, or even housing prices, you could claim that they were all part of the same asset bubble phenomenon. Significantly, the Fed is adverse (at least publicly) to tackling asset inflation. Stating that targeted bubble popping of a single asset class would be a threat to the broad economy, Bernanke warned, "One might as well try to perform brain surgery with a sledgehammer."

PARTY TIME

The gold standard worked as a regulator on spending and trade, since we have been off of it, the Fed has used its limitless check book to create money.



Source: www.economagic.com

ENTER THE DINAR

What if the Islamic nations were to re-adopt a gold standard? After all, the gold dinar holds historical, cultural and theological appeal for many Muslims. Many Islamic economists advocate a rejection of paper money, because it can be created out of thin air, and a return to gold. But the task is difficult and would throw Gresham's Law, "bad money drives out good," in reverse.

In 2002 Malaysia and Iran agreed to promote the use of the gold dinar in central banks in predominantly Muslim countries. The idea flopped. As former Reagan economic advisor, Jude Wanniski lamented in 2004, "The mistake may have been in [the] belief that a nation-state actually needs gold bullion in order to manage an Islamic gold standard. It does not." Wanniski said that "gold standard would simply use the market price of gold as a signal, adding to the dinar money supply when the dinar/gold price showed the slightest drop and withdrawing from the dinar supply when the market price showed the slightest increase." This concept was used by Alexander Hamilton, America's first treasury secretary, in persuading the U.S. Congress to adopt a gold standard at a time when the new republic had no gold at all.

However, a rapid shift has occurred in the world economy since Malaysia's push toward the gold dinar, which arose from its perceived bullying by the International Monetary Fund (IMF) during the 1997 Asian crisis.

First, the IMF, which prohibits debtor countries from linking their domestic currencies to gold, is losing its relevancy as a U.S. policy tool. As the world gets richer, it is starting to reject dollar-based loans. Argentina, Brazil and Russia have decided to pay off their IMF loans; and Turkey, which suffered economic collapse in 2001, has asserted it will no longer need IMF assistance by 2008. Also, the dramatic oil price increase has made most Islamic countries much wealthier in a short time span. What's more, the global easing of interest rates has made access to capital in domestic currency far easier, and at the same time the major fiat currencies are quickly depreciating against gold.

Additionally, the U.S. is becoming increasingly protectionist. By saying "no" to foreign investment, particularly

Mid East investment, it is throwing down the gauntlet to foreigners, daring them to jettison their dollar-based investments. Also, because the floating currency system has proved clumsy at regulating trade balances, it has forfeited some of this macro-economic function to lawmakers bearing spare economic know-how and blunt instruments such as tariffs, quotas, sanctions and engineered revaluations. Therefore, conditions, both economic and political, are in place to cause a shift in global finance.

FALLOUT FROM A DINAR SYSTEM

Much of the recent currency debate pivots on the USD/EUR contest, particularly on the possibility of the oil trade being switched to euros. But this debate presumes Europe is an ascendant economy. In truth, it is troubled by a declining population, unsustainable social programs and a deteriorating current account, placing doubt on a USD/EUR switch.

As for the dinar, a side-by-side system of dollars and dinars could function just as multiple sovereign currencies and their central banks do today. Barring geopolitical escalation between East and West, a wholesale rejection of the dollar in favor of gold is unlikely. Because the oil rich nations' coffers are swimming in petrodollars, such a move would decimate their balance sheets.

The same dilemma confronts the Asian bloc. If dollar discomfort became a global phenomenon, a decline against the yen and the Renminbi would harm the fragile banking systems of Japan and China. Japan is only now recovering from the 1985 Plaza Accord that spun it into a deflationary spiral. As for China, despite its storied growth, it may have a staggering $911 billion in nonperforming loans, according to Ernst & Young, explaining its resistance to a sharp appreciation of its currency against the dollar. A weak dollar would steepen its loan failure rate and decrease its export competitiveness.

But currencies in today's world, anchored only by faith in their purchasing power, behave with mysterious and inexorable wills. Former Federal Reserve Chairman Paul Volcker has predicted that throughout the next five years, a global economic convulsion looms with a 75% probability.

Many central banks are affirming their need to further "diversify" their dollar holdings into other currencies and gold. If dollar rejection were to gain traction, the result for the U.S. would be significantly higher import prices prompting the Fed to hike interest rates to levels not seen for a decade or more. Continued hikes in interest rates, without compensatory wage boosts, would severely constrain consumers accustomed to equity extraction from home values (topping $600 billion in 2004).

Amid these questions loom political actions. Financial instability usually breeds protectionism and interventionism. The Smoot Hawley Tariffs enacted in 1931 began as agricultural protections and snowballed into a comprehensive curb on imports. Within four years, global trade collapsed by 66%.

Do Islamic nations want their own Shariah-based financial system? Probably. But do they have the will and political organization to launch a pan-Islamic gold dinar system fulfilling the current U.S. administration's worst nightmare of a financial Caliphate stretching from Spain to Indonesia?

Because the 35 year-old floating rate system has no historical precedent, no prediction can be assured. Two millennia of history show no country and its sovereign currency have remained hegemonic for long while sinking in debt owed to foreigners. If the U.S. dollar continues to reign amid mounting budget and trade deficits, it will have performed the greatest alchemist's trick of all times: proving that the greenback after all is as good as gold. FM

Ann Berg has spent 30 years in commodities and capital markets as a trader, consultant and writer. She's a former director of the Chicago Board of Trade. E-mail: a.e.berg@netzero.com.