THE RISE OF ISLAMIC CAPITALISM

WHY THE NEW MUSLIM MIDDLE CLASS IS THE KEY TO DEFEATING EXTREMISM

A Council on Foreign Relations Book

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CHAPTER 1

THE POWER OF COMMERCE

It all happened quickly. The Muslim world changed dramatically in the short thirty-two months that separated the Ayatollah Khomeini's return to Iran on February 1, 1979, and the assassination of Anwar Sadat in Cairo on October 6, 1981. During that time of remarkable upheaval the forces of Islamic revolution seized Iran; Pakistan proclaimed itself an Islamic state; the Soviet Union touched off a jihad by invading Afghanistan; and Egyptian president Anwar Sadat was assassinated by radical fundamentalists. Since those fateful years, many more violent revolts, deadly clashes, terror attacks, and bloody suppressions have followed, along with deepening conservative Islamic attitudes and anti-Americanism across a vast swath of countries from North Africa to Southeast Asia. Extremism has come of age in this cauldron, giving rise to al-Qaeda, and its cult of violence and dark vision of the future.

In the face of all of this tumult, and in response to the rise of terrorism, America's most abiding objective in the Middle East since 1979 has been to contain and defeat Islamic fundamentalism. That objective has determined how America sorts its allies from its adversaries, which fights it has taken on, and whether in pursuing its interests it will champion reform, promote democracy, or look to dictators and military solutions. It has also led America perilously close to reducing everything in the Middle East to the fight against fundamentalism, and to seeing every expression of Islam as a threat. The U.S. leadership has seen the fundamentalist challenge largely as a new kind of cold war. That sort of
clarity can be a great help, but it can also grossly oversimplify, obscuring vital aspects of the situations within countries and regions that provide opportunities for improving relations.

Looking at the Middle East as it is today—caught in the web of violent conflicts, seething with anger and anti-Americanism, and vulnerable to extremist ideas—it is difficult to have hope for the future. But, however difficult, that is just what we must do. In his perceptive book *The Age of the Unthinkable*, the strategist Joshua Cooper Ramo argues that by intensely focusing on that which is before us, we miss important trends—some barely detectable—that will shape the future. The paradigms that dominate today may matter little tomorrow. We will do ourselves a disservice if we think of our future with the Muslim world only in terms of today’s conflicts. These conflicts are serious, and we must prevail in them, but we should also recognize that there are other forces at work in the Muslim world and they too deserve our attention—they may ultimately matter more to us.

Take the case regarding the paradox of Iran, a brutal theocracy lording over a restless population that is also a rising power with ambitions to match its glorious ancient history, and a keen sense of purpose honed by decades of confrontation with the West. An examination of the ironies of Iranian power, and the fault lines within the country—on display in the recent presidential election—offer a particularly revealing starting point for rethinking the true challenges, and prospects, in transforming relations with the Muslim world. Iran’s saber-rattling, and the Bush administration’s hard-line stance—now being softened by the Obama administration—have diverted attention from important truths that belie the received wisdom regarding the Iranian threat, and those truths speak volumes about opportunities around the wider region.

The recent history of Iran’s relations with the West is surely deeply troubling. Iran’s revolution empowered a particularly uncompromising brand of Islam that has turned anti-Americanism into an article of faith in much of the Muslim world, and Iran’s rulers have steadily supported terrorism with money, training, and weaponry. Iran also now openly seeks great-power status and is building a nuclear program. Making matters worse in recent years was the more antagonistic approach to dealing with Iran that was adopted by the Bush administration, and the badly managed prosecution of the wars in Iraq and Afghanistan.

For much of the past three decades, the United States and Iran were locked in a stalemate, with no diplomatic relations, but also not much in the way of direct confrontation. America was content to isolate Iran as much as possible while waiting for the clerical regime to succumb to perceived inevitable internal pressures for change. In the wake of 9/11 that approach changed. The Bush administration believed it could nudge history along. Veterans of Reagan era cold war politics—the so-called neoconservative hawks who gathered around Vice President Dick Cheney and Secretary of Defense Donald Rumsfeld—drew confidence from what they perceived as the U.S. role in helping to toss communism onto the ash heap of history. They believed the toppling of Saddam Hussein and the rise of a reasonably stable, democratic new Iraq next door to Iran would stir Iranians into revolt and sufficiently unnerve the country’s clerical rulers to provide that opening. The bitter irony was that when American troops showed up in Iraq, the grip of Iran’s ruling clerics was strengthened.

By breaking the Taliban regime in Afghanistan in late 2001, toppling Saddam, and then uprooting Baathism in Iraq, the United States removed local rivals that had contained Iranian power to its east and west. Since the Shah’s time and more so after the Islamic Revolution, Saddam’s military had been the main barrier to Iran’s expansionist aims. Today there is no indigenous military force in the Persian Gulf region capable of containing Iran. What’s more, in the political vacuum that followed Saddam’s fall, Shia Iran quickly extended its reach into the predominantly Shia lands of southern Iraq. Many of Iraq’s new leaders had spent years of exile in Iran and relied on Iranian support during the dark years of Saddam’s rule. It was no coincidence that Iran was the first of Iraq’s neighbors to recognize its new government and to encourage Iraqis to participate in the political order established by the United States. Now Iran runs extensive intelligence and political networks that give the Islamic Republic influence at every level of Iraq’s bureaucracy,
clerical and tribal establishments, and security agencies—impacting election results, the flow of trade, and the tempo of violence.

Iranian leaders are keenly aware of how their regional influence has grown since 2001, and especially since 2003. Former president Muhammad Khatami, the onetime great hope of the reformers in Iran, captured this sentiment when I asked him in 2007 about how he assessed Iran’s place in the region. "Regardless of where the United States changes regimes," he observed, "it is our friends who will come to power." True enough, Tehran has more impact on Arab politics—especially in the critical zones of Iraq, Lebanon, and Palestine—than it did ten years ago. Not only does Iran’s influence in Iraq far exceed that of any Arab government, but since the war between Hezbollah and Israel in the summer of 2006, Iraq has gained more say in Lebanon’s domestic politics as well—pushing for Hezbollah’s interests and constraining politicians favored by the United States or Iran’s Arab rivals. The clerical regime has also kept up, if not jacked up, its meddling in Palestinian politics through its support for the extremists of Palestinian Islamic Jihad and Hamas, as well as cultivating ties with Syria. By excoriating Israel and taking advantage of Arab frustration with the lack of progress in the peace process, Iran seems to curry more favor these days on the Arab street than the tired old Arab dictatorships in charge. So it is that Iran’s Supreme Leader confidently boasted that no problem can be solved in the Middle East without Iran’s consent and help.

Iran’s hubris was fueled by soaring oil prices in 2007 and the first three quarters of 2008, which eventually topped out at close to $150 a barrel. Flush with petrodollars, Iran’s rulers were confident they could afford their shopping spree for influence in the Palestinian Territories, Lebanon, and Iraq by supplying their allies and clients with funds, weapons—including rockets and missiles—and training. There is worry across the Middle East that all this activity will only increase if Iran goes nuclear. Then Tehran will have little fear of reprisal for its boldly aggressive policies, which is one reason why a host of Arab nations now contemplate nuclear programs of their own to temper Iran’s surging influence.

Talk of military action against Iran was rife in the Bush administration throughout 2007 and 2008, but the United States had too much on its plate in Iraq and Afghanistan, not to mention the deepening political crisis in Pakistan, to take any such step. All of this seems to indicate that Iran has become a juggernaut. But as the recent upheaval shows, the reality is more complex.

For the West, the most often used measure of Iran’s regional influence is the flow of arms and influence from Tehran to its allies and clients. In order to gauge how much weight Iran is throwing around, America looks to metrics such as those above about the dollar amount Tehran promises Hamas, the volume of weapons it smuggles to Hezbollah, and the numbers of those trained in terrorist tactics by the Iranian Revolutionary Guards’ shadowy Quds Brigade. There is plenty of this activity to alarm America and its Arab allies, and worse, those ties are becoming stronger. If Iran goes nuclear there is no telling what havoc might be wreaked by means of Iran’s minions. There is no denying, then, that Iran’s hard power and influence have been growing. But viewing Iranian power from that angle alone makes it look more inevitable and ominous than it really is.

Economics has more to do with determining the pecking order in the Middle East than the region’s dynastic tumult of feuds, wars, and saber rattlings would lead one to believe. The Middle East is not just a zone of clashing extremist ideas and zealous terrorist armies. It is also a place of struggling and thriving economies, where new classes and business elites are elbowing their way higher in the power structures of many countries, changing religious, social, and political life on the way. Other contenders for great-power status in recent memory, Brazil, China, or India, all rose to prominence not on the back of hard power but as economic stars driving growth in the regions around them. That is not the case with Iran. Iran is not going the way of the so-called BRICS (to use the somewhat misleading acronym that lumps petro-dependent Russia in with the more diversified economies of Brazil, India, and China). Iran’s economy is the 151st most isolated in the world (that is out of 160) and sixteenth most isolated in the Middle East (out of seventeen).
Iran’s drive for regional power lacks an economic underpinning. And that makes gauging Iran’s regional power a tricky business. Hard power is not its most effective means to greater influence.

Iran has most influence where it does most trade; where that influence is backed by economic and business relations. While Iran has deep ties to Lebanon’s Hezbollah and a long-running alliance with Syria, its most certain sphere of influence is far closer to home, in an arc that runs from Central Asia in the north and east down through western Afghanistan and on into the Persian Gulf and southern Iraq to the south and west. “When you go to Central Asia these days” remarks The Atlantic Monthly’s Robert Kaplan, “you feel you are in greater Iran.” It is in this arc where Iran does most of its regional business, selling agricultural products, electricity (a big-ticket item in this air-conditioning-hungry region), natural gas, and even manufactured goods.

The trade between Iran and the five Central Asian ‘stans was worth well over $1 billion in 2008 (up from $580 million in 2001). The Iranian rial changes hands there as easily as local currencies. Counting the unaccounted for cross-border trade, Iran does about the same amount of business with Afghanistan (up astronomically from a paltry $52 million in 2001). Trade with Iraq topped $4 billion in 2008 and with the United Arab Emirates reached $14 billion—a figure that does not include all the black-market trade that goes on across the Gulf. In fact, Iran has such a vital interest in this trade that the regime has created banking and financial ties and invested infrastructure projects in these countries ranging from roads, railways, and piers to pipelines and electricity pylons. Businesses of all kinds have grown in these countries on the back of this trade.

In so many ways, Iran is well qualified to become a true economic powerhouse driving wider growth in the region. Its nearly 70 million people give it a population about the same size as Turkey’s. It has vast oil and gas reserves, plus a strong industrial base by regional standards. Labor is cheap but the literacy rate is high, over 75 percent. As the country’s thriving art scene and internationally acclaimed movie indu-
ity. The same themes crop up routinely in Qalibaf’s speeches and interviews as the can-do mayor of Tehran.

Such hopeful talk from the higher-ups falls flat, though, before the reality of an Iran where inflation is running at double digits and about a quarter of the workforce is jobless. The problem is not a lack of enterprise or fundamental potential. Iran has a dynamic private sector and the middle class to go with it. The economist Djamal Saleh-Isfahani estimates that around half of Iran’s population of 70 million is middle class or above—counting their possessions, disposable income, level of education, and family size—with the kind of social attitudes that are needed to support robust consumption habits and modernizing change. The problem is that Iran’s private sector is shackled by a corrupt and inefficient state that dominates 80 percent of the economy. The state grew to its current size after the revolution by devouring large parts of the private sector—nationalizing businesses, banks, and industries. It prioritizes spending on the poor above achieving economic growth, and therefore sees no problem in stifling entrepreneurship with red tape, starving businesses of resources, and taxing them dry. It is top-down centralized economic management at its worst.

When it comes to the economy, Iran is not a regional leader but a regional laggard, dawdling in the soggy bottomlands of suffocating statism. This economic stagnation was a powerful driver of the vehement opposition to Ahmadinejad in the recent election. The thing to watch in Iran over the next few years is the private sector and the middle class tied to it—the same class that in the aftermath of the June 2009 election led millions to ask “where is my vote?” The great battle for the soul of Iran—and for the soul of the region as a whole—will be fought not over religion but over business and capitalism. At issue will be whether the state will free the economy and let this dynamic society reach its full potential.

The deeper truth about Iran’s power is that playing the anti-American and pro-Palestinian cards is not going to bring Iran lasting influence. As a senior Iranian official once told me, “When push comes to shove, the Palestinians will be the first to turn on Iran.” Iran will not be able to truly dominate the region if it does not do a better job of developing its economic clout. Great-power status presupposes economic leadership, and that Iran is not currently providing. This is the key to Iran’s quest for nuclear capability; the Iranian rulers think they need the threat of nuclear aggression or retaliation in order to forestall Western pressure for regime change and to intimidate neighbors, but even more important is to punch above their weight. After all, Iran’s GDP is about the same as that of Massachusetts. It spends only $6 billion a year on its military. That is less than a third of Saudi Arabia’s military expenditure of $21 billion a year, and close to half of Turkey or Israel’s annual military spending. Before the revolution, Iran’s military expenditure was as high as 18 percent of GDP; today it is a paltry 3 percent. How can a country with an economy the size of Massachusetts and the lowest military expenditure in its neighborhood take on the United States and claim great-power status? The answer in Tehran is that only nuclear capability will address Iran’s glaring economic and military deficits. And if Iranians had any doubts that nuclear capability will raise their stock, America’s near obsession with the issue over the past six years has convinced them.

But even with nuclear capability, the kind of status that Iran covets will elude it. Both India and Pakistan started down the nuclear path in the 1970s, but only one of them emerged as a regional great power in the 1990s. It was not nukes that turned India into a rising power, but rather its economic growth rate, newfound friendliness to free markets, and ability to integrate into the global economy. Iran today rallies the alienated and rouses the dispossessed, but those seeking progress and prosperity have to look elsewhere for inspiration. If Iran wants to be a great power, it will have to further nurture its economy so that it serves as the engine of growth for the region that it could be. That would mean bringing itself into concert with a vital economic transformation underway all around the region—the rise of a new middle class that is the key to more fully integrating the Middle East into the global economy, and to the building of better relations with the West. It is to this rise of a new middle class that leaders in the United States and around the West should turn attention—to fuel its potential—rather than allow-
ing the chimerical power of fundamentalism to dictate so much of the approach to the region.

The great irony of the fundamentalist threat is that the two years from 1979 to 1981 in which Islamic fundamentalism shook the world and terrified the West were also its high point of power. That is not to say, of course, that after fundamentalism won Iran, turned Pakistan, and destabilized Egypt it just died out; fundamentalists are too vocal, active, well organized, and well funded for that. Fundamentalism most definitely remains a worry, and its extremist edge a serious threat. Extremism that has been festering in the innards of Pakistan’s society is surging, laying claim to vast swaths of its territory, and those extremist forces are waging a two-pronged war against not only foreign troops but the governments of both Afghanistan and Pakistan. The thought of nuclear-armed Pakistan, with its 175-million-plus population—deeply divided along ethnic lines, and with a troubled economy and weak government—unraveling before the extremist onslaught is unnerving to say the least. A failed Pakistan in the clutches of extremism or plunged into civil war, and with no safeguards locking down its nuclear arsenal, would be deeply destabilizing for the region and the world.

The larger truth about fundamentalism’s drive to power, though, is that since 1980 it has toppled no more dominos. The Taliban visited horror on Afghanistan, but this rag-tag army of religious zealots and tribal warriors amounted to no more than an incomplete insurgency in a broken corner of the Muslim world—an antique badland even before decades of war ravaged it. There have been no additional Irans, and the prospect that another Islamic state will arise—whether through peaceful means or violent ones—has been steadily declining.

The West must remain vigilant against fundamentalism, but that should not stop Western policymakers and publics from seeing the “whole picture” in the Middle East, and a vital truth of the region is that the fundamentalist strain of Islam is not practiced by the vast majority of the population, and is not on the rise. What is true is that since 1980, a broader wave of Islamic resurgence has swept across the Middle East, and fundamentalism has surfed that wave rather than fueling it. The Islamic resurgence is much larger, deeper, and more complex. The vast majority of Muslims are moderate and pragmatic when it comes to religion, balancing law and piety with a healthy dose of mystical practices and folk religion.

It is not fundamentalism that accounts for the ubiquity of Islamic influence across the region today; rather it is the other way around: Widespread Islamic fervor—which can, but does not have to, take on a fundamentalist form—has allowed fundamentalism to survive past its prime. It would of course be foolish to ignore fundamentalism and the extremists associated with it, but it is also imprudent to consider fundamentalism the end-all and be-all of what we need to know about Islam and the Middle East. It is time that we take a good look at the vitality of the energetic blending of Islamic piety and capitalist fervor that is flourishing in many pockets around the region.

In November 2006, when Pope Benedict XVI visited Turkey, he made a stop at the seventeenth-century Blue Mosque, so called for the more than twenty thousand handcrafted cobalt-blue Iznik tiles that adorn its interior. A testament to Ottoman grandeur, the great mosque is an architectural marvel of unrivaled beauty. At one point, the gently strolling pontiff stopped and looked up at a large black tableau with ornate white calligraphy, etched into an arch at the mosque’s main exit, and asked his guide what the flowing script said. They were the words of the Prophet, he was told: “A merchant is the beloved of God” (al-habib). Benedict’s visit to Turkey was historic, his first to a Muslim country. It was also a hastily organized damage-control mission. Two months earlier, His Holiness had caused a furor when, in a speech in his German homeland, he had evoked the criticisms of Islam made by fourteenth-century Byzantine emperor Manuel II Paleologus, who led the empire during its last days, as the Ottoman Turks steadily encroached on its power, eventually seizing Constantinople. Manuel had written a “Refutation of Islam,” in which he argued that Islam was an irrational
religion, an evil falsehood that had been spread by the sword. Making the reference worse was the fact that Manuel, in his desperate efforts to obtain support for the fight against the Turks, had made an alliance with the pope in Rome. By quoting Manuel, the current pope seemed to be saying that Islam was essentially driven by jihad and was at odds with Western values—not only Christian values, but those of modernity altogether.

How ironic, then, that on that day at the Blue Mosque, the pope discovered that for centuries, the last words worshippers read when leaving the mosque were a call to commerce. Not only was commerce important to the seventeenth-century Muslim world, it is even more important to that world today. Washington is certainly not entirely unaware of this. The United States has been supporting economic reform and business initiatives in the Muslim world, but with too much focus on working with government planners and the top-level business elite. Change will not come from this upper crust—it has too much invested in the status quo and depends too heavily on the state. It is business with small “b” that should hold our attention.

All across the region, a whole new economy is rising, mixing local values with surging consumption and building ever richer ties to the global economy, and this trend is not only every bit as powerful and important as the threat of fundamentalism, it is more so.

In the spring of 2009, I met in Dubai with a group of Middle Eastern businessmen. Only a short time earlier, the little emirate had been swept to dizzying heights of wealth and prosperity, and these businessmen had done quite well for themselves. Now the discussion was more somber, focused not surprisingly on the global financial crisis. After much talk about failing banks and falling real estate prices, I asked the group how they were responding.

“Money is flying to Beirut,” one of them explained. “Everyone is putting what they can in Lebanese banks.”

Lebanese banks?

Why were these very savvy businessmen prepared to trust their substantial assets and investments to banks in a country with a reputation for war and instability—the Hezbollah land that so worries the West? Were they making a political statement with their money, sending a further message to the West about their willingness to support their cause even in a time of financial trouble? Or was I missing their point altogether?

“Why Lebanon?” I finally asked sheepishly.

“Well, the interest rate is much higher in Lebanon than here,” one answered, while another pointed out what was already obvious to the rest of the group: “Lebanese banks sit outside the global financial system. They have no toxic assets to worry about. Nor are they threatened with collapse or government takeover, as are banks in New York and London.”

Why had I needed to be reminded that capitalism is alive and thriving in the Middle East? There are signs of it everywhere, from the actions of these businessmen to protect their assets to the staggering rate at which shopping malls and modern retail establishments of all kinds have gone up in the Muslim world, and not just in Kuala Lumpur or Dubai, where one sees extravagant Rodeo Drive-style malls. In war-torn Beirut and fundamentalist-dominated Tehran, glitzy malls are filled on holidays with shoppers eager to buy the latest electronics or fashionable home furnishings.

This capitalist flowering has had clearly definable cultural ramifications as well. A quick glance at rooftops in any Arab city will leave little room for doubt that satellite television has mesmerized the Arab world, to the chagrin of its dictators and their censors. There are some 280 channels to choose from, and the more popular ones, such as Al-Jazeera or Al-Arabiya, claim viewership in the tens of millions. It is also on these airwaves that some of the most interesting religious debates take place. Clerics are not the only ones who draw the big audiences. They must now compete with a new breed of televangelists, who preach modernity and business-friendly Islam.

Internet use too is steadily growing. About 40 percent of Iran’s population surfs the Web, with the ranks of first-timers swelling constantly, as opinion and information flow briskly into and out of social networking websites and chat rooms, and then get further interpreted on blogs. Even clerics maintain active websites, blogs, and Facebook pages, and
have Twitter followings. Those two social networking sites took over the presidential campaign of 2009, upending traditional media to make way for new political dynamics in the country. The government has tried its hand at restricting and censoring the Net, but it is King Canute ordering back the tide. And even if the hard-line ayatollahs and their minions could strangle the Internet, what would they do about the explosion of cell phones and mobile texting? In 2000, fewer than a million Iranians had a cell phone. Now some 48 million—about two-thirds of the country—have one. Even people too poor to obtain a regular mobile subscription can buy cheap prepaid phones to start talking and texting. And it is not just Iran: Next door in war-ravaged Afghanistan, the close of 2008 found eight million mobile phones in use—about one quarter of the population. Pakistan’s numbers are even more impressive; in 2008, 78 million were using mobile phones; up from a mere 750,000 in 2001.

A vital characteristic of this flourishing capitalism is that it goes so much hand in hand with the resurgence of traditional Islamic belief. All over the Middle East, piety is shaping consumption. Those who live by Islam also demand Islamic goods; not just halal food and headscarves, but Islamic housing, haute couture, banking, education, entertainment, media, consumer goods (such as Europe-based alternatives to Coke and Pepsi, Mecca Cola and Qibla Cola), and even vacations—Islamic cruises are a growth industry in Turkey, and the governor of Najaf in southern Iraq has been thinking of ways to market pilgrimage vacation packages in order to coax some of the million-plus Iranians who visit the sacred sites in his city every year into staying longer and spending more. Some offerings mix the taste for Islam with that for globalization, as, for example, The Caprice, a luxury hotel with a distinctly French name that caters to the Islamically conscious vacationing on Turkey’s western coast.

This upwardly mobile class consumes Islam as much as practicing it, demanding the same sorts of life-enhancing goods and services as middle classes everywhere. Their preference that those goods have an Islamic flavor makes Islam big business. A booming economic sector around the region is catering to this exploding demand, and these ris-

ing Islamic consumers comprise as much as a sixth of humanity, spread across a vast expanse from Morocco to Malaysia, with notable footholds from Detroit to Düsseldorf and São Paulo to Singapore.

Americans are easily dazzled by the size of China’s economy, the speed of its growth, and the room it has to expand. In recent years, India’s economy has also made remarkable strides. Thinking of the notional “Muslim-world economy” provides an interesting basis for comparison. The global Muslim population of a billion-plus is about the same size as both India and China’s populations. In 2008 the GDP of the economies of five of the largest countries in and around the Middle East—Egypt, Iran, Pakistan, Saudi Arabia, and Turkey, with a combined population of 420 million—was $3.3 trillion, the same size as that of India, which has three times the population.

The bottom line is: A billion consumers have clout. Across economies as diverse as those of Mali, Dubai, and Indonesia—and outside the Muslim-majority countries, in the Muslim diasporas—the demand for Islamic goods and services is strong and growing, and it has already created waves in global markets. This is perhaps best demonstrated by the boom in Islamic finance, which is doing good work in further integrating the economies of the Muslim world and the global economy.

For Americans, seeing the words “Islamic” and “finance” in the same sentence tends to conjure up worries about terrorism. The need to identify and cut off terrorists’ money flows is entirely legitimate, but “Islamic finance” has nothing to do with funding extremism or violence; rather the term refers to banking and other financial services—such as insurance, mutual funds, equities, bonds, credit cards, and even derivatives—that are compatible with shariah rules and regulations. Shariah requires neither collecting nor paying interest on bank deposits or loans, and in the case of bonds, limiting the amount of debt a company takes on in issuing bonds to the value of assets on its books. Islamic finance also means avoiding investment in ventures that may violate the shariah, such as businesses that serve alcohol, involve gam-
bling, produce devices that can promote immorality, or in some cases, even the use of mannequins or bareheaded women in advertising.¹⁴

In place of charging interest, Islamic finance relies on forming partnerships that demand that borrowers, lenders, and investors jointly take an equity position in business ventures, sharing in the risk and reward of those investments.¹⁵ The whole thing works better in theory than in practice, and Islamic financiers have had to develop entrepreneurial ways of working around these restrictions to make the system work. For instance, car dealerships will simply add the amount they would make in interest for a loan to the cost of a car, and offer buyers a deferred payment schedule.

Although Islamic finance remains a fledgling, niche market in the vast global financial-services industry, it has lately been growing at the rate of 15 to 20 percent per year.¹⁶ The American consulting firm McKinsey & Co. estimates that by 2010, assets held by Islamic financial houses will total $1 trillion, a fivefold growth in five years.¹⁷ The Western ratings agency Standard & Poor estimates that these assets could ultimately grow to as much as $4 trillion.¹⁸ The 2008 global financial crisis may in fact give a good boost to these numbers as more Muslims may decide to pull their money from traditional investments for the perceived security of the Islamic alternative.

There are some three hundred Islamic banks and investment firms operating in more than seventy-five countries. By the end of 2006, some 218 shariah-compliant mutual funds were managing an estimated $14 billion.¹⁹ Iran accounts for the most shariah-compliant assets ($155 billion in 2007), followed by Saudi Arabia and Malaysia ($69 and $65 billion each) and then Kuwait and U.A.E. ($38 and $35 billion each).²⁰ These banks oversee banking services totaling close to $500 billion and an Islamic bond market worth $82 billion—a mere one-tenth of one percent of the global bond market, but expanding fast. The total investment in these bonds grew by an eye-popping 250 percent in 2006, and growth continued even with the global financial downturn.²¹

Three large Middle Eastern players dominate Islamic finance: the Faysal Group, al-Baraka, and the Kuwait Finance House. The most active hub for Islamic finance has for many years been Kuala Lumpur—where Southeast Asia’s boom in the 1990s charted the way for the integration of Muslim Malaysia and Indonesia into the global economy—but Dubai and Bahrain now account for a growing share of the market. All of them now warily anticipate competition from the larger financial centers of London, Tokyo, Hong Kong, and Singapore.

As an indication of how this form of financing can serve to build ties between the Middle East and global economy, many global financial brands such as HSBC, Deutsche Bank, Barclays, Credit Suisse, Citigroup, and the UK’s Black Rock are getting into the game. They are targeting a growing market of Muslims in the West for retail banking as well as more lucrative upscale financial services, such as private banking and wealth management, and looking to gain growing shares of the booming Islamic-bond market. Deutsche Bank, Barclays Capital, and BNP Paribas are now among the world’s top five issuers of Islamic bonds. The equity markets in the West are also joining in. Dow Jones has indexes for both Islamic bonds and Islamic investment funds.²² Research and analysis into Islamic finance is also going on at Moody’s and Reuters, and the premier annual gathering of experts on the subject takes place at Harvard University’s Forum on Islamic Finance.

London in particular has set its sights on becoming a major center for Islamic finance. The city saw its first Islamic bank open in 2004, and since then two more have opened and a fourth is on the way. The London stock market issued its first Islamic bond in 2007, and is well on its way to expanding into the sovereign Islamic-bond market. Competition is spurring legal reform and the creation of new regulatory mechanisms designed to encourage Islamic financial activity. So far that competition has favored Dubai, whose relatively hands-off regulatory environment is the most attractive to investors and borrowers, but there is no denying that increasingly Islamic finance is going global.

Arab Islamic banks are setting up shop in Europe and Southeast Asia, and European and Southeast Asian banks are providing Islamic banking in the Persian Gulf. Banks such as Saudi Arabia’s al-Rajhi or Kuwait Financial House have been building branches across the Muslim
world and competing with local Islamic banks such as the Dubai Islamic Bank or the Islamic Bank of Jordan, or the Islamic arm of local mainstream banks or global financial outfits like HSBC or Citigroup. Smaller markets are converging into one global market ruled by the same regulations and standards, which mix Western business practices with Islamic ones, all enforced by Islamic scholars and shariah-compliance boards. Malaysia has tried to enforce standards by creating the National Shariah Board, and there is a broader international effort aimed at creating common standards in the works at Bahrain’s Accounting and Auditing Organization for Islamic Financial Institutions.23

Islamic scholars on lucrative retainers with financial institutions, some in America, help design new Islamic financial products—and even help bend the rules to sell finance to shariah-conscious customers.24 One particularly influential one is Yusuf DeLorenzo, an American convert from Brooklyn. In addition to advising twenty global financial institutions and a few Muslim countries, the dapper sheikh is the chief shariah officer (rhymes with chief financial officer) at Shariah Capital, a Connecticut-based Islamic hedge fund. Meanwhile, many of these customers come from Turkey, Indonesia, and North Africa, where the religiously conscious middle class is growing.

When in 2006 the Dubai Port Authority acquired British Peninsular and Oriental Steam Navigation (which managed a number of U.S. ports), some in the United States pointed to the $3.5 billion Islamic bond that had financed the deal as proof of a threat to U.S. security.25 Islamic bonds were then unknown to most Americans, and the mere mention of Islam with relation to financing was enough to ring alarm bells. Yet a number of American companies had already dipped their toes into these waters. In 2004, the Texas-based oil group East Cameron Partners became the first American company to issue Islamic bonds.26 Recently, Ford Motor Company’s $848 million sale of Aston-Martin to the Kuwait-based Islamic bank Investment Dar required Islamic financing. Caribou Coffee, America’s largest specialty coffee chain after Starbucks, is owned by a shariah-compliant private-equity firm based in Bahrain.27 In Europe, British developers have financed the multibillion-dollar purchase of London’s historic Chelsea Barracks complex with Islamic bonds,28 while in 2004, the German provincial government of Saxony-Anhalt became the first non-Muslim sovereign entity to do so, raising 100 million Euros in the process.29 France, China, Japan, and Thailand are all poised to follow.

Key to understanding the growth of Islamic finance, and the insight it offers into the up-and-coming mind-set of so many Muslims, is that it evolved due to the demands of average customers. Some observers ascribe the spectacular growth of the last few years to the oil boom, and the flow back to the region of an estimated $800 billion belonging to Muslims made nervous by post-9/11 financial regulations intended to clamp down on the laundering of money to fund terrorism. Surely those cash flows have greatly accelerated growth, but consider that this money that had been stashed away in America, Britain, or Switzerland before 9/11 could, when it “came home,” just as easily have gone into regular banks and investment funds in the Middle East, which are plentiful. The directing of so much money into Islamic finance suggests a strong specific demand for this brand of the blending of capitalism and Islam.

Indeed shariah compliance has attracted many Muslims to investing who had previously shunned formal markets. One can think of Islamic finance in its early days as somewhat akin to microfinance, meaning the provision of small loans to those shunned by traditional bankers because of low income and little or no collateral to offer. When Bangladesh’s Grameen Bank pioneered the idea, the intent was not so much to make profits but to lift people out of poverty. But over the past decade, microfinance has evolved into big business, with large banks and investment funds competing over what the business strategist C. K. Prahalad calls “the fortune at the bottom of the pyramid.”30

Like microcredit, Islamic finance was a response to a moral imperative: to fulfill a demand for loans by those who wanted their business to be in compliance with the shariah. The largest Islamic financial institution, Saudi Arabia’s al-Rajhi Bank, started operations as a small firm providing the interest-free equivalent of modest loans, and it grew largely by bringing in new, piously interest-averse investors. Whereas in
1978, savings accounted for only 10 percent of all deposits in Saudi Arabia,\textsuperscript{31} thanks to Islamic banking, that number had grown to 53 percent by 2007.\textsuperscript{32} In 2008 the three Islamic banks in the kingdom accounted for 45 percent of all bank-credit facilities, and Al-Rajhi now has more branches—many located away from major cities—than any other bank in the kingdom, boasting an impressive $15 billion in deposits.\textsuperscript{33} So popular was the opportunity to bank in this fashion that when Kuwait Finance House, now one of the world's largest Islamic banks and the holder of its country's largest single deposit pool, opened its doors, it attracted so many customers that it met the deposit goal for its whole first year within thirty days.\textsuperscript{34}

There is no question that Islamic finance is now benefiting from an advantage in attracting deposits and investments from the growing wealth at the top of society, and in the government, in prospering Southeast Asia and the oil-rich Persian Gulf. Financiers in the West know very well about the kind of wealth that floats around at the top levels of these societies, especially the huge reserves of cash in government coffers and sovereign wealth funds—investment funds run by the government, with government money. But the growing ranks of newly cash-rich individuals in the Muslim world, who come not from the traditional elite but from the rising classes, are strong consumers of Islamic finance too.

Their counterparts in Europe and the United States are also fans. Accenture, a global consulting company, estimates that demand among Muslims in Europe will drive the next phase of the growth. Half of all Muslim middle-class savings in the world belong to Muslims who live in the West.\textsuperscript{35} American Muslims are more likely than their coreligionists in Europe or the Muslim-majority countries to enjoy middle-class status. According to Zogby polls, a majority of U.S. Muslims are educated and earn more than $50,000 a year. Pent-up demand among middle-class American Muslims has already made Islamic finance an instant success in Chicago. No sooner had that city's Devon Bank begun looking into the feasibility of Islamic banking in 2002 than local Muslims came to it in droves looking for shariah-compliant home mortgages and car loans.\textsuperscript{36} Islamic finance will likely soon be as ubiquitous in the West as in the Muslim world, and if Islamic finance's market share were to reflect the Muslim's 20 percent share of world population, then shariah-compliant finance will be growing at a spectacular pace for some time.

Islamic finance is also attractive to many women who generate, own, inherit, or manage wealth, but who find themselves inhibited by law or custom from dealing with the mixed-sex environment of regular financial institutions. "Ladies only" banks have been a growth industry. Coutts, a private bank based in London, has been doing a brisk business in private banking services for wealthy Persian Gulf female residents.\textsuperscript{37} The air of propriety surrounding shariah-compliant finance is attractive to women. There are fewer stigmas associated with walking into an Islamic bank or investing through Islamic investment arms without male supervision. To cater to this growing market, Islamic banks have been educating women in finance. The Kuwait Finance House, for example, holds classes for women. Islamic finance firms are also hiring more women than do regular banks. A third of financial-sector employees in Bahrain and two-fifths of those in Kuwait, for example, are women.

All of this is not to say that Islamic finance will in any way become dominant in the global economy, not by a very long shot. Limitations will rein in the growth of this business. Islam's ban on speculation, for example, means that transactions must be based on tangible assets, which makes it easy to do business in commodities and real estate, but much trickier to innovate financial products. Islamic finance could run out of assets to sustain its growth, and even short of that it may overemphasize investment in certain assets, such as real estate or retail, thereby increasing the risk of losses. The business may also suffer from squabbles over just what is properly Islamic. The Islamic bond market took a tumble—and along with it the value of properties funded by Islamic bonds—when in 2008 a group of clerics in Bahrain declared that most Islamic bonds are not Islamic because they fail to shift the ownership of collateral to bond holders. Without that transfer, they argued, a financial transaction isn't based on tangible assets and is therefore not Islamic.\textsuperscript{38}
The cost of that religious ruling was high and the evidence that clerics can send the market tumbling was disconcerting to many investors. The question is also open whether Islamic finance can keep growing by tap-dancing around the matter of interest rates. Profit-sharing instruments, or other work-arounds such as providing indirect car loans, are relatively inefficient, incurring higher costs in putting deals together. Islamic finance will need more innovation of clever strategies if it is to continue to grow market share by comparison to traditional finance. A great deal of money is being poured into research and development of schemes, but it’s hard to know whether those efforts will yield results.

Given ample demand and all the windfall oil cash slushing around the Middle East, Islamic finance will likely continue to ride high despite its inefficiencies, but it will eventually hit a glass ceiling. Nonetheless it has already become a notable part of global financial trade, and most important for our purposes here, it will serve as a vehicle for integrating the Muslim economy ever more into the world economy.

All this emphasis on morals in finance may not seem economically rational, but taking stock of the global financial crisis of 2008, there is something to be said for ethics in finance. Islamic financiers now brag that their ethics steered them away from the risky ventures that have caused so much havoc, and will make them more attractive to investors going forward. Indonesia’s President Susilo Bambang Yudhoyono recently told a gathering of Islamic bankers in Jakarta that they must educate the West in the merits of their enterprise.

The reason, though, that all of this economic vitality around the blending of Islam and capitalism is so important for the West to take note of is that it reveals so much about the nature of the new middle class that is driving this growth, and is in turn growing ever larger and more influential. Some members of this new middle class are the children of the old haute bourgeoisie, their families tied to large, venerable industries and the type of state patronage that the West is familiar with. But a far larger percentage—and here is the key—comes from the provincial and lower social classes. These sons and daughters of the poor and the provinces who have made the jump to the middle class have done so by accepting the requirements of modern economies and latching on to the economic realities that define modernism. They have embraced the rules of the market, responding to its incentives, and are guided in their decisions by the desire to serve their economic interests. So energetic is their commitment to the capitalist credo that their activities now account for most of the real economic growth in the region. The consumerism of the general population is largely the result of their handiwork. Ambitious and resourceful, they fill the ranks of the professionals, the entrepreneurs, the corporate businessmen, and the traders. It is they who have established for the next generation a new economic model of the good life here on Earth.

The interests that this economy is creating, and the ties with the global community that it is forging, offer ample opportunities for engaging this “critical middle” that has come to be the center of gravity in one Muslim-majority society after another. In coming years, that middle is only going to get bigger, and richer: In 2007, GDP grew at an annual rate of around 6.1 percent in the Muslim countries of Southeast Asia (Indonesia and Malaysia) and the Arab countries of the Persian Gulf rim (followed by robust but slightly lower rates in Egypt, Pakistan, and Turkey). Europe and the United States, by comparison, grew at around 2.2 percent that year. In 1970, only 4 percent of the professionals in Malaysia were Muslim; today, that figure is closer to 40 percent. Since 1970, Malaysia has emerged as a success story of globalization, one of the largest exporters of electronic goods to the United States and an integral part of the global supply chain for the computer and electronics industries. Globalization and rising middle classes with big wallets—and a continuing interest in living as observant Muslims—have gone hand in hand.

The crucial aspect of this “critical middle” that is difficult for those in the West to grasp is that for this population, Islam is a powerful supporter of the drive to modernity. The great majority of Muslims think that Islam improves their lives. They want heaven later, and wealth in the meantime—and think that handling the latter well can help lead to the former. As Pope Benedict learned at the Blue Mosque, Islamic piety
is not only about things that the West fears; it is also about things that the West appreciates. This distinctive blending of Islamic values and economic vitality is a crucial development in the Muslim world that should shape our approach to building better relations with the region.

Will the Muslim businessmen of the coming century lead a capitalist revolution much as Protestant burghers did in Holland four centuries ago? We do not know yet, but it is possible. The mayor of the booming town of Kayseri in central Turkey, where many of the so-called Islamically conscious “Anatolian tigers” come from, thinks so. “I had read Weber,” he says, referring to the German sociologist who first credited Calvinist ethic for the rise of capitalism. The idea of “how Calvinists work hard, save money and then reinvest it into business” seems, he continued, “very similar to what was happening in Kayseri.” Reflecting on the words of the Prophet hanging in the Blue Mosque, the mayor of Hacilar, a deeply religious little boom town not too far from Kayseri, explained the business activity around him saying “opening a factory in Islam is a sort of prayer.” If there is going to be genuine capitalism in the Middle East, in the broad sense of the term as experienced by the West—where individuals working through markets account for growth and prosperity—it will come from these pious businessmen and not from state-led initiatives and the state-sponsored economic elites associated with them who have for much too long ruled the Middle Eastern economies.

If European history is any guide only this robust breed of capitalism will bring true modernizing change to the Muslim world. The modern world was invented by children of the Reformation, but it was not their puritanical and intolerant faith that transformed the world—far from it—but rather trade and commerce that took hold in unlikely backward corners of Europe like Scotland, home to the early Industrial Revolution and the likes of Adam Smith, David Hume, and Sir Walter Scott.

If the Middle East is to be properly integrated into the global economy, turn to democracy, give women their rights, embrace values that transcend cultural divides, and keep extremism at bay, then it too will have to be transformed by the capitalist revolution. The most decisive battle for the future in the region will not be the one over religion—in which, as we shall see, the tide has already turned against extremism. Nor will it be the growing battle over political rights, as hopeful as that is. The key struggle that will pave the way for the decisive defeat of extremism and to social liberalization will be the battle to free the markets. If that battle is won by private-sector business leaders and the rising middle class tied to them, then progress with political rights will follow.

Even in Iran, the potential for opening, and an economically led entry into the world community, is strong. As the election protests vividly revealed Iran has a dynamic civil society. Women’s right activists, students, labor unionists, journalists, bloggers, artists, and intellectuals have made up the backbone of the struggle for reform and continue valiantly to resist oppression, bad laws, and arbitrary rule, and their voices could be heard loudly and clearly during the election. During the presidency of the reformist Muhamma Khatami between 1997 and 2005, they seemed to hold the promise of being able to liberate Iran from theocratic oppression and set it on course for true democracy. That campaign and the effort to elect the reform candidate Hossein Mousavi faltered, for reasons that we will explore further later, but those who launched those movements are still around, and they still believe in freedom. The civil society that they represent grew in tandem with the private sector, relying on its economic health to energize demands for rights. For that energy to nudge Iran decisively in the direction of change and openness, private-sector dynamism must be reignited.

When China opened to the world, human rights and political reform were hardly the goals Communist leaders had in mind. In fact, booming China all too often seemed to feel that its success made it free to ignore outside pressures to yield to its dissidents, change its laws, or move in the direction of pluralism and democracy. Whatever change came to China in the form of gradual legal reform and greater civil society activism owed much to pressure from investors and traders. Deepening ties with global business forced China to change many laws and practices—to adopt what the American geostrategic writer Thomas P. M. Barnett calls the transparent modern “rule sets” of the world’s developed and well-integrated “core.” None of the changes that China grudgingly
made—often in response to embarrassing crises like scares over the SARS virus and tainted toothpaste and pet-food exports—was explicitly political in nature. Yet they represented significant progress nonetheless.

A legal system and bureaucracy forced to change in one area becomes more receptive to change in other areas as well. Fueling the activities of the Middle East's rising middle class, and working to bring the economies of the region more fully into the web of globalization, can push the status quo to the tipping point where national leaders have no choice but to embrace change and try to make the most of it. That is the key first step toward liberalization of the political systems. The road to human rights, social freedoms, and democracy runs through business growth and economic progress.

If we were to ponder how change in Iran can change the Middle East (as it did once before in 1979), and how the specter of a rising Iran could guide the region around it in a new direction we would have to conclude that things will go right when developments inside Iran align with the main trend that is afoot in the region. The strong interests of the West are in seeing Iran line up with, not against, the logic of economic change; to yield to a rising business sector and a new middle class that would change politics and religion and then amplify the same trend in the Arab world. But we are not going to be able to help Iranians get there, or leaders in the other critical nations of the region, until economics becomes as important to our thinking about policy as hard power. It is time to think less about civilizations clashing, and to recover the great insights—which lie very close to the foundations of classical liberalism and modern political thought—about the transformative power of markets and commerce. Commerce, as David Hume and the other great minds of the Scottish Enlightenment liked to point out, softens manners and makes a politics based on reason and deliberation, rather than fighting and romanticism, far more imaginable.

Through the course of this book, we will probe into the different prospects and challenges for the rising middle class in the countries whose fate is most pivotal for realizing this future in the Middle East. Some, such as Dubai and Turkey, are forging ahead at astonishing speed, while others are caught in a vise of internal contradictions, such as Iran and Pakistan. Coming to appreciate why the stories of the countries are so different, and understanding the distinctive perspective and desires of this new class will also require delving into the history of subjugation and misguided reform that has held the capitalist potential of the region down for so long. Only by developing a fresh perspective on the struggles of the region—so different from the compelling but fundamentally flawed story of an intractable clash of civilizations—will the West understand how best to engage with these countries in order to precipitate reform and vastly improved relations.
CHAPTER 1. THE POWER OF COMMERCE

1 Joshua Cooper Ramo, *The Age of the Unthinkable: Why the New World Disorder Constantly Surprises Us and What We Can Do About It* (Boston: Little, Brown and Company, 2009).


4 Personal Interview with President Mohammad Khatami, Davos, Switzerland, January 2007.

5 Personal correspondence with Robert Kaplan.


7 “To excel in today’s world,” former chief nuclear negotiator and now Speaker of Parliament Ali Larijani told the Arab Strategy Forum in Dubai in December 2006, “you have to be good in either nuclear technology, nanotechnology, or
biotechnology. The West would prefer that we just make tomato paste, but we have our sights set on being a global economic leader.”


9 Interview with Djavad Salehi-Isfahani.


16 “Understanding Islamic Finance: Local Innovation and Global Integration,” Asia Policy, 6 (July 2008): 5.


18 “Savings and Souls,” The Economist, September 6, 2008, p. 81.


20 “Savings and Souls,” p. 82.


23 “Savings and Souls,” p. 82.


33 Smith, "From Petrodollars to Islamic Dollars," pp. 89 and 106.

34 Ibid., p. 84.


37 "Gender Gulf," The Economist, April 12, 2008, p. 86.


