- LECTURE -

The History of Capitalism:

Early Islam and the Birth of Capitalism

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Anyone who sells a house and makes a profit wants to know what to do with the money they made. If they live in a city with a bull market in property, often, the sensible decision is to buy another property. This investment strategy is not new. It was already tried and tested in a city that had a booming property market in the early seventh century in Arabia, namely Medina. There, the leader of the community gave out the following advice to anyone who sold a property: "He who sells a house and does not buy another one instead, is not likely to see blessing in that money."

This is straightforward investment advice: if you make money in property, keep it in property. There is nothing unusual about this recommendation, except where it came from. The recommendation to invest in bricks and mortar is by the founder of Islam, Muhammad.

Prophets who give investment advice are in a minority. It would be difficult, for example, to imagine someone asking Jesus or Buddha what to do with their savings. But for Muhammad, giving investment advice was entirely in keeping with how he conceived his office. Islam is a religion that guides Muslims in everything they do – including in business.

Muhammad knew a great deal about investing money. He had been a merchant by profession – he had taken part in trade caravans, and for most of his business career most likely managed a warehouse producing leather goods. Muhammad was in his early fifties when he founded his community in Medina, and by then he had some four decades of business experience behind him.

Islam differs from other religions in many respects. But the one that matters tonight is how Islam – a religion begun by an entrepreneur – marked the advent of capitalism, first in Medina, then in Arabia and in the realm of Islam, and at last beyond Islam's borders, in Europe. But before we turn to that story, let me spend a moment looking at the term 'capitalism' and what it means.

Capitalism is a word used so often that one would think everyone agreed on what it means. But that is not the case. One might expect to find a definition from two economists, who come to mind as those who first explained the nature of capitalism, Adam Smith and Karl Marx. But Smith never used the term at all. And in all of Marx's books, there are only a handful of references to capitalism.

It was a sociologist, Max Weber, who pointed out that capitalism is not only a way of doing business. It is more than that, it is a mode of organising society. There is more to capitalism than accumulating goods, or building factories, or offices. A society does not need to be capitalist to manufacture products. What makes capitalism distinctive, said Max Weber, is a particular frame of mind that makes someone want to produce and trade goods. Capitalism follows from a special set of attitudes – specifically, a willingness to invest time and effort, with a view to reaping a profit in the long run.

So, ever since Max Weber, capitalism has been understood as a set of mental attitudes that shape society. But there is no agreement on when that attitude first appeared, or on what brought it about. For example, ancient Greeks and Romans built great empires, but they had no notion of capitalism. Greeks and Romans left no economic literature of note. But if Greeks and Romans did not originate capitalism, who did? Max Weber suggested Protestantism fostered capitalism. He had an example in Benjamin Franklin. When Ben Franklin said, "time is money," he explained capitalism in a nutshell. But Weber's view has been contested, because capitalism existed earlier, in mercantile Italian republics such as Venice. As to locating the tipping-point, when capitalism began, the jury is out.

This brings us back to Islam and to Muhammad and his career in business. Muhammad came from a long line of prominent entrepreneurs in Mecca, and had been a merchant in Mecca himself. He had lost most of his money when his business was boycotted, but he made it back. That fact is another aspect that separates Muhammad from Jesus and Buddha – they died poor. But Muhammad, by the time he died, was the richest Arab of his time.

So let us have a look at Muhammad's biography and family background. The standard recitation of Muhammad's biography includes the following key events: Muhammad's father had died before he was born and Muhammad, as a teenager, made a living as a shepherd; at the age of 25, he married Khadija, a lady of means; but after opponents to Islam forced him out of Mecca, he founded a breakaway community in Medina; and within ten years had united most of Arabia under the banner of Islam.

However, the story of religions and trade in Mecca did not begin with Muhammad. From the very beginning, civic life in Mecca revolved around the local sanctuary, the *Ka'aba*. In the fifth century, management of the *Ka'aba* was taken over by a certain Kossai, who claimed oversight of the *Ka'aba* for his tribe. Two families became guardians of the *Ka'aba*, the Omayyads and the Hashimites. Hashim, who gave the Hashimites their name, was a merchant who became famous because he was a trade diplomat – he signed trade agreements with Bedouins and with foreign states. Hashim's accords made caravan journeys across deserts safer and more profitable. The family had a third notable figure, Abdul-Muttalib, who led negotiations to ward off an attack on Mecca.

Kossai, Hashim, and Abdul-Muttalib were key figures in the shaping of Mecca's civic identity. Kossai set rules for managing the *Ka'aba*, Hashim struck trade agreements, Abdul-Muttalib defended Mecca against attack.

These three also mattered to the story of Muhammad, because he was their lineal descendant. When Muhammad came forward and proclaimed the need to reform religion and society in Mecca, Meccans were listening to someone whose family had played a leading role in the town's history for many generations, in religion, in trade, and in war.

Muhammad was around the age of forty when he found his vocation to preach Islam. Let us now turn to his business career up until that point.

Muhammad had to pay his way in life. His father had died before he was born, his mother died when he was six. Muhammad did not inherit a large estate, however, he inherited an asset that helped him in his career: his family was connected to Mecca's merchant elite. When Muhammad was in his mid-twenties, his uncle introduced him to Khadija bint Khuwaylid, one of Mecca's wealthiest investors, who set him up in business and later married him. Muhammad had married into money.

Muhammad was the first to unite Arabs in a single state. However, he did not proclaim a new state when he settled in Medina. What Muhammad established in Medina were two institutions that shaped the public sphere in every city founded by Muslims: first, the mosque, and second, the market. Tonight's focus is on the market.

When Muhammad arrived in Medina, the city already had four markets. When Muhammad decided to set up a new one, Medina's local residents tried to stop him. However, Muhammad persisted and inaugurated his market by declaring to his adherents:

> Let this be your market, […] and no taxes will be levied on it.
> (Ibn Shabbah, *Tarikh al-Madinah al-Munawwarah*, 1:304-306)

Muhammad wanted this market to be big. It was large enough that the saddle of a camel, placed at its centre, could be seen from the periphery. Moreover, Muhammad created a fiscal incentive to attract merchants away from other markets, because trade on this market was tax-free. No surprise, then, that local merchants resented this competitor.

When Muhammad set a fiscal incentive to attract business, it was in keeping with his general management approach. Muhammad often promoted his policies by establishing tax incentives and fiscal provisions. I will give one example: in war, a warrior who provided a horse was entitled to three times the salary of a warrior who came on foot. By offering soldiers in his cavalry triple the standard rate, Muhammad was soon able to field a larger cavalry than his enemies, one of the reasons for his military success. Fiscal incentives were germane to Muhammad's military planning.

However, my focus tonight is not on war, but on trade and commerce, and that brings me to Muhammad's framework for business. Let me spend a moment on describing what that business was.

Long before the advent of Islam, Arabs were long-distance traders who connected Europe to Asia. Traders travelled in caravans, and in Muhammad's day a caravan departing from Mecca could comprise as many as 2,500 camels.

A caravan was a highly complex undertaking; a large number of participants had to agree on a departure date, and had to make sure their goods and supplies were ready in time for that date. Something else had to be in place for all this to happen: caravans would be gone for a long time, therefore someone needed to advance the money to pay for the goods they carried, and hoped to sell. Somebody needed to underwrite the risk of a venture. In other words, caravan trade needed investors.

Muhammad's first venture was small, only two camels. Considering a caravan could number over 2,000 camels, one has a notion of how many investors and managers there must have been in Mecca. These companies were called *qirad*, and they worked much like venture capital companies do today: each partnership needed to agree on how to split profits, losses, and who should pay for expenses.

Khadija, Muhammad's wife, was one such professional investor in *qirad*s. Muhammad and Khadija were married for 24 years, so he had first hand knowledge of the issues involved in investing in *qirad*s.

In Medina, Muhammad not only established a market, he also set rules on how trade should be conducted. Let me now turn to the cornerstone of Islamic business ethics, the Koran's pronouncement:

> God has permitted trading and made usury unlawful.
> (Koran 2:275)

This is a conjoined statement and both components matter. The Koran bans activities that exploit borrowers, but endorses trade that is fair. There are countless ramifications of the Koran's ban on usury, and we cannot go through all of them. But for our purposes tonight, what matters is that the Koran approves of investments such as those made in *qirad*s.

Muhammad introduced many other important innovations in Medina. I would like to highlight one in particular, namely derestriction of prices.

Once, there was a famine in Medina, and as one might expect, the price of food shot up. Many households came under financial pressure and they turned to Muhammad for help. What they asked Muhammad to do, was to set a price cap.

Muhammad was a manager who never shied away from making tough decisions to achieve his aims. So his followers were surprised by their leader's reaction: Muhammad refused to intervene in prices set by the market. They asked him why and he explained his reasons: "Prices," he said, "are in the hand of God" (Ibn Hajar al-Asqalani quoting Anas ibn Malik, *Bulugh'l Maram*, 834). Muhammad pronounced that, even though he was a Prophet, he had no mandate to regulate prices. By implication, if the Prophet had no mandate to do that, neither did any other government authority.

When Muhammad derestricted prices on the Medina market, he threw out the rulebook of economic management that had been in place from the beginning of Mesopotamian history. Traditionally, wherever possible, government authorities prescribed prices and customers could file complaints whenever they thought a trader was charging too much. So it was a highly significant step when Muhammad said that he did not want to set prices because doing so would be irreligious.

After Muhammad died, his successors were at pains to follow Muhammad's pro-market measures. For example, Ali, Muhammad's son-in-law, once spotted a trader on Medina's market who had built a stall. Ali insisted he remove it and told him, "For the Muslims, the market is similar to the place of worship: he who arrives first can hold his seat all day until he leaves it." So every evening, traders had to remove their stalls, and every morning, the competitive field was open to anyone.

To explain why these measures matter for the history of capitalism, let me turn briefly to an economist of the twentieth century who thought deeply about the nature of markets, Friedrich von Hayek. According to Hayek, the hallmark of every capitalist society is the presence of markets. Today, we often use term "market economy" instead of the term "capitalism." As Hayek has pointed out, pro-market policies have a ripple effect on society.

When markets are free to set prices, there are consequential impacts on wider society. Markets that create wealth need legal frameworks that protect property. There also are repercussions on intellectual life: a society exposed to new products will foster a climate of academic enquiry and of individualism. The history of early Islam proceeded on a track that Hayek would have expected: prosperous citizens endowed private charities, the *waqf*s, to promote public services, and there was vigorous growth of legal scholarship taught at the *madrasa*s.

Hayek stated that free markets evolve another innovation, sound money. This happened in the late seventh century in Islam, when the caliph Abd al-Malik introduced an Islamic currency based on gold and silver. The Islamic gold coins were called *dinar*s, and the silver coins were called *dirham*s. The ancient Roman gold coin was the *denarius* and the Greek silver coin the *drachma,* so these designations show that Abd al-Malik wished to be seen as a successor to ancient Greece and Rome.

Hayek pointed out that market economies do not need governments to evolve, and he asserted a corollary – strong governments can get in the way of markets. The history of Arabia illustrates his point – Arabs created markets long before they created a state.

Let us now have a look at economies in Europe at the time. After the collapse of the Roman Empire, the standard of living across of most of Europe dropped and stagnated for centuries. Even after Charlemagne founded a new empire, economic growth did not pick up in Western Europe. Throughout the Middle Ages, the standard of living in most of Europe hardly improved.

When commerce in Europe did come to life, it did not happen in places one might have expected. One might have thought trade and commerce in Europe would take off in cities that had already been wealthy in Antiquity, such as Rome, or Ravenna, or Milan. However, none of these famous centres of power and culture became leading trade hubs. In some cases, the cities where business clustered had not even existed in Antiquity.

Let me cite an example: the history of Venice. Venice is an unlikely spot to build a city. The city is ringed by marshes and lagoons. Nobody would settle there unless they had to. Venice had a single natural advantage: it was a good place to hide.

Venice was founded at a time when Italy was overrun by Huns and abandoned to anarchy. In Northern Italy, anxious families fled their homes and looked for a place where invaders were unlikely to find them. Venice, the city that became Italy's richest trade hub, began life as a hideaway.

After the Huns withdrew, Venetians made the first of many shrewd diplomatic moves: they placed themselves under the protection of the Byzantine emperor in Constantinople. Both parties benefited from this accord; the emperor acquired a bridgehead in Northern Italy, and the Venetians received trade privileges in Constantinople.

Venice did not aim at taking control over territory. What Venetians perfected was a business model; they left it to the emperor in Constantinople to consider himself their overlord, meanwhile, Venetians concentrated on what they did best: promoting trade over long distances. Step by step, over a period of several centuries, the Venetians negotiated improved trade privileges until at last they had the right to trade throughout the Byzantine Empire. In parallel, they struck trade agreements with authorities in the realm of Islam.

In the Middle Ages, the position of Venice in Europe was similar to that, in the twentieth century, of Hong Kong in the Far East – subject of a sovereign so far away that there was no realistic hope that the city could ever be defended against a serious attack. However, no one would ever want to attack the city, because the city's trade privileges would be worthless once it no longer belonged to an empire. To leave Venice alone suited everyone.

There are some parallels between Venice and Mecca: both cities are located in barren environments, lack a fertile hinterland, and any trader setting forth on a journey had to cross an immense distance before he found a trading partner. The difference between caravans and convoys was that one crossed deserts, and the other sailed across the sea. The dangers were daunting. The Mediterranean Sea was outside government control and infested with bandits and pirates.

European governments, at times, would have liked trade between East and West to stop, but they never succeeded. Trade between Christians and Muslims went on regardless of whether their political masters were at war. Thus Venice (and cities like her, such as Genoa) accumulated trade links and trade expertise, and in the process grew rich. Emperors and kings had little to contribute to promoting trade, either for Mecca or for Venice. This may sound an odd coincidence. But it fits with what Hayek would have predicted: markets do not need governments to thrive.

And there is a corollary to that: markets may be held back where governments are strong. That is what happened in Europe. Mercantile republics on Italy's coast grew rich at a much faster pace than countries with large domestic economies. In the twelfth century, the republic of Genoa raised more taxes than all of France.

Let me turn to spin-offs of Islamic legal and commercial institutions in Europe. Those Europeans who traded with Islamic countries had immediate exposure to Islamic institutions and applied what they saw at home. I would like to highlight four innovations in Europe:

- the first, is how firms were structured,
- the second, is business studies,
- the third, is the evolution of trusts,
- the fourth, is monetary reform.

Let me start with the forerunner of firms and corporations. I mentioned that caravans in Mecca consisted of a multitude of individual ventures, where each venture was governed by an agreement between investors and managers. Convoys in Venice had a similar corporate structure. The name of these agreements was *commenda*, which offered profit-share agreements between investors and managers that were analogous to the *qirad*s used to underwrite caravans. We have documentation for such agreements dating back to the tenth century.

Another crossover from Islam to Christendom was the development of a skill set to manage a business. To run a business, a manager needs to be able to write and know how to count. In medieval Europe, levels of literacy and numeracy were very low. Many merchants in tenth-century Venice, for example, signed agreements setting an 'x' where there ought to be a signature. However, by the early 1200s, the demand for training in quantitative skills had grown, and a leading mathematician of the time, Leonardo Fibonacci, made a success of a book on commercial arithmetic. Fibonacci's book showed how to calculate fractions and rates of return. Fibonacci was a professional mathematician who came from Pisa but grew up in Algeria, where his father worked in a Pisan trade colony. Like many other European mathematicians, Fibonacci learned his mathematics from an Arab teacher.

There were also crossovers into Europe from Islamic jurisprudence. I mentioned that benefactors in early Islam endowed schools attached to mosques, called *madrasa*s. The purpose of the *madrasa*s was to train lawyers. European organisations with a presence in the crusader states, the Knights Templar and the Franciscan Friars, had first-hand exposure to how these institutions worked, and they played a key role in replicating them in Europe.

The Knights Templar were key to establishing London's Inns of Court. One high-ranking English official of the time, with close ties to the Knights Templar, Walter de Merton, endowed Merton College in Oxford. The statutes of Merton College are an early example of a new form of legal entity in Europe, what we now call a trust.

Let me recap briefly how a trust is structured. A trust needs three parties: first, a donor, who hands over assets that make up the trust's endowment; second, a manager, who is at arm's length from the donor; and third, a trust needs to nominate the intended beneficiaries and what they are entitled to.

In Common Law, the trilateral structure of a trust was a novel legal concept. But it had a precedent, namely the Islamic *waqf*. Trust law in England was established in many test cases, and the plaintiffs in these cases were often members of the Knights Templar or Franciscan Friars. Considering Franciscans had a greater presence in Islamic countries than any other religious order, this can hardly be coincidental.

A fourth example where Europeans followed an Islamic template is monetary reform. Until the 1200s, the sole issuer of gold coins in Europe had been the Byzantine Empire. However, after issuance there stopped, several parties tried to fill the gap. In Europe, the first three states that launched their own gold coins were Venice, Sicily, and Genoa.

So we have Islamic antecedents for a host of institutional innovations: how to establish a company, advance business studies, found colleges and trusts, and launch a gold currency.

This begs a question. The mere fact that Europeans took longer to make certain discoveries does not quite prove that they depended on Islamic models to make them. How can we claim that Islamic templates provided the inspiration for these innovations?

To answer that question, let us look at who the innovators were. Then, we see a pattern. Leonardo Fibonacci, the Knights Templar, and the Franciscan Friars – they all had exposure to Islamic approaches to managing institutions. Next, let us have a look at the centres where innovation occurred. The vanguard of commercial progress was not in political power centres, not in Rome or Paris, but in cities with the best trade relations with Islamic countries, in Venice and Genoa. The agents of change in Europe were innovators who had insight into Islamic practices. Venice and Genoa had a competitive advantage because they had close trade links with the realm of Islam.

The pattern of commercial innovation, kick-started by entrepreneurs who take the risk of investing, that then spreads to promote advances in law and economics, not only replicated the pattern that we saw in the early Islamic Empire – it also conformed to what Hayek would lead one to expect: social progress originates in markets, rather than from government actions.

A word about the loss of dynamism in Islamic economies. There were several reasons for this. One was the discovery of new trade routes that bypassed the Middle East. The Portuguese sailed around Africa to reach India and trade with Asia bypassed the Middle East. The Spanish sent out a fleet that sailed to the Americas, and across the Atlantic new markets opened up offering bigger opportunities.

However, another reason was of Islam's own making. Islam reached a point where it was thought that everything which was unclear in the Koran had been settled. From that moment, the drive to discover and innovate drained away.

Let me wrap up my talk. For the sake of heading off misunderstanding, let me state the obvious: Islam is a religion, and a religion cannot be reduced to an economic system.

However, Muhammad also had a seminal impact on changing economic systems in the Middle East, and there were second-round impacts on economies in Europe.

I began my talk by quoting Muhammad's advice on property investment. And I pointed out that Arabia, prior to the advent of Islam, was a commonwealth that did not have a single government, and did not need one to develop markets. Many aspects of that legacy were carried over into Islam. Early Islam promoted pro-market policies, and framed institutions that supported entrepreneurs. Following from these, there were advances in law, economics, and the creation of a gold currency. The same pattern emerged when Europeans copied these innovations: markets developed on the periphery of European empires, not at their centre.

When Muhammad pronounced, "prices are in the hand of God" he expressed a notion which corresponds with Adam Smith's concept of the "invisible hand" that guides markets. The anthropologist David Graeber has noticed a "striking resemblance" between the notions of Adam Smith and Muhammad. What Adam Smith and Muhammad have in common, in my view, is that both overturned conventional wisdom on how to regulate markets. If Adam Smith, who asserted that an "invisible hand" guides markets, is considered the father of market economics, then, in my opinion, somewhere in the family tree of economists, there ought to be a place for Muhammad.

Ladies and gentlemen, thank you for your attention.