

GLOBAL FINANCIAL CRISIS: IS THERE A REMEDY

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ABSTRACT

In this paper we seek to assess the stance of Islamic perspective with respect to global financial crises. The paper examines the adopted remedies and actions that deal with the current global financial crisis and evaluates them from the perspective of Islamic finance. The significance of tackling with this issue at this particular time is that there is general agreement among the economists, financial scholars and financial experts about the causes and consequences of global financial crises. However the search for the solution thus has proved to be mission impossible and remains the subject of an international debate. So in this paper efforts have been made to prove that Islamic finance is well endowed to deliver noteworthy contributions towards a more healthy and stable international economy. The paper has argued that an honest implementation of Islamic theory of finance is potentially capable of solving, and in all probability averting, such crises from happening — simply because most, if not all, of the factors that have caused or contributed to the development and the spread of the crisis are not allowed under the rules and guidance of Shariah.

Keywords: Global Financial Crises, Islamic Finance. Financial Scholars, Islamic Theory, Shariah

INTRODUCTION

Many of today's problems derive from the fact that the world in which we live has rapidly shrunk to become a global village. However the pace at which the technology has created this global village has been far ahead of the human competence to adjust the changing scenario and as a consequence of that human life has gone suffocating and is cramped for time and space. In the contemporary postmodern and post-industrialization era human life has taken on to itself a materialistic connotation and as humans we have been left to no better than a machine which is relevant as long as the productivity is high and the depreciation least. These suffocations, instability and volatility have affected all realms of human life socio-economic as well as political. So much so that, the economic system of the world have become erratic in consequence of the human activities aiming at quick returns from investments, as is evident from repeating crises associated with the nations like USA, Euro-zone nations etc. These crises manifest itself repeatedly and the recent one being the global financial crises starting early 2007. The crisis threatened a worldwide economic recession, potentially bringing to a halt more than a decade of increasing prosperity and employment for western economies and potentially wiping a staggering \$1 trillion off of the value of the world economy. (Boeri and Luigi, 2008)

As such there is general agreement among the economists, financial scholars and financial experts about the causes and consequences of global financial crises. However the search for the solution thus has proved to be mission impossible and remains the subject of an international debate. Should governments intervene in markets or should the solution be left for the market to find out? Government bailouts of existing banking system neither present long term solution to the problem nor give assurance of evading a recurrence. Recent Spats of global financial crises have invalidated the augment promoted by free market advocates that “markets are efficient on their own” and market forces are capable of managing and correcting market inefficacies in which should they arise.

This paper is an attempt to search for alternative adjustments in the existing financial systems across the globe. Based on diverse opinions collected from various world financial news, and research articles it attempts identifying factors that in essence had led to the outbreak of the financial crisis. Carrying out systemic analysis of the causes of the crisis and measuring these causes against the intrinsic principles of the Islamic financial system reveals that such crisis are not inevitable and can be avoided by following the basic principles that make the Islamic financial system.

Financial Crises

Financial crisis broadly refers to disruption in financial markets causing constraints to the flow of credit to families and businesses and consequently having adverse effect on the real economy of goods and services. The term is generally used to describe a variety of situations in which investors unexpectedly lose substantial amount of their investment, and financial institutions lose significant proportion of their value. Financial crises include, among others stock market crashes, financial bubbles, currency crises, and sovereign defaults. The world has known several financial crises over the course of history, particularly in the 20th century, starting with the crisis of 1930-31, followed by the oil price boom in the 70's. Apart from these major breakdowns in the economies, the normal cyclical nature ups and downs in the form of balance of payment crises, inflation, over productions, low economic growth rates, etc. Although, normally all these uneven economic happenings does not coexist in cyclical manner and shakes the global economy as was seen in the 2007_08 crises and another global shaking form of crises came in the form of Euro Zone crises. These crises are of major concern for not only for economies which are the main centres of these crises but for those in developing countries having highest marginal utility for every penny of the currency.

The crisis of 2008 was undoubtedly the deepest and most widespread crisis of the era that shook world economics. Starting in the US from an overproduction of housing goods, it quickly developed into a mortgage crisis, infecting the financial sector, leading to cutting expenditures, decrease of income, growing uncertainly and high unemployment rate. As Ershov suggests, although the epicentre of the crisis was the household sector, the primary source of risks and panic was rather the financial sector endeavours of so many talented academicians, policymakers, and researchers especially in the west; the reasons behind these crashes still remain unexplored. After almost 25 years nobody has a solid answer regarding the reasons behind one of the spectacular stock market crashes of black Monday in 1987. The recent credit crunch and subsequent stock market crashes across the globe reveal that such madness has no remedy in the existing modus operandi of the economic systems. (Ershov, 2010, p. 39). According to IMF (international monetary fund), the world has witnessed more than 100 stock market crisis in last 30 years. However, with the endeavours of so many talented academicians, policymakers, and researchers especially in the west; the

reasons behind these crashes still remain unexplored. After almost 25 years nobody has a solid answer regarding the reasons behind one of the spectacular stock market crashes of black Monday in 1987. The recent credit crunch and subsequent stock market crashes across the globe reveal that such madness has no remedy in the existing modus operandi of the economic systems.

Causes of Financial Crises

Although it is difficult and impartial to pin point only one factor responsible for the financial crises, but one can rightly argue that the lending standard adopted by the conventional financial institutions is one of the major cause responsible for the crises. These institutions driven by greed and appetite for higher returns with absence asset holdings and government control. (Kayed and Hassan, 2009)

Financial crises are generally linked to easy credit, excessive debt, speculation, greed, fraud, and corruption. Easy credit leads to lack of adequate market discipline, which in turn instigates excessive and imprudent lending. There are several factors contributing in these financial *crises as*;

The generally recognized most important cause of almost all crises has been excessive and imprudent lending by banks(1). This raises the question of what makes it possible for banks to resort to such an unhealthy practice which destabilize the financial system but . There are three factors that make this possible. One of these is the inadequate market discipline in the financial system resulting from the absence of profit and loss sharing (PLS). The second is the mind-boggling expansion in the size of derivatives, particularly credit default swaps (CDSs), and the third is the “too big to fail” concept which tends to give an assurance to big banks that the central bank will definitely come to their rescue and not allow them to fail.(Umer Chaper 2008)

Financial markets have been driven by greed that has torn down the world’s financial system. Speculation has reached intolerable levels. The intense competition and shareholders demands for higher returns have encouraged excessive risk taking and lured banks to extend their credit to unworthy borrowers who normally do not qualify for loans under prime lending criteria. In many cases loans were approved without proper evaluation of loan applications or the credibility of the applicants. The nature and the means of delivery of the interest and debt-based conventional banking have caused the financial system to be completely “split-off from the real economy”. Deals and transactions have been concluded and executed on papers, and what have been sold and bought was of no real or economic value (Spiegel 2008). Poor enforcement and easy credit made it easy for lenders to sign off as many as loans of the borrowing agencies as they can.

Wilson (2009) argues that the existence of the sub-prime borrowers was also a major cause of financial crisis. Sub-prime borrowers are characterized by default on mortgage obligations, previous credit, low income hence inability to repay substantial mortgages and insufficient coverage of health insurance. Moralists have questioned the finance rationality of high return concept, which justified charging high interest rate to low income sub-prime borrowers and low rate to high income, rich credit worth borrowers.

The Credit Default Swaps (CDS) was another instrument which became responsible for financial crises “An interesting paradox arose, however, as credit derivatives instruments, developed initially for risk management, continued to grow and become more sophisticated

with the help of financial engineering, the tail began wagging the dog. In becoming a medium for speculative transactions, credit derivatives increased, rather than alleviated, risk.”

The false sense of immunity from losses that all these factors together provide, has introduced a fault line in the financial system. Banks do not, therefore, undertake a careful evaluation of the loan applications. This leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, and to an unsustainable rise in asset prices, living beyond means, and speculative investment. Unwinding later on gives rise to a steep decline in asset prices, and to financial fragility and debt crises, particularly if there is over indulgence in short sales. Jean Claude Trichet, President of the European Central Bank, has rightly pointed out that "a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds"

Islamic Overview

The current global financial crisis has accentuated the urgent need to embark on one of the most radical reshape of the international financial system. The attitudes and the approaches articulated by the advocates and the opponents of both government intervention versus free market economies schools of thought thus far have failed to deliver a viable long-term solution to the crisis or to prescribe a practical mechanism on how to deal with its consequences and implications. So, has the time come to seek out alternatives? As such the financial system that has over the time given birth to this state of affairs needs to be revisited. If there is a scope of rectifying it, that need to be done otherwise it needs to be shunned and a new system which is free of such vices has got to be advocated and put in place. Of the alternatives available to us at this moment. Rules and regulations laid down in SUNNAH AND SHARIAH are the best remedy. It is this set of financial code that has come to be known as the Islamic financial system.

Islam is the complete way of the, and Allah’s guidance extends into all areas of our lives. Islam has given detailed rules and regulations not only for the social and political point of view but also an economic system which is balanced and fair. The Quran opens with the verse, “All praises belong to Allah, lord of all the worlds.”(Q1:2). This presents the unified concept of humanity and of the universe. The message of Islam is not confined to any particular section of mankind. It embraces the whole of mankind and the entire universe. Say, “O mankind! Truly I am a Messenger to you all from Allah belongs the heavens and the earth. There is no God, but He. He gives life and He causes death...(Q&:159).

Islamic financial system is the financial system that operates with the Sharia (2) (principle of Islamic law). It is one of the fastest growing segments of today’s banking industry. The world financial system suffered for too long under conventional (Riba) based banking system. The world in searching for an alternative is “hungry to hear the message loud and clear”. Islamic finance is an asset based system. Money in itself has no intrinsic value. The prohibition of paying and receiving fixed, predetermined rate of interest is crucial in Islamic finance. The sale of debt and speculation are not allowed. In the conventional financial system risk is transferred and sold while in Islamic finance it is shared like collective insurance scheme. Ethics and social responsibility are pillars to Islamic finance. (Md. Al-Mamun & Abdul Hanana , 2012).

The most salient values of Islamic finance are fairness, socio-economic justice and its uncompromising commitment towards the well-being of future generations through the

caring for the environment and preserving earth's valuable resources. Accordingly, Ibn Taymiyyah (3) a highly respected scholar says: "Hence, justice towards everything and everyone is an imperative for everyone, and injustice is prohibited to everything and everyone. Injustice is absolutely not permissible irrespective of whether it is to a Muslim or a non-Muslim or even to an unjust person".

No doubt, Riba (interest, and usury) and Maysir (gambling, and speculative activities similar to gambling) are the major factors leading to the current financial crisis. Islam's prohibition of Riba and Maysir along with Islamic values and morals, and recognizing others interest in one's economic fortunes, if adhered to, could not have lead the world to the present day financial crisis. Islam considers interest institutions as the most exploitive institutions for humanity and has abolished its roots and branches and its every form and manifestation. The Holy Quran has condemned Riba very severely. The Quran says in the chapter The Cow (*Baqarah*) very emphatically, "Those who devour usury will not stand except as stands one whom the Evil one by his touch hath driven to madness. That is because they say: Trade is just like Riba, whereas Allah permitted trade and forbade Riba. The one to whom an admonition from his Lord comes and he refrains (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returns (to usury), such are rightful owners of the fire. They will abide therein eternally....O ye who believe! Observe your duty to Allah, and give up what remained (due to you) from usury, if ye are (in truth) believers. And if ye do not, then be warned of war (against you) from Allah and His messenger" [Al-Baqarah: 275, 277-78]. According to al Quran taking of interest tantamount to war against God and his Apostle, while according to Prophet Muhammad (PBUH) interest is the worse than adultery. Islam builds its economy on interest free basis and promotes profit and partnership as incentive for saving and investment.

The 1988 Nobel Prize winner, French economist Maurice Allais (4) has foreseen the inevitability of current structural global economic crisis and warned against its consequences. He categorically argued that the way out of such crises is best achieved through structural reforms that go far beyond addressing the symptoms of the crises to devising an efficient monetary system that is truly capable of preventing such crises from happening in the future. The two basic components at the heart of the proposed system are adjusting the rate of interest to 0% and revising the tax rate to about 2%. Incidentally, these are the core elements of Islamic economics; Islam prohibits interest (*riba*) and requires all Muslims who possess minimum net worth above their basic needs (*Nisab*) to pay *Zakah* (2.5% of the assets that have been owned over a year). *Zakah* is a major economic instrument premeditated to spread socio-economic justice amongst Muslims. Unsurprisingly, the US reserve has just announced the cut in lending rate to be between 0% and 0.0025% and the demand for meaningful tax cuts is building up.

The principle of „no pain no gain“ embedded in the Islamic financial structure entails that no one has the right to rewards (profit) if they do not equally share the risk of incurring loss. Chapra (2009) believes that this concept “should help introduce greater discipline into the financial system”. Realizing the affirmative linkage between sharing the profit and sharing the risk involved in any business transaction undoubtedly would motivate financial institutions to adopt a more cautious approach to lending and careful underwriting practices. Being a partner, rather than merely a lender, compels the financier (lending institution) to assess risks more carefully and to effectively monitor the use of funds by the entrepreneurs (borrower). The double assessment of risks by both the financier and the entrepreneur

“should help inject greater discipline into the system” and restrain excessive lending and borrowing as well (Chapra, 2009).

Derivatives which have the important role in financial instability and the crises. Islam has therefore, clearly prohibited such transactions because of interest and gambling. Ahmad narrated “the Prophet(PBUH) prohibited two contracts (safqah) is one contract. Abu Dawud narrated that the Messenger (pbuh) said: “Whoever sells two sales in a sale, for him is the lesser (awkis) of the two or (it is) riba” If one of the contractors said to the other, ‘I sold you my house for one thousand upon your selling me your house for one thousand’ and he says, ‘I have accepted’ in this one sale contract there occurred two sales which is not permitted since the Prophet (pbuh) prohibited two sales in a sale and two agreements in one agreement.

Unrestricted economic freedom *as* is evident from the unregulated US financial markets became a major cause of financial crises is a feature of capitalistic economy. This economic freedom generally leads to earning of wealth through foul means such as gambling and prostitution, and encourages smuggling, black marketing, hoarding etc. Thus a mad-race for earning wealth becomes order of day and high social and moral values such as fraternity, brotherhood, mutual help, and love give place to selfishness, callousness, hatred etc. In contrast to this Islam allows economic freedom to an individual who is at liberty to earn wealth, own it and spend his wealth at his discretion. But the freedom given by Islam is not unlimited. Allah says in Quran, “O mankind! Eat of that which is lawful and wholesome in earth; follow not the footnote of the devil. Lo! he is an open enemy to you.”(2; 168). The Islamic regulatory control system stipulates that potential investors and all stakeholders are cognizant of opportunities and risk in the business contracts. Risk must be explicitly communicated to all stakeholders, and financial institutions are under obligation to conform to comprehensive disclosure and transparency standards.

The rules of *Shariah* unconditionally prohibit Muslims from taking part in any transaction that might involve fraudulent, dishonesty, exploitation, and ambiguity “Woe to those that deal in fraud” (The Holy Qur“an, [Al-Mutaffifin] 83:1). The Prophet Mohammad (Peace Be Upon Him, PBUP) emphasised the significance of honesty, specifically in business dealings. Ibn Majah narrated that the Prophet (PBUH) said “if anyone sells a defective article without drawing attention to it, he/she remain under Allah“s anger”. These noble values are treasured and shared by many Muslims as well as non-Muslims who insist in investing in social responsible portfolios despite the fact that such investment might have a lower rate of return. Therefore, it would be fair and sensible to claim that each and every financial activity that complies with the *Shariah* rules and guidelines is a socially responsible activity.

Islamic finance is based on equity capital rather than debt. Lending transactions are based on the concept of assets backing. Consequently mortgage loans under such system would have been backed by solid asset structure that safeguards the banking industry against possible loan defaults. The enormity of loan defaults, should they occur within Islamic financial setting, will in no way threaten or compromise the health and proper functioning of the banking system. In the present crisis, trillions of dollars have been trading without backing of assets. One can strongly argue that the current financial crisis would have been prevented if such transactions were conducted in conformity with the Islamic finance model, where “virtual money” has no place in its accounting books. Islam preaches „moderation“ in all aspects of Muslims“ lives, and commands Muslims to live within their means. Therefore the

majority of Muslims would not have rushed to draw loans that they are in no position to repay – just because an opportunity has arise.(M. Kabir Hassan)

Md.Al-Mamun (2012).Islam's monetary policy is centred on a legal tender based upon the gold and silver standard and not one based upon paper standard for interest rates to regulate inflation and the economy. In Islam when it comes to exchanging a commodity with a specific monetary unit, Islam has guided Muslims to the monetary unit by which the exchange is to take place. Unlike today Islamic system doesn't allow to print any amount of money and no fractional reserve system. Thus historically during the time of Ottoman Khilafah (the Islamic System of governance) from the year of 1507 to 1589, an inflation rate of only 7% has been observed over eight decades. Moreover, Islam does not have a concept of income tax; value added tax, excise duties, nor national insurance contributions. Rather Islam puts the emphasis of taxation on wealth rather than income. This helps the citizen to reduce their financial burden.

CONCLUSION

Thus Islamic financial system is capable of minimizing the severity and frequency of financial crises, by getting rid of the major weakness of the conventional systems. It introduces the greater discipline in financial system. It promotes the economic development through real credit expansion and overcomes the individuals from the illusionary or temporary development complexity of products that have been created by intermediary players who sought to pass the entire risk of default to the final purchasers. Facilitated by financial globalization, the collapse of some US financial institutions associated with the subprime mortgage scheme activated systemic risk across national boundaries causing the current global financial meltdown. This paper neither can claim to have suggested an easy way out of the current global financial crisis nor to have presented inclusive answers to the many questions it has raised. However, evidence at hand strongly suggests that Islamic finance is well endowed to deliver noteworthy contributions towards a more healthy and stable international economy. The paper has argued that an honest implementation of Islamic theory of finance is potentially capable of solving, and in all probability averting, such crises from happening — simply because most, if not all, of the factors that have caused or contributed to the development and the spread of the crisis are not allowed under the rules and guidance of *Shariah*.

NOTES

1. This is clearly recognized by the BIS in its 78th Annual Report released on 30 June 2008 by stating that the fundamental cause of today's problems in the global economy is excessive and imprudent credit growth over a long period (p.3).
2. Sharia , the divine rule by the almighty for human prosperity and welfare 'Islamic law' is the usual meaning translation, but the meaning is broader . Sharia's ; the set of rules which govern behaviour of Muslim in all realms of life , from internal states of heart and personal affairs to social and political and global affairs . These rules may be directly specified in Islamic source materials, or else deduced from such sources.
3. Taqi ad-Din Ahmad ibn Taymiyyah (January 22, 1263–1328 CE) was an Islamic scholar (*alim*), theologian and logician. He lived during the troubled times of the Mongol invasions. He was a member of the school founded by Ahmad ibn

Hanbal and sought the return of Islam to what he viewed as earlier interpretations of the Qur'an and the Sunnah.

4. Prize was awarded to Maurice Allais “for his pioneering contribution to the theory of markets and efficient utilization of resources”. See (Winners of the Bank of Sweden Prize in Economic, 2008).

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