Current Financial Crisis and Islamic Economics*

Mohammad Nejatullah Siddiqi**
Formerly, Distinguished University Professor
International Islamic University, Kuala Lumpur, Malaysia
<mnsiddiqi@hotmail.com>

Introduction

The current crisis emanating from US financial markets and spreading to other developed and fast developing countries like China, India and Brazil, is threatening a global meltdown leaving the entire world poorer and full of forebodings regarding future. It started as a credit crunch due to highly over-stretched leverage, was aggravated by the complexity of the products and reached its zenith

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** After completing PhD from the Aligarh Muslim University, India (1966), Dr Siddiqi has taught Economics in various capacities at the Aligarh Muslim University, India; King Abdulaziz University, Jeddah, Saudi Arabia and University of California, Los Angeles. He has served as a Visiting Scholar at the Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, and as a Distinguished University Professor at the International Islamic University, Kuala Lumpur, Malaysia. He has written widely on the subject of Islamic Economics and has to his credit 16 books in English, 13 in Urdu and 7 in Arabic, along with 64 papers in academic journals. His works have been translated into several languages of the world. He is on the Editorial Advisory Board of a number of professional journals. He was awarded the King Faisal International Award in 1982 in recognition of his contribution to Islamic studies; American Finance House Award in 1993; Shah Waliullah Award for 2001 by Institute of Objective Studies, New Delhi.

due to moral failure generating conflicts of interest and mismatch between incentives of the various groups and individuals involved in the saga.

Islamic economics stands for abolition of *ribā* and *maysir* in financial dealings as well as a regard for the interest of others in one's pursuit of material gains. The purpose of this brief paper is to examine the relevance of Islamic economics today. Does it have a message for humanity insofar as its current financial problems are concerned?

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In what follows we first outline the broad features of the crisis under the four headings noted above, trying to establish the thesis that most of them are rooted in a moral failure that leads to exploitation and corruption. This would be followed up by an explanation of *ribā* and *mysir* that equates them to bank interest and gambling-like speculation based on risk shifting as distinct from risk sharing. It will be argued that debt-finance coupled with speculative products whose intricacies defy understanding provide ample opportunities to greedy profit-maximizing agents to exploit the aspirations of ordinary investors and for goading home owners and consumers into living beyond their means and chasing untenable dreams. Even the calls for more and more deregulation, and the philosophy of non interference with financial markets have [im]moral dimensions. There is a hidden agenda behind this call.[1] Though they swear by the name of efficiency and innovation, the champions of deregulation and *laissez faire* have their self interest in view, not the social weal. In conclusion a world of banking and finance without *ribā* and *maysir* will be suggested as the best alternative to the current scenario. In this new environment risk sharing will replace risk shifting and morality, advising people to be moderate in their material pursuits and considerate about public good in their private decisions, coupled with realism, will serve as the corrective to self-destructive outgrowths of current financial capitalism. It will be noted that for

1. See, Joseph Stiglitz and Bruce Greenwald, *Towards a New Paradigm in Monetary Economics* (Cambridge: Cambridge University Press, 2003), p. 206.

this alternative model to be robust and resilient, morality has to be rooted in spirituality. This will provide a basis for willing acceptance of social norms, state supervision, regulation and intervention in the market based on values rather than interests.

The Economics of Current Crisis

We begin with the fourth element of the crisis noted above, i.e. moral failure and a mismatch between the incentives of various players in the financial arena. The reason: some of the other elements of the situation described above are partly a product of this factor. Currently, financial institutions include banks, investment companies, insurance companies etc., managed by hired professionals. Those who govern financial conglomerates by virtue of owning enough shares have motives different from ordinary shareholders. Almost the entire population in developed countries is involved in supplying capital through purchase of stocks, bonds, insurance policies, pension funds, etc. While these 'principals' are interested in profits they care about many other things too, among them stability, jobs, social justice, and anxiety free communities. Not so the hired managers who consider profit maximization to be their mission as it earns them maximum bonus and continued employment. There are those amongst middlemen who earn fees. They earn more when transactions multiply. In an environment where no one cares about others, focused as everyone is on his or her own interest, public interest is supposedly guarded by regulators. How can the same self-focused assembly of individuals throw up regulators who would work to protect and promote public good remains a moot question for neo-classical economics. An answer to this question is, however, provided by the public choice school: public servants too, elected as well as appointed, seek to maximize private gain!

Those who govern financial conglomerates by virtue of owning enough shares have motives different from ordinary shareholders.

Without committing myself to this rather bleak view of man in society, I suggest that we embark upon a discussion of the first three factors from the vantage point provided by this very view. It means I regard *maysir*-infested financial products [like CDS, Credit Default Swaps], the inverted pyramid of debts [with a slender base of real assets] and the dearth of liquidity…, all the remaining three features of the current situation, to be rooted in the moral failure briefly described above. It could have been different. The reason it is what it is can be found in the denudation of economics from morality after the secularization of society in the wake of enlightenment. Islamic civilization has the instruments to pre-commit man in society to certain values leading to rules, for example, abolition of interest (*ribā*) and gambling (*maysir*), that guard the society from falling prey to short sighted predators. I proceed to elaborate taking the above-mentioned elements of the crisis one by one.

Casino Economics and Human Welfare

What is wrong with gambling? Firstly, gambling does not create additional wealth. Games of chance only transfer wealth from its (losing) owners to new (winning) ones. Considering the human resources consumed in the process, wealth transfers through games of chance cannot be considered to be efficient. They do not serve any social purpose. The satisfaction and thrill they provide to the players do not justify the opportunity cost involved. Other exonerating circumstances like the revenue to state in form of taxes or employment generated by casinos, lotteries, etc. cannot be considered as 'advantages' until the acceptability of gambling itself is established.

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I argue that risk shifting is gambling. One who buys risk exchanges a definite amount of money (the price) for an uncertain amount of money, whose delivery itself is not certain. Credit Default Swaps are an appropriate example. The millions of loans made by a bank are each subject to the risk of default (credit risk) in various degrees. As Joseph Stiglitz and Bruce Greenwald have rightly pointed out credit is not homogenous like money.[2] The risks attached to each loan are

2. See, ibid., p. 271.

unique. The institution undertaking to pay for all defaulters among, say a million borrowers has no scientific basis for measuring the risk it is taking. There is no long history to fall back on. The law of large numbers does not apply. It is just taking chances, gambling. The banks that so protect themselves against credit risks are emboldened to give more and more loans. That is how aggressive lending policy gained an impetus. The sub-prime mortgage crisis would not have occurred without the speculative deals like CDS. Aggressive lenders offered to refinance mortgages on the basis of rising home prices, virtually converting owned homes into ATM machines, sending people on a buying spree, some of it on instalment purchase basis, encouraging an expansion that had little basis in the fundamentals: earning powers, disposable incomes and savings and investments.

The Islamic approach to risk is realistic and cautious. It does not allow deals involving excessive uncertainty (*gharar kathīr*). It encourages sharing arrangements for facing risks. The additional wealth created with the use of existing wealth through risky ventures should be shared between fund users and fund owners while both bear the risks involved and the resulting losses. Differences in the participants' perception of risks involved will be decisive in determining the terms of bargain between those sharing risks. Even though the motive of each party is making profits, it is very different from taking chances in gambling. There is real wealth to be created, real gain to be reaped. It is different in case of risk shifting [as in CDS]. Neither the buyer nor the seller of risk has any stakes in real wealth creation. As in gambling only one party actually gains, either the seller of risk or the buyer. It is different in risk sharing in which both parties gain (or lose). Like gambling, risk shifting is a zero sum game.

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Risk sharing fits in with a system that integrates risk management with value creation. The Islamic institutions of *mushārakah,* and *muḍārabah*, for example target value creation and are good ways of managing risk. In a healthy venture fear of loss works to counter-balance hope for gain. When a system allows shifting the risk (at a cost) the fear factor becomes inoperative insofar as the seller of risk is concerned. It is worse when the government takes over the risk (as in case of Fannie Mae and Freddie Mac in USA). Such a system is heavily tilted towards the rich and leads to greater inequality as it protects the lenders but leaves the borrowers to fend for them selves. This is the feature of the current system that lead to an almost universal cry that it amounted to privatizing gain and socializing pain—profits go to the corporations, losses are borne by the taxpayers.

As an aside take a minute to ponder over the Islamic approach as encapsulated in *āyāt* 278–281 of the second *Sūrah* of Qur'ān:

> Believers! Be conscious of Allah and give up all outstanding interest if you do truly believe. But if you fail to do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the right of return of your capital; neither will you do wrong nor will you be wronged. But if the debtor is in straitened circumstances, let him have respite until the time of ease; and whatever you remit by way of charity is better for you, if only you know.[3]

In effect the above is an advise from Allah the Almighty All Wise as how to handle a crisis caused by default. A crisis like the sub-prime crisis in US (if it ever occurred in an Islamic interest free system based on risk sharing) would be handled not by extending credit to lenders but by giving more time to borrowers and writing off some of the debts.

Credit without Credibility

The primary concern of the lending institutions is making money that comes in the form of interest on outstanding loans.

Over extended leverage, outstanding credits amounting to an ever-increasing multiple of existing capitals of the relevant institutions, is a direct result of financing through interest bearing debts. The business of lending to thrive requires continued expansion of credit. After all, the primary concern of the lending institutions is making money that comes in the form of interest on loans outstanding.

3. The Qur'an 2:278–81.

Every loan recovery kills an existing income stream, every loan extension generates a new income stream. With credit defaults swaps available and insurance companies like AIG supposedly providing cover, sub-prime lending looked attractive. The rest of the story is well known.

Debt financing of productive enterprise amounts to preferring risk shifting to risk sharing. This is immoral as well as counterproductive. The environment in which productive enterprise takes place does not guarantee creation of additional wealth. It is only a probability. The lender's demand for a guaranteed positive return to the sum lent is unfair. Actually it cannot be met at the macro [i.e., society's] level in the long run. Some enterprises do fail. Some others end up without any positive return to capital invested. Repayment in these cases can come only from old wealth already existing when the debt financed new projects were launched. Repayment of the borrowed sum with interest added, by those whose ventures failed to create wealth, causes a transfer of wealth from the entrepreneurs to the owners of money capital who would not share risk yet want a return. Putting producers/innovators at a disadvantage as compared to those having money to spare does not bode well for society. Easy money for those who have contributes to a life style at the top of the wealth pyramid that creates problems at its bottom. Society can continue meeting its debt obligations as long as there is growth at an accelerated rate. But the planet earth, its ecology, environment and resources are not designed for limitless growth. Deterioration in environment, increase in inequality, and social tensions are direct results of heavy reliance on debt finance.

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The problem is aggravated when monetary expansion too takes place in the form of interest bearing debts, as is the case with the current monetary system. In order for new money to come in circulation a loan must be given, a new debt must be created. For every loan to be paid back with interest, borrowers need more money than they have. This additional money leads to additional debts, and so on. As pointed out in the previous paragraph the debt imperative creates a growth imperative that contributes to the destruction of the ecosystem.

Selling Debts

Some debt financing has always been part of the financial markets. Even in hey day of Islamic civilization trade credit, a form of debt financing, thrived. Islam has no problem with that as it fits in with prohibition of exchanging money now with a larger amount of money after a period of time. The problem starts with sale of debt, whether created by a money loan or owed as a price of goods sold on credit. Sale of debt is allowed at par or face value. But there can hardly be a market for exchanging debts at par. You have a market for debt when bond [i.e., debt] prices are determined by supply and demand. Sale of debt implies selling risk [or shifting risk]. A thriving market for debts at prices determined by supply and demand [as in conventional bond markets] is vulnerable to gambling like speculation as there exists no objective basis for measuring risks of default. The changing prices reflect changing subjective perceptions of the risks involved. As is well known these perceptions can sometimes be manipulated through planting stories in the media.

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Remarkably, a ban on selling debts would drastically reduce the outstanding volume of debt. In effect it would scale down the volume of outstanding debts to the level of existing real assets. The inverted pyramid of debts, standing on a slender base of real wealth, would be replaced by a rectangular column of debts, owed against an equal amount of real goods and services acquired. The volatility in the bond market is directly related to the total volume of bonds. The larger the volume of debts, the weaker its connection with real wealth, and the more the scope for gambling-like speculation.

Derivatives

Derivatives also involve excessive uncertainty. They facilitate managing certain market risks (related to prices, rates of exchange, etc.). Chance remains the basic element in the situation, however, expectations being based on pure speculation. Derivatives too are a zero sum game: you lose what I gain, unlike the win-win situations in trade or risk sharing. The claim that they increase liquidity and improve operational market efficiency in financial markets remains unsubstantiated. What can be empirically established is that, whatever the initial benefits for a certain class of investors, availability of derivatives invites speculative activity. This is evidenced by the fact that currently the volume of derivatives being traded stands at many times the world GDP. The market for derivatives literally becomes a casino.

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The Nature and Role of Liquidity

The demand for liquidity increases with expansion of credit. The current liquidity shortage is rooted in over extended leverage. Unbridled risk taking as in sub prime mortgage, results in lack of trust in the stability of the current prices as well as in defaults leading to strains on bank liquidity. The situation leads to a decrease in peoples' confidence in the banks, resulting in widespread withdrawals. Pouring in more cash in the system could be more effective if it were to be given to the ultimate debtors—consumers, small businesses, poor home owners, etc.—who would then use it to meet their financial obligations or engage in new purchases. As it works in the current system it is given to the banks and insurance companies. It enters the market as loans, creating another chain of debt obligations. This amounts to solving a crisis by methods that sow seeds for another crisis.

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Conclusion

I seek the readers' response to my central point: All the technical flaws and tactical mistakes leading us to the current crisis are rooted in a moral failure.

Given a society in which individuals care about public good and cooperate with one another to promote it, even though after securing their self-interest in order to ensure survival, we could escape much of the troubles currently facing us. Only such a society of individuals who care for public good can opt for the right mix of state intervention and private initiatives. Such a society is possible. Let us first shed the illusion that we have been living for decades now under the best of all arrangements, social, political, economic and financial. We have not. Let us all join the search for an alternative.

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