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Can a Financial Crisis Occur Under the Rules of Islamic Finance?

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Introduction

For at least four centuries financial crises have been a regular feature of Western capitalist economics. Financial crises are defined by a liquidation of credit and a decrease in stock prices resulting from the “forced sale of assets by overindebted firms” (Canova 110). Can a financial crisis occur in a system with no interest rates? In this paper, I will test the possibility that a financial crisis can occur under the tenets of Islamic finance, which eschews interest. First, I will outline the anatomy and characteristics of a classical Western financial crisis, the Panic of 1907. This will be our Western paradigm of a financial crisis. Then, I will examine the possibility of such a financial crisis occurring under the tenets of Islamic finance. I will provide an overview of the Islamic finance system, elaborating on the prohibition of interest (*riba*) and focusing on the profit making mechanisms of deferred sales contracts and profit-and-loss sharing contracts. I will use the cases of financial crises and the collapse of real estate bubbles in Dubai, United Arab Emirates and Qatar. By examining the cases Dubai and Qatar, I will prove that a financial crisis can occur under a system of Islamic finance and that the financial regulations of a central banking mechanism prevent or mitigate the occurrence of a financial crisis.

Western Crisis Anatomy

A financial crisis occurs at the peak of economic prosperity during the business cycle, “followed by a period of liquidation in which business, commodity and securities prices decrease” (Johnson 454). High business speculation has increased the frequency and severity of financial crises in developed economies (Sprague 353-4). Mitchell, Fisher, Minsky, and Kindleberger argue that financial crises are endogenous and occur at the expansion phase of the business cycle (Canova 105). As a result, the economy weakens toward the end of expansion because firms have difficulty paying their debts due to decreasing business profits. Canova

states: “firms rely on debt to finance capital investments on speculative schemes to increase expected profits; and there exist excessively optimistic expectations about the future of the economy” (Canova 105). A financial crisis spreads when there is a decrease in the financial environment surrounding several firms. Low expectations for future profits result in creditors reassessing the amount of credit to be issued, refusing in the expansion of additional credit, and liquidating of existing outstanding loans. Firms’ inability to refinance debt leads to asset liquidation, contracting business profit and resulting in extensive asset market crashes and bankruptcies (Canova 105).

Often financial crises are associated with panics. Panics occur when depositors feel that a bank’s assets are insufficient to guarantee their claim to their money. During a bank run many of the bank’s depositors simultaneously attempt to withdraw their funds (Allen and Gale 1245). Allen and Gale maintain: “A financial crisis or banking panic occurs when depositors at many or all of the banks in a region or a country attempt to withdraw their funds simultaneously” (Allen and Gale 1245). Likewise, Mitchell maintains a panic occurs when credit is liquidated affects the weakest sectors of the economy, spreading “unreasonable alarm” as large firms descend into bankruptcy (Canova 106). Moreover, Canova argues, other economists view panics as the result of the search for money to pay past debts without sufficient lender’s credit. Despite variations in the definition of a panic, the common theme is the unusual decline “in bank deposits associated with a run follows, the appearance of a crisis rather than precedes it” (Canova 106). In conclusion, a bank run occurs after the beginning of a financial crisis, not before.

There are many other additional factors that play key roles in the anatomy of a financial crisis. During a financial crisis the contracting money supply precipitates the forced liquidation of financial assets by banks. As a result, there is a decrease in the price of assets, high interest

rates, made banks insolvent, and decreased confidence in financial system, “transforming a stringency into a crisis” (Canova 106). In addition, Wilson, Sylla, and Jones have examined the link between stock markets and financial crises, specifically when a stock market crashes and leads to an eventual bank panic and recession. Specifically, Wilson, Sylla, and Jones’s hypothesis argues: “when the bubble bursts or runs against other constraints and when the insolvency of those banks that finance the speculation becomes publicly known, the call rate skyrockets, security prices tumbles and banks are run” (Canova 107). In other words, a financial crisis occurs when the speculation bubble bursts and the public discovers the extent to which financial speculation is occurring, resulting subsequent bank runs and the liquidation of assets. This instance leads to the “breakdown of the allocation mechanism of financial capital that causes contracts in business activities and leads to recession” (Canova 106). The disintegration of the financial system will subsequently lead to a financial crisis spawned by the insolvency of the banking system and its resulting bank runs.

Post-Keynesian economist, Hyman Minsky characterizes economies has inherently unstable and fragile as a result of capitalism (Minsky 5). He argues that in a capitalist economy, there is a threat of an “imminent collapse of asset values and employment and threats of accelerating inflation and rampant speculation...if the market mechanism is to function well, we must arrange to constrain the uncertainty due to business cycles so that the expectations that guided investment can reflect a vision of tranquil process” (Minsky 6). Additionally, Minsky maintains that Western capitalist economies are unstable because of the internal works of our economy’s financial structures that are prone to inflation and depression. Policy makers do not realize the flaws of their economy and the fact that they can use institutions and policy to assuage an economy’s inherent instability (Minsky 10). To contend with an economy’s inherent

instability, a country's central bank plays the role of the lender of last resort (Minsky 38). Minsky asserts "the lender of last resort stabilizes asset values and financial markets; for example the Federal Reserve buys, stands to buy, or accepts collateral financial assets that are not marketable" (Minsky 38). The creation of the lender of last resort, or a country's central banking system, is an essential mechanism in the attempt to prevent a financial crisis from occurring in a Western capitalist financial system.

The Financial Crisis of 1907

The Financial Crisis of 1907 is a paradigm of a typical Western financial crisis, beginning in January with the subsequent panic occurring in that October. Johnson argues that the resultant panic is "almost invariably the product of the remediable defects of the credit system (Johnson 454). The financial crisis had effects on the international economy, specifically in countries with currency on the gold standard. The panic only ensued in the United States. The foundations of the 1907 crisis were laid beginning in 1897. During this ten year period there was an increase in the supply of gold, expanding the amount of available bank credit. In addition, in gold standard based economies the price of commodities increased about 40 percent (Johnson 455). Between 1897 and 1907, economic prosperity went unmonitored: prices increased, the stock market boomed, and bank clearances increased (Johnson 456). Moreover, during this period there was the development and construction of industrial infrastructure and South American enterprises, and the "positive destruction of capital in three costly wars" (Johnson 457). As a result of this economic situation, interest rates rose and the prices of first-class bonds decreased (Johnson 457). In addition, the investment of capital in corporate industries was urged by banks, ultimately leading to the bank's money becoming stuck in long-term investments (Johnson 457-8). Also, the speculative environment of real estate and other

industries contributed to the impending financial crisis (Johnson 458). Johnson argues: “ it doubtful if this speculative diversion of loanable funds deserves to be regarded as an important antecedent condition of the crisis, yet it was probably a contributing cause” (Johnson 458). The combination of the expanding in banking credit and bank investment, increasing commodity prices and interest rates, and the speculative financial climate between 1897 and 1907 set the United States economy on the trajectory toward financial crisis.

Another signal that illustrates the United States’ path toward financial crisis is the decline in cash reserves between 1897 and 1907. During 1897, the cash reserves of commercial banks and trust companies made up 18 percent of net liabilities in the United States and by 1907, the net liabilities of these cash reserved dropped to 10 percent. Johnson argues this decrease in the ratio of banking reserve is a result of: “the growth of trust company deposits, supporting which there was a reserve of barely five per cent” and “the relatively smaller cash reserves kept in the country banks, many of these institutions having been tempted by high rates of interest to invest heavily in call loans and time paper in New York city” (Johnson 458). Johnson views this situation as increasing evidence that a financial crisis was imminent because bank leading was restricted (Johnson 459). The decrease in cash reserves and the cessation of lending further put the United States on the trajectory toward a financial crisis.

During the period from 1903 to 1907, the United States made rapid industrial, agricultural, and business sector advances. Prices rose, beginning in 1903, and hit their peak during January 1906. Once stock prices hit their peak, they began to fall, leading to the “silent panic” of March 14th, 1907 (Perkins 161). During this time there was widespread speculation, financiers and business leaders warned that more discretion should be taken during financial transactions (Perkins 161). The public was unaware of the potentially volatile economic

conditions. In December 1906 call money went from nine to fifteen percent; and in January it reached fifty percent. By March 1907 “banks were forced to call loans and securities dropped in a single day, Thursday, March 14th, from five to twenty-five points, and the market closed in a very demoralized condition” (Perkins 162). On March 15th, after this situation occurred, bankers and financiers saw no real threats of crisis or insolvency in the banking system. By the summer of 1907 the stocks of Amalgamated Copper, United States Steel, and other firms began dropping without reason (Perkins 162). This trend of depression continued into August, fears of financial crisis became a reality due to the failure of two stock exchange houses. Due to the imminent possibility of a financial crisis, capitalists converted their assets into cash to use later (Perkins 163). The foundations have been laid for a financial crisis and panic to ensue in 1907.

The first major corporation that crashed during the Financial Crisis of 1907 was the United Copper Company under the control of F.A. Heinze. Later, Heinze collaborated with Charles W. Morse, Orlando F. Thomas, and E.R. Thomas to establish the firm of Otto Heinze & Co. (Perkins 163). Charles W. Morse “was the owner of a ‘chain’ of New York banks, whose control he had secured by buying the stock of one bank, hypothecating the shares and with the proceeds buying control of another, and then repeating the operation as often as he wished” (Perkins 163-4). Morse controlled various banks: National Bank of North America, The New Amsterdam National Bank, and The Fourteenth Street Bank. Additionally, he was the director of Mercantile National Bank. The Thomases were involved as officers and directors in other banks, specifically the Consolidated National and Oriental. A financial connection between Morse and Heinze, who was also president of the Mercantile National Bank, was established. When Heinze’s United Copper Company collapsed, the depositors of Mercantile National Bank withdrew their funds because they knew about the business connection between Heinze and

Morse. As a result, the bank run spread and Mercantile National Bank had trouble meeting its Clearing House daily balance requirement. The Clearing House began to investigate the reason for the withdrawals at Mercantile National Bank. On October 16th, resulting from the Clearing House investigations, Heinze was forced to resign as president of the bank. This was followed by the resignations of all the board members, including Morse and the Thomases (Perkins 164). A bank run ensued in Manhattan on any bank that had the name Heinze, Morse, or Thomas in its board of directors (Perkins 164-5). On October 20th, a conference was held with various leading bankers and the decision was made that Morse, Heinze, the Thomases, and various banking speculators “must be eliminated from the directorship of all the banks in the management of which they were intimately connected” (Perkins 165). Similarly, the Clearing House investigated the Knickerbocker Trust Company—considered the strongest trust company in New York during the time—and was not satisfied with the conditions. The Clearing House investigation was intended to remain secret; however, the results of the visit were made public on October 21, and a bank run ensued. Perkins recounts the run’s affect on the Knickerbocker Trust Company: “it seemed impossible that a run so great as to place the Knickerbocker Trust Company in jeopardy could be made, as it possessed and turned into cash marketable securities...by 11 o’clock the following day it had paid out seven millions of the eight millions it had and then closed its doors” (Perkins 165). The night of October 21, the presidents of the trust companies associated with Knickerbocker convened to discuss the ways to prevent the spread of the bank run. However, no solutions came out of the meeting (Perkins 165-6). Financier J.P. Morgan took part in these meetings and stated that the presidents of the trust companies “must lay aside their jealousies at once and act together for the common good” to prevent a bank run (Perkins 166). As a solution to the bank run crisis, J.P. Morgan financed the Knickerbocker

Trust Company's low cash supplies (Perkins 166-7). Perkins argues: "the security of each bank and trust company was buttressed with promised aid of all the other financial institution. There were yet the brokerage houses that conducted their business from day to day borrowing from the banks on stock collateral" (Perkins 167). On October 23, brokers could not borrow money at all; and, the next day call money was "exhausted in a few minutes," resulting in the bankruptcy of many firms (Perkins 167). J.P. Morgan was called by the Stock Exchange's President to prevent its closure. J.P. Morgan's response to this predicament was "Tell the governors that the Exchange must not close. Tell them they will have all the cash necessary within fifteen minutes" (Perkins 167). As a result, J.P. Morgan gave twenty million dollars to these bankers (Perkins 167).

The Financial Crisis of 1907 can be simplified to disequilibrium between assets and liabilities. During the 1907 crisis, the world reacted like a businessperson would during a period of over speculation and over confidence by committing "itself so deeply to a heavy burden of demand liabilities that credit facilities are no longer available" (Noyes 206). Similar to when a firm is in this state, industrial and financial markets will go through a period of gradual liquidation to restore the equilibrium between assets and liabilities (Noyes 207). During a financial crisis there is a period of "financial distress" after the speculative boom—meaning that the banks cannot meet their liabilities. In the economy as a whole, there is a rush for liquidity among speculators to get out of assets and into money, developing inauspicious consequences for the prices of commodities. These speculators realize that the market cannot go higher, resulting in the withdrawal of assets. As speculators withdraw, price levels decline and bankruptcies increase. Liquidation occurs, and panic sets in because there is the realization that there not enough money for everyone to sell, and "revulsion" occurs—meaning "revulsion against

commodities or securities leads banks to cease lending on collateral of such assets”

(Kindleberger 15). Financial crises occur when there is speculation, monetary expansion, a rise in the prices of assets, followed by a sharp fall, and a rush into money, as exemplified in the 1907 and 2008 crises (Kindleberger 17).

Basics of Islamic Finance

The system of Islamic finance ensures that banking and financial services are *Sharia*’a compliant—adhering to Islamic law and religious practices. Specifically, *Sharia*’a compliant banking prohibits interest (Kettell viii). Instead of charging interest rates, Islamic finance uses a system of profit-and-loss sharing (PLS) agreements (Kettell vii). This situation results in a partnership to manage the depositors’ assets between Islamic banks and their depositors, Islamic banks and their investment clients (Kettell 4). *Sharia*’a compliant banking is established on the basis that the lender needs to decide if he wants to help the borrower or he wants a share of the profit. If the lender helps the borrower, the principle is secured and he has no claim to an additional amount of money. However, if the lender advances money to share in the borrower’s profit, the lender is entitled to a predetermined ratio of profit earned; and must share the loss with the borrower, if it is incurred (Usmani 7). Islamic finance is ultimately governed by “divine injunction”—limiting the unregulated profit motives of secular capitalist finance (Usmani 10-1).

There are a few central principles essential to the functioning of the Islamic financial system. The first is *riba*, the prohibition of interest on loan repayments. *Riba* originates from a quotation from an Islamic scholar stating: “the prohibition applies to any advantage or benefits that the lender might secure of out the loan such as riding the borrower’s mule, eating at his table, or even taking advantage of the shade of his wall” (Kettell 5). This quotation can be interpreted as the benefits the lender cannot receive benefits for the services they provide

because it is an unequal distribution of effort between both parties. Interest in Islamic finance is prohibited because it creates an unequal distribution of justice and opportunities and a loan is considered to be a charitable action (Usmani 11; Salah 509). Instead, contracting parties in Islamic financial systems profit through the use of profit-and-loss sharing contracts which creates a fair and just distribution of participating in the resultant profit from investment (Salah 509).

Profit-and-loss sharing (PLS) contracts are crucial to the Islam finance system. In *Sharia*'a compliant banking, lenders must invest and become business partners with their borrows to share in profit and risk, meaning everyone partakers in the outcomes—profitable or not—of financial transactions (Kettell 5). PLS requires banks to focus on productivity instead of creditworthiness, resulting in profiting on investments only when they are successful (Kettell 6). PLS contracts are related to the Islamic idea that money has no intrinsic value—one cannot make money out of money (Kettell 7; Salah 509). Money is a medium of exchange: its purpose is to determine the value of a good or service. It cannot function to generate more money through the use of interest rate payments. As a result, in Islamic finance, assets must back all financial transactions. Muslim jurists assert that money has the potential to be capital and it is considered capital only when it is invested in business (Kettell 7).

Additionally, Islamic finance prohibits uncertainty, risk and financial speculation (Kettell 7). The prohibition of uncertainty is known as *gharar* (Salah 509). During financial transactions, contracting parties should have knowledge of the goods received and/or the prices paid before entering the contract (Ketell 7). In Islamic finance, a financial contract should have specific terms relating to the “sale, price, deliverability, quantity, quality, existence, etc.” of the goods and services (Salah 509). Also, vague and misleading terms in contracts are prohibited because they promote uncertainty about the financial transaction. Contracts should be transparent.

Contracting parties must be cognizant and have advanced knowledge of all aspects of the financial transaction. *Gharar* is prohibited because it promotes injustice and inequality for one of the parties during the financial transaction due to lack of information disclosed. Likewise, Islamic finance forbids financial speculation, or *Qimar*. Speculation occurs when “two or more parties each undertake the risk of a loss where a loss for one means the gain for the other” (Salah 509). Under the tenets of Islamic finance, speculation is banned because there is the possibility of effortless profit creation (Salah 509). The main principle behind the prohibiting speculation and financial uncertainty is to prevent the immoral exploitation of the weak and lower classes (Kettell 7).

Another idea central to Islamic finance is only *Sharia*’a approved contracts are permissible. Islam regulates all aspects of life, including business and commerce. As a result, Islamic banks cannot finance businesses that “conflict with the moral value of Islam” (Kettell 8). It is prohibited (*haram*) for Islamic financial institutions to finance and invest in businesses relating to “alcohol, pork, armaments, military technology, pornography, prostitution and gambling” or activities that harm society (Salah 508; Kettell 8). Moreover, in Islamic finance there must be sanctity of contracts. There is a moral obligation of Muslims to conduct their business activities in accordance with Islam, meaning being “honest, fair, and just towards others” (Kettell 8). In order for a financial transaction to be *Sharia*’a compliant, it must occur under a legal system, meaning there must be a contract. The Qur’an promotes the idea of a binding commercial contract made in good faith (Salah 508). These principles are central to the functioning of *Sharia*’a compliant financial transactions.

Prohibition of Interest (*Riba*)

The prohibition of interest (*riba*) is central to the Islamic financial system. The meaning of *riba* in Arabic is an excess or increase. *Riba* is described as “a loan with the condition that the borrower will return to the lender more than the amount borrowed” (Kettell 13). In accordance with their religious beliefs, Muslims must avoid *riba* during financial transactions. The Prophet Mohammad warns that the institution of *riba* will become so ubiquitous and unavoidable for Muslims. According to the Qur’an, interest is prohibited (*haram*) for Muslims because “Allah has declared war on the usurer” (Kettell 15). As a result of the prohibition of interest, Muslims are urged to provide for their families using *Sharia*’a compliant methods (Kettell 15).

Islamic scholars have theoretically reconciled the prohibition of interest (*riba*) with “morality and economics” (Kettell 16). According to *Sharia*’a law, *riba* is morally unjust (*zulm*). Islamic scholars argue that interest based contracts is unfair to one of the contracting parties, either the borrower or the lender. A financial contract with interest may be considered to be unfair to the borrower because the transaction can either incur a profit or a loss. In the event of the borrower suffering a financial loss, he will not receive a return for his inputs of time and work, and is required to pay interest and capital to the lender. Despite the borrower’s financial loss, the lender must get paid interest. As a result of this situation described, Islamic scholars declare *riba* unjust. Additionally, the Prophet Mohammad and the Qur’an address the *riba* as being unjust. Kettell maintains: “punishing someone for default is unjust; an it should be a judge who decides what any compensation should be for a default, not the party to whom the debt is owed” (Kettell 18). In addition, the institution of *riba* is seen to corrupt society (*fasad*). As inferred from passages in the Qur’an, charging interest is considered to be *fasad*. In *Sharia*’a compliant finance, charging interest suggests the unlawful appropriation of an individual’s

property. In the Qur'an, Jews are reprimanded for taking usury when it is prohibited and taking an individual's wealth by false pretenses. Further, *riba* is linked to hoarding and some Muslims equate it to murder (Kettell 19). Clearly, the Qur'an denounces charging interest because it is viewed as immoral and corrupts society (Kettell 19). Also, *riba* has a negative effect on financial growth. The Qur'an implies that "*riba* is subject to destruction (*mahq*)"—a continuous decrease (Kettell 20). This notion is contradictory to the common meaning of interest: by charging interest one increases one's financial wealth. *Riba* is thought to negatively affect one's social wealth because it fails to stimulate growth of social wealth and allows for the inefficient allocation of societal resources. In a traditional Western interest based financial system, the distribution of credit is based on the creditworthiness of the borrower. However, in *Sharia*'a compliant finance, resource allocation is deemed more efficient than creditworthiness because the productivity of a project is more important. This theory causes finance to be put toward more productive projects. Lastly, Islamic scholars assert that charging interest "demeans and diminishes human personality" (Kettell 21). Therefore, charging interest violates natural social interaction that requires cooperation between parties. The prohibition of interest has moral and economic grounds in the Islamic financial system.

How Do Islamic Banks Profit If They Cannot Charge Interest?

The pressing issue with *Sharia*'a compliant finance is how do Islamic banks profit if charging interest is prohibited? There is a simple solution. Kettell asserts: "Islamic banks use *Sharia*'a compliant contracts with do not permit interest to be charged but do encourage trade and investment via alternative financing mechanisms" (Kettell 23). The alternative financing mechanisms of Islamic finance are divided into two groups: Islamically permissible deferred sales contracts and profit-and-loss sharing (PLS) contracts. In Islamically-permissible deferred

sales contracts, Muslim jurists ruled that it is reasonable to immediately sell a good with a deferred price greater than its cash price, which can potentially be paid in installments. The reasoning behind this ruling is that the seller is sacrificing benefits to make a good available to an individual buying it with a deferred payment. The price increase of the good is viewed as compensation to the seller because of the buyer's installment payments. Muslim jurists have justified these transactions considering the contract is independently specified and includes no ignorance (*jahala*). There are four types of deferred sales contracts: *Murabaha*, *Salam*, *Istinsna'a*, and *Ijara* (Kettell 24). In this paper, I will be focusing on *Murabaha*, sale with a known profit (See appendix). The second Islamically-permissible mode of finance is profit-and-loss sharing (PLS) contracts, meaning the "outcome is sharing based and cannot be predetermined" (Kettell 25). By using profit-and-loss sharing contracts, shareholders can only be repaid if the business venture makes a profit. There are two types of profit-and-loss sharing contracts: *Mudaraha* and *Musharaka*, both sharing profits and losses between contracting parties (Kettell 25).

The Islamic financial instrument *sukuk* or Islamic bonds create investment contracts in Islamic finance. The *Sharia'a* board, AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), defines *sukuk* as: "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity" (Salah 510). Special investment activity addresses the use of *musharaka* and *mudaraba* contracts (See Appendix). The profit-and-loss sharing partnership legally states that contracting parties own all tangible assets in the partnership. As a result, "shares in partnership are regarded as assets that can be securitized through a *sukuk* issuance" (Salah 510). The *sukuk* is based on the *mudaraba* contract, forbidding

the use of interest rates (Salah 510; Economist 82). A *sukuk* is structured when the contracting party that needs financing, the originator, establishes a special-purpose-vehicle (SPV) as a part of their financial contract, to facilitate investment and generate cash from assets (Salah 510; Economist 82). To facilitate the SPV, the originator participates in a *mudaraba* contract with many capital market investors. In this arrangement, the originator acts like the *mudarib* (entrepreneur) and the SPV as the *rab al-maal* (investor). The SPV receives financing for the capital investments for the *mudaraba* contract by issuing *sukuk* certificates—giving the holder of *sukuk* a “beneficial right in the interest and rights to the assets of the *mudaraba*: the SPV will declare a trust over all its assets and rights under agreements entered in with the originator in favor of the *sukuk* holders” (Salah 510). The holders of *sukuk* are the beneficiaries of the SPV under the *mudaraba* contract and are entitled to the profits generated, resulting in the SPV paying profits to the *sukuk* holders. The payments made by the SPV are not fixed. Instead, they rely on the performance of the *mudaraba* financial venture. These payments by the SPV are made until the *sukuk*'s maturity date. When the *sukuk* matures, the originator buys the SPV shares in the *mudaraba*. Lastly, the SPV pays the “purchase price to the *sukuk* holders, after which the *sukuk* will be redeemed” (Salah 510). The *sukuk* is considered to be *Sharia*'a compliant because there is no interest paid and the payments made rely on the performance of the *mudaraba* venture (Salah 510).

Can a Financial Crisis Occur if Islamic Regulations are in Force?

A financial crisis similar to 1907 could occur if Islamic financial regulations were in force. A central banking mechanism is key to prevent asset levels from falling, in both capitalist and Islamic financial systems. During the 1907 crisis, the Federal Reserve had not yet come into existence. There were no financial institutions during this era that could monitor the expansion

of business, as a result of speculation, to prevent an eventual financial collapse. Therefore, J.P. Morgan acted in absence of the central banking mechanism—providing financing and calling meetings between the New York bankers, to alleviate the crisis. In the modern capitalist banking systems, a central bank tries to prevent and reduce the effects of panics and financial crises. Despite the lack of interest rates in Islamic financial systems, financial crises can still occur. The severity of a financial crisis depends upon the strength of the country's central banking mechanism, in its attempt to promote stability and financial regulation. I will examine the cases of financial crises in Dubai, United Arab Emirates and Qatar to show that financial crises can occur in countries that follow the Islamic banking system. However, Dubai suffered a greater financial crisis due to poor regulation by its central bank. Qatar was able to survive and thrive during a financial downturn as a result of its strong central banking regulations.

The Financial Crisis in Dubai, United Arab Emirates

Dubai is recognized throughout the world for its extravagant and luxurious real estate and infrastructure. Despite its service and tourism based economy, it was vulnerable to financial crisis because its housing market was affected by the 2008 global financial crisis (Zembowicz 12). Prior to the global financial crisis, there was a period of high economic growth with easy access to borrowing and credit. This unrestricted availability of cheap borrowing and credit led to high investment and consumption. In addition, high oil prices facilitated increased wealth and capital growth (Brach and Loewe 45). The 2008 Financial Crisis ended up having a limited effect on Arab countries, despite the crisis in Dubai occurring simultaneously (Brach and Loewe 51). At the beginning of the financial crisis Dubai's national debt was US \$80 billion, putting it in a better position than most Arab states with oil-based economies. Dubai's economy was not affected by the decrease in oil prices and revenue only about 3 percent of its GDP comes from

the oil industry (Zembowicz 10) The financial crisis in Dubai transpired as a result of internal economic problems, not the global economic crisis. Dubai's government tried to diversify its economy to make it the center of the Middle East for high-end tourism, financial services, and transportation. As a result, the Emir of Dubai instituted construction companies to begin building new infrastructure "such as Port Dubai, the skyscraper Burj Dubai, Nakheel Island, World Island, and the unfinished Dynamic Tower" (Brach and Loewe 54). Consequently, the increased construction of infrastructure lead to Dubai turning into one of the world's largest construction sites. The high demand for construction in Dubai resulted in an increase in property prices (Brach and Loewe 54). During the period of economic growth before the 2008 Financial Crisis, Dubai reaped the advantages of the high availability of cheap credit and investors with high market expectations from the global economic upswing (Brach and Loewe 54).

In addition, Dubai's housing market was greatly affected by the global economic crisis because it is directly connected to international investors (Zembowicz 12-3). Dubai was the first Arab state to allow international investors to purchase land. International investors—who left economic stagnation in the home countries—in Dubai constitute about four-fifths of the emirate's population. As the global financial crisis progressed, these international investors' dispensable income decreased—shrinking the amount of money that flowed into Dubai's economy. Likewise, as the state-owned firms, such as Al-Nakheel, began downsizing their labor force as financial crisis hit, laying off their mostly foreign construction workers. Consequently, Dubai's Ministry of Labor started cancelling about 1,500 work visas per day (Zembowicz 13). These conditions in Dubai's economy put it on the trajectory toward financial crisis.

However, in early 2008, investors became weary of Dubai's development and economy as a result of stagnating property prices. The onset of the financial crisis in 2008 aided Dubai's

economic slump: foreign investors began to withdraw their money from Dubai to pay for their losses elsewhere due to the global financial crisis. Construction companies in Dubai began to collapse and eventually stop working on projects because they had very little assets left in their liquidity reserves. Dubai World, a state-owned investment company, took over the bankrupt Al-Nakheel company, a real estate developer, and many development projects ceased. In November 2009, Dubai's financial situation worsened, as other Arab countries began to overcome the global financial crisis because the government revealed that state-owned Dubai World and Al-Nakheel faced liquidity problems and requested debt payment rescheduling until May 2010. This revelation had dramatic effects on the stock market, already in a state of decline (Brach and Loewe 54). Foreign banks and investors had significant amounts of money invested into Dubai. If Dubai defaulted on its debts, these foreign banks and investors would incur huge losses (Balasubramanian 10). The Emirate of Abu Dhabi realized that Dubai's debt payment rescheduling had affected the creditworthiness, stock market indices, and credit rating of the Gulf states, and as a result provided financial assistance via conditional bailouts (Brach and Loewe 54; Balasubramanian 10). Dubai's financial crisis was ultimately the culmination of increased speculation in real estate markets that occurred during the global financial crisis in 2008.

As Dubai faced financial and real estate crisis, its status in the international financial system as a Middle Eastern symbol of prosperity has declined. For Dubai to achieve sustained economic prosperity, it needs to diversify its economy in order to become the cultural and financial center of the Middle East. Dubai's service and real estate based economy prospered during the period of economic boom before the global financial crisis. The sudden decrease in real estate prices and resultant excess supply and low demand of property, led to the downfall of Dubai's economy. Economic diversification could have helped mitigate the severity of the

financial crisis because “risk management warns against putting all of an economy’s eggs in one basket” (Balasubramanian 10). The United Arab Emirates’ central bank has established a liquidity scheme to help Dubai complete its short-term debt obligations. This scheme has helped reduce the effect of Dubai’s economic crisis on the global economy. However, for Dubai to completely recover, it needs to establish a diversified economy to achieve its goal to become the cultural and financial center of the Middle East (Balasubramanian 11).

The financial crisis in Dubai is considered to be a test of Islamic finance. Many of the loans and bonds issued by Dubai World, the state owned investment firm, are considered to be *Sharia’a* compliant. Dubai world asked to delay its repayment on its \$59 billion debt, creating legal problems for Dubai World’s investors (Timmons). Also, Dubai’s debt issues affected *sukuk* investors, issued by Al-Nakheel. A debt restructuring deal made sure that Al-Nakheel’s *sukuk* bondholders would be repaid on schedule. However this situation has lead to decreased confidence in this investment system (Economist 82). According to director general of Dubai’s finance department, Abdulrahman al-Saleh, the government does not guarantee Dubai World’s debt, and that lenders should “bear some of the responsibility” (Timmons). Since *Sharia’a* compliant finance creates a partnership between lenders and borrowers, through profit-and-loss sharing contracts, as a result of the prohibition of interest rates, there is confusion about who gets repaid first when a firm defaults on its debt. There is no legal precedent on who will get repaid first in the event of a major firm, such as Dubai World, defaulting on their debt (Timmons). There is much uncertainty surrounding the possibility of an Islamic financial default due to the issues of enforceability and “*Sharia’a* risk” (Economist 82). First, many *sukuk* contracts under the English law system and govern assets in the Gulf region. The question is which system of jurisprudence is enforced regarding the potential default of these Islamic firms. Secondly, there

is the issue of *Sharia*'a compliance. Some have argued that these financial transactions and instruments are not *Sharia*'a compliant because they involve an element of risk—prohibited by *Sharia*'a. In Dubai, there was a misuse of Islamic financial instruments creating a situation where Dubai's state-owned firms generated more debt than they could handle (Economist).

There is debate on whether the Islamic financial instruments, *sukuk*, are actually *Sharia*'a compliant. According to the United Arab Emirates' Central Bank's Federal Law No. 6 of 1985: "Islamic banks, financial institutions and investment companies shall mean those whose articles and memorandums of association include a commitment to abide by the provisions of the Islamic *Sharia*'h Law" (Central Bank of the United Arab Emirates 1). In other words, all financial transactions must be *Sharia*'a compliant. Scholars have debated the *sukuk*'s *Sharia*'a compliance. Chairman of the AAOIFI (Shari'ah Board of the Accounting and Auditing Organization for Islamic Financial Institutions), Sheikh Muhammad Taqi Usmani argues that the *sukuk* is not *Sharia*'a compliant because they violate the prohibition of interest and equally shared risk. Despite the Islamic prohibition of interest, the *sukuk* is sold to investors, Muslim or not, based on interest rates. Marketing asset-based returns by using interest rates is considered to be corrupt by Usmani. Usmani states: "the time has come to revisit this matter, and rid *sukuk* of these blemishes" (Black 44). Also, there is a problem of the allocation of risk. Usmani argues that the *mudarib* often agrees upon the *sukuk* maturity to buy back the original asset shares. Thus, the *sukuk* acts like a conventional bond, lowering the amount of risk taken by the investor (Black 44). The lowered investment risk created by *sukuk* issuance is not *Sharia*'a compliant because the contracting parties do not equally share risk.

The United Arab Emirates' Central Bank was not vigilant enough in preventing financial crisis through regulation. The real speculation that occurred during the real estate boom in Dubai

was not regulated by the central bank. This is problematic because Islamic finance prohibits financial speculation. In addition, the issuance of *sukuk* to promote investment in companies such as Dubai World and Al-Nakheel debated to be *Sharia*'a compliant. This is troublesome since according to United Arab Emirates' Central Bank law, all contracts must be *Sharia*'a compliant and adherent to the regulations of Islamic finance. If *sukuk* issuance is debated by the chairman of the AAOIFI, one of the leading sources of *Sharia*'a compliance standards for the Islamic finance industry, then it should violate the UAE's central bank law. The case of the financial crisis in Dubai illustrates that the lack of central bank regulation on speculation and investment in the real estate market contributed the financial crisis, not the adherence of to Islamic finance.

Qatar: Proof That a Central Bank Can Limit the Effects of Financial Crisis

Despite the global financial crisis that occurred in 2008, Qatar's economy grew 11 percent, unlike its Gulf neighbors: "real GDP in Kuwait, Saudi Arabia and the United Arab Emirates contracted by 1.6%, 0.9% and 0.2%, respectively" (Siddiqi 36). In the financial year 2009-2010, development spending increased by 15 percent, under Qatar's expansionary fiscal policy. The government invested in public works projects to promote economic growth. The Qatari government's economic intervention cost about 6 percent of their GDP though "purchases of the equity investment and real estate portfolios of commercial banks—has improved liquidity, maintained credit to private businesses and enhanced the system's resilience" (Siddiqi 36). The economic crisis in neighboring Dubai had a minimal impact on Qatar because of their strong banking regulations (Siddiqi 36). In addition, Qatar has been survived and thrived during the global economic crisis due to its diverse and sustainable economy based on petrodollars and domestic and international financial assets. Qatar is situated on the world's largest gas field,

producing about 32 million tons of natural gas per year. It has the potential for becoming the world's largest gas producer in the future. Moreover, Qatar has been invested in industries unrelated to hydrocarbons such as infrastructure, transportation, and construction. Likewise, Qatar's economy was not hit as hard by the financial crisis because it does not have a strong exposure to foreign markets, such as the EU or US. Qatar's neighboring GCC (Gulf Cooperation Council) states are more dependent on these foreign markets, which has made them more susceptible to crisis. As a response to the global financial crisis, the Qatar Investment Authority (QIA) bought a 20 percent share in all banks, a government effort to prevent financial instability and crisis. (Gad 46).

The Qatar Central Bank, an adherent of Islamic finance, has an active role in promoting financial stability. The Qatar Central Bank's policy on financial stability is to prevent the system from being exposed to unacceptable risk levels through regulation and supervision and promptly contain financial crisis by monitoring the solvency of financial institutions. In addition, the Qatar Central Bank set financing controls and oversight for real estate, investment (including *sukuk*), and credit (Qatar Central Banks). These financial controls and oversight helped in the prevention of the spread of financial crisis. A strong central bank is elemental in preventing exacerbated financial crisis as a result of regulatory mechanisms.

While under the rules of Islamic finance, the Qatari government was able to prevent the spread of the global economic crisis due to its government diversification in industry, lack of dependence on foreign markets, and a presence of a strong central bank with regulatory controls. Qatar is not dependent on one industry as a main source of revenue, like Dubai. Depending on one industry as a main source of revenue can be problematic because if that industry declines, then that country's economy will be in financial difficulty and face a potential financial crisis.

Having multiple investments can safeguard against that scenario from occurring and ruining an economy. Qatar's lack of dependence on foreign markets compared to other states in the Gulf region promotes its financial stability during the time of crisis. It is not as dependent on the EU or US as Dubai. Dubai's dependence on foreign investment and business, lead to its demise during the financial crisis because these investors could not pay on their investments in Dubai as a result of financial crisis at home. This issue is not a problem in Qatar, resulting in their ability to survive and thrive during the financial crisis. Lastly, the Qatar Central Bank has strong financial regulations governing investment, finance, and business dealings. Qatar Central Bank enforces the regulations of Islamic finance that eschew interest rates and prohibits speculation, risk, and uncertainty. The enforcement of the regulations of Islamic finance in Dubai is questionable due to the debate of the *Sharia*'a compliance of the *sukuk*. The strength of the central bank in Qatar, in combination with their strict financial regulations, prevented the occurrence of a severe financial crisis.

Characteristics of 1907, Dubai, and Qatar Crises

I will provide a comparison of the characteristics of 1907, Dubai, and Qatar cases. First, I will address pre-crisis conditions that lead to the imminent financial crisis. Then, I will explain the crisis conditions that occurred during the financial crisis. Lastly, I will focus on the presence of a central banking mechanism and lender of last resort in each case (See Table A).

Table A: 1907, Dubai, and Qatar Crisis Characteristics

	1907	Dubai	Qatar
Pre-crisis Conditions	<p>Increases in gold supply, bank credit, commodity prices, and interest rates.</p> <p>Unmonitored economic prosperity and stock boom. Speculative financial climate.</p>	<p>Increased economic growth.</p> <p>Easy and unrestricted access to borrowing and lending credit.</p> <p>Increase in property market.</p> <p>High economic expectation and speculation in real estate market.</p>	<p>Increased economic growth rate.</p> <p>Non-speculative financial climate.</p> <p>Diversified market based on oil market and other sectors.</p> <p>Monitored economic growth through government involvement.</p>
Crisis Conditions	<p>Decline in cash reserves.</p> <p>Cessation in lending.</p> <p>Stocks peaked and then dropped, resulting in a bank run.</p> <p>Firms went bankrupt due to low cash supplies.</p>	<p>Stagnating property prices.</p> <p>Withdrawal of foreign investment as a result of 2008 crisis.</p> <p>Lack of foreign investment causes real estate development to cease.</p> <p>The possibility of default and request for debt payment rescheduling causes a lack of creditworthiness.</p>	<p>Government invested in public works projects to promote economic growth during 2008 crisis.</p> <p>Qatar Investment Authority bought a 20 percent share in all banks as an effort to prevent crisis and instability.</p>
Central Banking Mechanism and Lender of Last Resort	<p>In the absence of a central banking mechanism, J.P. Morgan acts as lender of last resort.</p>	<p>United Arab Emirates Central Bank did not fully enforce the rules of Islamic finance, prohibiting speculation and uncertainty.</p> <p>The Emirate of Abu Dhabi acts as a lender of last resort by providing conditional bailouts.</p>	<p>The Qatar Central Bank has strict financial regulations in place to prevent and mitigate the effects of financial crisis and instability as per the rules of Islamic finance.</p>

The cases of the 1907 and Dubai crises have many similarities. The pre-crisis conditions in both cases depict an environment of increased and unrestricted economic prosperity in a speculative financial climate. Additionally, in the 1907 and Dubai crisis cases there were similar crisis conditions: both consisted of a cessation in lending as a result of low case supplies. Lastly, there is a lack of a strong central banking mechanism in each case. In 1907, a central banking mechanism was non-existent because the Federal Reserve was not established until 1913. In the case of Dubai, the United Arab Emirates Central Bank did not fully enforce Islamic financial regulations that prohibit speculation and uncertainty, that could possibly prevent or mitigate the occurrence of a financial crisis. The 1907 and Dubai cases both end with the entrance of a lender of last resort. In 1907, J.P. Morgan acts as the lender of last resort by giving 20 million dollars to the Stock Exchange to prevent its closure. In the Dubai case, the Emirate of Abu Dhabi provides conditional bailouts to Dubai because their crisis is affecting the creditworthiness of the other emirates. The similar circumstances between the 1907 and Dubai case illustrate that a financial crisis can occur under the rules of Islamic finance. The Qatari case, however, illustrates that a crisis can be prevented and mitigated due to the strong financial regulations of a central banking mechanism. The Qatar Central Bank took steps through the 2008 crisis to prevent internal crisis and financial instability. Qatar's strict adherence to the Islamic financial rules of prohibited speculation and uncertainty in financial transactions played a role in preventing and mitigating the effects of the financial crisis.

Conclusion

As depicted in 1907, a financial crisis occurs when there is an absence of a central banking mechanism that prevents speculation and promotes economic stability. Financial crises occur when there is speculation and monetary expansion, rising asset prices and followed by a sharp

fall (Kindleberger 17). A financial crisis similar to 1907 can occur if Islamic financial regulations are in force. The prevention and mitigation of a financial crisis similar to 1907 is mainly dependent on the strength of the central bank in enforcing regulations that prevent rampant speculation. In the case of Dubai, the United Arab Emirates Central Bank did not strictly enforce the Islamic financial rules and regulations that could have prevented or mitigated the financial crisis. There was speculation and uncertainty in Dubai's real estate market that contributed to the financial crisis. In addition, the use of the *sukuk* as a method of investment in Dubai also is problematic: they are not purely *Sharia*'a compliant because their performance is uncertain and involve financial risk to be taken. However, in Qatar, the central bank was able to survive and thrive during a time of global economic crisis due to its banking regulations and adherence to the tenets of Islamic finance, eschewing interest rates, risk, and uncertainty in financial transactions and contracts. Based on my findings, I conclude that a financial crisis can occur under the tenets of Islamic finance and the financial regulations of a central banking mechanism can prevent or mitigate the a financial crisis.

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Appendix: Modes of Islamic Finance

As a mode of Islamic finance, *Murabaha* contracts refer to a sale of a good with a predetermined profit mark-up on the cost. The basis of *Murabaha* is that the seller reveals the actual cost of acquiring the goods to the buyer, and then adds a profit mark-up. There are four components of the *Murabaha* contract. First, a prospective buyer makes an order to the seller to purchase a specific commodity or good for a profit. According to *Sharia*'a scholars, the order to buy a commodity from a seller is viewed as an invitation to do business, not necessarily a commitment. Secondly, after accepting the invitation, the seller is obligated to verify that he can locate the commodity, meaning buying and owning it through a legitimate contract. Third, the seller makes an offer to the prospective buyer after it has been bought and owned by the seller. Lastly, the prospective buyer can buy the commodity or renege on the promise. When the prospective buyer agrees to buy the commodity a *Murabaha* contract is established (Kettell 26-7). The *Murabaha* contract is considered to be *Sharia*'a compliant because Islam suggests that money and commodities have different characteristics and therefore should be treated differently

(Kettell 28). Money has no intrinsic value and is only considered a medium of exchange, and is different than a commodity (Kettell 29). *Murabaha* contracts are used for the following financial transactions in society: “mortgages, working capital, syndicated credit, GSM licenses, letters of credit, and car purchases” (Kettell 32).

Another mode of Islamic finance is *Mudaraba*, a type of profit-and-loss sharing finance, a “partnership between capital and work, conducted between investment account holders, owners of capital and the Islamic bank as an entrepreneur (*Mudarib*)” (Kettell 36). The buyer and seller mutually determine the allocation of profits in the context of the business transaction. Kettell maintains: “the profit is shared in pre-agreed ratios, and any loss, unless caused by negligence or violation of terms of the contract by the *Mudarib*, is borne by the Islamic bank. The bank passes on this loss to the bank depositors, known as investment account holders” (Kettell 37). A *Mudaraba* contract is technically a profit sharing contract because there is no loss sharing. In the event of a loss, the capital owner takes responsibility for the loss and the agent sacrifices the reward of his effort. Moreover, Islamic financiers have redefined the *Mudaraba* as the “Two-tier *Mudaraba*,” meaning that the contracts are expanded to include three parties: “depositors as financiers, the bank as an intermediary, and the entrepreneur who requires funds” (Kettell 38). The *Mudaraba* contract is considered to be *Sharia*’a compliant because it “means ‘journey through the earth seeking the bounty of Allah.’ Because of his work and travel, the *Mudarib* becomes entitled to part of the profits of the venture” (Kettell 41). *Mudaraba* contracts are essential to Islamic finance because it is used with businesses seeking finance, such as doctors, dentists, engineers, traders, etc. In a *Mudaraba* contract, “the bank provides the necessary finance as a capital owner in exchange for a share in the profit to be agreed upon” (Kettell 43).

Lastly, it is necessary for precautions to be taken in *Mudaraba* contracts to decrease risk because the lender bears all responsibility in the event of a loss (Kettell 43).

Another type of profit-and-loss sharing (PLS) contract is *Musharaka*. The *Musharaka* contract is a partnership where two or more individuals combine capital and/or labor, sharing in profits, rights, and liabilities (Kettell 46-7). This business partnership can take the form of a *mufawada*—an unrestricted partnership with equal rights of capital and management between the contracting parties. Both partners share profit and loss of the business venture in *Musharaka* contracts. There is no a guaranteed rate of return on the investment, unlike when interest is charged in Western financial transactions. The income earned during the business venture under *Musharaka* contracts can possibly result in losses for the joint business enterprises (Kettell 47). *Musharaka* contracts are primarily used for house purchase, service sector applications, small business applications, and commercial and real estate applications (Kettell 51-2).