GLOBAL FINANCIAL CRISIS AND THE LINK BETWEEN THE MONETARY & REAL SECTOR: MOVING BEYOND THE ASSET-BACKED ISLAMIC FINANCE

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Abstract

A major factor behind this crisis is financialization of the system, with a growing disconnect between the monetary and the real sector. Some proponents of the Islamic finance claim such financial crisis would have been avoided, if asset-backed Islamic finance were adopted. However, while Islamic finance in form and legality is asset-backed at the micro-juristic level, it is still largely delinked from real sector at the macro level. This paper articulates the need for Islamic finance to be better embedded in the reality of the real sector and be more effective to achieve the broader economic goals that it proclaims to pursue.

Introduction

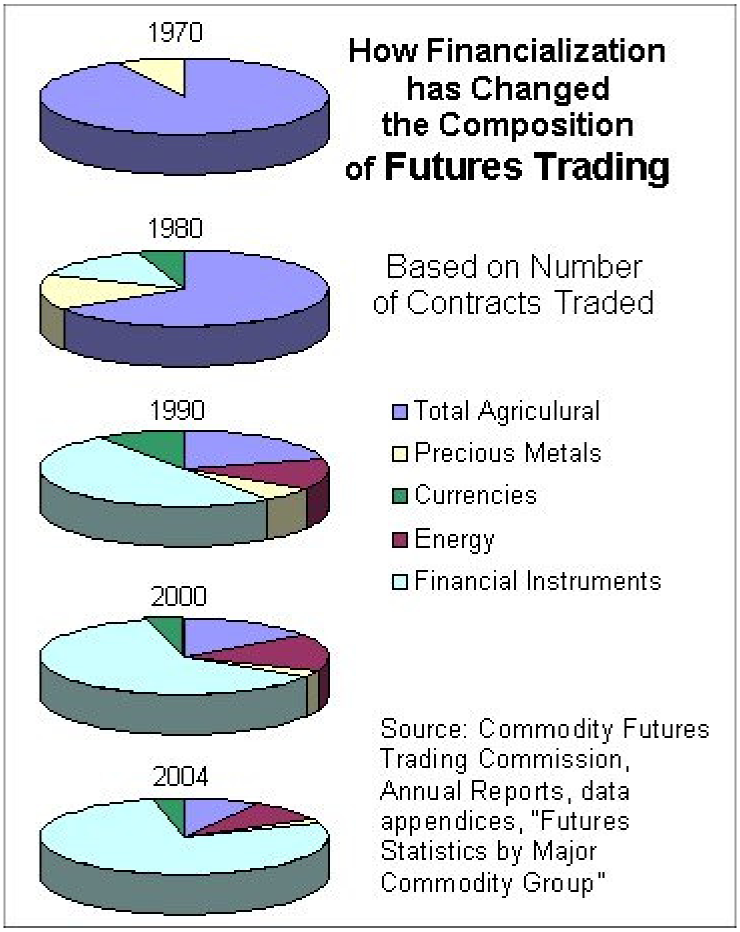
Recent global financial crisis has forced the academics, experts and policy-makers to grapple with the challenge of better understanding the nature of the problem and the state of the knowledge and understanding about the economy, of which the financial system is a part. Within the mainstream economic paradigms, ranging from the Neoclassical to the Keynesian along with their respective offshoots, the economists are searching for further explanations. Leading economists are sharing their thoughts: some scratching their heads,[1] while others have specific explanations for, and/or prescriptions to guide the economy out of, the current crisis.[2] There are also calls for a paradigm shift coming from a broader group of people.[3]

The bursting of the bubble in the real estate sector in USA is usually recognized as the starting point of the current crisis. However, one of the factors that is being commonly identified as a key process behind this crisis is an undesirable level of ‘financialization’ of the economy. Financialization generally leads to an increasing disconnect between the monetary/financial sector and the real sector. The true measure of an economy’s production and consumption is reflected in the real sector. Characterizing the contemporary global crisis as a “financial” crisis is also a reflection of the power of financialization, not just as a process, but also as a notion. While many economists and other relevant experts are trying to bring the economy out of this crisis, there is still much to be desired to better understand it as something much broader than just “financial.” Of course, much of the western, mainstream discourse about this crisis is within the established paradigms.

Some of the advocates of Islamic banking and finance (IBF) have been claiming that with IBF the world would have avoided such a crisis or at least it would not have been as severe.[4] They make such claims based on the resilience and performance of the IBF industry in the face of such crisis, especially pointing to the fact that one of the main principles of IBF is that all transactions must be asset-backed.[5] While this principle is valid, relevant and valuable, transactions being asset-backed is not enough for economic growth and development, or poverty alleviation, which is tied with the real sector. In this paper it is argued that similar to the conventional economics and finance, IBF is not just vulnerable, but also already entrapped at significant level of financialization, ignoring the real sector. The success of IBF as a *Shariah-compliant* industry clearly indicates that IBF can achieve what it sets as its goal. It is argued that IBF can make relevant and much needed contribution to the economic transformation of the economies it serves, if it is appropriately and desirably interfaced with the real sector.

Financialization and the Growing Disconnect with the Real Sector

As a term ‘financialization’ is of recent coinage and like another widely used term 'globalization' has a wide range of meaning attributed to it. Financialization is often identified with financial capitalism led by the financial giants like Goldman Sachs,[6] where financial leverage tends to dominate the equity capital market and the financial markets tend to eclipse the real sector of the conventional industrial economy.[7] The implication of such trend is clearly visible in the following Table.



Source: Commodity Futures Tradition Commission, Annual Reports, data appendices, “Futures Statistics by Major Commodity Group”

Epstein defines *financialization* as: “the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions.”[8] Among many factors indicative of financialization are: dramatic increase in leverage, reflected in debt-to-GDP ratio in most developed and developing countries; explosive growth in the volume of trading financial assets, including foreign currency exchange, now in excess of US$ 1 trillion a day; the increased importance of financial motives and pursuits in the governance of even non-financial corporations.[9]

Financialization has been viewed by some as “the ascendancy of ‘shareholder value’”[10] in corporate governance, by some as the shift in the financial system in terms of growing dominance of capital markets over bank-based financial intermediation, while others have seen as the political and economic power overwhelmingly skewed in favor of the ‘rentier’ class. Still others have identified the growing importance of the new and esoteric risk-management and/or speculative products based on financial engineering. The scope of financialization may well cover all the aspects mentioned above.[11]

Several impacts of unrestrained financialization include: (a) substantial economic costs to the economy, reflected in the threat to stability of national currencies and financial systems, as well as the solvency of entire states;[12] (b) widened income inequality, as significant shares of GDP accruing to those who own financial assets, as this class wields political and economic power through the corporate world.[13] The contemporary crisis is blamed to a large extent on financialization in its various forms.[14]

Islamic Finance to the Rescue?

The emergence of Islamic finance during the second half of twentieth century began with a bold polemical challenge to the western thoughts and models. As the revivalist ethos swept through the Muslim world as part of seeking independence from the colonial hegemony of the West, Islam was presented not just as a guide for the salvation in the hereafter, but also as a “complete code of life” providing solutions to every aspect of life, including in its economic sphere. The Islamic critics attempted to expose the weakness and vulnerability of the western economic ideas and systems. Thus came to the scene Islamic economics and finance to help offer a better alternative to a system that is inherently and chronically unstable, cares little about poverty and inequality, and prone to exploiting the vulnerable both at the individual, national and international level.

Within a few decades, while the preoccupation with Islamic economy has generally taken a backseat, and Islamic economics as a discipline has been eclipsed by its offshoot, Islamic banking and finance, the IBF industry, as a *shariah*-compliant enterprise, has become a resounding success. Pious Muslims have been taking interest in this industry that claims to be interest-free. The conventional financial powerhouses have also stepped in not just to have a share of the pie, but also to take lead in this industry. The same powerhouses that have been at the forefront of the financialization process now have a dominant presence, with *shariah*-scholars serving and validating these conventional financial institutions’ windows offering *halal* or *shariah*-compliant finance.

IBF industry seems to have reached US $1 trillion asset mark, with presence in all the Muslim-majority countries as well as many western countries with significant Muslim presence. As the contemporary financial crisis unfolded, the voices of the IBF industry have shown increased confidence in the industry[15] and even boldness to claim superiority of the Islamic system, and then some went even a step further to suggest to the West that they should also consider Islamic finance.

> As the global economy creates a new financial architecture, incorporating lessons from the global financial crisis, *Islamic banking could emerge as a role model because of its focus on ethical investments*.[16]

> A crisis such as the mortgage one would technically be unthinkable in the Islamic capital markets sector because it would be against Shariah principles to sell a debt against a debt. … In the present crisis we have seen trillions of dollars trading without backing of assets. *If such transactions followed the Islamic finance model it would have easily prevented the current economic crisis.*"[17]

Such claims and suggestions raise important issues as to how mature the industry and how verified its performance is, especially in light of the disconnect between the Islamic finance and the real sector.

Islamic Finance and the Real sector

The pursuit of economic growth and development is tied primarily with the real sector. Economists of Islamic persuasion recognize that "[r]ealization of the potential of Islamic finance will require structural adjustments enabling Islamic financial institutions to deal with real sector business …"[18] That "[f]inancial assets can only grow in proportion to the growth in real economic activities"[19] or that "[s]ustainable expansion of financial services in proportion with the real sector"[20] is critically needed is also recognized. But is that recognition translated into the real praxis of Islamic economics and finance? Unfortunately, this relevance of the real sector has suffered a reductionism that Islamic finance is asset-backed.

Indeed, one of the key principles of Islamic finance is that all transactions must be asset-backed. According to Usmani, one of the leading Shariah scholars, "One of the most important characteristics of Islamic financing is that it is an asset-backed financing."[21] He explains the importance of it in the following way:

> The conventional/capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; each unit of money is 100 per cent equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units *inter se*. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanges, one for another. The profit earned through dealing in money (of the same currency) or the paper representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on non-liquid assets which creates real assets and inventories."[22]

Notably, the view that money is only a medium of exchange, as articulated by Usmani, corresponds with the "Classical dichotomy," a corollary of which is "neutrality of money." According to this view of early Classical economics, the total production of the economy is independent of the monetary factors based on a clear distinction between the 'real sector of the economy' and the 'monetary sector'. Thus,

> "… the allocation of resources, and hence the determination of real GDP, is fully determined in the real sector. It is *relative prices*, including the price level of wages relative to the price of commodities, rather than money (nominal) prices, that matter for this process. … [T]he price *level* is determined in the monetary sector of the economy. If the quantity of money were doubled, other things being equal, the prices of all commodities and money incomes would eventually double. Relative prices would remain unchanged, and the real sector would be unaffected."[23]

With clear distinction between the monetary/financial and the real sector, the Classical economists wanted to ensure that the monetary sector or money does not become a distraction from the pursuit of the growth and transformation in the real sector. However, while the view of most Islamic economists echoes the Classical Dichotomy, the IBF industry seems to have preoccupied itself with the monetary/financial sector, and thus one hears so much about Islamic finance and so little about Islamic economy. For example, let's note the term "value addition" in the following statement by a prominent Islamic economist. "The prohibition of a risk-free return and permission to trade, as enshrined in verse 2: 275 of the Holy Qur'an, makes the financial activities in an Islamic set-up real asset-backed with the ability to cause '*value addition*'."[24]

An important nuance of the quoted verse widely being missed in the discourse about Islamic economics and finance and in the praxis of IBF industry is that before something can be traded, there must be something to trade from some prior real sector activity. Moreover, one single product or object of value can be traded million times, without any 'value addition" in the real sector. For the desired growth and transformation of our economies, we must move beyond the realm of asset-backed transactions to asset-creating enterprises in the real sector. Some Islamic economists frame this discussion in a way as if this is already taking place.

Being asset-backed is one of the primary reasons on the basis of which its proponents attempt to make the case that Islamic finance is more resilient to loss of value during this financial crisis and thus less vulnerable as a system. This has led to some bold claims, as articulated by, for example, Dr. Abbas Mirakhor, a well-known Islamic economist with International Monetary Fund, that: "Conventional finance is inherently unstable … (while) Islamic finance is inherently stable."[25] Elaborating on this claim, Dr. Mirakhor explains:

> In Islamic finance there are no risk-free assets and *all financial arrangements are based on risk and profit-and-loss sharing (PLS).* Hence, all financial assets are contingent claims and there are no debt instruments with fixed or floating interest

> rates. Investment accounts could be conceived as non-speculative equity shares. The rate of return on financial assets is primarily determined by the return to the real sector, and therefore in a growing economy, Islamic banks will always experience net positive returns.[26]

Dr. Mirakhor is clear about the importance and relevance of the real sector and how Islamic finance is resilient because it is intimately linked with the real sector.

> In contrast to conventional finance which has periodically experienced crises, Islamic finance is considered as a stable financial system capable of promoting sustained growth of income and employment. Prohibiting interest, speculation, and debt trading, *Islamic finance establishes one-to-one mapping of financial and real sectors of the economy*. That is, it is based on real trade and production activities. The financial sector cannot expand beyond the real economy, and is immune to unbacked credit expansion and speculation that are characteristics of conventional finance and that have destabilised even the most sophisticated and complex financial systems.[27]

Dr. Mirakhor claims that Islamic finance establishes one-to-one mapping of financial and real sector of the economy. In reality this mapping is possible at the micro and transactional level in terms of trade, but such one-to-one mapping does not translate into value-creation in the real sector, because due to uncertainty and risk factor the value-to-be created is not known *a priori*. Moreover, the claim that all transactions in Islamic finance are based on risk and profit-loss sharing (PLS) is patently incorrect, especially if it is staked not in a normative, but in a positive sense. It is well known that the mainstay of the IBF industry is not PLS modes, such as *mudarabah* or *musharakah*, but instead, the non-PLS modes, such as *murabaha*, *salam*, *ijarah*, that are fixed return based and generally risk-free (or they are structured in a virtually risk-free manner).[28]

More importantly, just like the financialization in the West has been integrally tied with debt-culture,[29] as the table below shows that the non-PLS modes, the mainstay of IBF industry, are generally debt-creating modes.

Features of various Islamic financing tools[30]

Type of contract	Liquidity	Guarantee	Rate of return
		Debt-creating modes	
Qard al Hasan	---	Collateral	Nil
Credit sales	Non-liquid	Collateral	Known
Salam	Non-liquid	Collateral	Unknown/known
Istisna'a	Non-liquid	Collateral	Unknown/known
		Semi-debt creating modes	
Ijarah	Liquid	Collateral	Known
		Sharing modes	
Musharakah	Liquid	Penalty for misconduct	Unknown
Restricted Mudarabah	Liquid	Penalty for misconduct	Unknown
General Mudarabah	Liquid	Penalty for misconduct	Unknown

Furthermore, much of Islamic finance industry is without being embedded in any economy that is also committed to Islamic principles, with some notable exceptions, of course. Without interfacing the financial system with the economic system of which it is a part, a financial system may have some formalistic and legalistic accomplishment, but it probably won't serve the broader goals of the economy. One of the Islamic economists who recognizes this problem explains it in this way.

> … Islamic banking is an integral part of a whole called 'Islamic economics' and thus must be in complete harmony with the mother system to guarantee coherence and consistency. Any dissimilarity between factors of the sub-system and its mother system is subject to failure, as capitalism has demonstrated on many levels. … Just as capitalism requires its own underlying assumptions, Islamic banking will not produce its fruits in a vacuum. … The varying degree of success experienced to date within some Islamic countries are evidence of this claim and directly attributable to their weak social capital. In most of these cases, the rate of interest (*Riba*) in these countries is labeled 'rate of profit,' which is akin to having bacon wrapped in *Halal* meat. Such unethical practices, while apparently convincing to laymen, are unacceptable and can only lead to failure."[31]

To properly focus on the real sector that would put an economy on the path of desirable transformation several aspects need to be identified and addressed: (a) directing resources to productive, asset-creating, enterprises, especially in manufacturing, agriculture and construction addressing the basic needs within the perspective of sustainability; (b) emphasizing productive education and training that enhance human capital; (c) building internalized technological capacity; (d) fostering institutions conducive to wholesome economic development; (e) reducing corruption and monopolization of resources, especially by the rentier segment; (f) focusing on maximization of jobs to bring people out of poverty and place them on track of achieving better standard of living; (g) facilitating broader participation of the people in capital; (h) nurturing a culture away from greed, speculation, and trivialization of consumption, and (i) resolving macro-monetary issues, such as the role of central banking, fractional reserve system and the extent to which it has impact on expansion of money and credit and in turn on price level stability. Of course, this is not an exhaustive list and to be Islamic, all these must be guided more by Islamic values and principles than just legalism. IBF industry is not currently dealing with the above aspects in a way or at a level that would facilitate the desired economic transformation.

This is further complicated by the fact that IBF industry is mostly involved in debt-creating modes, without appreciating the fact that debt culture is at the root of conventional western system and culture. Financialization, trading of credit and risk, greed, all these are closely related to debt culture. While emphasizing the prohibition of interest, based on riba-interest equation in a blanket manner,[32] it is forgotten how the Prophet Muhammad used to seek refuge from debt, regularly and repeatedly.

> Allah's Apostle used to invoke Allah in the prayer saying, "O Allah, I seek refuge with you from all sins, and from being in debt." [*Sahih al-Bukhari*, Vol. 3, #582]

Conclusion

In building a shariah-compliant industry, IBF has achieved remarkable success. However, still significantly delinked from the *maqasid al-Islam* and the real sector, the challenge remains as to how to interface this industry successful at the legalistic and formalistic level to the real sector affecting the issues of development, basic needs, poverty alleviation, reducing income inequality.

These broader challenges do not belong to the domain of Islamic finance. Rather it is a national challenge, where the financial system must be interfaced with the national approach and strategy to meet those challenges. The financial system is a component of any broader economy. Islamic finance in those countries, where there is a commitment not just to Islamic finance but also to transform the entire economy to put it on the foundation of Islamic values and principles, has an advantage as well as special relevance. In this paper only one key aspect is addressed: financialization, where an economic system becomes vulnerable to reducing all value to be exchanged either into financial instruments or a derivative of a financial instrument, especially in debt-creating modes with multiple layers of risk-shifting stratagems. Although financialization has its mature manifestation in the industrialized west, it is important to learn from the western experience, so that we do not blindly follow their footsteps, when experience has proven them wrong in those respects.

Islam has the relevant principles and guidance to help the Muslim societies to rise to the fundamental challenges of improving the lives of the Muslims and the humanity. Appropriately linked to the real sector and embedded in an economy that is also based on Islamic values and principles, and by being part of a mapped out national approach and strategy,[33] Islamic finance can play that vital role.

Endnotes

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