

World Financial Crisis : Lesson from Islamic Economics

By

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Do we have any guidance from the economic system of Islam to suggest to the world how to develop a financial system that would not lead the world to economic and financial crises that the world is now facing? If we need to draw lessons from Islamic economics, we need to look into the economics embodied in the institutional framework of Islam.

No doubt, riba (interest, usuary) and maysir (gambling, speculative activities similar to gambling) are the major factors leading to the current financial crisis. Islam's prohibition of Riba and Maysir along with Islamic values and morals, and recognizing others' interest in one's economic fortunes, if adhered to, could not have lead the world to the present day financial crisis. Keeping individuals and Society free form financial and economic crises can clearly be seen as one of the objectives of such instiutions.

The question, however, is how to do this now? Where to go from where we are now? Fine, we can declare that taking and charging of interest in the banking operations is prohibited. But what is the alternative? Current practice of Islamic banking has not provided any convincing alternative. With the Tawarruq made Shari'a compatible, the results can not be expected much different from those of interest based banking system.

I like to draw the attention of all concerned about the need to investigate into the institutional framework of financial system that prevailed in the Islamic societies before they were colonized by the West. The contemporary financial system came into existence when the Muslim societies had already been colonized and their institutions demolished or diluted. The modern financial system developed without taking any lessons from the Muslim civilization.

It is curious to note that almost all branches of modern knowledge admit the contributions of Islamic civilization often referred to "medieval ages" towards their discipline, except science of Economics and Finance which does not recognize any contribution made by Islamic civilization in this field. Even Schumpeter, writing history of economic thought totally ignores the long history of economic

successes in the era of Islamic civilization. It was the period when the poverty was non-existent. Basic needs of every one were met. No one was “poor” enough to look forward to receive charity. Worldwide famine type situations were intelligently and successfully dealt with. There is no evidence of financial and economic crisis in the long history spread over about 1000 years.

It is now the time that visionary economists and financial gurus look back and investigate into the institutional set in the economy of medieval ages to find solution for the current crisis. Those familiar with the economy of medieval ages do know that its financial system was not a banking-based system. Its system was either market (of goods and services) based system or it was based on Qardh Hasan (benevolent loans, normally understood as charities). Financing needs in the market were met through trade contracts. Sale contracts with deferred payments and sale contracts with advance payments met the financing needs through the market without needing financial intermediation. “Know thy client” is more relevant for market based financial system and hence the issues of adverse selection, moral hazard and transaction cost were minimized. The financing needs that market could not or did not want to meet, were met by the institutions of Qardh Hasan, Zakah and Awqaf promoted by Islamic teachings. The issue of moral hazard, adverse selection and transaction did not occur even in these institutions. The need for developing financial intermediaries never arose despite economic growth and development.

It is not the place to discuss the details of such a system to meet the financing needs of a modern economy. Once the concept is acceptable, the details can be worked out. The point is that market itself is a better place to generate a financial system to suit its own needs. If markets are functioning well and institutions are in place to give support and protection for the market to provide financing as part of the contract of the sale and purchase of goods and services and if there are institutions to meet the social needs not met by market, there will be no need to develop banks to provide a financial system on interest basis. Even now, several businesses large and small, wholesale and retail, are doing the business by providing financing while selling/purchasing goods and services, without letting their customers go through the banking system to get the financing. They do not have to explicitly refer to interest calculations when providing financing for their sales and purchases. Every thing is built-in within the price.

The concept of Forward Sale as given by Islam (known as Bai’ Salam) is a wonderful guide to develop a market of Futures contract without tempting the traders and producers in the market to go into gambling or gambling type “speculation”. (For more detailed discussion on this, see my paper on “Islamic Futures and their Market” published by Islamic Research and Training Institute and is downloadable free from their website). Modern finance, does not recognise the financial system prevailing in medieval ages because it did not borrow anything from there. Occasionally, somewhere we may find a reference to forward contracts of the medieval ages. But there is hardly any attempt to

understand the nature and economics of those forward contracts in comparison with the forward and future commodity contracts of today. The financial gurus may find a lot in the economic and financial system that was in practice when Islamic civilization was on top of the world

For drawing lessons from the Islamic financial system as prevalent in the so called medieval ages, what is needed to be done is to reform the market of goods and services in a way that allows the market to develop its own financial instruments to suit the financing needs of the society. Infrastructural institutions are required to be developed to promote and protect the financing provided by the market of goods and services as part of its sales and purchases, rather than promoting and protecting the banking institutions to finance gambling and speculation.

A bank-free but market-based financial system is the key to have crisis-free financial and economic system. The developed world can take lead in introducing market-based financial system and show the way to the developing world too, how to get out of the trap of banking based financial system.

Banking-based financial system has long been losing its credibility in the eyes of financial gurus. To Frederic Mishkin, it is a puzzle, "What makes banks so important?" when there are better and less complicated options available in the market to raise financing (including loans). See his book The Economics of Money, Banking and Financial System (Adison-Wesley 8th edition, pp 183). Another curious phenomenon that Mishkin raises is that why banks and financial intermediaries, which some how became so important, have lately been witnessing a decline in their importance in the financial market; and why their share of external funds for businesses has been declining in recent years. (This may probably be the real reason behind providing subprime lending that lead the banking sector to current crisis).

The world bank report on Institutions, 2000 identifies two types of financial system. Market based financial system and banking based financial system. Germany has been mentioned to be having a more market based financial system compared to other countries in the West and now, probably, it is Germany which is in a better shape among the G-7, in this time of worst financial crisis.

It is in the interest of both the Islamic economists and conventional economists to look into the Islamic economic system which has been in practice for a very very long time. It gave a lot to the modern world to develop the physical and natural sciences. Let us see if there is anything for the science of economics and finance to borrow from there in the interest of the wellbeing of man on earth. I particularly invite those working in the framework of New Institutional Economics (NIE) to take it up as a commitment to their own discipline. Let us think of an economy at

least free of commercial banking. To start with, let us see how an economy would look like if there were no commercial and there were no short term borrowing and lending on interest.