The recent turmoil and monetary policy in a dual financial system with Islamic perspective

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7 July 2014

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Abstract

The financial turmoil that the 2007 subprime debacle of the US set into motion has raised a welter of puzzling questions for the policy makers across the world. The position seems all the more confusing in the Muslim world where the fast expanding Islamic finance operates in competition with the conventional in a dual setting.

The turmoil has led many to blaming the private lure for the colossal failure of financial institutions. In contrast, others counter argue to put public policy in the dock under the exalted banner of 'regime uncertainty'. They blames the aggravation of the trouble on the uncalled for government intervention in financial markets. Interestingly, few draw attention to moral crimes committed on either side of the fence among the causative factors.

This paper seeks to investigate if the monetary policies the Central Banks follow - now including the Basel capital adequacy norms as well - would suit or suffice Islamic banking institutions competing with the conventional in a dual financial framework? In this context, it questions the claim that risk-sharing is or can alone be the basis for Islamic finance.

Keywords: Monetary policy, Dual financial system, Profit sharing ratio, Regime uncertainty

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1. Introduction

This paper deals with monetary policy in a dual financial system composed of Islamic and conventional sectors operating in a competitive setting. Monetary policy addresses a number of objectives: mobilization of resources for sustainable economic growth, promote distributional equity and keeping the internal as well as external value of money stable. But here we are looking at it from the viewpoint of controls a Central Bank can employ to achieve reasonable stability in the price levels so often disturbed disquietingly by financial crises like the one that has gripped the globe since 2007, the most devastating since the Great depression of 1930s. Such an exercise needs a relook on credit creation process and its efficacy for Islamic banks. As profit sharing replaces interest based financing, determinants of the sharing ratio and what role it could play in controlling credit creation has also to be assessed.

This crisis has not only downed the mighty financial institutions across countries but has bankrupted state after state in Europe. The fall of Lehman Brothers in US in 2008, triggered the onset of the economic devastation the world had never seen after the 1930s (Cihak and Demirguc-Kunt, 2013). The sub-prime debacle in the US pulled off the covering from the Western financial system. Its machinations to enrich bank owners, managers and agents at the expense of borrowers and depositors could no longer remain concealed. Figure 1 shows the process leading to the debacle. Giant banks and insurance companies long considered invincible took little time to crack and collapse in its aftermath. But the US happenings proved only symptomatic of the storm that was fast crossing the Atlantic. Europe soon

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[1]The author alone is responsible for the views expressed in this paper and need in no way be attributed to INCEIF where he currently works.

found banks failures knocking at the doors of one country after another, the Cyprus bank failures being the latest in the chain. As the institutions were considered too big to sink, keeping them afloat

Figure 1: Genesis of the DS sub-prime crisis 2007 (Edited)

became an unceasing social imperative laced with evil. Indeed, financial crises in the world became more frequent and damaging with the passage of time, the trend is gaining pace after the collapse of Britten Woods arrangements in 1971[2].

According to Global Financial Stability Report (2012), the Euro area crisis remains the key threat to global financial stability. The increasing nexus between monetary and fiscal policies across the globe made many countries on the continent face swelling mountains of sovereign debt. Along with banks, bailing out failing states – Greece, Spain, Portugal, Italy, Ireland, Belgium and now Cyprus are all in deep trouble. Oblivious to this unending scenario across the Atlantic, Islamic economists and financial gurus continue to look westward for guidance and imitation. The average rate of unemployment in Eurozone countries has already hit the 12% mark in 2011. Is it still sense to believe as some do, that "only by replicating conventional structures can Islamic finance create the breadth and depth of its products"? It is time perhaps to think afresh and change course. For this, we have to understand why the theory and practice of the system that inspired developing countries to follow the course failed its own champions so savagely.

2. Risk profit and finance

A primary attribute of competition is the tendency to eliminate economic profit or loss and bring the prices of real goods and services to equality with their money costs. Economic theorists have therefore searched for the source of profit in what makes competition imperfect. Frank H. Knight (1921) convincingly argued that it was uncertainty born of dynamic change that made reality depart from the ideal profitless state in an economy. Uncertainty breeds risk and divides the society into those who prefer to take risks in the expectations of large gains and those who want to avoid risks in favor of getting sure specific even if smaller incomes. *Risk-preference* and *risk-aversion divide*d human beings into the hired and un-hired production factors in all societies independent of time and space.

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[2] The current crisis exhibits a unique and worrisome characteristic. It is moving in a go-halt-go mode: today is sunshine in the Wall Street, tomorrow the pall of gloom. In 2010 the US economy was seen as out of the tunnel. The BBC on June 18, 2014 informs us that the Federal Reserve has cut for the fifth time the US growth forecast for 2014 to between 2.1% and 2.3%, down from its March forecast of 2.8% to 3%. It has also trimmed back its stimulus programme by $10bn a month to $3.5bn!

Entrepreneurs, however defined, fall in the un-hired category. They guarantee fixed specific returns to the hired factors of production – money lenders, workers and property owners – in the form of interest, wages and rent. Entrepreneurs choose to be claimants of the residual business earnings in the expectations of large gains but have to simultaneously expose their investment to the risk of shrinkage (loss) if revenue receipts belie expectations and fall short of payments due to the hired factors.[3]

2.1 Risk-sharing versus risk-transfer

This inevitable division of people into hired and un-hired factors knocks at the bottom of a plea now gaining currency in Islamic economics. It is being argued that risk-sharing could *alone* be the Islamic basis of pecuniary contracts. To be sure, this is not a new plea. Only a new garb is being provided to the old edict 'no risk, no gain' is an adage long paraded in Islamic finance. No one disputes that participatory finance is in principle a more desirable rather preferred mode for Islamic financing. But projecting that risk-sharing is the *only* form acceptable to the system raises ticklish issues.

First, there is little positive support for risk-sharing in the demonstration, however convincing, in showing what havoc risk-transfer has brought to world economy over time and space unless one can produce empirical evidence as to what risk-sharing could do in the present era.

Second, it may be argues that with eloquence that risk-sharing was the divine desideratum to promote mutual help and cooperation and peace among humans who had opted to run affairs on Earth as the vicegerent of Allah (swt). But what has man done; especially what Muslims are doing?

Third, leave the cosmopolitan approach aside and take the organization of economic activity within a country. All factors of production are exposed to risk, not capital alone. Workers are exposed to unemployment – there may not be coal I the house as there is too much coal in the market. Involuntary mass unemployment may and has occurred, due to natural calamities, wars to serve economic interests – Millions became penniless when Americans disbanded the Iraqi army with a wave of hand. Bridges, buildings, coal mines, nuclear plants collapse, many work in hazardous industries. Limb and life is lost. Who shares the risk with the hapless? Such risks are much more devastating for socities than the loss of money in business.

Fourth, ivory tower thinkers must avoid the glitch of considering risk sharing or transfer merely or largely an issue between groups of capital owners. Labour shares the risks too. So must share profits as well.

Fifth, risk-sharing cannot be detached from profit (loss) sharing. Risk being an ex-ante non-measurable variable, a one-on-one correspondence cannot be established between the two. Thus, a society based only on risk-sharing cannot be expected to ensure distributive justice and stay strife free. We cannot hope to put people long on opium.

Finally, it is misleading to suggest that current Islamic financing is all based on risk-sharing or all conventional finance is just deceitful risk-transfer. Only 20% is the share of

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[3] Now ism connotes a creed an ideology and a movement that persistently guards and promotes some specific interest economic, social, political and so on. Thus capitalism is an economic doctrine that evolved and grew into an institutional system to protect and promote the interests of capital owners in the world. Thus seen, the term 'Islamic capitalism' that recently gained currency seems to me internally inconsistent.

participatory modes in Islamic finance; thus debt-based transactions – leasing and murabahah - dominate. In fact scholars are going to the extent of asking: Is Islamic finance in Malaysia interest free? And, there is even an opinion that pure mudarabah involves risk-transfer from the financier to the worker which may ex post turnout less than the transfer earning of the latter. If so risk-sharing would become exploitative of the worker..

The logic of capitalism not only presupposes the existence of hired factors of production - workers and the natural resources - but also of an *initial* facility of finance provided by bank credit to pay for wages. The recent heterodox view that finance is a sort of invisible *ex ante* flow in modern economies has elements of truth; it links well with Keynes according recognition to the importance of money as financial asset. The recognition led to viewing money as an interest bearing claim the banks could create or destroy at will in response to variations in the demand for money (liquidity) even though it carried no intrinsic value. One reason, among others, for allowing banks to create credit is that the act facilitates the adjusting of supply of money to seasonal variations in its demand.

Islamic banks operate in a capitalist system in competition with their conventional counterparts. They cannot do business in defiance of the systemic requirements; they can possibly observe the Islamic ban on interest but would find survival difficult without credit creation. Fractional reserve system is a pre-requisite for credit creation. Hence, suggestions of keeping 100% reserve against deposits in Islamic banking are impracticable. It would thus be helpful to see briefly how banks create credit to understand and evaluate measures central banks use for controlling it to keep the system stable.

3. Credit creation process

How the fractional reserve system enables banks to create credit money is easy to see. Initially banks have cash deposits. Each bank knows by experience that on a normal day most people withdraw only a fraction in cash from their accounts. So, retaining a safe fraction of cash deposits, the bank lends the rest to a third party on interest. But it asks the borrower to open an account with the bank to deposit in the loan money. Thus, loans create deposits. The bank treats credit deposits as cash deposits and advances loan out of loan so to say. The process multiplies deposits raising their inverted pyramid. Suppose each bank retains on an average F fraction of cash deposits as reserve to meet the daily withdrawals while the central bank of the country wants banks to maintain with it a minimum fraction R of their deposits – cash + credit – in the form of cash. How much credit can a bank create given these constraints? Thecredit multiplier M provides the answer. Ignoring proof, M can be calculated as under.

$$M = 1/F \, [1 - R] \qquad (1)$$

To illustrate, assume a bank has $50m in cash deposits and has to keep F = 0.1 fraction of the sum every moment in its safe to meet the daily withdrawal demands. Furthermore, suppose that each commercial bank is required to maintain 5% of its deposits –cash plus credit - in in the form of cash with the Central Bank, implying that R = 0.05. The credit multiplier M wil
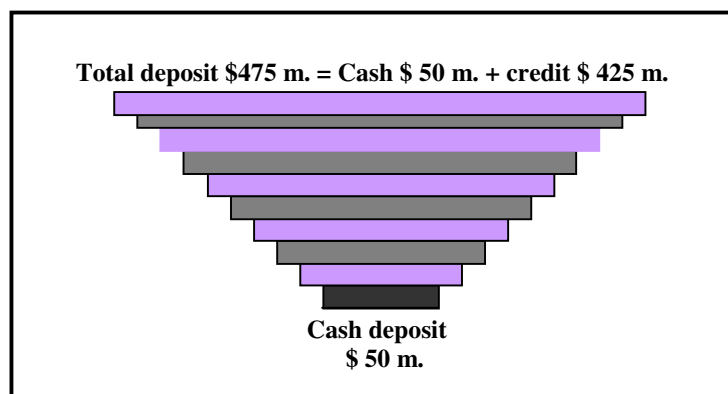
Figure 2: Inverted credit pyramid with
F = 1 / 10 and R = 1 / 20 (Multiplier M = 9.5)

then be 10 x 0.95 = 9.5. The 50m cash deposit with the bank will enable it to have a total deposit worth 50 x 9.5= 475m. If we take out $ 50m cash deposits from the total, the remaining $425m would be the *credit-on-credit* or loan deposits the bank has generated. Figure 2 presents a schematic depiction of how the process creates an inverted credit pyramid in the economy. Note that an individual bank cannot create credit disproportionate to others because on balance it will soon find its net cash inflows reducing via inter-bank clearances. The cash string forces it to remain with the group. However, the credit creation power of the banking system as a whole is tremendous as mutual claims against each other are largely cancelled. The interest received on this huge amount minus the part of it payable to cash deposit holders and other operating expenses will all belong to the bank owners which they share with their managers and agents.

Banking is thus an exceedingly lucrative business. Maturity transformation via renewals converts short-term credits into long-term funding. Leverage gains tend to make businesses over-adventurous. Rising profits lure banks continue pumping in the air until the bubble burst, economies roll down the hill; unemployment becomes rampant. Rising leverage gains fuel greed and have largely been the cause of frequent financial turmoil like the one world faces since 2008. The solution is seen in strengthening the capital base for restraining credit expansion beyond the limits of safety. Standard capital adequacy ratios are being developed under what are known as Basel Accords[4]. Islamic financial institutions have also to fall in line. Monetary authorities in various Muslim countries and the IFSB are seized with the issue: the regulatory frameworks are being revamped and new standards are being designed.

4. The determinants of profit sharing ratio

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[4] For a critical evaluation of Basel Accords, see Hasan (2014). The Capital Adequacy ratio is found as under.

$$CAR = \frac{Tier\ 1\ capital\ +\ Tier\ 2\ capital}{Aggregate\ risk-weighted\ assets} \geq 1$$

"Capital adequacy ratios are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. An international standard which recommends minimum capital adequacy ratios has been developed to ensure banks can absorb a reasonable level of losses before becoming insolvent. Applying minimum capital adequacy ratios serves to protect depositors and promote the stability and efficiency of the financial system". The Central Bak of New Zeeland.

Participatory finance is regarded as the high point of Islamic finance where losses are shared in the same ratios as the capital contributions but the sharing of profit arrangement is not to be the same. The interesting question then is how the sharing of profit ratio is determined? Of course, it is settled by negotiations between the parties. But there have to be some factors guiding the negotiations. *Mudarabah* is a contract in which a financier, say a bank, provides funds to an entrepreneur (firm) for investing in a business venture to share profits in an agreed proportion, losses falling on capital alone.[5] This view implies what we may call a *puremudarabah* model where the financier is assumed to provide the *entire* capital to an empty handed entrepreneur; the model fits well even today to small partnership businesses to undertake specific projects. But the modern economic scene is dominated by large corporations that have long eclipsed small proprietary businesses. Likewise, banks have almost completely replaced personal financing of the earlier era with institutional arrangements. What realistically fits in the present situations is the model of what we can term as *mixed mudaraba*, where the bank is an outside financier providing fund to running businesses on a profit sharing basis. Corporations operate mostly with their (owners) shareholders' money supplemented by bank finance, if need be. Banks mostly use customer deposits for provide finance to various sort of borrowers – individuals, firms and public institutions.

Banks mostly employ two-tier *mudarabah* models to work as financial intermediaries. On the one hand they obtain deposits from the clients under profit (loss) sharing arrangements, on the other hand they finance clients using the deposits plus their own money under the same sort of profit (loss) sharing contracts. It is obvious that the sharing ratio of profit with the depositors would be less than the sharing ratio with the borrowers, the difference being the *banks' margin* (Hasan, 2008). We shall show that the sharing ratio with the depositors can be used as a credit control measure by the central banks.

5. Profit sharing ratio and credit control

In the classical view of *mudaabah* the entrepreneur was an empty-handed person the financier providing the entire capital. The business constituted a one off short-run project; the concept of a large sized running business requiring perennial investment with changing owners was not there. The scenario today is totally different. Corporate businesses need large investments on a long-run basis; *Mudarabah* has to join in a participatory financing program. In such a program the bank as *mudarib* would mostly provide only part – say λ fraction - of total capital K invested in a business. Thus, borrowed amount of money L divided by K would equals λ Thus, λ operates both as the loss sharing ratio for the bank as also the leverage measure for the borrowing firms. The business owners' portion in capital would thus equal $(1-\lambda)$ K. Of course, losses, if any, are to be shared between the firms and the bank in the same ratios as are their capital contributions i.e. $(1-\lambda)$ and λ respectively.

In *mixed mudarabah* profit sharing applies to earnings that are allocable to the part of capital K a bank provides to the firm. Thus, if P were distributable profits, λP would be

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[5]Paraphrasing Bank Negara Malaysia, mudaraba is an agreement made between a party who provides the capital and the other - an entrepreneur – who is thus enabled to carry out business projects on the basis of sharing profit in pre-agreed ratios. However, losses, if any, are borne solely by the provider of funds. Bank Negara Malaysia <http://www.bnm.gov.my/index.php?ch=174&pg=469&ac=383>

allocable to the bank the pure financier. It is this part of profit which is the subject matter for sharing with the firm. Negotiations between the two lead to the decision that a fraction of this, say σ^*, will go to the bank and the remaining (1- σ^*) the firm will retain for entrepreneurial services it rendered to make bank money earn a return. It is easy to see what goes to the bank is a smaller fraction, say σ, of *total* profit P than σ^*. For, $\sigma^* \lambda P$, the bank's profit share, divided by P would equal $\sigma^* \lambda$. In $\sigma = \sigma^* \lambda$ both σ^* and λ being less than 1, their product σ must be smaller than either of them. The derivation of σ allows the treatment of the ratio issue at the macro level and helps construction of models to show, as in equation (2), that profit sharing ratio σ is a function of four variables i.e. the expected rate of profit r on capital K, the proportion of borrowings λ in K, the market rate of interest r_i and the risk premium or economic profit α (Hasan, 1985).

$$\sigma = \frac{\lambda}{r} (r_i + \alpha) \quad \text{where, } \lambda (r_i + \alpha) < r \text{ because } \sigma < 1 \qquad (2)$$

It follows from equation (2) that in a competitive setting the sharing ratio σ for the bank at the macro level varies inversely with profit expectations r and directly with the remaining three determinants λ, r_i, and α . We now change the explanation of these variables with reference to the *mudarabah* contract between the banks and their depositors so as to forge a credit control measure for Islamic banks.

    We assume r to be the rate of profit on capital K that a bank invests in business (r = P/K). The bank has (1- λ) and the depositors λ share in K. Likewise, σ^* is the banks' ratio for the sharing of profit with the depositors. Now, suppose the maximum leverage gain (risk premium) the central bank allows to banks is β. The upper limit for return on bank investment share $K_B = (1 - \lambda) K$ would thus be r + β the remaining profit accruing to depositors on their investment $K_D = \lambda K$. From profit P, the amount $(1 - \lambda) P$ would be allocable to the bank on its share in K but it will also get σ^* fraction of profit allocable to the deposits i.e. of λ P. Thus, for the bank we may set up

$$\frac{(1-\lambda)P + \sigma^* \lambda P}{(1-\lambda) K = K_B} \qquad \leq r + \beta \leq 1$$

$$\frac{r(1-\lambda+\sigma)}{(1-\lambda)} \leq r + \beta \qquad \text{We have } \frac{P}{K} = r \text{ and } \sigma = \sigma^* \lambda \text{ as above}$$

This reduces to

$$\sigma \leq \frac{\beta}{r} .(1-\lambda) \leq 1 \qquad (3)$$

    It is obvious from equation (3) that for any given values of r and λ the profit sharing ratio (PSR = σ) for the bank would vary directly with β. Thus, β can be a cost free policy variable that the central bank of a country can use for mandatory *ex post* adjustment of the PSR in Islamic finance to enforce fairness in the distribution of *mudaraba* profits between the banks and the depositors.

    The use of the instrument would also force banks to adjust their leverage ratios via σ of equation (2) to harmonize with changes in β. For, the introduction of β as the control variable into the picture would by definition affect α in equation (2) impacting in the process the size

of σ the banks' profit sharing ratio with businesses that is making credit costlier or cheaper for the latter.

Equation (2) provides us a common sense but useful link between the profit sharing ratio of the banks and the rate of interest in a dual monetary system. Let us merge α with r_i and put $\lambda / r = \mu$ to make analysis easier. Take μ as a constant implying that only r and λ could vary such that their ratio stays unchanged.

We now have a linear equation $\sigma = \mu\,(r_i + \alpha)$ which passes through the origin μ being its slope. It sets up a positive relationship between profit sharing ratio σ and the rate of interest plus α as shown in Figure 3. It follows that for the same r_i the profit sharing ratio σ may fluctuate with changes in leverage λ or profit expectation r or α. But it could also remain constant, if changes in λ and r take place in the same direction such that μ remains unchanged.
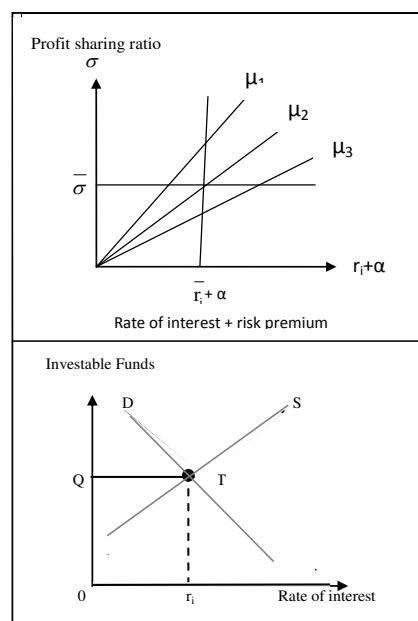

Figure 3: PSR interest rate and investment relationship

It follows that if the central bank of the country lowers β that would increase the rate of return to the depositors leading to a reduction in bank margins. To keep their margins intact the banks are expected to demand higher profit sharing ratio σ from the borrowing firms reducing the leverage lure and profits. Thus, β can be an effective control measure to curb inflation. During recession an increase in β could boost the sagging business morale through brightening profit expectations. Demand for investment funds may look up and credit creation may fill up emerging gaps.

The use of β as a credit control measure in a dual financial system has several advantages over the traditional bank rate policy. Bank rate policy operates through the manipulation of the money use price which conflicts with the Islamic ban on interest. In contrast, ϑ leaves interest rate untouched; it operates directly on profit margins of both the financiers and the borrowing businesses having a better psychological impact. Interest rate is a blanket measure. It affects borrowings for all purposes in equal measure – relatively more urgent and socially

desirable or frivolous. Possibly, ϑ proves more amicable to pursue discretionary policies i.e. for selective control of investment channels. Finally, changes in interest rate affect the entire financing system – all purposes, all modes and all markets restricting the frequency of using it; β is more flexible (Hasan, 2010).

6. Other credit control measures

Open market operations:
Normally, the Central bank of a country does not enter the financial markets but occasionally uses the right to encourage credit expansion or contraction through impacting the credit creation *base* of the commercial banks. It can do so because it always carries a stock of first class treasury bills and commercial securities. As opposed to interest rate the price of credit, open market operations affect the cash-base of commercial banks and thus their credit creation capability.

When the economy is climbing up money incomes tend to expand at a faster rate than real output (why?). Prices rise and the economy soon finds it in the grip of inflation. To reduce cash base with commercial banks, the Central bank starts selling securities in the open market competing with other sellers. The people purchasing these securities issue checks on their banks. Cash moves out from the banking system into the coffers of the Central banks. Credit multiplier is expected to work in to opposite direction exercising a dampening effect on price level. The action is reversed if the economy turns direction and going down the hill – deflation is taking place. The Central bank starts buying securities in the open market. Papers pile up with the bank, money being pumped into the system and credit creating ability of commercial banks rises. The policy may not succeed if people keep sale proceeds with them or demand for funds stays unresponsive. For, one can take a horse to water but cannot make him drink against his will.

Open market operations have some serious limitations as a measure of credit control. During inflation, the prices of fixed return securities – Islamic or non-Islamic – tend to fall because of better income avenues now available for free funds. Thus, in all probability the Central Bank must sell securities at prices lower than at what it may have purchased them. In the same way, it must purchase securities at higher prices during recession compared to new investments. Thus, it is likely to incur losses on purchases too. How much loss of money the bank can take and justify it in a democratic set up is an important question[6]. As open market operations too work via affecting return on securities divergent from the coupon rates, the method departs from Islamic norm of avoiding interest.

Statutory reserve requirements
We have mentioned earlier that the scheduled commercial banks – conventional or Islamic – have to maintain a certain percentage of their cash deposits in their accounts with the central bank. This ratio can be increased or decreased by the central bank. The central banks use the ratio variation discretion as a measure of credit control. As this policy measure contracts or expands the cash base of the commercial banks it is an effective measure in the hands of

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[6] The Federal Reserve has recently been buying bonds ad pumping money into the economy to keep long-term interest rates low to encourage borrowings from the banks. However, either the policy is not succeeding or the Fed is losing money on purchases; for It also trimming back its stimulus programme now to $3.5bn from $ 10bn a month (BBC News 2014)

central banks. They lower the ratio to overcome recessionary trends in the economy and raise the same when inflation is rearing its head.

Cash deposit ratio.

As a supplement to the statutory reserve requirement the central banks have a second string to their bow – the cash-deposit ratio. While reserve maintenance with the central bank makes commercial banks part with cash, they are not obliged to so in case of cash-deposit ratio. Here the banks do not lose their hold on cash but only have to maintain a minimal of cash with them defined by the ratio the central bank indicates from time to time. The impact of variation in the ratio is the same as variation in the reserve maintenance ratio. Islamic economists have no reservations about the use of the two ratios as methods of controlling credit creation by banks (Ahmad, 2008).

Moral suasion

Finally, as the Central Bank has special privileges and power, especially as the lender of the last resort it acts as a philosopher, friend and guide to all commercial banks in the system. Banks listen to its advice. Sometimes a circular issued to the banks concerning credit management may have the desired impact. Thus, *'moral suasion'* is counted among the methods of credit control.

There have been claims that Islamic banks withstood the current crisis better than their conventional counterparts. Several studies including Hasan and Dridi (2010), Lewis (2008), and Mirakhor (2007), indeed found that Islamic banks are generally more resilient to the crisis than the conventional. Cihak and Hesse (2010) find that small Islamic banks are stronger financially than small conventional banks. Beck et.al (2013) conclude that Islamic banks perform better in terms of capitalization, asset quality and are less likely to disintermediate during crisis. But there are also those who do not subscribe to this view. Bourkhis and Nabi (2013) for example, show that there is no significant difference in terms of the effect of the financial crisis on the soundness of Islamic banks and conventional banks.. One comes across some interesting observations on the issue in the IFSB 2013 Stability Report. The opening observation says that Islamic banks are found in a comparative study more resilient than the conventional; the reason being their sturdy capitalization ratios. But the Report hastens to add that these ratios for Islamic banks declined in Asian jurisdictions in 2007-2011, while conventional banks augmented their capitalization during that period (Executive Summary). Thus, the debate on the point remains inconclusive.

For us, Islamic banking is too small and has not yet developed the connectivity with the global system to attract infection. In any case, not a few Islamic banks did come to grief, especially in the Middle-East. Kuwait has recently refused to bailout the defaulting banks in the country. In sum, time has not yet come to feel elated; many hurdles have to be crossed; challenges have to be met to bring ground realities closer to aspirations.

7. Some related issues

We now turn briefly to the three issues gaining currency in discussions on Islamic banking in the wake of the ongoing financial turmoil across the globe. These include (a) Islamic banks have not been much affected by the current turmoil which shows the comparative resilience of their modus operandi (b) risk-sharing is or should be the sole basis of financing in Islam and (c) the efficacy of governmental intervention to pre-empt such crises in future.

(a) Current financial crisis and Islamic banks

Introductory section of this paper provided a thumbnail sketch of the financial crisis that has downed mighty banks even governments in the West over the past more than five years and gives little hope of abating. During this period has emerged a new line of thought combining two propositions. Islamic banks have faced the crisis better than the conventional testifying to the inherent strength and resilience of the system. This strength follows from a close link between financial flows and productivity in the real sector of the economy. Nabi (2012) finds that the presence of diversification in Islamic banking sector across countries reduces the vulnerability of financial contagion. Ahmed (2010) confirms: "This intrinsic property of Islamic finance contributes towards insulating it from the potential risks resulting from excess leverage and speculative financial activities which are part of the root causes of the current financial crisis". Abbas (2007) contains similar views. True, the factors mentioned in these writings might have kept Islamic banks less affected during the crisis but at the same time we cannot ignore certain other factors which softened the impact crisis on Islamic banks. Consider for example the following points.

1) Islamic banks are still too small to attract the contagion because of their tiny existence; the ratio of Islamic banks asset to the conventional is just 1:164 in 2011 even as it has been improving over the years[7] It has climbed down to 1:112 in June 2014.
2) It does not probably take one far to say that Islamic banks are not affected because they are based on profit and loss sharing. To be frank, the contribution of Islamic banks to participatory finance has still not crossed the 20% mark, the remaining transactions are essentially debt-based. (Hasan 2014)
3) Islamic banks have not yet developed enough connectivity with the mainstream system for the transmission of the contagion. Even then, it is not true that Islamic banks have not at all been affected. It is on record that several banks including Nakheel of UAE landed in trouble and the state have to bail out and Kuwait refused to bail out their failing banks.
4) Most comparisons employ econometric models where sample designs, reliability of data as also their homogeneity over time and space may be carry question marks. Particullarly

Figure 4: Islamic Banking global growth trends
Source: IFSB Survey Report 2013 (Modified)

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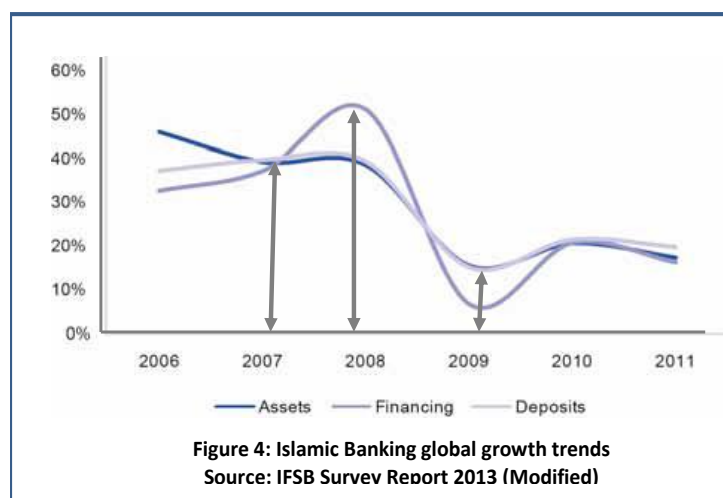
[7] The ratio is based on the volume of global financial assets being $213 trillion (IMF Financial Report 2013 and Islamic financial assets $1.3 trillion according to a Reuters 2012 study.

infection within the system units is a smaller matter than the overall macro impact of the turmoil on various banking variables. Here the injury is not the result of financial markets chaos; it is just its reflection. It is the consequence of wide and wild lurching of the broad macroeconomic variables – national income, savings, investment, money supply taxation, wage levels and so on. Figure 4 is revealing on the point.

(b) Risk-sharing as the sole principle for Islamic finance
From the perception that Islamic banks have faced the financial crisis better than their conventional rivals some Islamic scholars – particularly my friend Abbas in his various writings – probably thought that the basic reason is the avoidance of interest in Islam. This view has some serious implications: (i) interest based financing is entirely risk-free (ii) Islam does not allow fixed return on investment in any circumstance, (iii) No risk transfer is involved in a sharing scheme and (iv) finally, risk-sharing is automatically equitable. Let us examine if these implications are tenable.

In fact, pleading for risk-sharing as the *sole* permissible Islamic principle for financing is not new: it is a re-echo of the age long precept of the earlier Islamic economists epitomized in the Chapa's 'No risk, no gain' rule highlighted in his 1986 publication *Towards a just monetary system.* The evaluation of the precept was central to Hasan (2005). I need not reiterate my position here.

Now, the success of any policy to pre-empt future turmoil and maintain economic stability presumes a minimal honesty in intention and operation on the part of those who implement the reforms. And it is here that many are not sure of the required integrity. They cite the evidence from the happenings that led to the current debacle: interest-rate-property-price manipulation to reap speculative windfalls by the bank owners and managers (Bianco et al 2008) Figure 5 throws some light on the connection.
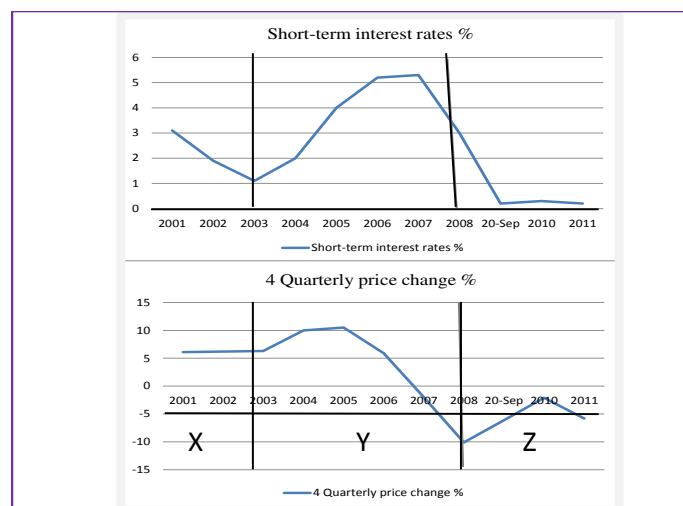

Figure 5: Low interest rates pushed up property prices but before the buyers could take in profit hikes in interest rates caused the crash in the property market. Fore closures mounted. Mortgage market debacle snowballed to other sectors of the economy and across countries.

the lagged response seems to reveal. In section X falling interest rates eventually pushed up property prices leading to expansion of mortgage loans. Interest rates gradually climbed up in Y section. Property prices continue rising for a while before correction could take place. Soon

property price crashed, foreclosures became rampant, collapsing banks in the process. In section Z interest rates touch the bottom, property prices recover slightly but then dip irrevocably: the crisis was well on course. Nicholas Ryder (2014) provides a detailed and graphic chronicle of crimes leading to the near collapse of the western financial system. In the process he raises some exceedingly important questions doubting the system's ability even to recognize such crimes, let alone its ability to address them.

Such sort of doubts revitalized old arguments in favour of governmental non-intervention in the markets. Recently, it was Robert Higgs (2012) who set the ball rolling: he saw the genesis of financial crises in the governmental intervention in national economies through the abridging of property rights and their mishandling. Higgs wrote:

> *In my conception regime uncertainty pertains above all to a pervasive uncertainty about the property-rights regime—about what private owners can reliably expect the government to do in its actions that affect private owners' ability to control the use of their property, to reap the income it yields, and to transfer it to others on mutually acceptable terms.*

Palpably, it is the reiteration of the old laissez faire doctrine that walked smart in the guise of liberalization towards the closing decades of the last century.

However, dissentions to non-intervention today are much louder. The global financial crisis has given greater credence to the idea that active state involvement in the financial sector can help maintain economic stability, drive growth, and create jobs. There is evidence that some interventions may have had an impact, at least in the short run. Even as there is some evidence that governmental intervention might have negative effects in the long run, it does not mean that the state should desist from keeping an eye on financial happenings to be caught napping (Cihak 2008; and Demirguc Kunt, 2013).

Islam stands for freedom of the individual and the markets but not at the cost of social well-being and fair play. The religion is not anti-rich and grants all protection to private earnings and wealth. But its norms of legitimacy are not a matter for market arbitration. State regulation of market behavior and practices carries undisputed evidence over time and space in history. Islamic requirements for the fulfillment of basic needs, removal of poverty, reduction in inequities and keeping the balances straight in all spheres of life presupposes a substantial state intervention in the economic life of the community with discretion. Government intervention in economic activities under Islamic dispensation is to be a source of certainty, not of uncertainty.

Let one understand that capitalism is in essence a system that free markets operate to protect and promote the interests of the capitalist class the world over through persuasion or oppression. Apart from unabated availability of human labor, natural resources and instruments for production, it pre-supposes the existence of a financial system to lubricate the wheels of trade industry and commerce. Islamic banks chose to join the competitive race of the system. In this competition, they cannot avoid credit creation which is the life blood of modern interest-based financing. Operating in a dual financial system, Islamic banks cannot survive without following conventional banks in some ways not to their liking albeit they can possibly avoid using the institution of interest and what goes with it.

In continuation, it is fallacious to argue that Islam approves only risk-sharing as basis of economic organization. And, to restrict it to finance alone implies that the dispute is conceived as within the capitalists' house to the exclusion of other cooperators in production,

especially labour. To that extent, the talk of justice in sharing may perpetrate injustice. Islam does allow fixed returns to factors of production; it grants even time value for money in deferred payment contracts. Let us be clear that an economy cannot work without a fixed incomes' benchmark. It is like seeing geography work without the sea level being the reference for measuring heights. Are not Islamic banks currently using interest rates for bench marking? (Shaukat 2014)

8. Concluding remarks

We have examined the instruments central banks can use to regulate credit creation from Islamic perspective and have suggested a new measure based on the Islamic profit sharing norm. Its merit is that it can impact both categories of banks – Islamic and conventional – in the same direction without imposing costs on the central banks.

The year 2009 was a critical for Islamic Finance as the downturn tested the resilience of the institutions and financing structures that endeavor to comply with the ethical and moral investment guidelines that form the core of the *Shariah* law. The crisis, however, showed that the sector has not been without its casualties, with high-profile Islamic names such as Tamweel, Amlak and The Investment Dar falling foul of the credit crunch (Howladar, 2010). Thus, the industry is likely to face increasing challenge in the future. Diversification, product innovation and standardization of norms and harmonization of regulations across countries can go a long way to help Islamic finance industry face the impeding challenge.

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However, to pronounce ethical norms is one thing; to see them operate on groud is quite another. It will far from truth to opine that conventional financial settings are devoid of ethical norms of behavior; the lament is that it is the blatant continual violation of these norms that has dragged the world to the brink of disaster.

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