The impact of the financial crisis on the global economy: Can the Islamic financial system help?*

Trabelsi, Mohamed Ali

Faculty of Economics and Management of Tunis, University of Tunis El Manar

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TRABELSI Mohamed Ali
Department of Quantitative Methods,
Faculty of Economics and Management of Tunis,
University of Tunis El Manar, Tunisia

Abstract

Research Question/Issue - The aim of this article is to analyse the different measures taken by the G7 and G20 leaders to face this crisis and to show whether such decisions represent a return to protectionism.

Research Findings/Insights - We proposed the introduction of a new economic system based on Islamic banks' principle which calls for cancelling interests. This line of thinking might solve speculation problems and put this type of crisis to an end.

Theoretical/Academic Implications - Our article represents a point of view on the financial crisis, the return to protectionism and the role of Islamic banking.

Practitioner/Policy Implications - This financial crisis pushed most developed countries to lower their banking rates and to implement null- approximating interest rates, a move which replicates the principle adopted by Islamic banks.

Keywords: Crisis, Economic, Finance, Protectionism, Islamic Banking.
JEL classification: G11, G12, G14, G19
Paper type: Viewpoint

1. The financial crisis

1.1. The crisis follow-ups

The international financial crisis which hit the world since approximately two years now is presented as the worst financial crisis ever seen since the 1929 great depression. Philippe Waechter (2008), the economic research director of Natixis Asset, observes that *"the crisis has shaken the largest banks of industrialized countries; a crisis which forced the Central Bank of America to innovate its intervention methods in order to allow for the financial system to function again. A crisis which showed to the world that the American economy can no longer survive by itself and that it needs the cumulated capitals from Asia and the oil-producing economies; a crisis which has lasted because it touched the American households' real estate capacities"*. Although it seemed to concern first the US sub-prime market (Bénard, 2008), the crisis has progressively spread across the whole of the financial markets through derived products, securitization of bank credits and allocation of credits. Risk incentives, i.e. the extra remuneration solicited by creditors to cover the attached risks, have increased over products emanating from securitization, reflecting an increase in failure probabilities and a small need for risks. Lack of transparency linked to multiplication of intermediation between lenders and borrowers has rapidly provoked a trust crisis. Setting of assets to market value forced banks to immediately record the drop of their value. Starting from summer 2007, banks have thus allowed in their accounts assets depreciations in each quarter.

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However, banks are expected to respect the ratios called "prudential" ratios (or solvency ratios) defined by a minimal share of equities relative to the assets which are given a heavier weight than that given to the high associated risk, consistent with the Basle criteria. Besides, banks' recourse to intermediary companies has permitted them by-passing these regulations excluding some assets out of their balance. However, since the loss in value of assets threatens the survival of theses intermediaries, banks have been forced to reintegrate them in their own balance, and impairing it more. In order to reset the prudential ratios, banks have sold a part of their assets, increasing their capital, and thus raising the level of equities offer and forcing markets to collapse.

The global nature of the crisis is one of its most distinctive traits; the majority of world economies have suffered. Sub-prime credits exist mainly in the US (and, under more or less moderate forms, in other countries like GB) and loans have been an exercise made by American institutions. This crisis has rapidly propagated all at once due to the interdependence of financial institutions, to securitization which resulted in investors accessing foreign real estate markets, and to re-evaluation of price risk. Decrease in prices of risk-bound assets has affected European banks which hold such assets, diminishing demand for them and damaging European stock markets.

Other assets have paradoxically received earnings linked to investors' outmost caution. This prudence has notably led to a return towards public bond markets. Investors prefer to invest in public bonds, reputed as more secure. Banks have had difficulties in ensuring equilibrium in their balances, namely through refinancing inter-bank operations or operations with the central bank. Central banks have had to intervene in a massive and repetitive fashion since summer 2007. They have reacted by increasing the quantities of funds lent to banks and by decreasing principal interest rates. The two actions have been undertaken simultaneously.

After a relatively stable 2008 period, tensions over financial markets have intensified again in September 2008 namely after Lehman Brothers bankruptcy. Bankruptcy of this leader bank has notably led investors to re-evaluate failure probabilities of other banks as higher, as revealed by the rise in interest rates intervals between inter-bank loans and state-bound loans.

Risk aversion entailed new tensions on stock markets and international inter-bank markets. If the plans swiftly put in place in the US and Europe and interventions of central banks (Adda, 2009) have significantly diminished tensions over inter-bank operations in the coming weeks, stock markets have nevertheless remained instable. In the US, the Standard and Poor index of December 2008 has registered its third collapse since 1872, after the 1932 and 1938 episodes.

Jacques Sapir (2008) underlines that the current crisis consists of three superposed crises that are linked by their nature, but separate in characteristics and time span; a liquidity crisis, a financial crisis and a crisis of capitalism as a model. This combination is extremely rare. It explains the seriousness of the current situation, which from now on cannot be compared to the 1929 crisis. He adds that these three crises do not develop at a similar pace. They have different repercussions and rhythms. They are, however, tightly linked in as much as the model crisis induces the financial crisis which touched on the liquidity crisis. These three crises have developed themselves at a moment in history where American hegemony is challenged and where the whole of the international institutions are questioned or questionable. They have come at a moment where no other power could claim hegemony and where new development models are emerging. These crises imply a global re-evaluation of international integration strategies.

1.2. An economic and a financial crisis

The economic and financial crises that the world is witnessing today created instability and uncertainty. Maurice Allais (2002) describes the causes of the financial crisis that preceded the one we know today. All of the major crises of the 18^{th}, 19^{th} and 20^{th} centuries have resulted from an excessive development of payment promises and their financing. Everywhere and anytime, the same causes generate the same effects and what must happen happens.

Starting from June 1997, a monetary and a financial crisis have been triggered in Asia and they still persist. Progression of these crises, which no one predicted their suddenness and extent, has been very complex. A first phase, from June to December 1997, purely Asian, began with a higher speculation on the decline of the Thai currency. This period has been stamped by the decline of Asian countries' currencies and stock markets. The second phase, from December 1997 to June 1998, resulted in the collapse of Asian stock markets. The distinctive feature of this period was the repatriation towards the US and Europe of Asia-bound short-term lending, entailing increase in stock rates in the US and Europe. The end of this period was characterized by a high decrease in raw materials and the collapse of Moscow stock market by 60%. During this period, the difficulties of financial intermediaries in Japan have intensified and the yen continued to depreciate. High monetary tensions have also emerged in Latin America.

The third phase started in July 1998, with the high political, economic and monetary tensions in Russia. This situation led to important stock decreases in the US and Europe. The French CAC 40 has spectacularly decreased by about 30%. The crisis has rapidly spread to the entire world. No one today seems really able of predicting the future with some certainty. In Asian countries, which have undergone substantial decreases in their currencies and stock markets, speculative capital leaks led to serious social problems.

There are several striking similarities between the current international crisis and the 1929-1934 great depression: the creation and destruction of payment means by the credit system, the financing of investments on the long run with short-term borrowed funds, the development of a huge indebtedness, a massive speculation on stocks and currencies and finally very unstable financial and monetary systems.

Today, and since the 1970s, a globalization geographically more and more spread over world economies has been noted, grouping countries of the previous colonial empires like Russia and East European countries since the fall of the Berlin Wall in 1989. The new division of the world is founded on economic development inequalities.

This crisis has caused everywhere, and particularly in Asia and Russia, terrifying unemployment figures and major social problems. Everywhere, the international free-exchange doctrine has been questioned. Two major factors have played a decisive role in this international crisis whose extent is unique since the 1929 crisis:

- The potential instability of the international monetary and economic system;
- Globalizing the economy on both the monetary and the real spheres.

Indeed, what has to happen happened. World economy, which was deprived of a real regulatory system and which has developed in a chaotic fashion, cannot but undergo major difficulties. The reigning doctrine has completely misjudged an essential element: a complete liberalization of exchanges and capital movements is not possible. It is possible only in the frame of regional communities, countries which are economically and politically associated and with similar economic and social development schemes.

This crisis has been marked by a return to protectionist policies. It is in this way that the economic crisis and the slackening of economic growth have coincided with a reinforcement of pressures towards protectionism, mainly in western countries. In fact, the degradation of banks and insurance companies' balances worldwide has led governments to rescue the financial system (Karyotis, 2008). Wasn't it Keynes (1936) who said that when monetary policy was inefficient, notably in the case of a cash trap, budget policy must proceed to socializing a part of the investments? Recent recapitalization of banks indeed falls under these terms. In the same context, Jean-Paul Fitoussi (2008) notes that the repercussions can be very dramatic if this crisis destroys credit allocation. Nationalizing banks and banking systems can be done with a high profit margin. Koreans have done it during the Asian crisis and it allowed the government to sell its banks five years later with substantial profits for taxpayers. We can as well find a similar system with systems based on public guarantee.

2. Protectionism

2.1. History of protectionism

We might define protectionism as a policy of protection of goods to face foreign competition and to maintain and develop domestic production mechanisms. History of protectionism is distinguished by three phases: the first relates to the 19th century, the second is situated between the two world wars and the third started after the WWII.

During the first phase, business relations have been dominated by free-exchange. Starting from the 18th century, Adam Smith (1776) and his classic successors attacked the control of international exchanges-based mercantilist policy. At the end of the 19th century, we have recorded elevated customs duties. The return to protectionism is essentially manifested in:

- Development of nationalist slogans and competition between the major European powers.
- The 1873-1879 depression which fed a stagnation of trade and production as well as major economic difficulties across countries.

During the second phase and after WWI, a new protectionist movement has developed in major western countries. This tendency has been fostered during the 1920s, mainly in the US and Great Britain. The trade policy of this period was characterized by:

- Generalization of protectionist measures over agricultural goods.
- The multiplication of protectionist instruments. Besides customs duties, there was the use of quantitative restrictions and control.

The third phase was characterized by aggregations and negotiations between major powers in order to establish a system of coordination of economic policies allowing the avoidance of the repetition of the inter-wars experiences. The result of these negotiations is the creation of two financial institutions:

- The World Bank for resurrection and development to play the role of a long-term credit bank.
- The international monetary fund which concerned itself with short-term adjustment of payment problems.

Finally, the 1984 general agreement on tariffs and trade (GATT) lists the major principles regulating the international trade system. Despite the developments achieved within the GATT's frame to liberalize world trade, some major problems were not resolved. In fact, despite diminishing the role of customs duties, countries have opted for tariff-free restrictive measures.

2.2. What is the role of protectionism?

Generally speaking, protectionism is presented by the official economy as an absolute evil. It shuts down export opportunities, represses world economy and throws the world into an infernal recessive vicious circle. A protectionism which consists in improving imported goods by leveraging taxes or limiting them by quota systems is still a taboo. Socialists evoke the term competitive good protectionism. For them, « competitive » protectionism has its rationale in the era of globalization where it should figure in the international division of work. It is this protectionism which was successfully practiced in Germany and which was able to reduce work-related costs at the beginning of 2000s by applying the social value added tax (VAT) scheme, shrinking thus salaries, delocalising sub-contracting activities and reducing the state role. Consequently, its good industrial specialisation as translated in competitiveness-cost profits allowed the economy to beat all exportation records. Competitive protectionism functions well when there are export opportunities. A good positioning in terms of quality as well as costs allows access to a growing world economy and benefits from appreciated returns. However, there is this inconvenience of being non cooperative. Germany's successful exportations have been to a large extent made at the expense of its major European partners, France and Italy. This strategy cannot really function in an isolated fashion. The effect is null once the competitor proceeds to strategies meant to improve competitiveness-cost efforts. In general terms, dragging the world economy into a recessive circle is highly probable. In fact, such reduction of costs to preserve or improve competitiveness would shrink demand and consequently markets would collapse. This "competitive" protectionism is tightly nationalist, non-cooperative and dangerous for world equilibrium. It is this latter which is induced by free exchange and which practiced by all major industrial powers that knew how to play the globalization game.

The ultimate objective of protectionism is to allow for a better work remuneration at the expense of capital in order to stimulate global demand. Protectionism will lead to reduction of margins, profits and dividends. Within developing countries, protectionism is needed to protect domestic industries from foreign competition. It is a necessary condition for the success of any industrialization policy. It preserves employment in sectors threatened by international competition and makes it possible for newly born companies to catch up with competitors over international markets. Nevertheless, it presents some inconveniences such as increase in prices due to imposing customs duties. We can note as well a degree of competition restriction which might hamper markets from functioning according to the free competition principle. Finally, it might slow down economic growth and disfavour competition since it eliminates competitors.

3. Protectionism and the financial crisis

The G20 leaders could not resist the temptation of protectionism. This is the official statement delivered by the World Bank through its president Robert Zoellick. Facing the crisis, during these last months most of the G20 state members have tried to protect their industries. However, in the words of Robert Zoellick, this would further worsen the situation. It was in last autumn in Washington that the G20 states solemnly vowed to maintain their trade frontiers wide open. Nevertheless, with reference to the World Bank we might notice that since the month of November, several protectionist measures have been undertaken: embargos on some goods and some technical or sanitary restrictions.

The World Bank points fingers to exploration grants. It is the case of grants allocated by the European Union for dairy products. The car industry is not an exception. Support plans in France and the US are perceived by the institutions as protectionist measures.

The President of the WTO, Pascal Lamy, pointed fingers to the protectionist clauses put in effect in some countries within the framework of their stimulating plans despite the G7 Ministers of Finance's vow not to succumb to protectionism.

Gathered in an extraordinary summit in Brussels, Heads of states and governments have adopted a document in which they stress that protectionism is not the solution to the current crisis. They affirm as well their will to optimally use the unique European market in a way to guarantee the free circulation of goods, services, people and capital so as to maintain growth and employment rates. However, the final communique and other declarations resulting from this meeting did not succeed in quenching the anxiety related to what market experts and financial analysts consider as a contradiction between the verbal commitments in favour of free-exchange and the measures which seem to be different, like the "Buy American" slogan which is part of Washington's stimulating plan and the national plans for rescuing the car industry in France and Italy.

4. Facing the crisis: is protectionism a risk, a threat or a solution?

"*We stress how much it is vital to reject protectionism and not to recoil back within ourselves in these times of financial uncertainty. In this regard, and within the twelve months to come, we restrain ourselves from erecting new barriers against investment or the trade of goods and services, from imposing new restrictions or to implement new export-stimulating measures not in conformity with the WTO's regulations*". Such was the declaration of the G20 representative at the end of the financial market and world economy summit in November 15th 2008. Two months later, the financial crisis became social and was revived again not only bringing keynesian recipes but also protectionist temptations that are so much stigmatised.

The current economic and financial crisis is a systematic crisis, spectacular and particularly destructive. Workers and more generally the companies of the relevant countries have formulated protection demands for their governments. The extent of the crisis and its socio-economic effects have forced these latter to massively intervene, yet fewer governments have even the intention or the means to do so (Borrell, 2009).

Nevertheless, who says protection often says protectionism. Thus, it took only few weeks for the Russians to increase customs duties over car importation and for the Indians to restrain steel importation. Recently, in the US, the Congress has given its approval for a clause entitled "Buy American". This latter stipulates that public works financed by President Barak Obama's stimulating plan will exclusively use iron and steel produced in the US. According to Europeans, this disposition constitutes a violation of the free-exchange and WTO's regulations. This return to protectionism is explained partly by the strong rise of popular demands for the protection of national industries and domestic employment and partly by the will of governments to avoid the fact that public national grants will only serve the importation of foreign goods.

The degradation of the social climate is translated by the multiplication of stimulating plans, whose effects are not yet visible but currently weight on the solvency of public debts and is exerting a heavy pressure over governments. We might notice as well the return of the monetary dumping tactic. No one might, however, ignore the consequences of the competitive devaluations of the 1930s. The crisis witnesses a return to "my own sake" politics as seen in deeds, despite a discourse bespeaking the opposite. Thus, since July 2008 China has put to an end its progressive re-evaluation of the Yuan, which started in 2005.

This state of mind has spread since. In fact, the stimulating plan for the car industry in the US reminds us of similar, even reciprocal, European and Japanese incentives meant only to preserve the competitiveness of national companies. However, if governments' interventions in favour of the mutilated financial sector are justifiable, the interventions for the car industry, the victims of loss of competitiveness and inability of innovation, are not economically justifiable. Certainly, the social and political repercussions of a failing "let go" principle might dramatically backfire and may destabilize once again financial markets. In the mean time, the question about the limits of public interventions is worth asking. What criteria? Which sectors ? Till when ? And for how long? If all these questions are ignored a new set of difficulties will be more difficult to handle.

This analysis shows that protectionism is back and some think it as one solution to the crisis. In addition, the tone has changed at the level of discourse. The declaration of the French minister of economy Christine Lagarde in Davos is very striking: *protectionism might* *be a necessary evil in time of crisis despite ferocious opposition from the others*. Gordon Brown, British Prime Minister, recently declared to members of the British parliament; *the greatest danger facing the world is a return to protectionism*. Angela Merkel, the German Chancellor, has reiterated *that protectionism is a bad answer to the crisis*. All of this brings no insurance and pressures towards protectionism are heating up.

Adding to this, there is the workers' up rise in Great Britain and Ireland against the high number of non-British employees, with slogans such as "British jobs for British workers". In Total in Lindsey, workers have organized a strike against employing foreigners and the board has given way to their demands (50% of the jobs to the British), and sent back 40 Portuguese who were brought there for a purpose. This has provoked protest from Brussels which reminded the world that free movement of people is part of the solution not the problem. Similar behaviour was seen in Spain against workers coming from the south of the Mediterranean. The Swiss have approved only 60% of the renewal of the free movement of people agreement with Europe. Finally, we cannot be oblivious of the survey indicating that 78% of the bosses of German small and medium enterprises (SME) wish to implement protectionist measures. Meanwhile, India has implemented two protectionist measures; one is for steel the other prohibiting Chinese toys (evoking health risks). China has decreased VAT on exportation. Indonesia forces some foreign goods to pass through specific ports and slow their entry. We can see similar behaviour in other countries like Russia, Brazil and Ecuador (increase of customs duties over 940 products).

Having said this, it is urgent that all countries have to end this drift. All historians acknowledge that in 1929 protectionism was one of the factors aggravating the crisis. How to produce, if we deprive ourselves of foreign goods we do not have or which are more efficient or less expensive? How to produce and create employment opportunities, if other countries shut down their frontiers to our products? How to reduce prices and shortage without foreign offers? How to promote productivity without stimulating competition? How to benefit from growth, competence and know-how of others if we chase them out? How to maintain growth without international exchanges? How to promote the third world when we know that external trade is the best way to that?

Certainly the current crisis is serious. Freedom of exchange, if we opt for it, is one of the major anti-crisis measures. Consequently, we should promote free exchange by finalising, for instance, the negotiation cycle of Doha within the WTO in order to boost world economy. The current protectionist spirit, if it changes into a generalized protectionism, would be an irreparable mistake. In this case, the crisis changes in nature and we move from a recession to a depression. It is urgent that we react and make it clear that defending free exchange and denouncing any form of protectionism is necessary. In this context, the economist Fréderic Boccara[1] (2009) brings some answers. According to him, closing frontiers is not the solution, however, we must write down some social and environmental norms with our economic partners and impose a public iron hand on credits destined to investment with a selective credit policy. Credits must be allocated to investments with better returns, extra employment and training at very low rates. He even evoked loans with zero rates. In the same vein, Muslims seem to have the solution which is very simple; bank interest must be cancelled. Indeed, we witness a regression in bank interests everywhere. This might be the birth of a new economic system based on the principle practiced today by Islamic banks.

5. Islamic finance as an alternative

Islamic financial institutions have established a world presence over the last three decades, and indications are that the asset base of these Islamic institutions will continue to grow. It

[1] See l'Humanité of February 14th 2009 : Le protectionnisme, une réponse à la crise ? Entretiens croisés.

seems only a matter of time until an Islamic banking institution, compliant with *Shari'a*[2] practices, will be established in the United States. Doing so will mean that banking institutions' organizers will forge new ties with banking regulators and customers.

The development of Islamic financial practices (Khan & Bhatti, 2008) has significantly altered our archeology of thought as well as the world's financial practices. Recently, the practices of Islamic economics and finance, including Islamic banking, have gained significant progress, yet challenges to future development will be hard to overcome. Therefore, the various supporting elements should continue to be optimized to help accelerate the future progress of Islamic economies.

Chapra M. Umer (1992) noted that it is not possible to design a new architecture without first determining the primary cause of the crisis. The generally recognized and the most important cause of almost all crises has been excessive and imprudent banks' lending. There are three factors that nourished these practices: inadequate market discipline within the financial system resulting from the absence of profit and loss sharing (PLS); the mind-boggling expansion in the size of derivatives, particularly credit default swaps (CDSs); and the "too big to fail" concept which tends to give large banks an insurance that the central bank will definitely come to their rescue and not allow them to fail (Miskhin, 1997). In the same context, Beng Soon Chong and Ming-Hua Liu (2009) noted that Islamic banking is different from conventional banking because riba[3] (interest) is prohibited in Islam, i.e., banks are not allowed to offer a fixed rate of return on deposits and are not allowed to charge interest on loans.

A unique feature of Islamic banking is its profit-and-loss sharing (PLS) principle, which is predominantly based on the *mudaraba*[4] (profit-sharing) and *musharaka*[5] (joint venture) concepts of Islamic contracting. Under the PLS paradigm, the assets and liabilities of Islamic banks are integrated in the sense that borrowers share profits and losses with the banks, which in turn share profits and losses with the depositors. Advocates of Islamic banking, thus, argue that Islamic banks are theoretically better positioned than conventional banks to absorb external shocks because the banks' financing losses are partially absorbed by the depositors (Iqbal, 1997). Similarly, the risk-sharing feature of the PLS paradigm, in theory, allows Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and, thus, to promote economic growth (Chapra, 1992; Mills and Presley, 1999). Bruneï, Abdul Hassan (2009) showed that Islamic banks are somewhat reasonably efficient in managing risk where risk identification and risk assessment and analysis are the most influencing variables in risk management practices.

6. Conclusion

Recently, the global financial crisis that hit the world has given the finance community a sign of how fragile a global financial system that relies only on financial markets. The capitalist

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[2] Shari'a: Divine law, perfect and immutable, as set forth in the *Qur'an* (the holy book of the Islamic faith) and the *Sunna* (recorded teachings of the Islamic Prophet Mohammed).

[3] Riba: Traditionally translated as "usury," the concept of riba includes interest and other forms of profit or gain that are not earned from work efforts.

[4] Mudaraba : A transaction between a financial institution and its customer akin to a venture capital transaction. The financial institution provides all of the capital and, as such, assumes all of the risk of loss. The customer acts as the financial institution's agent in utilizing the funds and also provides sweat equity (including know-how). The financial institution and customer share profits in accordance with a contractually stated percentage formula.

[5] Musharaka: Translated "partnership", a *musharaka* financing typically involves a business undertaking where the financial institution provides a percentage of the capital needed by its customer with the understanding that the financial institution and customer will proportionately share in profits and losses in accordance with a formula agreed upon before the transaction is consummated. The customer provides a percentage of the capital and sweat equity (know-how and management).

system which has become the vehicle for world economic mobility failed to create a valued new world economic order that is more fair, balanced, and able to provide welfare for world citizens.

The financial crisis, for which markets sometimes take the responsibility, is primarily the result of inappropriate regulatory measures undertaken within the Basle II accord which targeted consumer protection, financial and products transparency resulting from the securitization of credits. This crisis is revealing of the failure of the governance model and international regulatory institutions like the International Monetary Fund and the World Bank, calling for the restructuring of regulatory institutions, fiscal paradises, the re-appreciation of rating firms and the creation of a new economic model. This crisis led public authorities to intervene under the guise of cash injections in the form of debts or equities and total or partial nationalization. This type of intervention gave birth to a debate on the return to protectionism and on the role of the state.

This return to protectionism, which we explained on the one hand by a sharp rise in popular claims that aim at protecting national industries and employment, and on the other hand by governments' concern with using public provisions to finance foreign goods, represents a danger to most experts. However, other alternatives were proposed to solve this crisis. We can mention the one which proposes the introduction of a new economic system based on Islamic banks' principle which calls for cancelling interests. This line of thinking might solve speculation problems and put this type of crisis to an end. In fact, this financial crisis pushed most developed countries to lower their banking rates and to implement null-approximating interest rates, a move which replicates the principle adopted by Islamic banks. Also, it is necessary to include the moral and ethical principles in our behavior and in the management of our institutions and to highlight the ill-fate of speculation.

Finally, Mirakhor (2009) noted that one of the important lessons of the recent crisis is the ineffectiveness of a fragmented regulatory framework based on a flawed conception of divided asset-money-commodities markets. Financial innovation, recent information technology advances, and the rapid pace of financialization have blurred the traditional distinction between various markets, calling for a serious questioning of a fragmented regulatory authority. Arguably, the interrelationship of markets would be stronger in Islamic finance, making the case for a unified regulatory framework more appealing.

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