

Remedial Measures for Financial Crisis in the Light of Prophetic Teachings

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Abstract

A few years ago the world suffered from a financial turmoil which emerged in the United States of America, Europe and Asia. It made a large population redundant; many businesses shuttered down and reduced consumption, production, purchasing power, GDP and leading many economies into deep recession. Consequently poor and middle class people found difficult to survive. In the beginning of the financial crisis many suggestions were propounded by economists, policy makers and bankers to reduce its impact. Several policies were implemented to combat against financial crisis yet billion of people are suffering from poverty and hunger. Prophetic teaching is a complete code of life; in its guidance there is a set of teachings which govern financial issues of the society and the market. This paper aims to explore the measure suggested in the light of the Hadith and the Quran

Keywords: Financial Crisis, GDP, Recession, Poverty, Prophetic Teaching, Quran

1. Introduction

According to Kabir Hassan (2011) Financial Crisis is a kind of disruption in financial market causing constraint to the flow of credit to families and businesses and consequently having adverse effect on the real economy of goods and services.

The word “Financial Crisis” is applied broadly to a number of situations in which financial assets drastically start losing their nominal value. The last two centuries witnessed many financial crises associated to banking panics and many recessions coinciding with these panics. Financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults.

Financial Crisis badly hits the production level of the economy and household income and reduces consumption of people living below poverty line thus effecting entire economy. Habib (2010) observed that recent financial crisis caused million jobless and liquidated thousands of corporations. Krugman, P. (2008) also endorsed the poisonous impact of financial crisis in his several writings in various newspapers

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and magazines. Islam provides a cogent solution for these problems; in fact complete application of Prophetic Guidance will not cause financial problems in any society. Most of the contemporary businesses are based on artificial trading which is against the essence of Islamic Economic Policy. Secondly Islamic economics doesn't consider money as goods but a medium of exchange or measure of unit. The contemporary business practices consider money as goods and the interest gained is visualized as rent over money. This is the beginning of major economic evils. It is obvious that when people consider money as goods; they will hoard it which is against the objective of money. Money is made to facilitate exchange, store value and measure unit. It clearly shows that money should be circulated and hoarding it creates a barrier and unables it to discharge its duty. The case of money hoarding is similar to imprisonment of a postman.

Factors Responsible for Financial Crisis

2.1. Subprime Mortgage Lending

The stimulus for financial crisis were excessive and imprudent lending by financial institutions over a long period, housing bubble, global financial imbalances, lack of transparency, securitization problems and rating agencies. Subprime mortgage problem was the first trigger of the global financial crisis. Subprime credit extended credit facilities to borrowers who have deficient credit. The interest rate applicable in the subprime market credit is higher because of the higher risk involved in lending to people who do not show adequate credit worthiness.

According to Jickling, M (2009), US government's lending standards were relaxed in 2000 to the point that many people were able to buy houses they could not afford. As a result when prices began to fall and loans started going bad, there was a severe shock to the financial system. In the early stage of crisis, the interest rate was very low and real estate was continuously rising. The rationale behind taking an excessive mortgage was with home prices in secular uptrend. The people who had borrowed were in the hope that in a few years the market value of the mortgaged house would become greater than both principal and interest payment liabilities attached to it. Borrowers were thinking that they would sell their houses in the open market and excess of the market value of the mortgaged house over the liability towards the mortgage would be potential capital gain to borrowers. However, when the housing market started showing signs of weakness, no longer could borrowers think of selling their houses and paying off their mortgage liabilities as the price of their houses started to fall below the mortgage liability attached to it. Because huge lending occurred during this period of time, when borrowers defaulted, there were huge losses. In the estimation of Schwarcz, S. L. (2008), more than \$20 billion investments were shut down because of the losses on account of investing in mortgage related securities.

2.2. Economic Imbalances in US Economy

The lack of proper and just regulation in the financial system creates imbalance in economy. It is observed that United State had faced the fiscal challenges emerged due to unsound financial regulation. Public-sector budgetary deficits and the private-sector saving deficiency, ring a worrisome note not only for the United States but also for the world economy. The federal government has been running budgetary deficits ever since 1970, except for a brief respite between 1998 and 2001.

The budget moved from a surplus of \$255 billion in fiscal year 2000 to a deficit of \$412 billion in 2004 (Kohn, 2005, pp. 1-2; and IMF, August 2008, p. 602). The deficit declined thereafter to \$317, \$248 billion and \$163 billion in 2005, 2006 and 2007. (IMF, August 2008, p. 1188),

2.3. Easy Loan and Credit Facility

Interest is driver for money circulation in economy. It is considered influential and instrumental tool in modern economy. Interest rate controls the credit system of the country and a little variation in interest rate may increase or decrease the level of debt in the economy. It encourages borrowing. During 2000 to 2003, the Federal Reserve reduced the federal funds rate target from 6.5% to 1.0%.(Federal Reserve Report, 2002) It was done to soften the effects of the collapse of the Dot.Com Bubble and to combat a perceived risk of deflation but later on it was realised in 2002 that credit was fuelling housing instead of improving business and investment. However curtailment of interest rate spoiled economy rather than improvement. Moreover, empirical studies of some economists show that excessive credit growth contributed greatly to the severity of the crisis (Krugman, P 2002). Additional downward pressure on interest rates was created by the high and rising U.S. current account deficit, which peaked along with the housing bubble in 2006.

2.4. Derivative Market

Derivative is an artificial financial product which is very similar to gambling. Expansion of derivatives has detached financial economy from the real economy. The economy in the Western countries is said to shift from the industry to services in the last 30 years. In US the service sector represents over 80 percent of the US economy. Abul Hassan (2010) discusses about the nature of derivative transaction that the participants in the financial industry gamble on what is going to happen in the real world, by betting on how businesses are performing and by betting on their profits. The real economy consists of housing, land, factories, cars and goods that can be traded in real market. Financial economy consists of tradable paper with financial values that rise and fall based upon the value speculators give them usually with no real asset represented. Hassan argues that the financial economy is now valued more than the real economy. The size of the gilt market is estimated at \$45 trillion, the stock market at \$51 trillion, and world derivatives markets is calculated to be around \$480 trillion and more than 12 times the size of the world economy. According to this arguments presented by AbulHassan (2010), investors are not seeking anymore to receive dividends, but rather to take advantage of the inflated price rises. This practice he said has led to speculation of extremely large proportions, including bets on the collapse economies.

2.5. Debt Markets and Non Banking Financial Institutions

Debt Market is considered an important segment of economy; thousands of companies raise their funds from debt market. Non Banking Financial Institution is very similar to bank which only deals with businesses and big corporation in the economy. Both the institutions work as intermediary in the mobilization of funds, from surplus unit to deficit unit. Debt Market and Non Banking Financial Institution were badly hit by bad debt and artificial trading in Hedge and Derivative Market. Features of Derivative market were discussed in preceding chapter. Duthel, H. (2010). Calculated the assets financed overnight in triparty repo grew to \$2.5 trillion and assets held in hedge funds grew to roughly \$1.8 trillion. The combined balance sheet of the five major investment banks is \$4 trillion. It was also an important factor to induce financial crisis in global market.

2.6. Bankrupted Financial Institutions

Financial Institution especially corporate banking is considered the backbone of economy. It helps to elevate economy through proper money circulation but when it deviates from the national financial policy it may spoil the entire economy. As it was experienced in the United Kingdom on August 9, 2007 when BNP Paribas blocked withdrawals from three hedge funds (Hope, W.2011). Initially it was not apprehended but soon led to a panic as investors and savers were tempted to liquidate assets deposited in highly leveraged financial institutions. The International Monetary Fund estimated that large U.S. and European banks lost more than \$1 trillion on toxic assets and from bad loans from January, 2007 to September, 2009. These losses are expected to top \$2.8 trillion from 2007 to 2010. U.S. bank losses were forecast to hit \$1 trillion and European bank losses will reach \$1.6 trillion. The International Monetary Fund (IMF) estimated that U.S. banks were about 60% through their losses, but British and Euro zone banks only 40% (Reavis, C. (2009).

Remedial Measure

Islam has complete treatment of poverty which is discussed at various places in the Quran and Hadith. Muslim jurists like Ibne Taymiyya, Ibne Khuldoon and Imam Shatbi Undulshi has written extensively on this topic. A contemporary Islamic Economics historian, Umer Chapra (2000) has explored the remarkable works done by Muslim jurists. Yusuf Qardawi quoted the incidence of economic well being of Umayyad Period when Umer bin Abdulaziz was the ruler of Arab. Umer bin Abdul Aziz thriftily managed the public resources for the welfare of people. A similar incidence of poverty and drought management which is analogous to resent financial crisis in terms of effect is mentioned in the Surah Yusuf (12:55) in The Quran. The skills used to combat with economic crisis were clearly described in the Quran. Islam has a set of rule to deal with such problem, the most important one is the trustworthiness and honesty, and secondly the person going to deal with the situation should have ILM (Knowledge) and experience. But sadly the people appointed for the task did not have the qualities expected by the Quran to be a manager and possess authority. Most of the economic problems borne in the world are due to said deficiencies. If prompt justice without discrimination, immediate reward, controlled expenditure and acceptance of supremacy of one creator is achieved; poverty and financial crisis will be eradicated from human society.

3.1. Thriftiness in Consumption

Thriftiness in consumption is a grand solution for economic problem. This is an age of consumerism where people are induced to buy the commodities which they do not need. Media attracts consumers through glamour; attractive offers, easy credit and EMI to buy unnecessary goods eat up half of the income of working class people. The Quran urges to priorities human expenditure. It is mentioned in Surah Israel that a person should be frugal in daily spending. God has kept a share of relatives, friends and poor people in the income of every earning person. In order to save the rights and share of poor deserving people Allah asks to spend earned money in thrifty manner, so the rights of relative and poor people could be protected. Allah swt made a system of dole and Zakah to safeguard the economics benefit of people. Private consumption occupies very significant role in balancing the economy. Nowadays most of the economies emphasizes over the printing of currency and circulation of money which causes inflation and rapid price increment in merchandise goods. However the middle class and poor people are constrained to buy necessary commodities. Prophet Pbh saw told that a meal for one person may be

sufficient for two people thus it is apparent that Islam wants to make the people careful about their expenditure. Those who believe in luxurious life and loves extravagant are pronounced as the brother of Satan in the Quran (17:26-27). Extravagance is considered as a sin against the society. This is how Islam holds people equal on the basis of justice. If people follow the principles of Islamic guidelines for expenditure very soon they can bring prosperity in the economy. It is agreed that recent financial crisis is not a direct outcome of extravagance but certain extent it was related to post financial crisis. Those who were affected during financial crisis might have some savings only if they had not spent their money lavishly. The saved money could be used for sustenance. Extravagance is always known to be an enemy of well-being.

3.2. Dole

Dole has a significant position in Islamic economics. Allah swt interlinked dole to freedom from Hellfire. It is clearly instructed in hadith that dole should be given silently. Dole is an instrument which lets money reach very poor people in the society. Research conducted to study human relation shows a lot of disparities, hatred and confliction found between poor and rich. Practice of Giving Dole cultivates relation between rich and poor and reduces social gape in society; moreover it removes poverty and leads society toward prosperity and economic well being. Dole can help in inducing circulation of interest free money in an economy. It extends micro credit which is one of the prime needs of people living below poverty line. Presently microfinance institutions have failed to extend micro credit to poor and needy people of society. Dole possesses the capacity to eradicate extreme poverty from the society. Anyone can give dole; it does not lay down any particular condition like Zakah. Prophet PbuH said a person even having half a date can give it in dole and earn reward. It is concluded that dole is a powerful tool for micro financing without interest.

3.3. Avoiding Debt

Debt has become a kind of market in the economy, thousands of companies are raising their funds through debt market but Islam discourages DEBT. Prophet PbuH Muhammad swt avoided offering funeral prayer of the person who had debt. Global Financial Crisis is an outcome of heavy debt. Debt has exploitive nature; one should avoid it, moreover today Debt market has synchronized with interest rate. Interest rate became an integral part of debt and it is assumed as rent on money. Debt has removed the concept of benevolence from the society, no one wants to give loan to needy people without interest. Islam propounded the concept of Qard-e Hassan (Benevolent Loan) as an alternate to Debt. Debt creates a kind of selfishness and cruelty among people. Though Islam has given the permission of benevolent loan but in fact Islam does not encourage loan. In order to meeting the need of people Islam has opened the door for Dole and Zakah. It is observed people prefer to take loan on interest for their business while Islam has made several financial contracts to facilitate business on partnership but it requires fair practice and superior moral behaviour. Bond market and derivative market is the component of debt market. Most of Muslim jurists disprove the buying and selling of debt

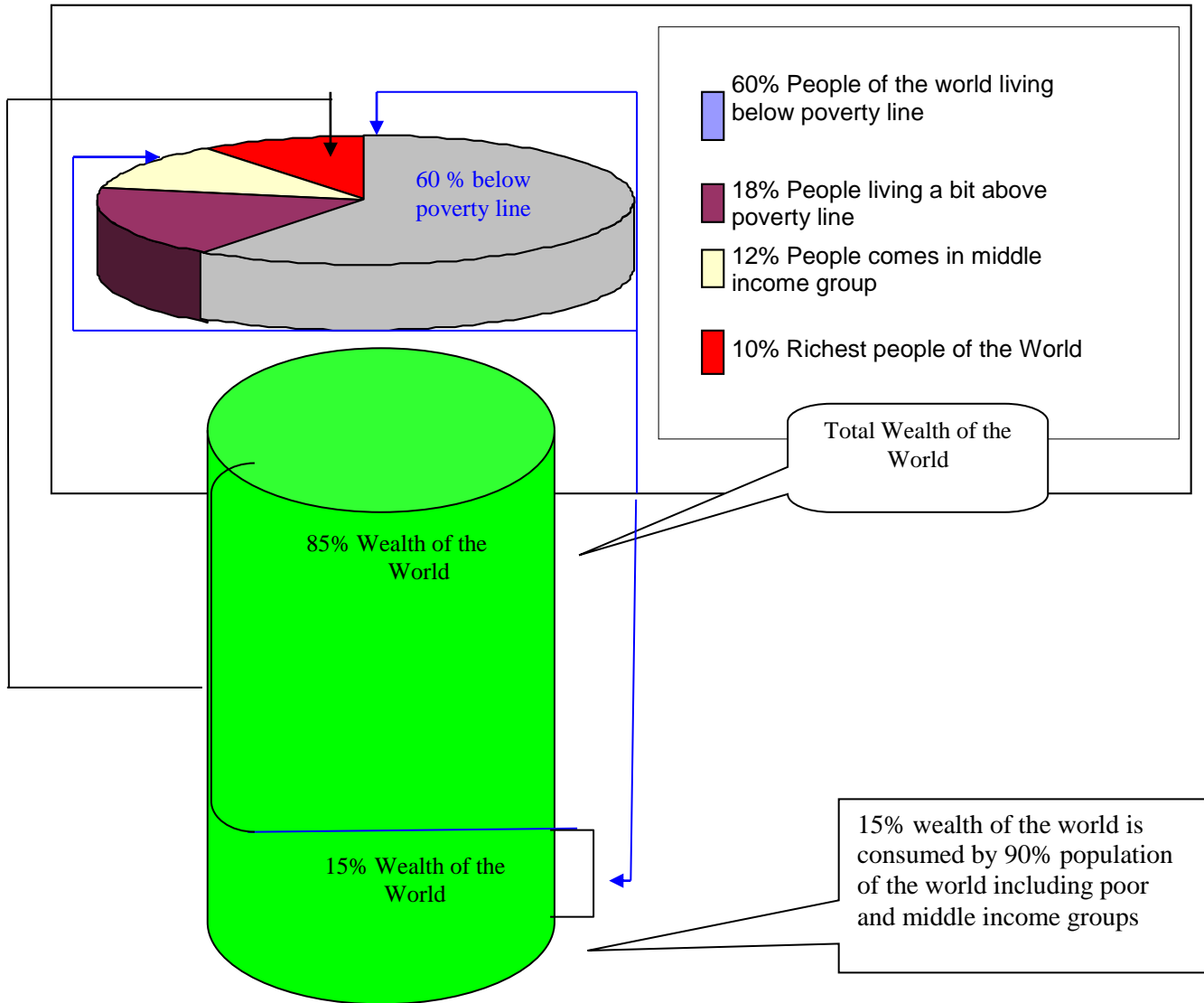
3.4. Distribution of Zakah and Income Inequality

Due to the distribution of Zakah, average and marginal propensity to consume would be higher in an Islamic economy, than in a non-Islamic economy which does not have a similar fiscal measure. (Faridi, 1991)

According to World Institute for Development Economic Research of the United Nation University (UNU-WIDER: 2010), more than 60% of the population live below the poverty line. 18% are just a little above the poverty line. 12% are from the middle-income group and 10% are the richest people in the world. The 10% richest people holds 85% income of the world and remaining 90% people are surviving on 15 % income of the world. This unequal distribution definitely raises curiosity and wonders on the part of politicians and those in charge of the economic policies, as well as those who are responsible for the domestic, regional and global peace and security in the rich countries and poor countries alike (Ali Tawfik al-Sadek, 2007)

If 10% people of the world give 2.5% Zakah on wealth, then not a single person will remain poor in the world. All social, educational and economic problems will be automatically solved. According to Sipri Year Book (2011), the world's annual expenditure on arms is \$1000 billion while that on providing water and sanitation to all the people in developing countries for the same period is just \$10 billion. This is a very serious phenomenon in the world economy. Such a condition creates dilemma in the economy. Islam provides a suitable treatment for this problem by prevailing peace and harmony in society and extending distribution of Zakah for the poor. Below is a figure to show income distribution in the world.

Figure.1: Income inequality & distribution of wealth



Source: Authors own based on the report of WorldInstitute for Development Economics Research of the United Nation University:2010

3.5. Conclusion

God has created the universe before the creation of human being and made available all the necessities required for the survival of life. A careful study of the universe shows that all natural resources on the earth have certain kind of balance and correlation with each other. A frugal and infinite use of these resources would not create shortage. The present deadlock is not an outcome of scarcity of resources; it is a result of mismanagement and gambling of natural resources available for human. Secondly Islamic economy emphasizes on real trade and business which is day by day getting disappeared due to artificial trading in Goods Market, Metal Markets and Money Market. A number of financial crisis occurred since 1900 but none of the financial crisis was associated or linked to the business of Real Goods. Artificial trading like derivative has removed the concept of spot delivery of goods and services in the economy that leads to price overshooting and inflation in economy. The measures suggested to combat with financial crisis in this research were used centuries ago to mitigate the impact of financial deadlock during the times of Prophet Pbuh Yusuf, and during the time of Abbasid Caliph Umer bin Abdul Aziz. These two economies were among the major economies of their times. Thirdly diverting Money from its basic function from a medium of exchange to making itself an object of trade to an unlimited extent gave birth to the greed of making money out of money, and turned the whole economy into a balloon of debts over debts. Prophetic teaching has absolute solution to financial crisis.

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