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Severe Financial Crises and Fundamental Reforms: The Benefits of Risk-Sharing - A Comment

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Risk is the probability of an unpleasant event that inflicts a loss quantifiable in terms of money (dollars). It is an integral part of life, and every individual faces some amount of risk, in particular financial risk, in his day to day activities. The risky event could be a health problem resulting in medical bills, a car accident resulting in repair and compensation costs, a flood resulting in loss of lives and goods, etc. People, on average, avoid bearing risk as it disturbs the pattern of their lives and makes them unable to maintain the standard of living at par with the level before the happening of the risky event. Hence, people in societies with developed financial systems generally buy insurance to maintain a smooth level of consumption. On the other hand, people in societies with weak financial systems mostly rely on family and borrowing or past savings to meet the consequences of an unpleasant event. However, all types of risks; such as financial losses associated with earthquake, floods, storms, macroeconomic factors, etc., are not insurable. In this regard, the responsibility of the society is to do two things. One is before, and other is after the risky incident. Pre-incidents measures include steps for reducing the probability of risky incidents; for example, plantation at a broader level to avoid floods. Post-incidents measures include institutional arrangements for distributing the burden of financial losses across people and thus minimize the sorrows of sufferers.

The problem of today's world is that instead of making institutional arrangements for distributing the aftermaths of the incidence of risky events across people, it has rather created institutions that generate risks and transfer their burden to the poor. One such institution is of financial intermediaries known as banks. The banks create risks for the society through their power of generating money. This power of generating money has caused many crises including the financial crisis of 2007/08. And there is no guarantee that the financial crisis of 2007/8 is the end as the same types of crises occurred in the distant past in 1837, 1873, 1907 and 1929-1934 and did not stop. It shows that current financial system has in-built features that can produce a crisis. Many scholars including Mian and Sufi (2014) have pointed out to this in-built problem in the current financial system. They have provided empirical evidence from the mortgage sector of US economy in support of this in-built problem of interest-based financial sector. The work of Mian and Sufi is a manifestation of the weak aspects of interest-based financial system.

The fundamental problem with the interest-based financial system is that it generates fake demand in the economy through fake money, that leads to crises. Instead of punishing those involved in the creation of fake money; the system protects them. The following example befits current financial system. Let you lend me $1000. I lend this money onward to my friend, but instead of giving cash, I give him a coupon that is worth $1000 if cashed. I repeat this process of lending to 9 other people (10 in total). In reality, the available cash with me is equal to $1000, but I have created demand of $10,000. Out of the total created demand, the true demand is equal to $1000 as I can honor the deposit coupon of only one person on demand. All of the rest ($9000) is fake since it carries no cash on its back. I cannot pay the coupon of my nine friends on demand. In fact, I have deceived them. I have promised them payment of cash which I don't own. Hence, I should be punished for this act of deceiving them. But, if conventional financial system makes the same deception, they are provided support to save them from default instead of punishment. Current institutional structure (central bank/governments) do not blame the deceiver (financial intermediaries) for default; rather it blames the borrower for not returning the loan. In the presence of the conventional system, it is almost impossible to halt deception as the system has incentivized it. This is the reason that world has observed severe consequence of such deception in the distant past (1837, 1873, 1907 and 1929-1934) as well as in the recent past (2007/08).

How can the world get rid of this deceptive system? The only solution is to stop the power of creating money by financial intermediaries. This solution is not new. As mentioned by Asakri (2015), it was recommended in the Chicago Plan (1933) and also in the book of Irving Fisher (1936). The Chicago Plan suggests 100% reserves against demand deposits and hence, prohibits banks from creating any money or near money. It gives complete power of the issuance of currency to the government. However, we cannot expect promulgation of such a plan in a system that allows interest. Such plan requires a complete paradigm shift which is provided by Islam only. Hence, Islamic finance is the solution for financial crises. Islamic finance provides a paradigm shift based on its world view. It offers a solution to the problems of the current conventional financial system at both micro and macro levels. At micro level Islam, constrains selfish motives when they clash with the interest of the society. Private gains due to deception are in sharp contrast with the interest of the society. Hence, Islam, first encouraged individuals to give it up voluntarily and then prohibited it using the strongest words against those who take or give interest; terming it as a war against Allah. Islam eliminates the main motive due to which one is likely to lend others over and above than what he/she has. We know that the only motive for lending in the current financial system is to earn a fixed return (interest) on it in addition to getting back the principle amount lent. Islam completely prohibits any fixed return on lending and terms it *ribā*#. As the temptation for having fixed return on a loan is very high, hence Islam hits this temptation hard by considering fixed return on loans like waging a war with the Sovereign Authority as narrated in the Qur'ān:

يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِنْ كُنْتُمْ مُؤْمِنِينَ (٢٧٨) فَإِنْ لَمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِنَ اللَّهِ وَرَسُولِهِ وَإِنْ تُبْتُمْ فَلَكُمْ رُءُوسُ أَمْوَالِكُمْ لَا تَظْلِمُونَ وَلَا تُظْلَمُونَ (٢٧٩)

O you [who claim to be] believers! Fear Allah and give up whatever is left in lieu of ribā if you are indeed believers (278). *[Watch out:] If you Do not do so (and give up all outstanding ribā), there is a declaration of war against you from Allah and His Prophet. However, if you do tawbah (i.e., repent along with the resolve to make amends for the past mistakes), you are entitled*

For meaning please see glossary in Intro- pages of the issue. [Chief Editor].

> *only to your principal. Neither you should do ẓulm (wrong or injustice) to others, nor you should be subjected to ẓulm (by the others)* (279). (al-Baqarah 2: 278-279)

Islam recognizes the weakness of individuals and does not remain confined to moral appeals only. At macro level, Islam asks regulators (government) to use force against those who ask fixed return on loans. Hence, Islam, first, decreases the demand for interest-based loans in the society at individual level and then asks the government for curbing any residual demand with force. Moreover, Islam does not work on the prohibition of fixed return on loans, only. It also provides an alternative channel for earning a return on monetary wealth. The whole Islamic finance revolves around the idea of how one can earn interest-free return on their wealth.

The outcome of Islamic finance is that the aggregate demand in the economy becomes completely a real demand. A money-holder can consume, donate, save, lend or invest it and all these uses of money would not create any fake demand. Similarly, a person/institution who receives money for investment cannot lend it forward. Hence, Islamic finance gives monotonic relationship between the growth of money (nominal sector) and the growth of goods and services (the real economy) and thus eliminates financial crises. So the economic system based on Islamic finance is inherently stable as has been mentioned by Askari (2015):

> "*-----There is no money creation out of thin air or through the credit multiplier. Money injection does not multiply through the banking system as banks do not lend deposits. Deposit-taking (safekeeping) banks cannot cause general financial crises as they do not lend money, and there is little or no leveraging. Investment banks cannot cause a financial crisis as they invest their clients' money only on a pass-through basis and thus systemic risk is minimized. As a result, Islamic finance is inherently stable.*"

One of the key objections on Islamic finance is that it lacks provision for financing activities that are inherently non-productive such as war. In this regard, we should keep in mind that such activities are exceptional cases.

Islamic finance is not for exceptional circumstances. It is for routine and normal life. Moreover, war and war-related activities are not projects rather these are permanent struggle for the protection of Islamic economy. Hence, Islam asks all the society to take the possibility of war seriously and stand ready for it all the time. In this regard, government can establish a separate account where individuals can make regular donations. Government can also ask for *qarḍ ḥasan* in such situations and even resort to compulsory taxation without limit. The reason is that in the exceptional case of war; it is like protecting the land of a farmer from which he earns his life bread. If the land stays intact; the farmer can expect earnings in future. Hence, for financing a war every individual of the society should stand ready to sacrifice current earnings in order to protect their future earnings.

Moreover, the advantage of Islamic finance is that it makes the conduct of monetary policy simple. The injection and ejection of money could be made through buying and selling of risk-sharing securities. The conduct of such monetary policy directly affects the financial portfolio of the private sector — households and firms — and indirectly affects the holdings of banks and conditions in capital markets that in turn affect the real economy.

The presence of such a useful financial system depends on some role model. Hence, the key responsibility for creating a role model falls on the governments of Islamic countries. However, those who have got a vested interest attached to the current system and who are very powerful in the world will not allow that to happen and will create hurdles for the current rulers of the Islamic countries to do so. Hence, the responsibility shifts towards people in general and scholars in particular in Muslim countries to raise voices for the establishment of governments who could ensure the implementation of true financial system in their countries without being influenced by the opposition of the vested interest groups in the media and people. Likewise, the private sector of Muslims in the western societies can play a partial role in showing the advantages of Islamic finance to general masses. They can establish private banks purely based on risk-sharing and highlight their success and stability.

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