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Eurozone Crisis Viewed From Islamic Finance Perspective

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This short paper is a "work in progress". It is being distributed with two purposes:

1. As a handout for a lecture to be delivered on October 13, 2012 through Video Conference from Islamic Economics Institute, King Abdul Aziz University, Jeddah.
2. For Peer Review

It may not be quoted.

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Short Version

In a lecture at this very forum in May 2012 entitled, "Creditor-Debtor Relations: Some Issues, Some Proposals", we had a brief section on 'A digression on Sovereign Debt'. We take up that 'digression' as the focal point of this paper, with special attention to the ongoing Eurozone crisis. This is a sizzling issue at the moment. In this paper we will study the Eurozone crisis in some detail and attempt to provide an Islamic Finance perspective on the issue.

We know that the root cause of the Eurozone crisis is excessive debt. The economic rule for individuals, corporations and the countries alike is living within their means. This does not mean that there is absolutely no role for debts. Debt is a double edged sword. There are circumstances when debts may become unavoidable. Furthermore, if used in 'moderation' and 'wisely', it may have some benefits. For example, it can improve future incomes under specific conditions. In general there are two reasons for incurring debt:

(i) In case of extreme need (mostly in cases of personal debt, but governments have also borrowed in emergencies such as wars).

(ii) If a future stream of income or assets, is expected and **fairly assured**, such that it will enable the debtor to pay off past debts.

These two rules apply to consumers, corporations and governments alike. In case of governments a third reason for incurring debt is the **potential** 'growth enhancing' role of debt. This last reason is the one most cited as a justification of sovereign debt. We will attempt to evaluate it in case of Eurozone debt. As a general rule, in case of government debt discipline and governance structures are most important. These can be, and in many cases have been, legislated. The problems arise when those laws and rules are flouted.

As we have stated, the economic justification for governments to borrow is the growth-boosting potential of debt. In this paper we will examine how far the sovereign debt in general and Eurozone debt in particular has generated growth. On preliminary examination, it seems that many rich countries have exhausted that potential. With ageing populations and shrinking workforces, their economies may grow more slowly than they have done in the past. The pile up of huge governmental debt appears to be largely a political affair. In dictatorial regimes, the rulers, in general, have been exploiting their people throughout the human history. In democracies, voters can 'punish' and discipline the rulers. Recent evidence from European elections shows that voters did 'punish' many governments. Already, 11 governments have fallen in Europe, partly due to their election platforms on the issue of debt. Unfortunately, it seems doubtful if the new governments stepping in have been 'disciplined'.

It is interesting to note that in the Corruption Perceptions Index (CPI), prepared annually by the Transparency International, many Eurozone countries, particularly those affected by the financial crisis, including Greece and Italy, are doing worse and worse. Many of the lowest-scoring European countries are those hardest hit by the financial and debt crises.

Besides tackling corruption, the need for fiscal reform is a major issue in US, Europe and other countries around the globe. Reducing budget deficits is the most important issue in elections in the US and European countries including France. Political parties; Right, Left and Center, all agree on the need to reduce budget deficits in the shortest period of time. French President Nicolas Sarkozy, seeking re-election went to the extent to promise that he intended to insert the "balanced budget" rule into the French constitution, subject to approval by French electorate in a referendum on the issue. Even though, possibilities of budget deficits are not completely ruled out, there are calls for austerity measures and fiscal discipline. Talking of the recent Europe's fiscal pact, German Chancellor, Ms Merkel has said that the pact, which binds eurozone countries to keeping their deficits below 3pc, was "non-negotiable" and would "last forever". This author believes that that is wishful thinking. With growth prospects not very bright, it will require either more taxation or austerity measures. **Both are unpopular measures with voters**. Sarkozy's defeat makes him the 11th euro-zone leader who fell prey to sovereign-debt crisis as Francois Hollande won the French Presidency on an anti-austerity platform. To this author, it seems very difficult that he will be able deliver on his election promise.

Across the Atlantic, worried about the reaction of the electorate who consider budget deficit to be their top worry, both front runners, Barak Obama and Mitt Romney, are trying to lure voters promising to cut the Federal deficit, though through different plans. They were forced into this by a public outcry after Standard & Poor's downgraded the US credit rating and raised the fears that the United States may default on its obligations. If that can happen to a "currency issuer", who pockets billions of dollars annually in 'seigniorage', simply by running the printing press, the other countries are much more vulnerable.

Election promises aside, balancing the budget in present situations of these countries is easier said than done. It requires austerity measures that the electorate cannot digest after they have got used to public supports. Dissenting voices are already being heard, because of political expediencies, rather than economic fundamentals. From an economic point of view budget deficits, except in very special cases and for short periods of time, are bad economics. However, the shackles of debt once on, are not easy to break out from. Strong lobbies are created as is evident in most Western countries. American President, and the author of 'United States Bill of Rights', James Madison, once said, "I go on the principle that a public debt is a public curse, and in a Republican Government a greater curse than any other". Today the US national debt stands at $16 trillion. The Democrats hold Republicans responsible for the massive increase and blame them to be big 'spenders', but the fact remains that total Federal debt has grown by about US$5 trillion under Obama's regime. Everyone knows it has not grown for economic reasons. The average American citizen, who shares around US$ 50,000 in the national debt is crying, "It is the War, Not the economy".

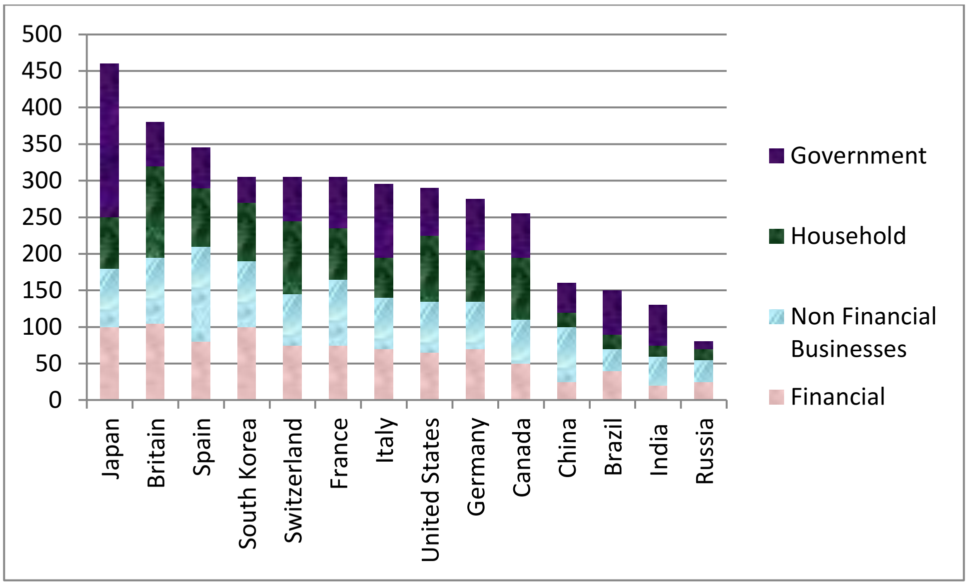
Governments may have borrowed from the future, using debt to provide a standard of living to the populace that is unsustainable; simply to improve their parties' vote bank. According to Leigh Skene of Lombard Street Research, which studied the relationship between debt and growth in US for the period 1956-2010, each additional dollar of debt is associated with less and less growth. This is shown in the following chart:

Chart 1

The situation is not different in other countries. From early 2007 onwards there were signs that most Western economies were reaching the limit of their ability to absorb more borrowing. Political expediencies prevented them to return to economic fundamentals. The debt pile up went on too long. A survey by the McKinsey Global Institute found that average total debt (private and public sector combined) in ten mature economies rose from 200% of GDP in 1995 to 300% in 2008.

Chart 2

Debt/GDP Ratio By Composition



Source: McKinsey Global Institute

The debt of European countries including Greece, Spain, Italy and several others is preventing a faster recovery after the Global Financial Crisis. It has changed the trajectory of growth for all humanity. Global economy is growing at about 1% now compared to three times higher growth rates we witnessed in the past.

Austerity or debt-propelled growth is one of the top concerns of electorates on both sides of the Atlantic. There is almost consensus among politicians and economists that the present levels of budget deficits are unsustainable and must be drastically reduced. The debate is about how to do it; whether through the use of the claimed growth-enhancing potential of debt or through cutting expenditure by adopting austerity measures. The divide between Merkel-Sarkozy and Hollande-Obama election platforms will remain a hot economic, social and political issue in the years to come. Whether the European Fiscal Compact, which aims at bringing more financial stability and sustainability in public finances, will be endorsed by member countries appears to be rather doubtful to this author. To me, the very existence of Eurozone seems to be at stake. At the very least, fundamental changes in the level and ways of financing government expenditure would be necessary.

In this background, we believe that the world needs a different approach to the whole issue and is ready to consider alternative solutions. Our understanding of Islamic rulings about debt and Islamic finance inspires us to suggest that Islamic finance can be of some help in determining the proper role of debt and help avoiding situations like the debt crisis of 2008-09 and the ongoing Eurozone economic crisis (2011-date).

In the, Wealth of Nations, Adam Smith speaking of public debts stated, “When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about by bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment”[1].

Though the measures given in the legal package generally do not apply to governments, the six principles given in this paper equally apply to governments as they do to individuals and corporations. It is interesting to note that in the Corruption Perceptions Index (CPI), prepared annually by the Transparency International, many Eurozone countries, particularly those affected by the financial crisis, including Greece and Italy, are doing worse and worse. Many of the lowest-scoring European countries are those hardest hit by the financial and debt crises.

[1] Smith, Adam, The Wealth of Nations, Book V, Chapter 3, p. 481, www.econlib.org/library/Smith.

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Across the Atlantic, worried about the reaction of the electorate who consider budget deficit to be their top worry, both front runners, Barak Obama and Mitt Romney, are trying to lure voters promising to cut the Federal deficit, though through different plans. They were forced into this by a public outcry after Standard & Poor's downgraded the US credit rating and raised the fears that the United States may default on its obligations. If that can happen to a "currency issuer", who pockets billions of dollars annually in 'seigniorage', simply by running the printing press, the other countries are much more vulnerable.

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In this paper, we make an effort to present an alternative view on the role of state in the area of debt-creation as well as the wealth creation potential of debt and its appropriate limits. We believe that the concept of so called "Welfare State" needs to be revisited. One reason of Eurozone Crisis is that governments have created vested interests and pressure groups that do not allow them to reduce their budget deficits. A good part of these deficits may be feeding 'economic parasites' who unnecessarily developed dependencies on welfare benefits. In this respect, we will examine the economic role of state from an Islamic perspective. Title

The paper will also discuss the relationship between excessive debt and economic stability. In this respect, we will present seven axioms, which we call "Iqbal's Axioms on Economic Stability". These are:

Seven Axioms on Economic Stability

Axiom 1. Economic instability is result of a delink between production of credit and production of physical wealth. We call it M-R delinkage. [Delink between Monetary and Real Sectors]

Axiom 2. The level of economic instability is inversely related to M-R delinkage.

Axiom 3. Incentive-compatible sharing contracts for production of wealth are 'superior' to debt contracts.

Axiom 4. Governments' provision of welfare services must be linked to availability of 'resources' to public exchequer. We call it R-S Linkage. [Resources-Services Linkage]

Axiom 5. Participation of 'Society at Large' in promoting 'Public Welfare' must be made a central objective of public policy. We call it PPPW [Public Private Partnership for Welfare]

Axiom 6. Sovereign Debt Crisis (SDC) is directly related to ignoring R-S Linkage and PPPW.

Axiom 7. In order to circumvent SDC, constitutional provisions must define the 'prerequisites', 'level', duration, and conditions of continuity of budgetary deficits.

The full paper will discuss these axioms in some detail.