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ABSTRACT

The paper tries to determine the primary cause or causes of the financial crises that have plagued almost every country around the world over the last three decades. Of particular significance are the 1998 LTCM breakdown and the prevailing subprime mortgage crisis in the United States which is more severe than any in the past and has had devastating spillover effects worldwide. It argues that one of the major causes of these crises is the lack of adequate market discipline in the financial system. This leads to excessive lending, high leverage and ultimately the crisis. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a steep decline in asset prices accompanied by bank failures and economic slowdown. Risk-sharing along with the availability of credit for primarily the purchase of real goods and services and restrictions on the sale of debt, short sales, excessive uncertainty (gharar), and gambling (qimar), which Islamic finance stands for, can help inject greater discipline into the system and, thereby, substantially reduce financial instability.

INTRODUCTION

The financial system has decidedly played an active role in the accelerated development of the world economy, particularly after the Second World War. An unending stream of financial innovations, including the revolution in information and communications technology, has played a crucial role in this development. The system is, however, now plagued by persistent crises. According to one estimate, there have been more than 100 crises over the last four decades (Stiglitz, 2003, p. 54).

Not a single geographical area or major country has been spared the effect of these crises. Even some of the countries that have generally followed sound fiscal and monetary policies have become engulfed in these crises. The prevailing financial crisis, which started in the summer of 2007, is more severe than any in the past and shows no sign of abating despite a coordinated bail out of three to four trillion dollars by the US, the UK, Europe and a number of other countries. It has seized-up money markets and led to a precipitous decline in property and stock values, bank failures, and nervous anxiety about the fate of the global economy and the financial system.

This has created an uneasy feeling that there is something basically wrong with the system.

There is, hence, a call for a new architecture. The new architecture demands an innovation that could help prevent the outbreak and spread of crises or, at least, minimize their frequency and severity. Since a number of the crises experienced around the world are generally of a serious nature and have been recurring persistently, cosmetic changes in the existing system may not be sufficient. It is necessary to have an innovation that would be really effective. It may not be possible to figure out such an innovation without first determining the primary cause of the crises.

PRIMARY CAUSE OF THE CRISES

There are undoubtedly a number of causes. The generally recognized most important cause is, however, excessive and imprudent lending by banks. [1] One cannot blame banks for this because, like everyone else, they also wish to maximize their profits in a materialist cultural environment where maximization of income and wealth is the highest measure of human achievement. The more credit they extend, the higher will be their profit. It is high leverage which enables excessive lending.

Excessive lending, however, leads to an unsustainable boom in asset prices followed by an artificial rise in consumption and speculative investment. The higher the leverage the more difficult it is to unwind it in a downturn. Unwinding gives rise to a vicious cycle of selling that feeds on itself and leads to a steep decline in asset prices followed by a serious financial crisis, particularly if it is also accompanied by overindulgence in short sales.

It is the combined influence of three forces which can help prevent the recurrence of crises. One of these is moral constraints on the greed to maximize profit, wealth and consumption by any means in keeping with the mores of the prevailing secular and materialist culture. The second is market discipline which is expected to exercise a restraint on leverage, excessive lending and derivatives. The third is reform of the system's structure along with prudential regulation and supervision appropriately designed to prevent crises, achieve sustainable development and safeguard social interest. Since all of these three forces have become blunted by the philosophies of secularism, materialism and liberalism, mankind has been flooded with different man-made problems, including recurring financial crises, family disintegration, flagrant inequalities of income and wealth, and crime and anomie.

This raises the question of why market discipline has not been able to exercise a restraint on excessive lending. Is it possible that market discipline is not adequate in the financial system? If this is the case, then why is it so? The market can impose a discipline primarily through incentives and deterrents. If incentives and deterrents do not exist or become weak, market discipline will also become weak.

The incentives and deterrents come through the prospect of making profit or loss. The major source of profit in the conventional system is the interest that the banks earn through their lending operations. The loss comes through the inability to recover these loans with interest. One would, therefore, expect that banks would carefully analyze their lending operations so as not to undertake those that would lead to a loss. There would be a check over excessive lending if the banks were afraid of suffering losses that would reduce their net profit. This does not happen in a system where profit and loss sharing (PLS) does not exist, and the repayment of loans with interest is generally guaranteed.

There are two factors that enable banks to assume that they will not suffer losses. The first of these is the collateral, which is indispensable and unavoidable in any financial system for

managing the risk of default. The collateral can, of course, do this only if it is of good quality. Collateral is, however, exposed to a valuation risk. Its value can be impaired by the same factors that diminish the borrowers ability to repay. The collateral, cannot, therefore, be a substitute for a more careful evaluation of the project financed. However, if there is no risk-sharing, the banks may not always undertake a careful evaluation of the collateral and extend financing for any purpose, including speculation. This may be more so if it is possible for banks to transfer the risk of default by selling the debt to someone else. The second factor that provides protection to the banks is the "too big to fail" concept which assures them that the central bank will bail them out. (See Mishkin, 1997, p. 61). Banks which are provided with such a safety net have incentives to take greater risks than what they otherwise would (Mishkin, 1997, p. 62).

Given that banks lend excessively to maximize their profit, why is it that the depositors do not impose a discipline on the banks? They can do so in several different ways: by demanding better management, greater transparency, and more efficient risk management. If this does not work, they can always punish the banks by withdrawing their deposits. They do not, however, do so in the conventional financial system because they are assured of the repayment of their deposits with interest. (Mishkin, 1997, p. 62). This makes them complacent and they do not take as much interest in the affairs of their financial institution as they would if they expected to suffer losses.

The false sense of immunity from losses provided to bankers as well as depositors impairs the ability of the market to impose the required discipline. This leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, to even subprime debt, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favour of debt financing - dividends are subject to taxation while interest payments are allowed to be treated as a tax-deductible expense.

This shows that the absence of risk/reward sharing reduces market discipline and, thereby, introduces a fault line in the financial system. It is this fault line that makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources. (BIS, 1982, p.3). It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. The IMF acknowledged this fact in its May 1998 World Economic Outlook by stating that countries with high levels of short-term debt are "likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises" (p.83).

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have high debt profile and for the private sector to live beyond its means and to have high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily

reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period.

While there may be nothing basically wrong in a reasonable amount of shortterm debt that is used for financing the purchase and sale of real goods and services by households, firms, and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock, and property markets. Jean Claude Trichet, President of the European Central Bank, has rightly pointed out that "a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds" (Trichet, 2005, p. 4).

If we examine some of the major crises in the international financial system like the one in East Asia, the instability in the foreign exchange markets, collapse of the Long-term Capital Management (LTCM) hedge fund, and the prevailing crisis in the U.S. financial system, we find that the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets due to the absence of risk sharing. (see Chapra, 2007, pp. 166-173). In this paper I will refer only to the collapse of the LTCM, the prevailing imbalances in the US economy, and the subprime mortgage crisis in the US financial system.

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