Islamic Financial Instruments and their Impact on Islamic Economies: A Lesson from International Financial Crises

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Abstract:
The impact of extensive growth of credit has been widely discussed in the literature. It is generally assumed that continuous and unchecked growth of credit may lead to collapse of economies. In this paper the underlying causes of international financial crisis are discussed under the models presented by Minsky and Mathur. Furthermore, the conventional financial system is compared with Islamic financial system and strengths of Islamic financial system to stabilize the economies are discussed.

Keywords: Minsky-Mathur Model, Islamic Financial Instruments, International Financial Crisis, Strengths of Islamic financial system.

I. Introduction

After seventies most of the researchers had discussed about the excessive growth of credit. Among them Minsky's approach has its unique value. Minsky wrote about the excessive growth of credit and concluded that excessive debt caused instability in economic conditions and uncertainty in business forecasting and planning. He did extensive analysis of economic instabilities and found that most of the economic instabilities are due to excessive credit growths and eventual collapses - and this term 'Minsky moment' has become popular even in the mainstream financial news media. He also discussed the three layers of financial investors' position, i.e., hedging, speculating and ponzi one1.

Minsky recommended in the mid-1985 that banking system should not be allowed to grow so big. In 1999 the trio (Dr. Alan Green, Dr Larry Summers and Mr. Robert Rubin and banking lobby) conspired and lobbied the Congress to abolish The Glass-Steagall Act (put into law by President Franklin Roosevelt in 1933) that separated insurance, investment banking and commercial banking. Since the abolition of Glass-Steagall Act in 1999 banks went on a spree to get bigger.

In the same era Mathur also discussed on the same lines as discussed by Minsky but his approach was related to the layers of techniques and he also mentioned three layers of techniques i.e. best practice, average and worst one. He also mentioned that due to the high interest rate there were more chances of debt deflation and the worst practice techniques were becoming obsolete and fetched their scrap value and that was the main cause of creating instability in the economies (see for example Azid, T (1993, 2002), Law, D and Azid T (1994), Azid T and Ghosh, D (1998) , Azid T and Law, D (1994, 1995), Azid T and Choudhary (2005), Azid et al (2008).

Experts and policy makers recommended that to prevent such instabilities there should be many community or cooperative banks; this process increases the money velocity that facilitates Small and Medium Enterprises where money and goods are exchanged at many small vendors rapidly. The modern banking (due to its contractual and collateral practices) is moving away from Freedom and Justice and towards the enslavement of the ordinary people, and endowing the riches to the bankers and wealthy shareholders.

In the current Islamic Financial there are two types of contracts i.e. Uncertain contracts (Musharakah and Mudharabah) and Certain contracts (Iijarah, Murabaha, Salam and Istisna). The certain contracts like murabahah, ijarah and diminishing musharakah etc. are based on real assets and do not amount to trading in money and financial papers, which is the case in an interest based financing. Secondly, unlike an interest-based transaction, the financier, in each one of these instruments assumes the risk of real commodities, properties or equipment without which the transactions cannot be valid in Shariah. Thirdly, these modes can be used only to finance a commercial activity that is permissible according to Islamic rules and principles. These basic distinguishing features are enough to draw a line between the two.

It should be noted that the original concept of Islamic financing is undoubtedly in favour of equity participation rather than creation of debts because it is only equity participation that brings an equitable and balanced distribution of wealth in the society. Debt-ridden economy, on the other hand, tends to concentrate wealth in the hands of the rich and creates a bubble economy which fuels inflation and brings many other social and economic evils and certainly it is not the Maqsad of Shariah.

As explained above, debt-based instruments are not preferred ones, but they were suggested to be used as modes of financing to start the wheel of interest-free financing and to bring an instant relief from interest in an atmosphere that was not fully prepared for immediate switch over to an equity based system. Credit creation far beyond available tangible assets gives rise to asset price inflation which is good for the bankers because they can collect more interest on inflated asset prices. However, they do not pass these inflated earnings to their depositors, rather share it among themselves and shareholders. Failure to abide by this idea has caused many problems resulting in total neglect of equity-based financing. Despite the differences that we have explained, between interest and these instruments, there are many similarities in the net result, especially because of the benchmark used for their pricing. This has prompted Islamic Financial Institutions to compete with their conventional counterparts in all respects, and restrict themselves to the debt-based products. In their zeal to compete conventional banks, they are trying to invent ‘Shariah compliant’ counterparts for each and every financial product available in
conventional capitalist market regardless of whether or not they are in consonance with the ethos of Islamic economy. Instead of gradual progress towards equity, the tendency is to make maximum compromises to accommodate debt-related products matching with practices of the conventional market.

Keeping the above in view an effort will be made in this study to develop a theoretical model for an Islamic economy and analyse the economic impact of debt-based Shari’ah compliant instruments on the Islamic Economy. The study will be organized in the following way. Section 1 presents some glimpses about the financial crises, section 2 presents the Minsky-Mathur model of business cycle, section 3 discusses the behaviour of Islamic economy having debt-based instruments, however more emphasis will be given to Tawarruq and Murabaha and section 4 presents the conclusion.

II. Some Glimpses of Financial Crises

The financial crisis of 2007 has given a different dimension to the experts of macroeconomics and indisputably, the recent financial crisis has damaged the reputation of macroeconomics. So, it is the time to question what went wrong with it and try to put it right. A new debate has started among the policy makers, academicians and researchers about the role of the government and central bank. For example, in Alan Greenspan’s words, “those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief”(New York Times, 10/23/2008). For Colander et al. (2009, p. 2), the majority of economists “failed to warn policy makers about the threatening system crisis and ignored the work of those who did”. Another opinion is that “there is nothing inherently bad in business cycles: they are the optimal response of rational economic agents to unexpected changes in the economic environment. Consequently, there is no room – nor need – for stabilisation policies implemented by the government” (Pensieroso 2009). However a majority of the economist has a common opinion that the institutional changes that made the crisis possible were inspired by the neoclassical thought based on the holy trinity of competition, rationality and efficiency. In general two common questions are raised within the circle of academicians and financial experts after this crisis:
1. Does the continuous evolution of the financial system have impact on the economic system?
2. If there is any, change in the financial system does matter?

However another question which is related to Islamic finance is also vibrating among the circles of academicians and experts:
3. Does Islamic finance have sufficient strength to stabilise the economy?

As mentioned earlier that the thoughts of Minsky after his death in 1996 got a tremendous attention among the economists. Minsky discussed the different stages of capitalism especially he compared the capitalism before World War II and after the thirty years of World War II. In the following sub-section we will try to discuss the message of Professor Minsky and Professor Mathur.

III. Minsky-Mathur Model of Business Cycle

This section presents the business cycle model which is developed by Minsky and Mathur.

Layers of Financial Positions and Business Cycle

Minsky defines three financial positions of increasing fragility:

- Hedge finance: income flows are expected to meet financial obligations in every period.
- Speculative finance: the firm must roll over debt because income flows are expected to only cover interest costs.
- Ponzi finance: income flows won’t even cover interest cost, so the firm must borrow more or sell off assets simply to service its debt.

Over a protracted period of good times, economies tend to move from a financial structure dominated by hedge financing to a structure with increasing speculative and Ponzi financing. The shift toward speculative positions occurs intentionally and more or less inevitably because of the way in which success in a boom enhances expectations. However the shift from speculative toward Ponzi finance is usually unintentional. It is interesting to note that three types of investors are expecting three things at the time of roll over the debt: interest rate will not increase, there will be no tight policy of the banks, and the value of real estate will not decline.

According to Minsky, instability is a normal result of modern financial capitalism. “Securitization lowers the weight of that part of the financing structure that the central bank (Federal Reserve in the United States) is committed to protect. A need by holders of securities ...may mean that a rise in interest rates will lead to a need by holders to make position by selling position, which can lead to a drastic fall in the price of the securities” (Minsky, 2008, p. 3). And "a fundamental property of all capitalist economies is the existence of a system of borrowing and lending based upon various margins of safety… a debt instrument or a lease provides for payments to be made on account of both interest and principle. An equity liability has only a contingent commitment to make payments, dividends need to be paid only if earned and declared, and there is no contractual need to repay principle. For any given cash flow, from operations or from the fulfilment of owned contracts, the greater the share of equity financing in a balance sheet the greater the margin of safety that protects the owners of the non-equity liabilities". (Minsky 1993),

Financial instability is fostered by three factors:

1. the rise of debts relative to income;
2. the rise in the price of stock market and real estate assets and
3. The decrease in the relative size of ultimate liquidity (Minsky 2008., pp. 325–6).

As pointed out by Randall Wray (2011, p. 62) “Minsky’s view is that the transformation of the economy and its financial structure from robust to fragile is due not to external market factors like government intervention and regulation, but to the ‘normal’ operations and incentives of financial capitalism”.

Minsky said that the instability is the product of modern financial capitalism. According to him, during expansions, profits grow unreasonably to firms with the most aggressive financial practices, resulting in an erosion of safety margins. This marks the beginning of what Minsky calls “the euphoric economy” (Minsky, 1982b, p. 121), where both lenders and borrowers suppose that the future is secured, and therefore most investments will be successful.

When overindebted investors are forced to sell even their less speculative positions, markets spiral lower and create a severe demand for cash—an event that has come to be known as a “Minsky moment.” This term was very much under discussion during the financial crises of South East Asia and then in Russia. In his opinion stability can never be a destination, only a journey to instability. He got the strength in his proposition from the Kalecky’s equation that the basic instability in the capitalist economy is upward because of a speculative move (as investment generates profits), which breeds more investment (Wray and Tymoigne, 2008).

Keen (1995, 2000, p.) added that “a period of economic volatility followed by a period of moderation, leading to a rise of instability once more and a serious economic crisis”

The end result is that no payment of debt, shortage of liquidity, interest rate will increase, a high interest rate lower the prices of long-term assets and the holders of illiquid assets will sell for liquidity. More supply in the asset market and the euphoria turns into a panic, the boom converted into a depression. This is known as the financial fragility whereas depression and inflation are the ultimate result of financial fragility.

**Layers of Techniques and Business Cycle**

Minsky missed the different layers of techniques which were working simultaneously in his analysis. Actually in the real world both markets are working simultaneously, i.e., one is the financial market and other is the goods market.

Azid et al (2008) reviewed the phenomenon of layers of techniques in the following way “As Schumpeter envisaged an innovation ushering new technology resulting in creation of exogenous demand on the economy for instance by being financed by bank credit”. As the demand of capital goods increases in the short run they will be produced by less and less efficient equipment. This increase in the ‘marginal’ increase in the cost of production will imply higher prices. Not only higher income will be generated by the original program, but the profitability of all the existing working firms will increase. The consequent increased demand will spill over to almost all industries and thus opening their submarginal firms for production. This will imply a rise in the prices of all commodities. This will not only lead to decrease in unemployment, but also increase in money wages, which tend to increase with inflation.

When the burst of activity resulting from innovations is over, unemployment will be generated from two sources. The extra activity generated in the capital goods sector will taper off and together with it a lot of secondary production activity generated as a consequence. This will, of course, throw out labor working on those sub-marginal firms that go activated during this period. Further the new capacity created will make some old technology redundant and obsolete. As pointed out above, the new techniques of
production are likely to employ less labor for producing the same amount of goods than the one on its way out.

**Layers of Techniques and Vintages Capital**

An economy having continuous technical advance will be embodying a portion of improving know how in the new investment being undertaken. Investment of different vintages will work with different efficiencies, and as such may require different amount of various inputs, labor and working stocks to produce a unit of output. At a particular time, we may expect fixed capital equipment of several vintages to be in situ for producing the same commodity. When investment is done in the equipment of the latest technique, the older equipment may also continue production, though by the very nature of things it is likely to be earning lesser returns. The old equipment will go on producing until enough capital of the newer vintages is not accumulated to satisfy total demand for that commodity. In a competitive industry with a free entry, innovators with better techniques would be able to start production units and if the demand does not increase pari passu, they will be able to lower the price there by displacing the requisite number of the most inefficient production units of the commodity from the market. However, a monopolist may delay purposely the introduction of the new process thus giving more time for the older capital equipment to survive economically than would have been otherwise possible.

Thus in a state of technological change we expect to witness a spectrum of technologies of different vintages existing and working simultaneously. We can define the technology associated with ‘kth’ vintage capacity for the production of the ‘jth’ commodity as follows.

\[
\text{C}(kj) \text{ may denote capacity; } \text{A}(kj), \text{ and } \text{S}(kj) \text{ input and working stock per unit of capacity; and } \text{l}(kj) \text{ labor coefficient.}
\]

Further, let \( e(kj) = P_j - w(l(kj)) - PA(kj) - rPS(kj) \) be the excess left after meeting the prime costs per unit of output. We may call this excess as ‘Residual’. It may be noted that while price (P), wage rate(w), and interest rate can be assumed to be the same for all units irrespective of their vintage or technique of production, the ‘residual’ is different for each. It is on the value of this residual that the actions of an individual unit depend. When investment is being undertaken in equipment pertaining to a new technology, the expected residual should be large enough to cover not only the interest and depreciation charges, the risk premium etc, but also the profit expectations of the entrepreneurs themselves. It may remembered that this residual is not like a fixed annuity over the physical lifetime of the equipment as will be the case if there is no technological progress and so no obsolescence. In this age advancing technology, the value of this residual should be progressively declining, and an entrepreneur should take this into account while making his investment decision.

However, after installation of fixed capital equipment when it eventually becomes not worthwhile to produce with it, it can only fetch its scrap value. Thus its opportunity cost is almost zero. Therefore, in taking decision whether to continue the production process, the unit will not consider whether it can get any returns on the fixed capital by continuing production. It should continue production so long as it can cover the prime
cost of production. In other words, a unit will remain in production until its residual is not negative.

Mathur discussed three types of investors/producers, i.e., best practice, average and then worst one which is on the verge of obsolescence. These are parallel to the Minsky’s layers of the financial position. The users of the best practice are actually behaving in the same way as behaved by the hedging position, average are like the speculating position and the users of worst techniques are same as the ponzi investors. But the issue is raised when in the Mathur’s analysis these ponzi are not able to sell their assets because this is the fixed capital which will fetch its scrap value. Because with the increase in the interest rate the cost will increase and this will create the environment of cost push inflation with unemployment. Both are following the Keynesian model but in a different way. If we will combine both of the approaches together then we can see that with the minor increase in the interest rate or wage rate, the profit will decline and then there will be a change in the portfolio of the financial institutions as well as in the structure of the industrial sectors. As profit go to zero, the value of capital assets and investment go to zero. A debt deflation as described by Fisher is one of the possible results of the similar formulation. The overall fragility of the economy depends not just upon the course of financial commitments but also on the cash of flows and also on the technological obsolescence.

From the above two approached we have the following main results.
1. lower output and income is exclusively due to a large decline in profit
2. decline of aggregate demand, underutilization/zero-utilization of the assets and inputs

IV. Islamic Economic System: An Outline

Islamic Economic system is an ethical and moral order based upon private ownership and directed by the Quran and Sunnah. Economic activity is the same as we have in the conventional economics, it is a process among income, employment, asset prices, and property value over the period. However, Islamic system has some basic norms which are not compatible with the conventional economic system. The concept of life hereafter and accountable to Allah (SWT) are more important. The concepts of stability and balance are very much important. Instability is the sign of destruction as it is explained by a quite number of times in Quran (Al-Quran 101: 1-7, 99:1-6 and 78:6-9). It is guided by the ethical and moral dimensions of Sharia’ah so there are very few chances of any artificial trading and marketing in the economy. Greed is not appreciated. Effective training is the main policy of the Islamic system whereas effective intervention has the secondary position. Chapra (1992) explained as “Unless humans are motivated to pursue their self-interest within the constraints of economic well-being (the application of the ‘moral filter’), neither the ‘invisible hand’ of the market nor the ‘visible hand’ of central planning can succeed in achieving socio-economic goals.”

In the system of Islam, every revenue program has its own structure and moral dimension and simultaneously every spending has its own structure and moral dimensions (Al-Quran 9:60). Islam does not appreciate any type of propensity to evade and avoid religious compulsory duties. Labour market conditions are one indicator of the success or failure of an economy (Azid 2005). Debt deflation is not part and parcel of the Islamic economy (Al-Quran 2:276-280). If all the guided variables and instruments are
behaving properly then there is less chances of depression and also a few chances of collapse of asset values. Because market rules are clearly explained and there is not any type of exploitation. There is built in stability in the Islamic system because of its two important injunctions, i.e., zakah based and interest free system. It is assumed that aggregate demand provided by the religious consumption (such as zakah, sadaqah, infaq fi sabillah; these are not religious tax) is a key stabilizing feature of the Islamic economy (Azid 2005) and its financial system based on the risk sharing even without the central bank intervention are the main stabilizing features. Transfers (like infaq- fi-sabilillah) play in fuelling consumption, but normally there is no space for the consumers simply borrowed to keep consumption up (Al-Quran 17:27). To maintain the distributive justice and the reduction of poverty is the main agenda of Islamic system (Al-Quran 5:3, 4:3, 4:59). It is highly appreciated to increase the real productive capacity and wealth producing ability of the economy under the umbrella of Sahri’ah. Wastage of resources is not allowed and resources would not be allowed to be diverted to the production of luxuries until the production of necessities was ensured in sufficient quantities (Siddiqi, 1981; Azid et al 2008a).

Islamic banking and financial system must be developed on the basis of distributive justice and the main agenda should be to reduce the poverty. The transactions of financial institutions must be interest free, have risk sharing and asset and service backing, have contractual certainty and that all the elements of the transaction must, in and of themselves, be moral and ethical. The mode of finance of Islamic financial institutions generally can be divided into four categories, i.e., equity, trading, leasing, and debt. Murabahah, Musharakah, and Sukuk are all equity based (uncertain contract), Murabahah, Salam, and Istisna are trade based and Ijarahs are lease based (certain contract).

The current scenario of Islamic banks can be realized from the following statement, “The fact that Islamic banks have made significant changes and improvements to their business models and are now able to compete with conventional banks on areas related to customer service and innovation has put a lot of pressure on Islamic windows. Basically if you can walk through the door, why climb through a window?” (Islamic finance in 2013: beyond the growth). The value of Islamic financial industry in the worldwide is $1300 billion. However, it is important to note that the modern concept of bank is risk aversion whereas Islamic finance is all about risk sharing. According to IMF estimation that in the next five years $800 billion will be required for the development projects in the Gulf States. It will be a great opportunity for the Islamic finance industry through its sukuk products. It is consensus among the experts that the recent trends in the industry are more in line with the conventionalisation of Islamic banking and finance and less on Islamisation of conventional banking and finance.

Islamic Teachings and Debt
The philosophy of Islam has no any ambiguity towards debt and given a transparent policy. The Qur’an prohibits debt based contracts” (Al-Quran 2:276-279), and

4. ibid
“Islam offers a system that prohibits all debts” (Zarqa 1983). A number of authors reviewed this aspect in detail. For example Chapra (2007) says, “the primary cause in our view is the inadequate market discipline in the conventional financial system. Instead of making the depositors and the bankers share in the risks of business, it assures them of the repayment of their deposits or loans with interest. This makes the depositors take little interest in the soundness of the financial institution. It also makes the banks rely on the crutches of the collateral to extend financing for practically any purpose, including speculation... the ability of the market to impose the required discipline thus gets impaired and leads to an unhealthy expansion in the overall volume of credit”. The current situation of the Islamic financial industry is not promising and its direction is towards more certain contracts. According to Al-Shubaily (2011) “PLS modes of financing on the asset side of twelve Saudi banks constitute no more than three (3) per cent of the total assets of these institutions. In Malaysia, on the other hand, the situation is even worse. According to Chong and Ming-Hua (2009) ‘only 0.5% of Islamic bank financing is based on the PLS paradigm of Mudarabah (profit-sharing) and Musharakah (joint venture) financing” (Cited by Altaee et al 2013). Ming-Hua (2009) have doubt that in Malaysia the deposits accounts are not presenting the true picture of interest free banking instead they are similar to the conventional-banking deposits.

In Askari’s (2012) view “whether the reforms implemented are called the Chicago Plan, Limited Purpose Banking, or Islamic finance, the message is unified: the world needs a financial system that reduces risk-shifting and debt financing in favour of risk-sharing and equity financing in order to create a financial system that promotes growth and minimizes instability” Askary (2012) has explained the difference between the debt and equity based economy in a very beautiful way:

“In place of debt, Islamic finance introduces securitized “asset-linked” securities. The key difference, between conventional securitization and asset securitization in Islamic finance is the end investor’s ownership rights, or access, to the securitized assets. In the conventional system, there are multiple layers of ownership, which may leave the final investor without any recourse in case of default. In the Islamic system, there are strict requirements of clear ownership rights for the investor. This feature affords a measure of stability because the same underlying asset is not traded multiple times, which could have a cascading effect in the case of liquidation. More importantly, in conventional securitization, the underlying assets are debt-based, and thus have an implicit guarantee of the principal. Securitization in the Islamic system, on the other hand, is based on equity or risk-sharing, and thus the principal return would depend on the market value of the underlying asset. Again, this is an important structural element that reinforces financial stability.”(http://yalejournal.org/wp-content/uploads/2012/04/Article-Hossein-Askari.pdf, accessed on 10-05-2013)


6. Al-Quran (2:276-279)
i. Islamic Banks better performed during the current financial crises than their conventional counterparts so they contributed towards more stability.
ii. Due to the interest free banking Islamic banks are observing the less risk.
iii. The demand of Islamic banking has been increased due to current financial crises.
iv. Recent financial crises has not significant impact on the Islamic banks.

Financial institutions need help and support from the governments in the state of debt deflation. There is a need of big government and need a billion of dollars to solve the problems of bankruptcy. However if we will try to find any Muslim state then we cannot able to find any state has a system that could be fully classified as such. The social and economic condition of most of them is fragile, institution are not well established, most of them are inefficient economies are not knowledge based, human resources are not well developed and also not well equipped with the new requirement of the current state of the knowledge so it is not possible for them to establish the true Islamic financial system in its true spirit. Other dimension which is also getting importance that is the moral aspects of the Islamic economic system. In this profit-hungry world it is another challenge for them to work on ethical and moral basis. Islamic teachings are more towards distributive, social and economic justice. In this sort of environment greed, exploitation, speculations, injustice should be minimized. The role of government is not only to look after the economic and security matters but also to train the society on the ethical and moral grounds. It is interesting to note that Individuals are ignorant, not because they do not know how to behave rationally, because the future is not written in stone; it is fundamentally uncertain (Al_Quran 31:34).

Mudharaba/Musharakah

Mudharaba as a financial instrument promoting the real investment and aggregate demand in the economy which has the positive impact on the employment whereas in this mode of financing interest rate is not involved so the cost of capital due to this mode of financing is not changing. As we have already discussed whenever there is increase in the rate of interest or increase in the wage rate that increase the cost of the production and reduce the level of profit. In the inflationary period this has not negative impact on the inefficient firms (because of the current price structure), however, when there is deflation then it has impact on the inefficient firms. As Minsky said that during the debt deflation the price of asset will decline because of the behaviour of Ponzi investors. But it is not possible for the ponzi investors in the manufacturing sectors to sell their assets even at the low price. That will fetch their scrap value. But on the contrary, there are less chances to quit the market for the producers (if they are running their business on the basis of Musharakah or Mudharabah) comparative to interest based system.

Tawarruq/Murabaha

According to Mohammed Netajullah Siddiqi, “the harmful effects (mafasis) of Tawarruq include:
• Growth of debt
• Need more money in the future.
• More chances of gambling/speculations

Debt deflation
Inflationary pressure on the economy
Inequity
Inefficient allocation of resources
Increase the anxiety and social unrest

It is consensus among the Muslim scholars that debt is not illegal in the system of Islam but its consequences. If there is too much growth of the debt and ultimately Islamic economy will face the situation of debt deflation more priority should be given to the public interest. This is the responsibility of the authorities to measure that how much economic activity is generating through different modes of financing. If this is generating that at what cost and what will be the impact on the economic and social stability.

In the case of Tawarruq apart from it legal position here we will only try to discuss its impact on the economy and on the structure of the goods and service sector. The most important thing is that it is double edge of the knife. The first aspect is the debt growth in the economy and the second is the main cause for increasing the cost of the production which leads the cost push inflation. As we all know that the most of the Muslim countries exception are there are very small and not able to become the big government and simultaneously their banks are also very small in their size. If there is debt deflation then government is not able to help them in bailing them out. Especially in Tawarruq the cost will be higher than Murabaha. This increase in price will increase the size of the ponzi investors and consequently then they will try to sell their assets in the market which will reduce the price of their assets but on the other side because of the deflation the price of the product will also decrease which will create another problem and the most of the equipments of the manufacturing sector will become obsolete (mal-investment not the over-investment).

No doubt in the Islamic system there is no comparison in between the MEI and interest rate but if we are promoting too much Murabaha and Tawrruq then we have to face the same scenario as world has been observed in the recent financial crises. The only solution for the economies to protect themselves from the debt-deflation is if they give more emphasis to the risk sharing projects. In fact in their essence Tawarruq and Murabaha are not trade instrument but debt based instruments.

Askary (2012) discussed this phenomenon in the following way:
“Absent true risk- sharing, Islamic finance may simply encourage debt-like, short-term, low-risk, and highly-liquid financing without manifesting the most important dimension of Islamic finance: its ability to facilitate high growth in employment and income with relatively low risk to individual investors and market participants” and he also emphasised that “to enhance financial stability, regulators would have to adopt policies and practices that eliminate moral hazard, excessive debt creation, and leveraging”(http://yalejournal.org/wp-content/uploads/2012/04/Article-Hossein-Askari.pdf, accessed on 10-05-2013)

If we will see both of the theories which we presented in the Section II then it will be observed that tawarruq may become the cause of business cycles in the Muslim states, because when the banks are relying more on Murabaha and Tawrruq and issuing more debt based financing in the good days will ultimately lead to the bad days (debt-deflation).. Another important feature is the generally is not for investment but for
consumption this will create the problem for the economy and increase the consumption and not for the production of fixed capital. It is consensus that circulation of capital is the fundamental characteristics of the Islamic economy but it may not be possible through Tawrruq and Murabha, however, Musharakah and Mudharabah lead the circulation of capital.

If for example, there is high demand for working capital (monetary funds) because of high returns then financial institutions will raise their markup for the working capital, ultimately fixed capital and labor reduce their portion then pushing the economy at that point where production will become slow. It is well known phenomenon that capital assets are valuable, because aggregate demand is large enough to make them scarce; such assets are not valuable because they are productive. So the productivity of the capital does not play any role. It depends upon the price structure of the economy. If profit is reducing, the value of capital is also reducing, so the debt deflation will be the final result of this formulation.

It is observed from the data that Islamic banking and financial industry is following the same path of conventional industry and there is a significant growth of the financial capital (Table 1, Figure 1). Then in the light of above discussion it may be difficult to avoid the phase of instability and depression.

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<td>3,553,886,578</td>
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<td>8.1%</td>
<td>8.1%</td>
</tr>
<tr>
<td>2011</td>
<td>418,772,876,838</td>
<td>4,758,782,691</td>
<td>8205154915</td>
<td>5.2%</td>
<td>5.2%</td>
</tr>
</tbody>
</table>

Source: Bankscope
Generally, there is rolling over the debt in the conventional financial due to financial fragility but this is not the feature of the Islamic Economy, however if Islamic economy relies more on the debt instruments and the financial institutions will issue the more loans to the ponzi investors/managers of the marginal techniques then this over-debtiness will create the same problem as the world has been observed in 2007 that leads the increase in the debt to equity ratio with the increase in the mark-up.

In the global scenario another problem can be observed and that is known as “Carry trade”8 Traders will borrow from that country where markup is low and will lend in another country where markup is higher. Debt deflation can take the form of a debt exchange-rate interaction. In this situation Islamic Development Bank and OIC should play their role.

V. Conclusion

We do not propagating that the role of Islamic financial institutions should be minimized. Islamic banks like each profit seeking financial intermediary has agenda on its own: These are not charitable institutes. However, we believe that as a student of economics that this is the Maqsad of Shariah to reduce the poverty, promote the distributive justice, and enhance the productive capacity and the growth of the economy through an independent and profit-seeking banking institutions that specialize financing a

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8. Financial institutions used this device in the Asian financial crises by borrowing in countries in which interest rates were low, such as Japan, and lending in other Asian countries, in which interest rates were higher
smaller businesses. The primary goal of the Islamic banking should be to increase the productive capacity through participatory mode of financing, i.e., Musharakah and Mudharabah. And also provide the assistance to community (have the skill and expertise but lacking the funds) which is not served by the conventional banking. This is the ethical and moral obligations of these institutions. On the other hand the depositors should share the goal of the Islamic banks and should also show their concern in creating the moral environment. We believe that the integration of economic and the moral values will result in greater outcome and less inflation and less unemployment. Remember that policy agenda in Islamic economy would be different. —Employment is a means to an end, not the end in itself.

Keeping both banks and corporations small also promotes employment because “smaller firms tend to use more labor-intensive techniques merely because their ability to finance position in long-lived and expensive capital assets is lower” (Papadimitriou & Wray, 1998, p. 214). In addition, smaller banks have other benefits such as high capital-to-asset ratios and stronger competition.

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