THE GLOBAL FINANCIAL CRISIS:

The self-destruction of global capitalism and an introduction to the alternative Islamic economic model

Hizb ut-Tahrir Britain
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INTRODUCTION

Global Capitalism has faced no lack of criticism since its inception, always controversial and never dull. From Das Kapital in the 19th century to the Anti-Globalisation movement in the late 20th century, there has been no shortage of predictions that the Global capitalist system was about to fail, on its last legs hoisted by its own petard of excess and greed.

Some may try to argue that the crisis of September 2008 is not the end for capitalism. They will argue this was a bubble, like many before. However, the fact that major western nations, led by the United States and Britain, have injected record amounts of capital to save the banking sector from complete collapse is unprecedented. Banks have been nationalised – something repugnant to those who believe in the free market – rather than allowed to collapse like Lehman brothers. Stock markets around the world plummeted by record levels. The effect on pensions, inflation, taxation, home repossession and unemployment is expected to be dire, but the eventual extent is as yet unknown. The human tragedy that may occur as the ripple effect affects economies in poor countries is frightening to contemplate. The geo-political implications of the crippled US economy will unfold over the coming years in a way that is as yet hard to predict.

In our view, this unfolding crisis marks nothing less than the beginning of the end of capitalism. For what is certain is that a foundational element of capitalist belief – an absolute trust in the free market – has been irrevocably damaged. Those who continue to argue the usefulness of the current system, who say there is no alternative and who seek greater regulation (a tweaking of the system) cannot defend the very key principle upon which the system was founded and under which it flourished.

Moreover, not only has the free market ideology failed, but certain fundamental principles of capitalism are central to the cause of this current crisis, yet no one has proposed any change to these fundamentals. These, which are discussed in this paper, are the interest led banking system, the fiat currency model, the system of trade in the stocks and derivatives markets and the failure to identify that not all ownership should be in private hands.

Furthermore, people around the world outside of the west - who were dazzled by the brilliance of capitalism's light, now see that light fatally diminished. What little faith they had in this western model, which for decades they have tried to emulate, now raises more questions than provides answers. Can this be the only way to trade, create wealth and see economies grow? Can it be right for business that trade occurs in such an inherently unstable system? Where is the fairness if profits largely remain in private hands and based on massive bets in financial markets, and that consumers and taxpayers have to bail out the cumulated losses of the rich due to their risky transactions?

The embers of capitalism may still glow and provide heat for some time yet, but they are only embers. Just as freedom and democracy have been severely undermined by Abu Ghraib, Guantanamo bay and extraordinary rendition, free-market capitalism has been severely undermined by this financial meltdown.

People are now looking for an alternative. People are now looking for leadership. It is only in Islam that such an alternative exists. For Islam has a system, tried and tested over centuries which has certain pillars rendering it as not only a system capable of producing economic growth but of sharing that growth more fairly – something that capitalism has manifestly failed to do.

Islam provides stability in its economy for the currency must be fully backed by gold and silver. Islam prohibits interest-based lending. Whereas, the Islamic treasury – the Bait al Maal can lend interest free to businesses and those who need help. Trade is hugely encouraged in Islam, but the rules of trade are clear, fixed and not open to political manipulation by powerful lobbyists. Finally, Islam clearly defined which things are owned by the state, which is held by the state but for public ownership, and which is the private wealth of citizens in which the State has no power to interfere.

This work provides little more than an introduction to this system, reflecting on Islamic solutions to the key financial crisis questions. What is clear is that two things lie in a huge state of flux: the future of the world economy and where political influence in the world will lie in the years ahead. And in that state of flux opportunity for change exists. Moreover, it is a duty upon the Muslim world to establish the Islamic system, under the Khilafah, to lead that change and to provide the alternative that will end, not only the inevitable cycle of boom and bust, but also the intractable gap between rich and poor - a misery that capitalism has utterly failed to address while it dominated the world.

“And Allah has full power and control over His Affairs, but most of men know not.”
[Translated Meaning of Quran Yousuf: 21]

Anatomy of a Crisis

There has been no shortage of writers predicting an end to the system as we know it. Indeed as we speak many authors are probably sending manuscripts to publishers trying to be first with the title “The End of Capitalism” to rival Fukuyama’s infamous (and now defunct) essay on the End of History in 1989. But will this event really be the end for Capitalism? Unlikely. But, is this the beginning of the end of capitalism? Quite probably, and it is without doubt that Capitalism currently needs intensive care and is facing its greatest crisis.

The events of September 2008 will go down in history as one of the darkest times in the history of Capitalism. Alan Greenspan former Chairman of the US Federal Reserve stated that the current events were rare, once every fifty or hundred years. For the US, in particular the current crisis constitutes the economic equivalent of Pearl Harbour and 9-11 combined a profound shock to the system which will be felt for years if not decades ahead. Not only have we witnessed the end of the stand alone investment banking model which was the cornerstone of modern financial capitalism, we have also seen the dogma of laissez faire free market economics trashed as Governments scramble around to bail out the next financial institution.

Greenspan is wrong about a once a century occurrence, it has only been eight years since the dot com fiasco which wiped off almost 7 trillion dollars off stock market valuations. So how did we get into this mess, how could the United States, a superpower with a $14 trillion economy now become a laughing stock. How could investment banks valued only recently at tens of billions of dollars and who were able to survive two world wars and the great depression be wiped out so easily. How could western governments who used to smugly preach to the developing world the art of economic competence act no better than glorified banana republics?

The events of the past month were rooted in the sub prime sector when brokers incentivised by fat commissions sold mortgages in their truck loads to millions of borrowers. This policy of encouraging widespread home ownership had been followed by successive administrations who believed that owning one’s house was part of the American dream. For many borrowers motivated by a quick buck and cushioned by easy credit, getting a mortgage was a small price to pay in exchange for a huge profit as house prices rose exponentially. Brokers having banked their commissions decided to sell their mortgages on and soon these would be parcelled up and form mortgage backed securities (MBS) sold and resold by banks throughout the world. At a time of low interest rates, banks throughout the world egged on by shareholders and analysts, the cheerleaders of corporate capitalism, were challenged to seek to gain higher and higher returns. MBSs therefore were like nirvana from heaven and while house prices rose, demand for such instruments and other alternative instruments remained high.

At the time, this new model of selling on such instruments was considered ingenious by regulators and commentators alike as they believed these products diversified risk and ensured that no one entity would be disproportionately exposed. After years of house price growth, everyone was happy until the inevitable crash. At the time, far from the benefits of diversified risk, deep panic set in as banks discovered that they actually didn't know where the risk was, thereby leading to a chronic loss of confidence and the freezing of inter bank lending. Banks simply didn't trust each other believing that other banks could be potentially sitting on huge losses as these MBSs lost value or to use the technical term became "toxic". This freeze would make certain banks insolvent and others would go to the wall due to a lack of liquidity following highly leveraged derivative bets. It would also make credit more expensive, lead to mass insecurity around savings, increase commodity prices and weaken currencies, so making prices higher. The following are the key events that have hit the world since the crisis began.

- **June 2007: Two Bear Stearns hedge funds suffer after bad bets on U.S. subprime mortgage-related securities**
- **Sept 14: Major run on Northern Rock bank the first in over a century as customers panic**
- **Feb 17 2008: Northern Rock nationalized after funding crisis**
- **March 16/17: Bear Stearns sold to US investment bank JP Morgan Chase after pressure from the US administration**
- **July 11: US banking regulators seize IndyMac Bancorp Inc a large publicly traded US mortgage lender after depositors withdraw more than $1.3 billion over 11 days**
- **July 13: U.S. Treasury and Federal Reserve effectively nationalise mortgage finance companies Fannie Mae and Freddie Mac entities who owned nearly half of all outstanding US mortgage debt**
- **Sept 15: Lehman Brothers in largest US bankruptcy ever; Merrill Lynch sensing a similar fate rushes into talks and is taken over by Bank of America**
- **Sept 16: AIG one of the world's leading insurers is rescued by the Federal Reserve who announce a plan for $85 billion package in return for a 80 percent stake (package is later increased to over 130 billion)**
- **Sept 17: Lloyds TSB buys rival HBOS following the latter's desperate situation. The British Government waives all competition issues**
- **Sept 20-21: Details emerge of U.S. plan for $700 billion bailout for firms burdened by toxic debt; Goldman Sachs and Morgan Stanley the two remaining investment banks transform themselves into bank holding companies, thus ending Wall Street's investment banking model**
- **Sept 25: Washington Mutual the US's largest thrift bank finally declares defeat and is bought out by JP Morgan**
- **Sept 29: US House of Representatives rejects the bipartisan bailout package leading Wall Street to fall 778 points, the biggest drop in the index's history. Wachovia the fourth largest bank is swallowed up by Citigroup. British Government nationalises Bradford and Bingley. Governments in Belgium, Holland and Luxembourg partially nationalise Fortis bank with a €11 billion package. Icelandic government takes over Glitnir, the country's third largest bank. German government extends a €35bn credit guarantee to Hypo Real Estate**
- **Sept 30: Belgium and French governments inject $6.4 billion into Dexia the world's biggest lender to local governments. Ireland guarantees the deposits of six banks.**
- **Oct 2: The US House of Representatives and US President pass unprecedented $700 billion bill to buy "illiquid" and troublesome assets from banks**

- **Oct/Nov: US, UK and European governments announce multi trillion dollar loan, guarantee and bailout packages including nationalisation of key banks.**
- **Nov: Iceland's banking system and currency collapses leading to the effective default of the country, a developed western nation. The IMF steps in**

The events have been of unprecedented volatility. Not since the Great Depression have we witnessed such events and seen such fragility in the financial system. The US government's proposal to buy toxic assets up to $700 billion from the US banking system was initially defeated by 228-205 in the House of Representatives, with many citing the sheer unpopularity of the package with the American people. People have rightly pointed to the fact that Wall Street was more than happy to keep their billion dollar profits private in the good times and yet want to 'nationalise' their losses, to be paid for by the American taxpayer when the going got tough. While people continue to suffer from higher food, energy and healthcare costs, Wall Street bankers' compensation packages continue to be paid with ex Lehman's staff on course for huge multi billion dollar bonuses from their new employers in 2009. No wonder people are so disillusioned with Wall Street and their cohorts in Washington.

In addition some ask how the US, already trillions in debt can afford such huge bailouts and how they can continue to be able to provide hundreds of billions of dollars in liquidity to the US and world markets. Step forward Ben Bernanke the current Chairman of the Federal Reserve and his magic wand! In a speech given six years ago Bernanke revealed his secret weapons when he stated the following

> *"Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost."*

With the fundamental condition of confidence now shot, the only things capitalist governments have at their disposal is their printing presses and electronic equivalents. Having bailed out Bear Stearns, AIG as well as Freddie Mac and Fannie Mae at the cost of hundreds of billions of dollars, all financed by either printed money or borrowed by issuing more treasury bills. Intent on stabilising the system in the short term at all costs, the impact on higher inflation and a devalued currency are completely ignored.

Diagnosis

Though everyone agrees that the capitalist patient is chronically sick, an analysis of how we got here is more controversial. Many right wing ideologues continue to preach the superiority of capitalism as former President George W Bush did in his televised address on 24th September. Their view is that the fundamentals of capitalism remain strong and that what happened is a case of excess and bad decision making. In remarks at a private fundraiser Bush had earlier compared Wall Street's behaviour to someone getting drunk and now facing a hangover. Though accepting the seriousness of the situation such ideologues differ in their response, whereas Bush and his Treasury Secretary and former CEO of Goldman Sachs, Henry Paulson, favour large Government bailouts, other conservatives find any government bailout an anathema, akin as one politician (Representative Sam Johnson) stated, to embarking down the road of socialism. For those on the left their glee is palpable, having argued against unfettered free markets for decades, they now believe capitalism's chickens have come home to roost.

The left see that this crisis has two causes. Firstly the greed and corrupt practices of Wall Street and secondly the culture of deregulation which resulted in either regulation being absent, or asleep at the switch. Their solution is very simple, crackdown on the bonus and remuneration culture on Wall Street and beef up regulation and oversight.

However, both those on the left and right have misdiagnosed the causes of the crisis. Though both point to a culture of excess and regulatory mismanagement, they seek to detach this away from capitalism as if the behaviour exhibited was somehow detached from the core values of capitalism. But greed and deregulation are as essential to capitalism as an engine is to a car. Expecting that capitalism can effectively operate without greed and a risk-taking casino culture of high risk taking, is like expecting a dog not to bark. Greed, high-risk taking and bending the rules are the essential oils that drive the whole capitalist system. The culture in many of the banks in Wall Street and the City of London exactly proves this point. They are testosterone rich, they put a premium on material ambition, they expect people to live to work, not work to live and any weakness is frowned upon. Fuelled by their high salaries and extraordinary bonuses, a culture of greed is not just expected but is obligatory if one is to succeed. These arrogant Wall Street and city traders call themselves “Masters of the Universe”.

There is little controversy over this in the sense that most reasonable people believe the capitalist culture that dominates the financial services industry is prone to excess, which is why there must be effective regulation. However, no amount of regulation can ever mitigate capitalism, for the following reasons:

1. Firstly, the complexity of some of the financial products being traded has grown exponentially. Regulators at the best of times are hardly the most agile of entities, in a world where product innovation is rapid and fast changing, regulators struggle to keep up. Their knowledge and capabilities are far behind those that they are regulating meaning that they might as well sleep-in on most days for all the good they do.

2. Secondly, companies pay politicians to keep regulators off their back. This is through campaign contributions and other favours. This usually ensures regulators are kept in check. But if this stick doesn’t work, then the carrot of future lucrative work in the private sector is always on the table. There is an unhealthy revolving door between the regulators and the private sector which makes a mockery of the whole oversight process.

3. Lastly, regulators are always reactive, fighting the last war. Increasing regulation after a major crisis and scandal is common, but is hardly relevant to forecasting the next crisis. For instance after the Enron crisis, Sarbanes Oxley was introduced which, though lucrative for accountants and risk specialists, was entirely useless in preventing or even anticipating the sub prime crisis.

So trying to regulate capitalism is impossible, it is – using a now infamous metaphor - like trying to put lipstick on a pig.

Contrary to popular perception, the world would not end if capitalism was consigned to the waste paper bin. Progress, advancement, technology all prospered before the inception of global capitalism and they can prosper again. Yet the high priests of global finance remain in denial, believing that despite the current systemic crisis, capitalism will once again regain its lofty position. This was reiterated by George Bush in his address of September 24th in which he stated that democratic capitalism remains the best system. In 2002 a prominent speech cited the following statement which has significant relevance to today’s events

> *Over the years, the US economy has shown a remarkable ability to absorb shocks of all kinds, to recover, and to continue to grow. Flexible and efficient markets for labor and capital, an entrepreneurial tradition, and a general willingness to tolerate and even embrace technological and economic change all contribute to this resiliency.* ***A particularly important protective factor in the current environment is the strength of our financial system: Despite the adverse shocks of the past year, our banking system remains healthy and well-regulated, and firm and household balance sheets are for the most part in good shape.***

That speech was given by Ben Bernanke - the same Bernanke of the ‘printing press’ quote. But Bernanke was wrong in 2002 and Bush is wrong now, capitalism cannot be reformed it needs to be replaced.

WHAT WENT WRONG?

Capitalism's Financial Instruments: A House of Cards

Perhaps nothing characterises better the excesses of a capitalist system out of control than the Derivatives market. Warren Buffett one of the wealthiest investors in the world and doyen of Berkshire Hathaway's $196 billion investment fund famously described derivatives as "financial weapons of mass destruction". In Berkshire Hathaway's annual report to shareholders in 2002, he said, "Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses - often huge in amount - in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen)".

Buffett was speaking from first hand experience having bought a small US Insurance company which had a derivatives portfolio on its books. After expressing scepticism over its seemingly inflated valuation, Buffett ordered the portfolio to be liquidated. After several million dollars of losses and wading through over 670 counterparty (the institution on the other side of the transaction) relationships the job was done.

The derivatives market has grown almost exponentially over the past 10 years and is now estimated at between $500 trillion and $1,000 trillion (a quadrillion) in size. A level that dwarfs the "real" economy which is estimated at $50 trillion worldwide. Most of the derivatives market is un-regulated and is characterised by the OTC (over the counter) market which is effectively managed by contracting parties to the transactions, mostly banks, investment firms, hedge funds and their customers which include municipal bodies, councils, pension funds and wealthy individuals. According to the Bank for International Settlements as of December 2007 the OTC market was worth $596 trillion in notional value. Derivatives are in essence financial instruments whose value depends on the value of underlying financial instruments. They are contracts which depend on the performance or movement in prices of assets rather than transactions involving the actual assets themselves, and include commodities, equities, mortgages, real estate loans, bonds, interest rates, exchange rates, or indices (stock market indexes, consumer price index, etc.). Derivatives include futures, forwards, options and swaps.

The main publicised use for derivatives is to reduce risk. But in fact due to the nature of the derivatives developed and their disconnect from the real world, their sheer scale, and the fact that they are held by such a multitude of institutions via complex counterparty relations, it is questionable as to whether they are achieving anything other than a highly tuned means to gamble on a simply catastrophic scale. To amplify on to the detail of these transactions three popular forms of derivatives; CDOs, Credit Default Swaps and Currency Swaps are presented in the Appendix of this paper.

Gamblers Folly – let them fail

It would be easy for one to argue that if grown men (and women) are happy to gamble on the direction of interest rates, the strength of the US housing market and over who will, and who will not fail in the corporate world (for example with Credit Default Swaps), they should be allowed to get on with it. After all there is always a winner and a loser, and maybe the loser will learn from his mistakes and come back a better person. Like the perpetually failing gambler who always returns addicted yet expectant for a big payout, the assumption was that the markets are efficient and losers will pay out fully and on time just as the winners will gleefully pocket their gains. This is an absurd notion, which fails to take note of the inefficiency of those that get in out of their depth who will struggle to meet their debts and those that are completely wiped out by their gambling losses. This crisis is no different.

We've watched companies bet "the firm", or to be more accurate through leveraging (loans) bet many multiples of the firm. Despite armies of accountants, risk experts and compliance staff the world's largest banks did not see it coming and walked into the storm. Blinded by dreams of constantly accumulating profits on ever larger and riskier bets they just assumed they would never lose. And from the chief executives all the way down to the traders they are all culpable for the results. Yet, with only a few exceptions, they did nothing illegal. The system and the law endorsed what they did. The heart of the problem lies with the system (Capitalism) and its approach to transactions and gambling in general. Both the Royal Bank of Scotland and Barclays two of the largest and most prestigious banks have recently been reported to be each holding (according to their published report and accounts) $2.4 trillion dollars of Credit Default Swaps, nearly twice the size of Britain's total Gross Domestic Product. Little wonder they have both been at the centre of bailout discussions with the British government with the RBS succumbing.

Credit default swaps played a major role in the mushrooming credit crisis which led to Lehman Brothers filing for bankruptcy protection. Similarly the government rescue plan for insurer American International Group Inc. (AIG) ($124 billion and counting) and the emergency sale of Merryll Lynch & Co to Bank of America is rooted in the CDS bubble. AIG had become a major player in the CDS market, shunning traditional insurance for the more exotic and supposedly more lucrative CDS market. As a major seller of CDSs, had AIG failed, it would have triggered many billions of dollars in losses at numerous other banks and financial groups who traded with AIG, sending them into failure as well. The domino chain would be well and truly kicked off. Lehman Brothers despite its history and standing on Wall Street was deemed expendable, and was allowed to fail. Nevertheless its failure has in many quarters been criticised because it has played a key part in the current crisis.

By going into liquidation the full extent of its massive derivatives and leveraged positions became clearer – there is still 1.5 million Lehman derivative contracts which a large team of lawyers are struggling through. It also triggered a "credit event" over Lehman, following the credit events of the Government takeovers of the largest US mortgage companies Freddie Mac and Fannie Mae. These credit events brought the fragility of the financial system into sharp focus and no one knew who would fail next, or with such large CDS and other derivative losses washing around the system, who could pay who. If the largest of banks including all the key investment banks, were possibly insolvent who do you trust? The five core US investment banks have now all either failed (Bear Stearns, Lehman Brothers, Meryll Lynch) or abandoned their business model and become banks with access to special funding support and protections from the US government (Goldman Sachs and Morgan Stanley).

Liquidity Crisis – The banks stopped lending

This situation then rapidly led to a full blown liquidity crisis where financial institutions don't trust one another. Inter bank lending ground to a halt. The spread between what the Bank of England set as its interest rate, and what the banks would use to lend between them ballooned (the LIBOR rate). This created further problems as most banks borrow short term to provide long term loans. If short term loans are not available who is left to get money from? The central banks as lenders of last resort had to step in. The US Federal Reserve and Bank of England have been forced to provide masses of liquidity via "emergency" loans to keeping rapidly failing banks afloat. A position which hardly strengthens confidence in the banks or the system. It is no wonder that the most recent UK bank bailout bill included special provisions to hide the names of banks making use of emergency loans in order that the "stigma" of doing so was taken away. The other key factor in the liquidity crisis is that failing banks can hardly afford to weaken their balance sheets by making more risky loans to other "dodgy" banks, mortgage holders (in a recession) and failing companies – a vicious cycle. Consequently the banks are hoarding what cash they can get their hands on. Hardly conducive to encouraging the next big business upturn the governments expect. The banks are now hoarding cash, and many of the wealthy will be following them.

The Domino Effect

While Bank asset values are evaporating, loan positions are having to be repaid as short term lending dries up. Effectively the banks are being caught in a downward spiral of deleveraging in which the massive loan positions built up in recent years have to be unwound. Even the more conservative European banks are facing the same problems as they rely heavily on three month loan financing to maintain their positions vis a vis their long term investments. Additionally the Hedge funds, investment funds and associated groups are facing heavy margin calls against their leveraged positions as the markets dramatically drop, added to high levels of customer withdrawals from their funds, as everyone clambers to get off the sinking investment ship.

Rather than queues around the corner from bank offices in the high streets of the UK and main streets of the US, the internet age has spared the banks from that indignity. Nevertheless deposit holders voted with their "clicks" moving money out of bank accounts on mass to wherever and whoever was seen as a safe port in the storm. A less visible run on the banks, yes, but no less devastating. A perfect storm of dropping deposit base, credit contraction, heavy derivative based losses and complete lack of confidence in who next might collapse meant that many banks were effectively on the brink of collapse, indeed many were technically bankrupt. It was no surprise that their Chief Executives beat a track to the door of their governments for help.

GOVERNMENT INTERVENTION: SUPERHEROES TO THE RESCUE?

The Corridors of Power

The head of the IMF, Dominique Strauss-Kahn, told a Washington meeting over the weekend of 11/12 October 2008: *"Intensifying solvency concerns about a number of the largest US-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown."*

In London Gordon Brown and his Treasury team were working overtime with their investment banking advisors including Standard Chartered, JP Morgan, Citigroup and Credit Suisse. During the week ending the 12th of October, teams worked around the clock to find a solution to the crisis. Senior executives from Credit Suisse set up a temporary office in the central hallway of 10 Downing Street, bringing new meaning to the term access to the corridors of power. When the announcements were made of the bank bailout Monday morning the 12th of October, British papers hailed the "Balti Bailout". This was in reference to the late night sessions between the Treasury team, lawyers, investment bank advisors and stricken bank executives to thrash out a deal to save the banks and the system, in which the crisis teams dined on take away curries worth £245. Not wanting to be outdone by the US $700 billion bailout package that Congress had passed the week before, Brown now had his own plan cobbled together in a dawn deal done over the take-away boxes.

While the US$700 billion plan passed with great controversy at the second time of asking by Congress, the UK bailout would total at least £500 billion ($850 billion) and take the government beyond its borrowing rules without any significant Parliamentary debate.

Despite enormous vested interests in ensuring that their "gambling buddies" did not fail, investment banks were the architects of the "investment bank" bailout plan. Knowing full well that Royal Bank of Scotland, Barclays, Halifax Bank of Scotland and others were key pieces in the long domino chain of derivative contract holders there was never going to be any other solution but a massive bailout doing "whatever was necessary" to quote from the Chancellor Alistair Darling. But it would also be naïve to assume that the leading investment banks were also not acting in their own interests by nobbling those slightly less fortunate than themselves who would be lumbered with Government controlled high rate paying preference shares and a moratorium on executive bonuses and future dividends. US Treasury Secretary Henry Paulson as a former head of Goldman Sachs could hardly be seen as an impartial figure as he drew up the $700 billion US bank bailout plan. A plan for which a treasury official admitted the figure of $700 billion was calculated by merely adopting "a very large number".

Although equally hurriedly put together at least the UK bailout had some detail to back up the number, not that the numbers made for good reading.

Bailouts

The UK government committed to pay up to £50 billion to improve the balance sheets of stricken banks, by way of direct investment including preference shares. The bailout package also included £200 billion to provide emergency funding via extension of the Special Liquidity Scheme which enables banks to borrow for "short term" liquidity needs and £250 billion for debt issuance backed by the government.

The emergency injection of capital into the Royal Bank of Scotland and Halifax Bank of Scotland, could not be seen as an investment of capital because the UK government did not have the capital available to invest. Consequently the money will be added to their borrowings. When coupled with the nationalisation of Northern Rock and Bradford and Bingley the government has broken its golden rule of only borrowing to invest over the economic cycle and not for funding day to day spending needs.

In comparison the US on the 2nd of October committed to $700 billion to buy "toxic" assets of stricken financial organisations to provide liquidity until asset prices recover, a plan which was amended later to include the US government taking positions in the recapitalisation of some institutions.

The use of the emotive word "toxic" conjures up images of some form of Chernobyl disaster, and whilst that may be an appropriate analogy, that's not the only imagery associated with toxic. It would be difficult to find a positive value or price for something toxic, unless one was using it to injure someone. The apparent rationale for the bailout plan is that while the injection of tax payers' money into the Wall Street casino may not be fair, it is a necessary evil that will free up the "troubled assets" and create liquidity in the financial markets, thereby triggering a much-needed new wave of lending, borrowing and the next round of growth.

There are several problems with this approach

1. The inability to find buyers for the "toxic assets" (such a contradiction in terms) is not a liquidity problem but a price problem. There is a market for them, but the problem is that the price in the market is unpalatable to banks and investment funds that want to survive. If the market prices them as junk, who is the government to price them otherwise? This betrays the real problem of confidence. The problem is one of a lack of faith and trust, and this is because of too much junk/overblown assets relative to real assets. The liquidity crisis is not that there is no liquidity available, simply that those with it will not spend in a serious downturn and with overblown asset prices. Owners of liquidity are not willing to lend it to owners of junk, particularly if they may fail.
2. Although $700 billion is a really large number, it is no way large enough. It is only a fraction of the accumulated bad debts and likely debts moving forward. The Washington Post reported on the 29th of September that 20 of the US's largest financial institutions owned $4.7 trillion in mortgages and mortgage backed securities (with non recorded CDOs on top of that). CDS losses are also now beginning to hurt and this too is unregulated, unreported, and huge. It is now very questionable as to whether the assorted bailout, loans, and guarantees from the US/UK/European governments will ever be paid. Amounts which as of December 4, 2008 were in excess of $10 trillion.
3. The main underlying problem of the housing bubble and sub prime lending is not addressed. Consequently millions in the US will lose their homes and be driven even further into poverty. At the same time that the government is bailing out major financial institutions, following aggressive mortgage selling by those same institutions there are millions who will lose everything (their homes, wealth, and jobs). There is no provision in these bailouts for the victims of the housing bubble and the media is quick to point blame at them for "over-extending" or taking out mortgages they couldn't afford. Yet the aggressive sales policies are not punished. Why are the victims not being bailed out to enable them to keep a roof over their heads? If the governments did this then they would at least be taking on real assets (houses).
4. The economic stimulus packages are only an inconvenient "add-on". The auto industry pleaded for a $25 billion bail out due to the overall economic malaise and decline in their own industry. The financial bailout will send good money (from the taxpayers, or via

> inflated money supply – printing of more dollars) to cover the toxic losses of the speculators. That money will fall into a black hole to cover their (bank's) losses and will not help homeowners or the general public.

Concerns about the profligacy of the US government's spendthrift bailout policies have accelerated. The NY Times reported on the 27th of November that with the Federal Reserve and the Treasury announcing a new $800 billion in lending programs on Tuesday the 25th, that they were sending a message that they would print as much money as needed to revive the nation's crippled banking system.

"In the last year, the government has assumed about $7.8 trillion in direct and indirect financial obligations. That is equal to about half the size of the nation's entire economy and far eclipses the $700 billion that Congress authorized for the Treasury's financial rescue plan." [1]

In addition to the government bailouts, distressed lenders are looking to the suspension of "mark to market" accounting rules as a means of salvation. These rules required institutions to value their mortgage assets according to the most recently traded price. However, changes recently implemented by the Financial Accounting Standards Board (FASB) under pressure from the large banks to allow more advantageous model based valuations have now been brought in. Lenders are now able to pretend that the losses do not exist, or defer accounting for them, thereby dangerously removing the transparency that investors so desperately need.

"It gives companies more leeway to employ estimates and their own judgment in many cases when they deem the market to be "disorderly" or seized by liquidity problems" [2]

As a result the banks can now present inflated values for their mortgage assets, and that their balance sheets are well capitalized. They would not need to raise more capital in order to fund new loans. However, like the person with no sensitivity to pain runs the risk of serious injury, this move encourages the same financial institutions to take greater risks. In the end this will likely lead to more losses, allowing them to try to gamble their way out of the problem without reporting their true economic position.

[1] U.S. Details $800 Billion Loan Plans, 25 November 2008, New York Times, http://www.nytimes.com/2008/11/26/business/economy/26fed.html?pagewanted=1&_r=2

[2] SEC Loosens Accounting Rule BankBankBanks Blame for Crisis, 30 September 2008, Washington Post, http://www.washingtonpost.com/wp-dyn/content/article/2008/09/30/AR2008093002298.html?hpid=topnews

CAPITALISM'S SYSTEMIC FLAWS

The £500 billon stake in the banking sector appears to be the last throw of the dice by the UK Government in an attempt to rescue systemic collapse in the financial system. Like a losing gambler who returns to the casino repeatedly to recoup his losses the British Government too keeps pouring real tax payers money to cover financial 'asset' losses.

Western nations have for decades lectured the world about the benefits of freedom of ownership as epitomised in market capitalism. Not only that, they have, via highly paid consultancies, developed and implanted privatisation programmes, free trade policies, capitalist company structures and stock market operations around the globe.

Through the so-called 'Washington consensus' the IMF and World Bank have imposed capitalist policies on poor developing nations ill equipped to deal with the disastrous direct consequences of these 'adjustment' programmes. Whole economies have been brutally vandalised with catastrophic consequences. Yet the bankers (IMF and WB) have argued each time and after every crisis that these capitalist policies are a necessary step in the right direction.

However, faced with an economic collapse at home western nations have contradicted, overlooked or plainly disregarded the same prescription.

Contradictions with capitalist free market policies and principles which provide clear signs of an ideologically bankrupt West have been numerous in the current crisis:

1. Previously profitable failed private companies have been nationalised (e.g. Northern Rock and the Royal Bank of Scotland in the UK and Fannie Mae, Freddie Mac in the US)

2. Monopolies and anti-trust (or anti-competition) laws have been disregarded (e.g. the merger between Lloyds and HBOS in the UK)

3. Hundreds of billions of tax payer's money has been poured into the private banking system to lend money to commercial profit making financial institutions

4. Interest rates have been cut despite relatively high inflation contradicting 'sound' monetary policy (e.g. US, UK and Europe)

5. Taxes have been cut despite high public borrowing and debt (e.g. US) contradicting 'prudent' fiscal rules

6. 100% of the financial liabilities of private profit making companies (banks) have been guaranteed by governments (e.g. Ireland)

7. Car manufacturing private corporations have been given credit guarantees to stimulate investment (e.g. US)

8. Governments have used taxpayer's money to buy shares in insolvent private corporations (e.g. UK bank rescue plan)

9. The planned amendment of accounting rules including fair value (mark to market) within Financial accounting standards.

The systematic failure of financial markets is a clear indictment of capitalism because the financial system epitomises capitalism in its thoughts, values, policies, culture and outlook, more than any other capitalist institution. The capitalist principle of freedom of ownership once sacrosanct has proved disastrous and ruinously damaging for society in the West. The other extreme of communism which denied ownership altogether has also proved unworkable.

A Monetary Time Bomb

In November 2008 the NY Times reported that the US Treasury had effectively (and so far) committed a staggering 7.8 Trillion Dollars to assorted bailout schemes, designed to save the US economy and enable the system to continue.

$1.7 Trillion in loans (Companies are borrowing from the government, using hard-to-sell securities as collateral)
$3.0 Trillion in investments (The government has bought stock and corporate debt and will buy mortgages)
$3.1 Trillion in guarantees (The government is guaranteeing corporate bonds, money market funds and money in some deposit accounts) [3]

In addition to the above, the action of nationalising the two main mortgage companies Fannie Mae and Freddie Mac effectively adds another $5.3 Trillion in mortgage liabilities to the US government books.

There is little consensus on the ultimate scale of losses to be absorbed within the Financial system. The IMF originally estimated about $1 trillion in losses and now says that will be too low. Nouriel Roubini has estimated eventual losses of over $2 trillion and others talk of more than $5 trillion. Even a small percentage write down on the 500 to 1,000 trillion derivatives mountain could make these large figures look tiny. The counterparty risk carried within the banking system is far greater than that which can be covered by even the largest governments acting together. US GDP is $14 trillion, and the US is already the greatest debtor nation with a more than $10 trillion government deficit, and its budget deficit in the coming year may balloon to more than $1 trillion, particularly with the stimulus package that the new President Barack Obama is promising.

There is also growing disquiet over the lack of transparency in the governments actions. Bloomberg reported on the 10th of November, "The Federal Reserve is refusing to identify the recipients of almost $2 trillion of emergency loans from American taxpayers or the troubled assets the central bank is accepting as collateral. Despite assurances given to Congress over transparency in the $700 billion bailout of the banking system. Two months later the Fed is lending far more than that in separate rescue programs that didn't require approval by Congress, Americans have no idea where the money is going or what securities the banks are pledging in return[4]".

Dr Ronald Solberg of Armored Wolf Asset Managers highlighted that the US government has effectively become a bank and worst still is offering loans without any security.

The Fed's balance sheet is dramatically growing - in the 8 weeks to Oct 08 the monetary base grew an unprecedented 38% to $1.142 trillion and shows no signs of slowing down [5]. However, reserves injected into the balance sheets of the banks have not been disseminated into the broader economy.

[3] U.S. Details $800 Billion Loan Plans, 25 November 2008, New York Times, http://www.nytimes.com/2008/11/26/business/economy/26fed.html?pagewanted=1&_r=2
[4] Fed Defies Transparency Aim in Refusal to Disclose (Update2), 10 November 2008, Bloomberg News, http://www.bloomberg.com/apps/news?pid=20601087&sid=aatlky_cH.tY&refer=worldwide
[5] Source: US Federal Reserve Oct 30, 2008, BCA Research

The banks are using the cash to repair and shrink their balance sheets – ie write off their bad debts. So there are serious questions over how effective the bailout schemes will be and how soon the credit crunch will be over as banks deleverage and write off their losses.

The commitment to do whatever is necessary to save the economy from absolute collapse and the winding up of the major financial institutions of the US is unquestioned. Where this money would come from is less certain. The US government is faced with the choice of: massively curtailing expenditure on social, health and welfare projects, raising taxes dramatically, increasing borrowing from overseas, or literally printing the money. As the first two options of cutting spending and raising taxes is not tenable and cannot raise the necessary trillions needed, the money will come from either foreign loans including the holding of US Treasury bills or via printing money which will effectively devalue the currency and cause a hike in inflation. It is questionable as to whether foreign governments will continue to fund the US particularly as the US consumer will slow down in its purchase of Chinese and Japanese goods. The Chinese government which already holds $1.8 Trillion in US bonds is also unlikely to want to further increase its holdings of a currency which could go into meltdown.

If the US government fails in extracting this money from foreign sources then there is no alternative but for a massive increase in the US money supply which will be inflationary or hyperinflationary.

With Governments buying up bank's bad debts Governments themselves become riskier propositions for investment. Governments are vulnerable to defaults. The risk of this is greater now then at the start of the crisis as Western economies rapidly contract with tax revenues falling and public spending on the rise. Thus a financial crisis precipitates an economic crisis leading to a political crisis.

The absurdity of the business cycle: Boom and Bust

If the metre, gram and second remain constant, why does the dollar keep changing? The former units are measures of stable physical quantities, while the latter is a pseudo-measure, i.e. it is used as a measure but currently no stable physical quantity can be correctly attributed to it. But as currency is currently not backed by something stable and tangible, significant numbers of bright people (not to lose out on the spoils) devote their time following the dance of the currency markets. Rather than considering it a problem, they see it as an opportunity to generate more profit. Some make profits by predicting the next move while some try to actually choreograph the dance itself.

Currency or money is a unit of value. In other words, the exchange ratio of a product/service with money is called its 'price'. It is noteworthy that the 'value of exchange' or 'value' as it is usually called, is the ratio of an exchange of one thing with another, and price therefore is a type of exchange. But unlike exchanges of one thing with another, it is possible that the prices of all things rise or fall at any one time. Hence the price of a thing is merely one of its values.

If money had a fixed value in terms of something stable and tangible (for example 1 unit of money = 1g of gold), it would indeed be a measure, like the metre or the second. For more than a millennium money was based on some standard (like the gold standard) and it continued to be the medium of exchange, and hence for most ordinary people money is commonly understood to be a measure of the value of things. But that standardisation to something as stable and tangible, ceased to be the case in the latter part of the 20th century, and as such money came to be considered a mere object, which only has a notional or temporal value. The notional value of money may not necessarily be based on real exchange ratios with other commodities or services; in fact it came to be based merely on the perception of people or traders.

So, the price or value of things fluctuates according to the notional value of money, as much or even more than the importance or benefit of the product or service, or the 'value of benefit'. This is unfortunately how things are valued in today's world – hence it is not surprising to find the value of your house rising and falling, and for over a century there has been talk about boom and bust at least once every decade for over 150 years.

Doomed to live in a crisis ridden world?

The economic systems that are in place reflect the prevailing ideology of the state. Therefore such instability cannot be attributed to economic systems per se. The reigning capitalist economic system suffers from marked instability; so periodically it is referred to as the business cycle (list of US business cycles [6]) and is a primary concern of (capitalist) macroeconomics.

The history of the past 100 years of the implementation of the capitalist economic system shows that it is hard to treat these instabilities as exceptions. There are several takes on the explanation for the business cycle; a thorough exposition requires a level of academic rigour that is unwarranted here. A usual treatise on business cycle dynamics concerns itself with the variants of capitalist systems and data on various variables, and does not delve into different ideological systems or societal models. The lack of consensus and the nature of capitalist economic studies, not surprisingly make prominent economists argue that the biggest failure of (capitalist) economic theory is the failure to explain the business cycle, the size of fluctuation in prices and causes of growth and innovation[7].

Smith and Walras implied that the economy can be understood as an equilibrium seeking and sustaining system and mainstream capitalist economists view busts as outcomes of external shocks to the system. Both classical and Keynesian economists are mired in the debate over the agility of the market in the event of aggregate demand and supply shocks to achieve long-run equilibrium[8]. Classical economists posit that prices adjust rapidly to imbalances in quantities supplied and demanded, so that the economy gets to its long-run equilibrium in a few months or less, hence recession is likely to end quickly (in the strictest version equilibrium is simply maintained). Since adjustment occurs quickly, they argue that little is gained by government intervention (consistent with the invisible hand argument). Keynesians argue that the prices/wages do not adjust itself quickly and return of the economy to long-run equilibrium would be slow, and do not believe in the self-correcting powers of the economy, hence the role of government in fighting recessions (for example Keynes argued for an increase in spending).

Others like Minsky contended that even in the absence of external shocks, instability is a fundamental characteristic of financial systems in capitalist economies. Others from the Austrian school argue that the inherent instability is due to intervention of the government such as the role of central banks, and would not occur in free market capitalism. In general (with few exceptions), all positions look to extend the freedom of ownership to the maximum possible as free marketeers in spirit, but with varying caveats and degrees of government intervention to achieve stability.

If resolving the problem of the business cycle was the issue, the solutions within the capitalist framework are highly contentious, where holding on to the ideals lacks practical relevance and the patchwork interventions often violate the very central precepts of capitalist economics. Rehashing

[6] National Bureau of Economic Research, *US Business cycle expansions and contractions*, www.nber.org/cylces.

[7] Dubra J, 2005, *Interview with Kenneth Arrow*, Unpublished manuscript, Munich Personal RePEc Archive, http://mpra.ub.uni-muenchen.de/967/

[8] Abel A B, Bernanke B S, 2005, *Macroeconomics*, Pearson Addison Wesley, Boston.

the words of Islamic scholar Shatibi[9] for capitalism, violating the capitalist ideal under the pretext of pursuing the objectives of capitalism is like the one who cares about the spirit without the body, and since the body without the spirit is useless, therefore the spirit without the body is useless too.

Inherent Instability

Instability is a lack of balance – a reasonable relationship between value of money and goods. A prominent view is the financial instability hypothesis, which states that the economy has financial regimes under which it is stable, and financing regimes in which it is unstable, and that, in periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system[10]. Furthermore, if an economy with a sizeable body of speculative financial units is in an inflationary state, and the authorities attempt to exorcise inflation by monetary constraint, then the speculative units will quickly evaporate leading to a collapse of asset values. The financial instability hypothesis is a model of capitalist economy, which does not rely upon exogenous shocks to generate business cycles of varying severity.

The Austrians accept the instability hypothesis as describing what is happening, but also feel it does not provide a satisfactory explanation, hence cannot indict capitalism as such. They conclude that the instability is yet another failure of big government intervention through central banks. For example: if Jack deposits £100 of real savings (say from farming) in a bank. Jack has the right to demand his £100 at any time. Let us say that the bank then lends £50 out to Jill. At this stage, we have £150 backed by £100 (a universal practice in modern banking called fractional reserve banking). To make it clear, let us say Jack and Jill purchase £100 and £50 worth of goods with cheque payments from a shop. The bank now faces a shortfall of £50. The Austrians argue that in a free market, if a bank engages in unbacked expansion of credit, it runs the risk of being caught, and therefore the threat of bankruptcy is likely to serve as a deterrent. Hence Minsky's instability hypothesis only applies to the modern capitalist economy with its institutional setup and not free market capitalism devoid of big governments[11].

The causes cited by the instability hypothesis is psychological and pathological in nature, and the cause cited by the Austrians is institutional in nature. Both do not provide founded alternatives that provide stability. Absolute free market anarchy could never be sustainable, would never be accepted by any community and is self-contradictory, for the one who enforces the free market is intervening by definition. As for the Keynesians and the post Keynesians, there would always be disputes on what regulations and limits are appropriate. The market would evolve perpetually, facing crisis after crisis, as it suits its ideas based in reality (often parsimoniously) rendering the economy vulnerable to internal and external fluctuations.

It is undeniable that the central bank model is central to the problem facing the economy. For it allows the bank to directly borrow or sell some of its assets for cash. The key question is where does the central bank get its liquidity? – it just prints it with no backing. The bank could also borrow from other banks, but that could increase interest rates, which slows down demand from borrowers. The modern banking system is guided and coordinated by the central bank, which ensures sufficient liquidity for investments and expenditures by injecting money through a joint expansion of unbacked credit.

[9] Imam Shatibi (ra) said in his al Muwaffaqaat fee Usul al Ahkam volume page 25, "…Violating the Shariah under the pretext of following the basic objectives or values (maqasid) of the Shariah is like the one who cares about the spirit without the body, and since the body without the spirit is useless, therefore the spirit without the body is useless to."

[10] Minsky H P, 1992, *The financial instability hypothesis*, The Jerome Levy Economics Institute Working Paper No. 74. Available at SSRN: http://ssrn.com/abstract=161024.

[11] Shostak F, 2007, *Does the Current Financial Crisis Vindicate the Economics of Hyman Minsky?*, Ludwig von Mises Institute article, http://mises.org/story/2787.

Evidently, it was the loose monetary policy of the Fed between Dec. 2000 and Jun. 2004 i.e. lowering Fed funds rate (interest rate of lending federal funds) from 6.5% to 1% that laid the foundation for the emergence of the bubble activities. And then between Jun. 2004 and Sep. 2007, the Fed raised the Fed funds rate from 1% to 5.25%. This tightening of liquidity undermined the bubble housing market (which had ample warnings); gaining bust-level pressure by the end of 2007. The Fed funds rate is one of the open market levers to regulate the economy. The sheer volume, globalisation, securitisation and a veritable explosion in complex derivatives have combined in a way to make for a calamitous bust, rivalling the great depression of 1929.

The above provides a reasonable backdrop to highlight two fundamental systemic elements, which underlie the causes of boom and bust:

1. Lack of a standard such as the gold standard (allows unbacked minting)
2. Interest based banking (which encourages debt accumulation for high returns)

There is already considerable concern, even in the west, over both of the above. The return to the gold standard is supported by many including followers of the Austrian School of Economics, objectivists and libertarians largely because their free market ideals i.e. their objection to the role of the government in issuing fiat currency through central banks. Even Alan Greenspan had attested to the importance of the gold standard, "The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit... In the absence of the gold standard, there is no way to protect savings from confiscation through inflation… Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard." [12]

Any alternative model should not possess these weaknesses. The fixed currency standard and interest free banking form some of the key institutional basis for a sustainable system.

Prosperous or Preposterous System?

As for whether the prevailing model is prosperous or preposterous, it is apt to quote Kennedy: "Money does not only help the exchange of goods and services but can also hinder the exchange of goods and services by being kept in the hands of those who have more than they need. Thus it creates a private tollgate where those who have less than they need pay a fee to those who have more money than they need. This is by no means a "fair deal". In fact, our present monetary systems could be termed "unconstitutional" in most democratic nations" [13]

The government covers its expenditure and promotes growth of the corporations (which rarely trickles down to the common man) by several means. The resulting bust is covered by a complex set of taxes which covers almost every aspect of life: income taxes, utility taxes and stealth taxes, inflation, bail outs, subsidies, pension and welfare cuts and not to mention efforts to liberalise trade in developing countries. It is not surprising that the capitalist economic system is punctuated with crises, wars and revolutions.

Booms will not always follow busts. Taking the west and the past crises as an example, only reveals part of the story. A crisis of the current magnitude has sufficed for many western commentators to

[12] Greenspan A, 1966, *Gold and Economic Freedom*, First appeared in The Objectivist, reprinted 1967 in Capitalism: the unknown ideal, Signet, New York.
[13] Kennedy M, 1995, *Interest and Inflation Free Money*, Seva International, Munich.

discuss apocalyptic scenarios for the capitalist economic system. A future mistake would certainly be more severe; awaiting such a fatal blow is patently foolish. Western problems are often exported via global ventures, where other countries absorb the brunt. Even without resorting to such examples, the 1997 Asian crisis stands as a clear example of a bust gone without a subsequent boom. Once a tiger economy (a term for the fastest growing economies in the 1990s) Indonesia continues to reel with $113bn of external debt. Malaysia intervened to prevent the bust and has emerged as a relatively successful middle power, only to be criticised as a threat to capitalism and the free market[14].

The US displays obscene deficits of over 2/3 of its GDP (over $10 trillion of Federal debt and when unfunded obligations are included this raises it to around $60 trillion). Foreign owners of US treasury securities exceed $2.6 trillion. There is declining willingness of foreign investors due to the long term falling dollar, and the existing debt is owned in particular by Japanese, Chinese, and oil exporting central banks. The US faces increased dependency on diminishing export markets for its products due to competitive foreign imports and fierce competition overseas. Even weak countries such as Kuwait are pulling out of the dollar peg and opting for a basket of international currencies. The bailouts of the largest banks are loading further debt into a system teetering on the edge. In addition to its inherently unstable financial system, any changes in the global political economy can have serious implications for the health of the state. The capitalist system appears to be non-correctable, as it would need to undermine itself to do it.

An Interest-free Economy

Interest and profits have very different implications for the parties involved and the system as a whole.

Some of the consequences of an interest based economy are:
1. Exploitation of the needy.
2. Interest is paid by the public even if they borrow no money. Interest is included in the price of everything paid for and there is interest on the national debt extracted via taxation.
3. All are not equally affected by interest rates, which serves as a hidden re-distribution mechanism.
4. Lending money for high returns offers unbacked liquidity, which is the agent of instability and a chief cause of the current crisis.
5. Discounting the future: Since interest results in appreciation of invested capital, it is a presumed rationale for people to prefer having an amount now than the same amount in the future. This rarely questioned logic can have disastrous implications. Discounting affects the rate at which we use up natural resources – the higher the interest rate, the faster the resources are likely to be depleted[15]. There is no reason that this cannot be taken to its logical conclusion that discounting can lead to the "economically rational" extinction of a species[16], and that "in evaluating long term investment projects, particularly those in which the benefits and costs are separated from each other with a long time interval, the net present value rules guide the decision maker to maximise the utility of present generations at the expense of future ones"[17].

The mixing of interest and profits has confused an accurate understanding of their difference in the West. In Islam the distinction is maintained legally. Profits are backed by real output. There are also specific regulations on company structures that can be formed to make profit, which gives substance to the link between profits and outputs.

[14] Soros G, 1998, *Capitalism's last chance*, Foreign Policy, December - Winter issue.
[15] Pearce D W and Turner R K, 1990, *Economics of Natural Resources and the Environment*, Harvester Wheatsheaf, London
[16] Daly H E and Cobb J B, 1990, *For the Common Good*, Greenprint, London.
[17] Kula E, 1981, *Future Generations and Discounting Rules in Public Sector Investment Appraisal*, Environment and Planning A, 13: 899-910.

The historical account of more than 1,000 years of the erstwhile Islamic state stands a brilliant example of stability and prosperity. It is interesting to note that between 1932 and 1933, the small Austrian town of Wörgl started an experiment where the town's mayor convinced the business people and administrators to conduct a monetary experiment in the way suggested by Silvio Gesell, who suggested securing the money flow by making money a government service subject to a hold/use fee[18].

The town council issued 32,000 "Work Certificates" (i.e., interest-free Schillings), covered by the same amount of ordinary Austrian Schillings in the bank. The fee on the use/hold of the money was 1% per month or 12% per year. This fee had to be paid by the person who had the banknote at the end of the month, in the form of a stamp worth 1 % of the note and glued to its back. Otherwise, the note was invalid.

This small fee encouraged those who were paid in Free Schillings to spend them before they used their ordinary money. People even paid their taxes in advance in order to avoid paying the small fee. Within one year, the 32,000 Free Schillings circulated 463 times, thus creating goods and services worth over 14,816,000 Schillings. The ordinary Schilling by contrast circulated only 21 times.

Wörgl reduced its unemployment rate by 25 % within this one year, while Europe was struggling with rising unemployment and depression. When over 300 communities in Austria began to be interested in adopting this model, the Austrian National Bank saw its own monopoly endangered. It intervened against the town council and prohibited the printing of its local money[19].

Capitalism and its future

As Karl Polanyi argues, capitalism is an anomaly - for it is a system, where social relations are determined by economic relations. This is unlike in previous systems where economic interactions follow from social relations[20]. Capitalism suffers from bigger conceptual problems:

1. Mixing needs and their means of satisfaction
2. Needs are only materialistic
3. Commodities and services are not related to the structure of the society.

These assumptions have left societies and the world in disarray both physically and intellectually. The future will certainly see a correction; correction of a non-correctable system entails replacing it with an alternative system.

[18] Gesell S, 1949, Die natürliche Wirtschaftsordnung, Rudolf Zitzmann Verlag, Lauf bei Nürnberg, Translated, Pye P. is available at http://www.appropriate-economics.org/ebooks/neo/neo.htm as of 4 Oct. 2008.

[19] Suhr D, 1989, The Capitalistic Cost-Benefit Structure of Money - An Analysis of Moneys Structural Nonneutrality and its Effects on the Economy, Springer Verlag, Heidelberg.

[20] Polanyi K, 1944, *The great transformation*, Rinehart & Co., New York.

THE ISLAMIC PERSPECTIVE

Gordon Brown was right to highlight the problem of the boom and bust cycle so regular and so damaging to society. To have consistent growth or at least a consistent environment devoid of out of control expansions and debilitating contractions is what all seek. Consistency is also essential in terms of the monetary and fiscal environment. When business does not know the value of the currency it is forced to trade in, whether domestically or internationally, the tax it will be subject to and the stability of prices vis-à-vis inflation, it becomes doubly hard to maintain a consistently profitable business and full employment.

In addition to the monetary and fiscal environment and attendant damage of inflation, capitalist society constantly fights over the regulatory environment. The supposed "free market" we are told will provide a steadying hand. And conservative liberal governments aim to minimise the interventions of government and reduce legislation to a minimum. Yet, the statute books are full and are constantly being amended with reactionary legislation which patches over the inherent flaws of a system which is failing to provide the stability so dearly expected. Rather than a constant and confusing mosaic of patchwork regulation to deal with the latest crisis, society is requiring of principles, and clear, stable laws that enable people to plan their futures with confidence.

The Financial crisis can be characterised by unrestrained credit creation on the back of an out of control financial system that not only allows the creation of money and interest from nothing, but gambling on a mind-boggling scale. Wealth has been extracted out of the system in never before seen amounts, and will not be easily replaced. From an Islamic perspective this is entirely predictable and preventable. Yet the cure is requiring of the complete application of Islam within the governance structures set down within the Caliphate ruling system. A ruling system in which the economy is geared towards meeting the needs of the people, not faceless banking corporations.

The following principles of economy in Islam are presented, not as reactionary points of debate to be part of the patchwork of crisis and flawed response, but as an ideological alternative which has enjoyed many centuries of success for Muslims and non-Muslims alike.

The Human Crisis

Perhaps the most startling aspect of the crisis is that it is in fact a human rather than financial crisis. It is real people that are losing their homes, jobs and savings, yet the headlines focus upon the mechanics, the companies and the dollars. This spills over into Government policy which in this crisis has focused on preserving companies and an elusive commodity called "confidence" in the system, not the individual. The irrational emphasis upon growth in GDP at all costs and misplaced notions of the trickle down positive effect of growth to the poor in society have been proven repeatedly to be false as the division between the wealthy and poor in Capitalist society continues to widen.

The first principle of economics in Islam is to meet the basic needs of ALL the people in society. The economic problem is described as one of distribution, not production. We do not lack resources and wealth in the world, yet the drive for constantly increasing production which has been unequally accumulated has led to massive levels of poverty even in the most developed countries. Islam does not discourage success and throughout history many Muslims and non-Muslims living in the Caliphate were very wealthy. The difference lies in the responsibility of both the state and the individual to ensure that all in society have at the least their basic needs of food, accommodation, clothing, health and education. In a narration from Prophet Muhammad صلى الله عليه وآله وسلم he said that: **"The son of Adam has no better right than that he would have a house wherein he may live**

and a piece of cloth whereby he may hide his nakedness and a piece of bread and some water" (Tirmidhi).

This forms the basis of the Economic system of Islam, all policies and rules are geared towards achieving such ends. Where the extended family unit is unable to, and only when it is unable to, the state will act to ensure that the basic needs are met. The poor and indebted are included in those that are eligible for zakat payments (an enormous pool that the wealthy contribute 2.5% of unused wealth to). This is in contrast to free market Capitalism which is focused towards increasing Gross Domestic Product (GDP) a very misplaced measure of progress. People have rightly asked why there is no bailout of the 100's of thousands now losing their homes in the US housing crisis, or those losing their jobs in the recession. The urgent governmental response has been to bailout banks and provide liquidity to the banking system. Major banks cannot be allowed to fail but individual failure is widespread and acceptable. Governments cite the need for restraint when re-negotiating public sector and essential service pay rounds that do not even reach the level of inflation, claims that would cost the public purse a few millions. Yet hundreds of billions, indeed trillions of dollars are ploughed into the banking system with undue haste, and little understanding of the assets held on the banks balance sheets. Islamic Shariah dictates that the State provides a backstop to ensure the basic (and only the basic) needs of all are met, and has no responsibility to bailout private companies at the expense of the State and public. Nationalisation of public banks is also against the Shariah which clearly distinguishes between state, public and private ownership.

Rich countries have fallen seriously behind in living up to their promises to increase aid, debt relief and access to their markets for exports from developing countries. The Millennium campaign announced in 2000 to solve poverty by 2015 is at the half way point but is sadly falling behind in terms of the promised payments and the proposed results. Although promising to meet a welcome, but still inadequate, increase in aid to reach a 0.7 of one per cent Gross National Income target most nations are falling badly behind the targets[21].

We are also witnessing an attendant falloff in the likelihood of poverty eradication targets being met, particularly in sub Saharan Africa[22].

The financial crisis has made the disparity between concern for big business versus concern for human life very clear, when very modest anti poverty measures extending over a period of 15 years cannot be met, but 10's and 100's of billions of dollars amounting to several percent of GNI can be rustled up over a weekend for bank bailouts. Islamic law dictates that the sanctity of life takes precedence, and the strict requirement to meet ones contractual commitments both individually and by the State is also set out as the Quran commands:

"Believers, fulfil your obligations"

[Translated Meaning Quran Al Maidah: 1]

[21] Europe's Governments are Failing their Global Poverty Commitments, February 2006, http://www.millenniumcampaign.org/site/apps/nlnet/content3.aspx?c=grKVL2NLE&b=1008653&content_id={8254E86C-13FD-443A-B632-2FE626ABEF88}&notoc=1

[22] Anti-poverty targets in Africa will not be met, UN warns, 2 July 2007, Guardian, http://www.guardian.co.uk/business/2007/jul/02/debt.development

Credit or Misery Creation

"Neither a borrower, nor a lender be; For loan oft loses both itself and friend" [Hamlet, William Shakespeare]

The categorical prohibition of interest in Islam is well known, less well known is that lending is very strongly encouraged in Islamic society. The Prophet (peace be upon him) said:
"**No Muslim would give another Muslim a loan twice, except that one would be written for him as charity.**"
Which means that to loan to someone twice carries the same high reward of giving charity.

It was narrated by Abu Huraira that the Prophet صلى الله عليه وآله وسلم said:
"There was a merchant who used to lend to the people, and whenever his debtor was in straitened circumstances, he would say to his employees, 'Forgive him so that Allah may forgive us.' So, Allah forgave him."

The making of loans and leniency in demand for repayment are highly encouraged in Islam. Similarly the non-repayment of loans is treated harshly with the Prophet صلى الله عليه وآله وسلم refusing to lead the funeral prayer over such individuals. The most important point to note, however, is that the taking and giving of loans in Islam is without compensation (interest) which means that it is impossible to inflate lending assets beyond what is actually available of real assets in the society.

All lending at interest is prohibited in Islam so banks or anyone else cannot seek to gain from lending. In such a society the question is raised as to where the incentive comes for anyone to lend? The key to this question is in understanding the incentive for investment, and the allowable forms of investment within the Islamic environment. Without loans at interest and without credit creation via open market operations or the monetisation of derivative securities a major avenue for insecurity in society is closed off.

The Asymetric Threats Contingency Alliance (ATCA) recently estimated that in the past 12 years of the most recent "boom" period 100 trillion dollars of debt securitisation has been created (part of the 1.1 quadrillion dollar derivatives mountain they estimate has been created in the same period). The word created is used advisedly here as these "assets" dwarf the real assets which are truly in existence on this planet (the sum of all goods and services are estimated at 60 trillion dollars, with US dollars in circulation (M2) at 16 trillion dollars). In Capitalist economies banks can, and do create money and derivative products from nothing, and at enormous multiples of the real economy. If a bank has a reserve requirement of 5% it can create loans 20 times the size of assets on deposit. This is before the complex web of leveraged derivative products are also considered (the SEC in the US in 2003 gave the then 5 largest investment banks the green light to leverage their own assets by up to 30 times). Beyond this banks have seen fit to develop "off Balance sheet" assets which are further from reality and certainly out of public oversight. It is little wonder that these banks took full advantage of what was a green light to create from nothing products that would pay high returns in what has traditionally been a low risk environment – generally banks earn from interest on loans, and guarantee returns by repossessing assets when the business cycle moves down. In the down cycles there is of course deleveraging as loan positions must be unwound. When the unwinding is slow and punctuated by bank or institutional failures a credit crunch results with all available cash going to repay loans, prop up ailing balance sheets or covering losses. Due to the unprecedented scale of the run-up in credit creation in this past decade, by necessity the unwinding will be more painful and on an equally massive scale. It is no different from the fallout from any of the myriad of pyramids or bubbles witnessed over the centuries, only this time numbers 10 or even 20 times the size of the whole world economy are at stake. This very painful credit crunch is now panicking governments worldwide into thinking of ways to resume an upward growth trend without recognising the mess they are currently in due to these corrupt practices.

Islam views the charging of interest and repossession of assets by the money lender as oppressive and forbids it. The creation of new money from nothing to then lend at interest is also clearly corrupt and a recipe for disaster which we unfortunately are now witnessing. This prohibition extends to these practices whether in the small or large scale. Instead those with capital are faced with options to invest which are non interest oriented and which are based on the principle of sharing of investment returns and sharing of risks of actual loss (in accordance with the capital share of the investors).

The incentive to invest and ensure a consistent circulation of wealth that all economists desire, stems from two distinct features of the Islamic economy both fiscal and legislative. Faced with non interest bearing bank accounts and the levying of zakat at 2.5% per annum against unutilised (according to various criteria) wealth there is simply no incentive to take money out of circulation. If it lay fallow in a bank account it will be subject to the zakat charge. The other great stimulus in Islamic economy for investment is via the effective nil rate of company income and dividend tax. Although certain stocks and inventories of companies are subject to the annual 2.5% zakat levy, punitive corporation tax and the disincentive of being taxed on the dividend payouts of company activity, which is also absent in the Islamic economy acts as a strong incentive to invest.

The Islamic taxation system does not tax income, but taxes wealth (although modestly). With greater disposable income available for goods and services, and tax liable on unspent wealth, there is a strong fiscal boost to demand for goods and services right across the economy which will generate an increase in trade and in turn an increase in wealth for businesses. All of this will create a dynamic economy which creates more jobs. As more jobs are created, more money is spent in the economy or re-invested in the economy, which creates more jobs in turn. This type of dynamism does not exist in the world, and only existed in America after World War II.

The key legislative factor leading to high and consistent investment levels is the prohibition of hoarding money, which is the practice of taking money out of circulation for no purpose (saving for a purpose such as a large asset purchase is not considered as hoarding). The Quran clearly sets out:

"And let those who hoard gold and silver and do not spend them in the way of Allah know that a severe and painful punishment is awaiting them"

[Translated Meaning Quran 9:34]

In a Hadith Qudsi (Imam Nawawi) the Prophet صلى الله عليه وآله وسلم narrated:
"**Spend oh son of Adam, and I will spend on you"**.

The combination of prohibiting banks from trading with interest, or acting as the sole middle man in effectively controlling the money markets, together with the incentive for investment (zakat on unused assets and prohibition of hoarding) has meant that the Islamic society benefited from high and consistent investment. These disincentives to take wealth out of circulation have consistently been applied over hundreds of years and massively softened the impact of business downturns, which usually resulted from natural shocks such as climactic disasters. The current liquidity crisis is as much about those that are taking their cash and wealth out of circulation as the incredible levels of losses that banks are experiencing which have caused massive retrenchment.

Compare the Islamic rules for consistent investment levels with the comments of Andrew Lahde a hedge fund manager that announced the closing down of his hedge fund in October 2008 [23]. While denigrating the "idiot bankers" who had lost in their "bets" against him, he announced that he was closing down his hedge fund to "spend time with his money". Not so much has been written about the winners of these gambling sprees, but you can be assured that many more like Mr Lahde are spending time with their money at the expense of the wider society. Not only are governments bailing out banks for their gambling debts, but stimulus packages are now on offer to try and put money into the economy as billions have been spirited away by those that will have nothing to do with the idiots they fought against and won, and have purely selfish reasons and no disincentive to now hoard cash. With stock markets plummeting and bond yields set to plunge with inflation soaring, much of this money will sit on the sidelines (or in the playgrounds of the super-rich), possibly for years, and all at a time when its wide circulation is most needed.

"In order that it does not merely make a circuit amongst the wealthy"
[Translated Meaning Quran Al-Hashr 59: 7]

The Islamic system provides a compelling investment model, and there is no basis to suggest that the Islamic economic system does not promote investment. The truth is that Islam encourages business and investment, but does not encourage interest based investments which ultimately restricts the flow of wealth around the economy. Allah (swt) distinguished between this when He said:

"... they say, "trade is like usury" but Allah has permitted trade and has forbidden usury"
[Translated Meaning Quran Al Baqarah 2: 275]

Stability in the economy is built upon investments only being permitted in real products or business which makes wealth generation a result of work and profits, not debt.

Gambling and the Legal Environment

They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit." They ask thee how much they are to spend; Say: "What is beyond your needs." Thus doth Allah Make clear to you His Signs: In order that ye may consider.
[Translated Meaning Quran Al Baqarah 2:219]

There is no doubt that the alcohol and gambling industries are enormous businesses in Western economies, but as the Quranic verse above highlights, they also bring great damage, and Islam prohibits both. Communities reel from the addicted bread winners that waste their family incomes in betting shops. Hospitals are full on any given evening with the results of the abuse of alcohol. Families and lives are regularly destroyed by the influence of these two great vices. That gambling has now become so pervasive in western society can be seen in the extent to which it dominates the financial markets. Rather than being a market for the efficient provision of capital between competing business, industry and investors it is now dominated by banks, investment funds, hedge funds and related groups that are seeking to deliver enhanced "investment" returns via increasingly complex "bets" and via leveraging (borrowings). As set out in the earlier parts of this paper many of these transactions are not based on real assets. When the scale of the gambling becomes so over-whelming that the losses of participants can bring down the whole system, then it is clear that this is

[23] Letter: Andrew Lahde, Lahde Capital Management, 17 October 2008, Financial Times, http://www.ft.com/cms/s/0/128d399a-9c75-11dd-a42e-000077b07658.html

a problem that is out of control. The Islamic Shariah recognised these dangers and established prohibition regardless of scale. It is simply too dangerous to contemplate.

Islam sets out clear rules for investment and transactions. Chief amongst these is the requirement that assets are owned and in possession before they are sold. The Prophet (peace be on him) forbade any kind of transaction which could lead to a quarrel or litigation due to some uncertainty "The Prohibition of al-Gharar (Transactions Involving Uncertainty)" or which involved an unspecific quantity to be exchanged or delivered. This includes the sort of transaction in which there is no guarantee that the seller can deliver the goods for which he receives payment.

Additionally many commodities, including gold, silver, wheat and barley must be traded on the spot market, ie without delay in settlement.

The Prophet صلى الله عليه وآله وسلم said: **"The gold for gold, the silver for silver, the wheat for wheat, the barley for barley, the dates for dates, and the salt for salt, like for like, measure for measure and hand to hand (i.e. immediately) and if they differed sell as you wish if it was hand to hand".** (Authority of Ubada ibn as-Samit)

The wisdom of such a prohibition on delayed settlement of key commodities and currency becomes clear when we consider the way certain markets have been manipulated by the practice of short selling, where an asset which is not owned at the time is sold in a market (the asset is usually, but not always borrowed), in the anticipation that it will be later bought at a lower price and then settled for a profit. The opportunity for market manipulation via this practice is obvious. A good example of how short selling was used to destroy an economy came in the Asian financial crisis in the 1997 when hedge funds sold Malay and Indonesian currencies and stocks short via derivative contracts which were in such a high volume that the markets collapsed in price and the local populations suffered extreme losses. [24]

When sales can be made at enormous volume and without the assets for immediate settlement it is logical that the market price will drop, enabling large profits when the asset are bought back later to settle the transaction. Islam prohibits this type of trading outright.

It is ironic that the short selling practice has now turned full circle and was used to great effect in forcing down the price of many financial institutions during this recent period. Many of which used this underhand tactic previously to attack other industry groups, commodities or currencies. It is also quite shocking that the US authorities saw fit to outlaw the practice, but only in respect of banking shares and for a period until January, 2009. Surely if the practice is wrong it should be wrong in all markets, for all assets, and without time limits, as Islamic law dictates.

Futures contracts which are not based on immediate settlement can also be used to manipulate prices. The Comex (Commodities Exchange in New York) which deals in future settlement of gold is tiny ($1.6 billion) compared to the overall physical market for gold yet its prices are often used to indicate current sentiment in the gold price as its prices are beamed around the world virtually instantaneously. Again the opportunity exists for determined short selling to depress the price, a matter which has been widely argued in the current crisis as the physical gold market price of coins and small bars is now significantly at a premium compared to the "paper" market written for "future" settlement. That most futures participants never take settlement but roll over their contracts further removes the real market from current "prices". The advantage for governments under pressure such as the US administration, to see a low gold price in a time when they are attempting to re-establish some form of stability in markets and confidence in the US dollar is obvious. The

[24] Hizb-ut-Tahrir, 1998, The turbulence of the Stock Markets: Their causes & the Shari'ah rule pertaining to these causes, Khilafah Publications, London.

administration is quite open in its use of intervention in markets. The Exchange Stabilization Fund (ESF) is a reserve fund of the US Treasury Department specifically used for exchange intervention, normally currency but is also available for gold and other instruments since a change in US law allowed the Secretary of the Treasury since 1970 to “deal in gold, foreign exchange and other instruments of credit and securities”. [25]

Credit Default Swaps (CDS) are a form of insurance. Islam encourages agreements of guarantee but forbids any form of compensation for them. Consequently the standard contract of insurance which entails compensation (premiums) from one party to another in return for a promise to pay some level of compensation should a particular act or acts occur in future is not acceptable in Islam. Not only is there uncertainty over the possibility of the future event occurring or not, but there is compensation involved in the contract. By greater reason the contracts for CDS not only involve these illegal elements, they also encourage gambling as many of the contracts were taken out by businesses which have no relationship whatsoever with the defined credit events that may or may not happen. Furthermore, that participants in this market can gain from short selling the companies subject to these contracts further highlights the corruption of these contracts.

A market free from manipulation

The most important aspect of trade is that participants feel confident in the market, its rules, regulations and consistency of application of the rules. Where governments intervene whether via tariffs, taxation, direct intervention (eg ESF) or change of regulation, participants are frustrated and lose confidence in the system. The Shariah rules in this regard are explicit. The Prophet صلى الله عليه وآله وسلم said:
“If people are left alone, Allah will give them provision from one another”

This establishes a basic principle in the field of commerce: that the market, its prices, and sales, should be left free to respond to internal economic forces and natural competition without manipulation.

Anas reported: **“Prices soared during the time of the Messenger of Allah صلى الله عليه وآله وسلم so they said to him; ‘O Messenger of Allah why don’t you introduce pricing (price controls)?’** He said; **“Verily Allah is the Recipient, the Extender of wealth, the Provider, and the Pricer, and I hope that I will meet Allah (swt) without having anyone accusing me of having perpetrated an oppression against him be it in blood or in money.”**

So the notion of market manipulation or State interference in markets is absolutely prohibited in the Islamic state.

Ahmed and Abu Ubayd reported on authority of Uqbah ibn Amir that the Prophet صلى الله عليه وآله وسلم said:
“He that imposes customs duties would not enter paradise”

Barring the imposition of customs for reciprocity when applied against the Islamic state, it is against the Shariah to apply such taxes which restrict trade. Similar protectionist measures against trading partners as subsidising some industries, tariffs and intellectual property right restrictions all act as barriers to free trade and have no part in Islamic economic life.

[25] , US Dept. of the Treasury, 2007, Exchange Stabilization Fund, http://www.ustreas.gov/offices/international-affairs/esf/

Use of public money to bail out some business groupings (banks) is also an anathema to fair economic practice and is effectively a new form of tax on the masses who will pay for the bailouts via tax, cut backs in public spending or a decline in the value of their wealth via inflation.

Corporate Bias

The opportunity to invest wealth, aggregate labour and expertise, and form companies in an efficient manner is fundamental to any society. While western societies have congregated around the joint stock company which is freely traded on stock markets, Islam has set out specific rules for the formation and function of companies which have some distinct differences.

Islam treats the formation of the company as a specific transaction requiring an offer and acceptance by all participants meaning that there must be agreement between partners for new participants. Fundamental to the transaction is also the notion that the corporate entity has a specific capital and body element, whereas the standard joint stock company is a company of capital only (even the Directors are employees). A “body” element to the company is an absolute requirement as it establishes complete accountability and responsibility for the actions of the company. This coupled with prohibition of “limited liability” means that the anonymity behind which many hide in the standard PLC (Public Limited Company) or SA (Société Anonyme in France) is avoided. This lack of an accountable body with limited liability has had disastrous consequences in the current crisis. [26]

When the disgraced Chief Executive officer of the failed investment Bank Lehman Brothers, Richard Fuld, gave testimony to Congress on October 6th, 2008 he defended his $484 million in salary fully aware that he was walking away from the disaster he and his colleagues oversaw at the bank. Without any personal liability for the 20 or 30 times leveraging of their balance sheet assets, the enormously risky bets they were taking nor the hundreds of thousands of derivative contracts which remain outstanding, Fuld could happily brush aside most questions. In his testimony he said he took “full responsibility” for the bankruptcy of Lehman Brothers and “felt horrible” about it. Yet, even days before the bank collapsed (failed to gain a Treasury bailout) their executives were endorsing $20 million in ‘special payments’ for departing senior executives[27].

The debate over levels of executive bonuses in this crisis and whether they should be curtailed neglects the most important fact. When there is little or no actual monetary and legal accountability for the actions of a bank then we can expect the type of excesses that have become common. Islamic corporate law ensures that the owners of the company are not shielded behind limited liability, they are fully accountable for the performance of their contracts and any monetary impact for all the transactions they enter into. Furthermore reactive legislation such as the Sarbannes Oxley laws introduced in the US in response to the Enron and Worldcom debacles where senior executives were effectively “cooking the books” has had virtually no effect in this crisis because it failed to address the key element of liability for the transactions of the banks/institutions.

In Islam the owners/partners of any company remain liable for losses even after a company has failed. This issue of real accountability for actions, rather than potential curtailment of bonuses provides a level of sobriety to the trading practices of company executives.

[26] Taqiuddin an-Nabhani, 2000, The Economic System of Islam (Hizb ut-Tahrir), Khilafah Publications, London, http://www.hizb-ut-tahrir.org/index.php/EN/bshow/174/

[27] Lehman Brothers Boss Defends $484 Million in Salary, Bonus, 6 October 2008, abc News, http://abcnews.go.com/Blotter/Story?id=5965360&page=1

It must also be stressed that, with a few exceptions, the aggressive leveraging (borrowings), derivative bets, and array of risky transactions were all fully legal under the lax corporate laws governing business in the West. It is thus little wonder that executives have taken advantage of such a lax trading environment to drive massive compensation packets for themselves, with little concern for the risks involved.

Accounting for Success and Failure

Along with the run up in credit over this past period we have seen a deterioration in accounting standards that have contributed to uncertainty and a lack of confidence in the system in general. Mirroring the growth in credit has been a growth in "off-balance sheet" recording of assets and liabilities, many of which are derivatives. This has enabled the holding of risky assets and liabilities beyond the gaze of investors and regulators alike. The extent of this could be seen in the recently bailed out Citigroup, the largest bank in the world, which as of June 2008 had 1.2 Trillion dollars of off-balance sheet holdings. Pauline Wallace, a partner at PriceWaterhouseCoopers LLP accurately portrayed this off-balance sheet accounting when she said: "Magicians come to parties, and they make things seem to disappear. The risk is somewhere, but you never knew where[28]".

Off-balance sheet holdings include futures, forwards and certain loan commitments – whilst Islamic law forbids outright the entering into many of these contracts, the effective hiding of them is doubly a problem as it runs counter to the requirement for transparency of accounting for all assets and liabilities. Like western markets Islamic society places enormous importance on the provision of timely and accurate financial statements for the regulation of company practice and reporting of earnings and financial position. Islamic law mandates that company accounts be prepared regularly and the distribution of earnings amongst investors is based upon the accurate provision of same. The non recording of any assets or liabilities in the financial statements is simply not allowed.

In addition to the government bailouts, distressed US lenders are also now looking to the suspension of "mark to market" accounting rules as a means of salvation. These rules require institutions to value their mortgage assets according to the most recently traded price. However, the recent relaxing of these rules will not make the losses go away. Rather it will simply allow lenders to pretend that the losses do not exist to the expense of anyone investing in these companies and confidence in the system. Banks can now pretend that their mortgage assets for example have greater value, and that their balance sheets are well capitalised. They would not need to raise more capital in order to fund new loans. But, just as a person with no sensitivity to pain runs the risk of catastrophic injury, such a move actually encourages financial institutions to take greater risks, which, in the end, will produce more bankruptcies and greater losses.

Rather than letting corporations dictate to regulators how accounting standards should or should not be applied, the Shariah law requires consistent application of market values in determining financial position. Investors joining or leaving a company cannot do so on the basis of "mark to model" or other estimates of what those whose bonus is dependant on the highest value, want to include. There is too much influence on government policy from corporate elites in the West, a matter that cannot arise in Islam as with the election of a new Caliph, the company structure, formation and accounting laws cannot be changed. The constant tinkering with the corporate laws expose the inherent failures of a system that is not fit for purpose and lacks the true transparency investors crave.

[28] Greenspan Slept as Off-Books Debt Escaped Scrutiny (Update1) , 30 October 2008, Bloomberg News, http://www.bloomberg.com/apps/news?pid=20601170&refer=home&sid=aYJZOB_gZi0I

Inflation versus Gold/Silver

For centuries mankind has used a medium of exchange to facilitate trade and the provision of services in society. To ensure fairness and confidence in trade it has been vital that there be stability and real value in that which was chosen to be the medium of exchange. Quranic injunction has made it clear via many references that the Islamic society operate a bi-metallic currency standard of gold and silver. Whilst the Shariah did not forbid the ownership of other (non gold or silver) currencies, the Islamic state cannot and will not operate any other currency standard, and the fiat based systems where currencies are not backed by any assets at all is completely shunned. Islam made all the rules linked to currency, linked to gold and silver in their capacity as a medium of exchange for all goods and services and as currency for exchange, both as coins and as ore.

Gold and silver are both ideal to act as mediums of exchange because they have intrinsic value (including jewellery and industrial use) are widely available, cannot be dominated (monopolised) and there is a regular, yet growing supply of them to meet the needs of growing economies. The annual increase in gold supply for example is 2%.

The Breton Woods agreement in 1944 established that the main economies of the world would operate on a fixed exchange basis with gold fixed at $35 per ounce, and other currencies fixed against the dollar (and therefore gold). This system operated effectively until Richard Nixon unilaterally took the US off the gold standard in August 1971 and utilised a free floating fiat currency with no backing of gold whatsoever. Following this decision, the supply of US dollars globally ballooned and annual inflation trebled from 2% historically that century to an average of more than 6% and peaking at more that 20% in some countries.

Money itself is not wealth, merely one particular measuring unit of wealth, which is dependent upon the soundness of the control over the volume of money. When central banks flood financial markets with money by printing more (increasing liquidity), this does not add wealth; it can accelerate financial transactions but this can create or destroy wealth depending on certain factors as mentioned, for example due to inflation.

In the real economy, wealth is created by the creation of productive hard assets such as agriculture, manufactured products etc, which are then sold for a profit. Wealth is increased by increasing production (i.e. you produce more goods and services and sell them for a profit).

If you flood financial markets with money you create inflation. This is because there is more money chasing around the same number of goods, which devalues money and means you have to exchange more money for the same goods over a period of time. That a bottle of coke today costs 100% more than it did 10 years ago, is primarily because the value of money has been devalued. At the same time, assets such as property, land, or gold do not devalue as they keep the same intrinsic value at all times, but since the value of paper fiat money is falling, the net effect is that the purchasing power (ability of money to buy goods and services) is lowered, and hence in real terms wealth is actually falling, because money is being devalued, compared to real hard assets.

Today we have witnessed that people’s ability to save has been diminished over time, despite the fact that we are earning more than ever. The purchasing power of money has declined in real terms as the value of assets generally remains the same, but the amount of money required to buy hard assets (land, property, goods) is increasing. In general terms people today save very little compared to people only two decades ago.

Islam put the emphasis on wealth and seeks to guard people’s wealth by ensuring that its policies do not devalue money. The Islamic system does not allow the printing of money as it pleases since all its currency must be 100% backed by gold or silver reserves. This means that the currency itself has a value relative to all assets. So this means that the value to the consumer of land will always remain in proportion to the value of gold. This creates stability and confidence in the value of the State's currency.

Furthermore, since the Islamic state does not print money because it cannot print more gold, there will not be an increasing amount of money chasing the same number of goods; hence the Islamic system is largely inoculated against inflation, since the main factor behind inflation is the easy printing of money (although there are other factors). Inflation within the Islamic state will be a rare occurrence as businesses and individuals acquire wealth; their wealth is not devalued.

As there is continuing growth with increasing demand and improving technologies, the unlikely case of inflation or devaluation of money could only be entertained if there is an abnormal increase in gold supply, which is unlikely. Even in such a case the distributive obligations of the state and improving standards of living would produce commensurate growth to stabilise such unlikely outbursts in supply. The health of the economy is not based on the confidence of growth in wealth, rather the ability of people to live a good standard of living. Growth in the Islamic economy is not viewed in terms of mere increase in GDP compared to previous years, but is a more holistic and profound measure of how transactions in society have improved in terms of quantity, quality and equity. Hence quantitative GDP growth that is sought by nations today which leads to a declining way of life, is not seen as growth, but rather as a decline. To grow is a natural instinct in people; and enhancing it is a problem of science, which is never in short supply. However enabling sustainable macro growth without booms and busts is a problem for the economic system, which can only be addressed by Islam.

Although many economies are now facing price deflation for goods and services, a massive wave of monetary inflation is being stored up for coming months and years. The strict application of the metallic money standard as practiced in the Islamic system is the only way to avoid this when there is such little control over the central bankers of the world.

CONCLUSIONS

Virtually un-constrained credit (money) creation and the ballooning of the “over the counter” derivatives market in many ways are natural consequences of capitalism. There is nothing illegal in this phenomenon and until very recently these were seen as good and key factors in the growing economies of those countries that emphatically embraced them. With the benefit of recent hindsight the belief in this aspect of the free market has been fatally shaken. It is equally perplexing that the solutions now espoused are progressing with little debate and seem to owe more to trying not to repeat the mistakes made in the early 1930’s. Governments are throwing fiat money at the problem and will create a problem potentially greater than the problem they seek to solve, that of out of control money supply and the horrors of inflation or even hyperinflation. A further deterioration in confidence in the system is likely as the recession/depression deepens.

Can stimulus packages work when there is no real change to the hegemonic role of banks, and the sheer scale of the problem is so vast? Can there be an artificial upturn in investment and growth in the economy when all around are retrenching/deleveraging, laying off staff, and banks shutting up their lending shops? If ever there was a time for consideration of alternative ideas it is now. Yet Muslim voices are not prominent in the debate. The emphasis to date, in the Muslim world, has been on raising cash to fuel bank bailouts from cash rich Gulf countries. UK Prime Minister Gordon Brown stressed this role as he toured the Middle East seeking money for bailout purposes[29].

Yet the Muslim world which has been operating under secular capitalist rule is as much a victim of the crisis as any country, and is facing the loss of resources as aggressive nations seek capital to fund their losses from resource rich regions. Several misguided Gulf countries even maintain a US dollar peg. It is of the utmost regret that the Islamic economic system in operation within the Caliphate system of governance is not in evidence today to offer the alternative leadership so needed. Regardless of this, the Muslim world is now moving strongly for a return to the stability that the Caliphate system provided historically for the longest period in its history (623 to 1924). World public opinion.org reported after an extensive survey throughout several large Muslim countries strong support for the re-establishment of the Caliphate via non-violent means in the Muslim world:

“Two-thirds would even like to "unify all Islamic countries into a single Islamic state or Caliphate.” [30]

The sadness is that these aspirations of the Muslims have yet to be fulfilled. Until the day that Islamic society is representative of not only the beliefs of the people but also the rules and laws of Islam including those of the economy, the frustrations of a dying and corrupt system will dominate. Only then can the Muslims hope to live up to the description that Allah has given those that implement and call for justice.

“You are the best nation (O Muslims) brought out for mankind, because you enjoin what is right and forbid what is wrong, and you have faith in Allah..”

[Translated Meaning of Quran Al Imran 3:110]

[29] British PM tours Gulf for bailout fund help, 1 November 2008, International Herald Tribune, http://www.iht.com/articles/ap/2008/11/01/business/EU-Britain-Brown-Gulf.php

[30] Muslims Believe US Seeks to Undermine Islam, 24 April 2007, World Public Opinion: Global Public Opinion on International Affairs, http://www.worldpublicopinion.org/pipa/articles/brmiddleeastnafricara/346.php

APPENDIX

CAPITALIST FINANCIAL INSTRUMENTS

We have included this appendix for those with a particular interest in finance. Those who have simply sought to emulate western models of wealth creation would do well to look at this brief overview of not just some of the main products at the centre of the crisis, but also the government attitudes towards them.

Collateralised Debt Obligations (CDO's)

Collateralized debt obligations (CDOs) are an unregulated asset-backed and structured credit product. CDOs are constructed from a portfolio of fixed-income assets. These assets are divided into different tranches according to the value placed on the assets by the issuer: senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). Losses are applied in reverse order of seniority and so junior tranches offer higher coupons (interest rates) to compensate for the added default risk. CDOs have risen to infamy on the back of the sub prime mortgage melt down led from the US since mid 2007. Some blame the financial woes of the 2007-2008 credit crunch on the complexity of CDO products, and the failure of risk and recovery models used by credit rating agencies to accurately value these products. Some institutions buying CDOs lacked the competency to monitor credit performance and/or estimate expected cash flows. On the other hand, some academics maintain that because the products are not priced by an open market, the risk associated with the securities is not priced into its cost and is not indicative of the extent of the risk to potential purchasers[31].

As CDO products should be valued on a mark to market basis (where securities are marked in balance sheets at current market price), this coupled with the paralysis in the credit markets and the collapse of liquidity in these products led to substantial write-downs in 2007. Additionally a major loss of confidence has occurred in the validity of the process used by ratings agencies to assign credit ratings to CDO tranches and this loss of confidence has persisted through 2008. Research firm Celent estimated the size of the CDO global market at close to $2 trillion by the end of 2006.

CDOs vary in structure and their underlying assets, but the basic principle is the same. Essentially a CDO is a security constructed to hold assets as collateral and to sell packages of cash flows from those assets to investors. It is a means to securitise debts. With growing demand for CDOs and other high yielding securities investment, banks saw an opportunity to package up sub prime mortgages together with higher grade mortgages and other debts into one vehicle. A CDO investor takes a position in an entity that has a defined risk and reward, not directly in the underlying assets (eg the mortgage). Therefore, the investment is dependent on the quality of the metrics and assumptions used for defining the risk and reward of the tranches. Many CDOs have been proven to be hopelessly overvalued in light of the poor quality of underlying mortgages included in many of them and in light of the US housing bubble, and subsequent price slide.

CDO issuers, usually the investment banks, earn commissions at time of issue and management fees over the life of the CDO. Investors have often been highly leveraged using loans to benefit from the positive spread between the high returns on tranches of CDOs and their cost of borrowing.

[31] Credit Crisis Interview: Susan Wachter on Securitizations and Deregulation, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1993

Many institutions became vastly over-leveraged in the seeking of high returns. A simple example demonstrates this. A bank with $1 million of capital would borrow $29 million to then buy $30 million of structured product like a CDO, for example written over mortgage debt. The interest payments on the CDO of $30 million are much higher than the cost of borrowing on the $29 million. Twenty percent ($6 million) of the mortgages go into default, with a poor recovery rate (say 2 thirds or $4 million). This leaves a capital loss of $2 million which wipes out completely the original $1 million of capital and leaves a net loss of $1 million (capital of minus $1 million, assets of $28 million which are falling, and liabilities of $29 million). When the above example becomes real, but is in billions of dollars then the scale of the problem can be felt. With the mix of borrowings (leveraging) and now severe housing market downturn, the losses have been catastrophic on these products. And even the higher quality tranches of debt have suffered significant losses. The now defunct Bear Stearns, which at the time was the fifth-largest U.S. securities firm, said on July 18, 2007 that investors in its two failed hedge funds will get little if any money back after "unprecedented declines" in the value of securities used to bet on subprime mortgages.

Credit Default Swap (CDS)

A credit default swap (CDS) is a credit derivative contract between two counterparties, where the "buyer" makes periodic payments to the "seller" in exchange for the right to a payoff if there is a default or "credit event" regarding the failure of a third party. They are very similar to an insurance contract over the possibility of company failure particularly on the bonds and corporate debt of the "reference entity" company which is the subject of the CDS. Unlike insurance, however, there is no limit on the number of times that a company can be covered or subject to a CDS. In return for small payments like insurance premiums the buyer of the CDS could stand to make an enormous windfall profit in the event of the failure of the subject. The recent failure of Lehman Brothers caused a credit event which ultimately led to a 92 cents on the dollar liability on CDSs written on Lehman debt.

Credit default swaps are the most widely traded credit derivative product. The Bank for International Settlements reported the notional amount on outstanding OTC credit default swaps to be $42.6 trillion in June 2007. By the end of 2007 there were an estimated USD 60 trillion worth of Credit Default Swap contracts. In the US alone, the Office of the Comptroller of the Currency reported the notional amount of outstanding credit derivatives from reporting banks to be $16.4 trillion at the end of March, 2008. (To put these numbers in perspective, the CIA World Fact Book estimated the US GDP for 2007 at $13 trillion).

One large difference between credit default swaps and other types of insurance, is you do not need to own the bond or instrument being insured in order to obtain insurance on it. If the bond fails, then you get paid, provided the bank writing the contract does not fail. Yet the "insurer" of the bond is not regulated on any exchange and the transaction is largely beyond any government regulation. Speculators can make money by purchasing insurance on a company's bonds then short the stock (sell the stock without owning it) of the company in great quantity, causing pressure on the company to either fail or the value of their CDS to rise. If the company fails the returns can be enormous.

There is a massive overhang of speculative positions in CDS – the market is dramatically larger than the corporate debt which it is covering. One can possibly understand the motive for mitigating the risks of corporate failure for those holding the corporate debt of the reference company. However, when CDS amount to several times the debt in existence it is clear that a large number of speculators are gambling over company failure rather than seeking to mitigate risk. For Lehman

Brothers $150 billion total of debt, $400bn of CDS contracts were in issuance. The $60 trillion market for these weapons of mass destruction has taken gambling to a new and unprecedented level.

Currency Swaps

A currency swap (or cross currency swap) is a foreign exchange agreement between two parties to exchange a given amount of one currency for another and, after a specified period of time, to give back the original amounts swapped. Currency swaps can be negotiated for a variety of maturities of up to 30 years. Unlike a back-to-back loan, a currency swap is not considered to be a loan by United States accounting laws and thus it is not reflected on a company's balance sheet.

The US government, during the current financial crisis has via the Federal Reserve given the go ahead to providing possibly trillions of dollars to the world banks and financial entities by funding central banks around the world should they wish to call on this "non loan, off the US balance sheet" technique.

The impact on the US money supply and real inflation will be devastating.

Hizb ut-Tahrir Britain
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Rabi` al-Awwal 1430
http://www.hizb.org.uk
http://www.financial-crisis.eu

Hizb ut-Tahrir

Hizb ut-Tahrir is a global Islamic political party that was established in 1953 under the leadership of its founder - the scholar, political thinker and judge in the Court of Appeals in al-Quds (Jerusalem), Taqiuddin an-Nabhani. Hizb ut-Tahrir global leadership is currently headed by Ata' abu Rishta.

In the Muslim world, Hizb ut-Tahrir works at all levels of society to bring the Muslims back to living an Islamic way of life under the shade of the Khilafah (Caliphate) State following an exclusively political method.

Hizb ut-Tahrir adopts the methodology employed by the Prophet Muhammad (peace be upon him) when he established the first Islamic State in Madinah. The Prophet Muhammad limited his struggle for the establishment of the Islamic State to intellectual and political work. He established this Islamic state without resorting to violence. He worked to mobilise public opinion in favour of Islam and endeavoured to sway the political and intellectual elites of the time. Despite the persecution and boycott of the Prophet Muhammad and the early Muslims, they never resorted to violence. The party is therefore proactive in disseminating the Islamic intellectual and political thoughts widely in Muslim societies so as to challenge the existing status quo that exists there. The party presents Islam as a comprehensive way of life that is capable of managing the affairs of state and society. The party also expresses its views on political events and analyses them from an Islamic perspective.

The party disseminates its thoughts through discussion with the masses, study circles, lectures, seminars, leaflet distribution, publishing books and magazines and via the Internet. We encourage people to attend our demonstrations, marches and vigils.

In the West, Hizb ut-Tahrir works to cultivate a Muslim community that lives by Islam in thought and deed, adhering to the rules of Islam and preserving a strong Islamic identity. The party does not work in the West to change the system of government. The party also works to project a positive image of Islam to Western society and engages in dialogue with Western thinkers, policymakers and academics. Western governments, under the banner of the War on Terror, are currently working to present Islam as an 'evil ideology'. Indeed at the heart of this campaign is to malign the Islamic ideology as an alternative to Western liberal capitalism. Because of this propaganda aspect to the War on Terror, Hizb ut-Tahrir works to develop opinion about Islam in the Western countries, as a belief, ideology and alternative for the Muslim world.

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