Economics of Enough and Islamic Finance, in Course of Financial and Economic Stability

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Abstract
This paper gives an overview of the two important studies made by Diane Coyle and Hoosein, Zamir, Noureddine, & Abbas (2010). It provides an important frame work for understanding the relation of stable financial system, in future's stable economy, under historical perspective. Coyle's work high lights various factors which are linked with the future of economic uncertainty. We tried to explore the solutions of the problems raised by Coyle; by reviewing the work of Hoosein et al. This study analyzed the role of financial instability in current and future economic perspectives by comparing it with Islamic financial system. The conventional financial and economic system that claims to be powerful and efficient somehow failed to achieve stability, equality, and trust, which therefore, requires epistemic reforms. In different yet complementary ways, Hoosein et al. and Coyle conveyed the same message in their work. Coyle raised a variety of hard questions, and started a debate on global capitalism with respect to the sustainability and stability of the financial system, growing inequality, erosion of trust on social and natural capital in context of the future of our coming generations. Whereas, Hoosein, Zamir, Noureddine, & Abbas (2010) focused on the inherent stability of Islamic finance, and expressed its relation to the social equality, justice, and trust. This study suggests that Islamic financial system can lend a hand to solve the financial instability, and economic uncertainty of the conventional system. However, we also think that Islamic economic system still needs thorough study and sound regulatory / institutional frame work to replace or merge the current system.

Key words: Financial crisis, financial system, economy, Islamic finance

Financial stability

The US financial crisis that broke out in August 2007 has raised many questions on stability of the conventional financing and it revealed the structural fragility of the system. This has led to a debate among economists to review the way current financial system works in modern economy. Though, this was not the first crisis, but it was unique of its nature that cleaned out the well-known global financial institutions, believed as "too big to fail."Its outcome prevailed the global economic uncertainty, especially in advanced economies. This uncertainty and frequent happening of financial crisis has made several economists to question the competitiveness of capitalism. It is due to the way crisis had severely affected the most advanced and highly capitalist global economies.

The importance of sustainability of financial system has been pointed out by Coyle (2011). She gathered the critiques on financial system from various studies and discussed in her book. To find out the answers of the questions she raised, we looked upon the alternative hybrid or harmonized financial system recommendations by reviewing the Hoosein *et al.* (2010)'s book on the stability of Islamic finance. The idea for both books has been provoked by the financial crisis, which is an interesting fact. The authors of both the books have certain consensus on the instability of financial systems which has a contributing role in the aforementioned crisis. Furthermore, if we fail in finding the solutions to the above mentioned problems, the economic uncertainty will probably prevail in future.

The Economics of Enough: How to run the economy as if the future matters

The main theme of the book is "how much is enough in terms of economic activities?"Means our future generations will pay a high price to repair the damage inflicted by the current generation. The author analyzes economic challenges that are being faced by a capitalist economy or it will probably be faced in the future by examining the past and current incidents. It is concluded on the basis of these incidents that "things that are not sustainable are not getting sustained". In respect to sustainability, the author took a wider perspective of sustainability including the environment, natural resources, finance, debt, and deficit etc., and emphasized on the vitality of financial sustainability in the future economy. She also criticized the use of GDP as the only indicator to measure the overall social welfare and well-being.

The book is divided into three parts: first Challenges: The world's leading economies are not only threatened by the financial instability but also struggle with eroding climate changes that is intimated through economic growth. The economic development being on the agenda of the developing economies has not provided any fruitful result except to eradicate inequality at global level. The developed economies are also facing the increased level of inequality. These crises destroy the social fabric by demolishing the social capital with wide spread erosion of trust. These challenges are considered most important among other issues and needs to be resolved through the academia for the sustainable growth in future.

Second Obstacles: Three factors, measurement, value, and institutions need reforms in future perspective. It needs to build a consensus and should include more variables that measure the economic growth along with GDP in terms of happiness and equality. To overcome the above mentioned challenges, what kind of institutional framework reforms should be on agenda of future economic policies? Financial greed and failure has questioned out the functionality of markets as an institution both in free markets and intervened one. Economic turmoil intermediated through financial institutions also brought capitalism into the discussion as well. The government's response to the past and current crisis proved that it is not only the failure of government but also of democracy as well.

Third Manifesto: The final section of the book highlights the steps required for future amendments. It suggested the publishing of the real debt figures; motivate the public to live by their means, reducing the economic inequality, government assessments of various economic indicators in official figures, utilization of the latest technologies and direct involvement of the general public in policy making decisions.

The stability of Islamic Finance "Creating a resilient financial environment for a secure future"

Hoosein *et al.* (2010) also questioned the stability of conventional financial systems in the modern economy, which has been crippledsince2007 by the financial crisis. They primarily focused on inherent financial instability in the conventional system, and compared the stability of Islamic financial system. It is argued that financial instability has been a frequent phenomenon in contemporary economic history. Financial stability is defined as a regular treasury position, in which the sources of funds exceed the uses of funds. While financial instability is opposite of it, i.e. payment defaults, payment arrears and insolvency issues.

In the first chapter, the term capital has been explained within the context of Classical and Islamic system. The former one rely on rate of return or interest rate, independent of real or physical capital, while the later one is based on real or physical capital. Therefore, later one has the immunization power for the instability because of the absence of speculation. It also explained the causes of instability i.e. over-indebtedness and deflation. They evaluated the instability of the financial system by discussing the Minsky's theory of endogenous instability. Furthermore, they criticized the role of central banks to support uncollateralized credit that leads to the speculation. Optimistic expectations about higher returns and lower interest rates could lead to a speculative state; the boom followed by the burst is a failure of the banking system and reflection of the endogenous instability of the conventional banks. The argument is supported by citing several empirical studies that proved monetary policy as a factor in financial instability. The negligent role of regulatory bodies is also described as a one reason of the instability.

They compared the spreading of financial crisis to the international markets. The instantaneous international expansion of the crisis occurred due to the integration of the global financial markets. Authors also pointed out the role of information communication for the rapid expansion of the crisis. The system based on debt financing that helps the central bank to manipulate the interest rates to manage monetary policy has also been compared with the equity based system. The debt assets are not real assets so they could easily flow across the countries and their non-physical existence makes it difficult to evaluate the value of the asset. However, equity based assets are considered as real assets and not easy to flow across the borders.

They differentiate Islamic finance with conventional finance in terms of the credit multiplier. It is irrelevant in the former system and highly relevant in the later one. Therefore, the collapse of credit pyramids results in the financial bubble to burst. The next part of the book explains the inherent stability of Islamic finance. As it is based on the principles of social and economic justice, economic efficiency and growth as set out in the Quran and Sunnah. The Islamic finance prohibits interest, speculation based transactions and lending as a form of financial intermediation. Risk is mitigated through investment in the assets whose return is distributed to the investors and not to the return of capital as in the conventional system.

They explain that basic principles of Islamic finance are not new or entirely different from the conventional system and showed the classical model, based on full employment, is a representative of an Islamic economy where interest is prohibited. It encourages profit-and-loss (P&L) sharing and investment in real assets with direct ownership. They tried to fit the capital asset pricing model (CAPM) in the Islamic finance by analyzing the Islamic financial products and the role of intermediate institutions to promote these products in the markets. In the authors' opinion, Islamic financial products having lack of diversification and risk transference are quite limited. To overcome these problems they suggest that recently growing institutions can use this financing system to flourish in the real world.

In proceeding sections, the authors looked into the risk related to the financial products. As the Islamic finance is similar to the equity based financing, the liquidity and credit risks are less relevant compared to the debt centered conventional finance. However, inherent market risks of equity financing will also exist in the Islamic system due to the information asymmetry. The conventional system has also been suffering even though it has a well established regulatory framework for the institutions, so the promoters of Islamic finance may have to look at this end as well.

The last part of the book deals with the core factors necessary for the financial stability. Among various important factors, the authors pointed out the rapid boom of financial engineering, derivates, leveraging, greed and tax regulations in the past three decades caused more damage to the financial system. Despite their contribution to economic progress, financial engineering has created an economic and financial instability. Contrary to this, they suggested Islamic finance working on its core principles can promote less risky products and promote social justice. This will lead to financial stability and sustainability in the financial system.

The importance of good governance and fair practices for the economic growth in both the conventional and the Islamic system have been endorsed. Finally, the performance of Islamic financial products, so far in the markets has been reviewed. The satisfactory performance of the system is supported with the argument of emergence and development of the Islamic financial system. However, it has warned that if the Islamic system moved away from its core principles of interest free and profit/loss sharing, the damages will be more severe.

Financial stability and economics of enough

The economics of enough, analyzed the historical events and policies, which leads the advanced economies to current turmoil. To further discuss the issue we will try to explore the phenomenon of financial stability and its impact on economics, equality, social capital, trust, and happiness. In the past, several eminent scholars studied the financial stability in the modern economics and recommended their solutions. Hyman P. Minsky's work on capitalism and financial stability is well known. In his work, he mentioned "Keynes recognized that capitalism is not merely a market economy: it is also a financial system" (Minsky, 1987). Minsky contributed to Keynes's "investment theory of cycle" by adding financial theory of investment. In his book, "Stabilizing the unstable economy", he concluded that our economy is unstable because of capitalist finance. In continuity to this work, work of both

Coyle (2011), and Hoosein *et al.* (2011) had consensus that financial instability has created future economic uncertainty.

The economics of enough has raised the questions of financial sustainability and discussed the way it has contributed to destroy the trust among institutions, public etc. and the way this leads to destruction of the social capital and increases inequality in the societies. From all of the above discussion, it can be concluded that the there is an inherent instability in conventional system, which produced a series of crises since World War II. The work of Hoosein *et al.* proved the inherent stability of the Islamic financial system. The interest free and profit/loss sharing financing activities primarily contribute to gain mutual trust in society. Trust asserted as a component of social capital, was a strong explanatory factor in the economic performance of industrial countries (Fukuyama 1996).

However, Coyle asserted that trust among the financial institutions has been eroded due to the collapse of mega financial intermediaries, which has been described as a contributing factor in the economic performance in past. Hoosein *et al.* concluded the trust as a significant factor while referring to the Quran. In Quran verse 8:27 "O you, who have attained to faith, do not be false to God and Apostle and do not knowingly be false to the trust that has been reposed in you". Stable finance system based on interest free borrowing and lending, profit/loss sharing would lead to avoid greed, false speculation built in thin air, investment into real assets with real ownership, which can contribute to social equality and built a trust among societies. In this way we will be able to live by our means and will not be in demand to borrow more even from our future generation. Not only this but also we will leave a system that will have real assets with real value but not the speculative assets, with no real value.

Conclusions

In context of ongoing debate in terms of problems related to the financial stability as a common agenda, we tried to highlight the views of authors that they expressed in their relevant books. We made an effort to point out the possible solutions of these problems from existing work on Islamic finance. The purpose of the review is not to rule out or challenge the entire current system. However, from analysis of historical perspective we have seen cycles of crises after every two to three decades. Even they have been studied thoroughly and extensively, yet the ultimate objective has not been achieved. We think the purpose of this comparative review study is not to provide an ultimate solution to complex social and economical problems.

However, we do think that this can be one minor aspect of a debate on solutions to the current problems in future. The two highly valuable studies by Coyle and Hoosein *et al.* provide important frame work for understanding the relation of stable financial system in future's stable economy under historical perspective. This also has started an important debate on global capitalism. A system that claim to be powerful and efficient, somehow fails to achieve stability, equality and trust, and we need a massive reform in it. In different yet complementary ways, Hoosein *et al.* and Coyle convey the same message. Coyle raises a variety of hard questions in respect to sustainability of financial system, growing inequality, erosion of trust in social and natural capital and on the future of our coming generations.

One thing that came to my mind while going through these books, when we think about equality, can we achieve it the way we are dealing with it. For example, we have seen when there are crisis situation has not been improved. Even governments intervene through stimulus of bailout packages from tax payer's money. However, it provides bailout packages to big banks or firms and those are behind these crises. In reality the real owners or those who manage them, lose less but get more compared to the investors, or borrowers who lose more and get nothing. If we want to achieve equality, the governments should transfer that money to the people who are affected directly and enact the laws to manage the financial institutions.

Secondly, as discussed above that Islamic finance which works on equity based financing, investor owns the real asset and if he wants to sell it he will sell a real asset, not like the conventional system where loans are sold in markets with securitization created from thin air but not backed by real assets. There will not be problem of trust. On the other hand, I also agree with other scholars that success of Islamic financial system is based on principle of no interest, profit/loss sharing, promoting equality, and justice. If we will try to deviate from these principles the problems we are facing and discussed by Coyle will become more devastating.

I personally prefer that a harmonized system can be established by developing a good regulatory frame work and utilizing the current institutional frame work, and revising our policy and preferences, on the basis of core principles of Islamic Finance. To achieve financial sustainability, social equality and justice regain the trust about institutions. This can ultimately contribute in our social-economic future and to our future generations as well.

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