

Did capitalism and the market economy fail after the last financial crises?

**Is Islamic finance, a better chance beyond the “*crazy*” development of
the financial markets and their instruments?**

Discussion Paper

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Abstract

The latest financial crises, created unimaginable effects, by putting in doubt the ability of the social organization and the finance of the global economy. While the thoughts for the free market economy failure become already a normal issue, now the voices that call for the need of a reshape at the global economic architecture are increasing more and more from day-to-day arguing this way the need for a kind of moderate return to the Keynesian model of the state intervention, in order to secure the society from such financial disasters. However there are still voices protecting the system of “*laissez-fair*”, by neglecting a failure of capitalism and calling for a more careful analysis of some economic phenomena which did not predict the danger that threatened the finance world. Arrows of criticism of this approach’s supporters fall mainly on regulatory bodies in the financial market which were mainly incapable to predict or prevent what had happened.

This discussion paper is an attempt to address the roots and development of the international financial crisis, which started in 2007 in the real estate market in U.S. It intends to shed light on the factors that led to the creation of the crisis by protecting the hypothesis that it was not the free market economy who failed, but the institutions responsible for the supervising and regulation of the financial industry. Finally, because finance based on principles and beliefs of Islamic religion was barely influenced by the negative effect of the financial crisis, this paper intends to make a short analyze over the possibility of its model in the global financial architecture.

Introduction

The world crisis that was born on the financial markets and spread out very quickly all over the world is considered with the biggest effects since the Great Depression period. Even though it was born and created in real estate markets in U.S.A, due to the integration of financial markets, it spread very quickly in all other markets by influencing all international financial centers as well as the actors and financial intermediaries.

The negative effects of this crises are unimaginable both in the aspect of the financial cost as well as in the aspect of losing confidence in markets, or even worse at the market operators, financial intermediaries and further more at the system regulators, who were supposed to be there to protect consumers from such dangers.

The effects of the crises are so strong that they have put in doubt even the ability of the own social organization and of the way the global economy is financed. If the thoughts of the free market economy failure have become normal in our everyday life, the voices that call for the need of a reshape of the global economic model are increasing more and more everyday by arguing about the need to return at a “*moderate*” Keynesian model of government interference to the economy, in a way that the society is protected from such financial disasters.

However, despite these arguments, there are economic and academic analysts who still protect the “*laissez-fair*” system by neglecting the failure of the free market economy and by drawing attention towards a more careful analysis of some economic phenomena that permitted or did not predict the danger that threatened the financial world. Arrows of criticism of supporters of this approach fall mainly on regulatory bodies in the financial market which were mainly incapable to predict or prevent what had happened.

In this context, this discussion paper is an attempt to address the rise and development of the international financial crisis that started in 2007 in the real estate market in U.S. After it takes a look at the actual way the financial market functioning, this paper brings in a summarized way ideologies of economic thought that have dominated the international economics during the last century such as: *capitalism, Keynesianism and neo-liberalism*. Furthermore, it intends to shed light on the factors that caused the crisis by protecting the hypothesis that it is not the free market economy based on free and fair competition which has not failed, but the institutions responsible for the supervising and regulation of the financial industry.

Lastly, given the fact that finance based in principles and beliefs of Islamic religion was barely influenced by the negative effect of the financial crisis, this discussion paper intends to make a short analyze over the possibility of adopting this model for the whole global financial architecture.

How did the crisis in U.S.A rise, evolve and spread out in the whole world.

The world crises that invaded developing countries and then spread out over the globe, is still considered as one of the most deep economic crises that have ever been experienced, not only after the Great Depression but further beyond. The impact and consequences that the crisis caused on the world economy were so strong and tangible that it caused a “*shock*” in the academic and economic environment according to the debate about the necessity of changing the current economic order (capitalism), by putting this way in question the efficiency and safety of the market economy¹.

It should be pointed out that the beginning of the crises was not entirely unexpected, because during the last few decades we have had other financial crises accompanied with financial scandals, that have shocked the foundations of the international system, but however without destroying them. Despite this fact, what was not calculated or predicted was the side effect that this “*financial tsunami*” would cause not only to the world finance, but even in the way of economic thinking.

Another characteristic of this crisis is that even though it was born in the financial markets, it began to spread quickly almost in all international financial centers and markets. Very soon it was transferred to the goods market by putting the world economy in a vicious circle. By many researchers such situation was called: “*free fall*”, which signifies a non precedent situation that doesn’t fulfill any standards or forms in its evolution. Actually in an integrated global market such as the one we are living today, it can’t happen differently because of the fast development of the information and

¹ Al Nasser, (2008), Posner, (2008), Civici, (2009), Stiglitz, J. & Sorros, G. (2009)

technology, associated with an aggressive increase in competition, has reached an ambiguous situation in the market. On the other side, the speed of these developments did not give enough time to the regulators alert or prevent of unwanted phenomenon, which have led to frequent financial crisis.

As already known, the financial crisis has begun in the American financial market with the failure of the so called: “*sub-prime mortgage loans*” (mortgage loans in the secondary markets), which is a label for loans and debt instruments with a relatively higher risk than similar instruments within the official market. The super saturation of real estate markets brought the overvaluation of the prices in this sector by creating a financial bubble which blew up in a particular moment creating a cost around 1 trillion US\$ to the world economy.² The reason why its effects had a great impact is because many financial institutions like investment banks, investment funds etc had invested a considerable part of their portfolios in such instruments. Portfolio failure of these companies as well as the panic created in the market because of the depreciation of real estates held by population, caused a tendency to sell in mass these assets, by reducing prices in the market and creating a negative domino effect on other financial intermediaries related indirectly to the industry such as: insurance companies, commercial banks etc.

This massive tendency to give up real estates that was purchased with an expensive price, as well as the lack of investments in such instruments that were related to refinancing of mortgage loans, exposed to the risk banks that had given a considerable credit for the purchase of mortgage, as well as it directly affected the insurance companies which provided insurance policies with “*closed eyes*” without taking into account the default of these loans to the commercial banks.

This vicious circle, which has similar characteristics in almost all countries with developed financial markets, created unimaginable effects in international finance by shocking deeply the security and system functioning.

The rest of the story is known. Soon, a continuous chain of bankruptcies began among huge banks such as the Lehman Brothers, Merrill Lynch and as well the biggest insurance company in U.S.A, AIG³ nearly got destroyed, but because of its considerable size and the immense negative effects that it would create on the economy, it was not left alone by state to go bankrupt. This brought the use of an already known economic phenomenon that had to do with nationalization of many private assets while taking in governments' hands the companies which were mostly influenced by the financial crisis.

On the other side, as they had no more time to search for the “guilty ones” the governments of many countries, in full coordination with their central banks, started to inject liquidity at a wide level in market by giving them breath in order to save them from collapsing the whole system. So in a relatively short time, during the year 2008, hundred milliards of Euros and dollars were injected into the international financial markets, softening the negative effects caused by the crisis.

Actually, even though the situation has improved and now many countries that were influenced such as USA, UK, Germany or Japan have begun to publicly announce the

² Boeri & Luigi, (2008), “The Sub-prime Crisis: Greenspan’s Legacy”, *cituar në* Hassan, (2009)

³ Grey, (2008), “The Wall Street crisis and the failure of American capitalism”,

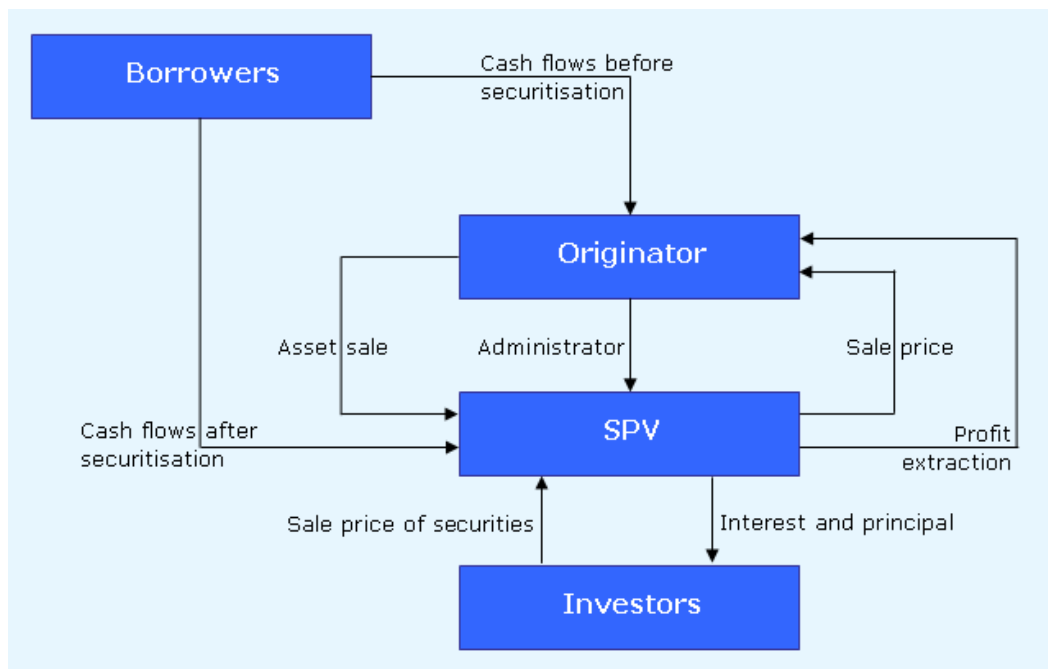
<http://www.wsws.org/articles/2008/sep2008/lehm-s16.shtml>

emergence from the dangerous red zone, still it must be said that the effects “*post-tsunami*” are quite large and are mainly characterized by the loss of confidence in financial markets, as well the very high level of budgets deficits or national public debts.

The huge gap between Real and Virtual Economy

But what was the primary cause that brought the shock to the foundations of the international financial system? This is one of those 1 million dollar questions because it is very hard to give a clear and definite answer in this respect. However, it should be mention that many researchers think, and empiric factors, lead towards the conclusion that the main cause is the big separation of the virtual economy to the real economy⁴, by focusing on financing of real economy with ever more complex instruments which are based mainly on speculations.⁵

Within the context of this paper, while the real economy is an economy based on its normal activity, by virtual economy we understand securities created in range, by either depending on intangible assets or various securities portfolio. In other words the process of securitization or repackaging process of different assets, and at a second phase, issuing other securities based on the former repacked securities.⁶ And if this situation continues, the number of repacking levels increases by making the process entirely virtual and slightly not based in real economical values (*a graphic explanation of the process follows*).



⁴ Hassan, (2009), “The Global Financial Crisis and Islamic Banking”, *The Islamic Foundation*, United Kingdom

⁵ Araghi, (2008) “Political Economy of the Financial Crisis: A World-Historical Perspective”, *Economic & Political Weekly*, Vol. 43, No. 45

⁶ In financial language this is called “Structured Funding”.

As it can be noticed from the figure, according to the securitization process, banks that give loans to their clients, indirectly “freeze” in some way their financial resources. Therefore they pack all their loans in a total portfolio and then sell it to a financial intermediary that is called *Special Purpose Vehicle*. Based on these loans, SPV issues on new securities, with a relatively diversified risk (*because SPV could collect different portfolios with different risks, from different banks*) which are then purchased by portfolios investors. Meanwhile individuals that had taken loans from banks continue to pay the principle and interest into their banks and these funds are transferred to SPV which then sends these to the investors. This is a very simple scheme of a securitization process. If the collection process for the securities portfolio at the first instance (1st SPV), join in the 2nd SPV where other securities are issued, and so the process becomes more complicated by completely detaching the real economy from virtual one.

In this way, the securitization process, the invention and use more and more of these new financial instruments called the “*innovative financial instruments*”⁷ brought the emergence of the market bringing it out of the control of financial supervision and regulatory authorities. If we add here the negative role played in this process by so-called Rating Companies, then the situation becomes more complex and therefore even less manageable. However these effects are discussed in detail in the following parts of this material.

In order to reflect in a simple way the complex situation of the securitization process and the use of innovative instruments that created a huge gap between virtual and real economy, it would be appropriate to prescribe the history of the Governor of the China’s Central Bank,⁸ which is mentioned frequently in economic blogs and discussion forums of the economic thought. Called by the political leaders to explain the financial crisis in capitalist countries and found in difficulties because of the lack of information of leaders regarding financial market development in market economy countries, the Governor takes an empty glass of water from the table and says: “Pretend that this glass is a real asset. In the moment in which right next to this glass there’s a mirror, we’re going to see two glasses, but we have in our hand only one glass. And so on, the more mirrors we add, the more glasses will see when in reality we have only one glass (tangible asset).

Market economy (laissez-fair) and Neo-liberals vs. Market interference (Keynesianism)

The “*laissez fair*” is a theory of economic thought that roots in the 17 century and defends the idea of the avoidance of state intervention in regulating the economy and relations among operators.⁹ Meanwhile, “*capitalism*” is a pejorative term used in a wrong way from the socialists in the middle of the 19th century, just to show the economic individualization. So, economic individualism was widely accepted from the classis of the economical thoughts and notably from the father of this theory, Adam Smith. Classics thought that the economy functions through the “*invisible hand*” of the human being

⁷Securities issued based on repackaging the loans or other different SPV securities.

⁸ The Popular Bank of China.

⁹ The origin of this term is believed that comes from the state finance director at the time of King Louis XIV, Jean-Baptiste Colbert, when they asked the government what to do to help, they received from industrialists: leave us alone (*laissez-faire*, from French.)! - Encyclopedia Britannica

(*homo-economicus*) which was in search of maximizing his benefit from the society, bringing an increase into the social welfare. This doctrine was backed up strongly from the principles of market freedom; it supported the idea that the role of the government in economy should be only to guarantee the individual freedoms of people.¹⁰

This theory broke down together with the economic crisis of the Great Depression in 1929.¹¹ Precisely in this period began the economic thought of Keynesianism, according to which the intermediate role of the government into the economy is crucial to stimulate the demand and the market functioning. Keynesians defend the idea of an aggressive role of the government within economy, while arguing that this would increase the society's welfare and defending the idea that the active presence of government in the economy not only enables but also improves the free market.¹²

Financial crisis in the late '70s put into question the Keynesian interventionist model turning once again the need to reform the classic model of Adam Smith, observed in a different context. Thus, the Austrian school scholars like Hayek, or followers of the Chicago School influenced by Nobel price winning economist Milton Friedman brought in the international arena a new line of thinking by joining at some common point as individualism, skepticism about success of the commanded economy or confidence in economic efficiency based on complete freedom of the market and free and fair competition.¹³

Did market economy fail?

A considerable debate has run over the fact that how comes that economists failed in foreseeing this crisis¹⁴. This question has confused many economists within the international context. Nowadays, when the crisis effects are relieved, many economists and analysts while trying to analyze the causes have argued that the system based on a virtual financial economy had "*put asleep*" forecasting sensors. This comes mainly because in the first quarter of a century (from 1982 to 2007) we were used to have a continuous sustainable global growing economy with relatively low inflation rate and high level of wealth creating,¹⁵ which now a day is doubtful whether it was real or virtual.

However, despite the worldwide economic debate, which has put in discussion the capitalism, based in the economy and the free market, there is also an opposite approach which argues that the market economy did not fail because of the economic crisis, but because of the government or more specifically the role of regulators¹⁶ (*watchdogs*) to

¹⁰ Hessen, R. "Capitalism", The Concise Encyclopedia of Economic

¹¹ Araghi, (2008), "Political Economy of the Financial Crisis: A World-Historical Perspective", Economic & Political Weekly, Vol. 43, No. 45

¹² Blidner, A. "Keynesian Economics", The Concise Encyclopedia of Economic

¹³ "Neoliberalism." *International Encyclopedia of the Social Sciences*. 2008. retrieved for the last time in 05.02.2010 from Encyclopedia.com: <http://www.encyclopedia.com/doc/1G2-3045301734.html>

¹⁴ Civici, (2009), "Globlizmi: *Ante Portas*", UET Press, pg. 116-120

¹⁵ Sargen et al, (2009), "Reflections on the Financial Crisis: When Diversification Failed", *Fort Washington Investment Advisors*

¹⁶ Civici, (2009), "Globlizmi: *Ante Portas*", UET Press, pg. 127-128

prevent the abuses or the “*out of control*” development of innovative instruments, creating the premises for an expansion beyond the gap between virtual and real economy.

Whereas it is paradoxical the fact that although aware of the regulators failure to prevent or foresee this crisis, the Obama administration, tries to minimize the phenomenon by tending to incriminate some players on Wall Street accountable for the damage caused to the system. This, according to economist Posner who is one of the biggest critics of President Obama on this issue and ardent supporters of the idea of failure of market economy, is like: “*to blame the capitalist for capitalism failure*”.¹⁷

In this context, we find out that there are three main moments where reformers of global financial system should focus their attention in order to extract the lessons and undertake the necessary measures in order to avoid similar issues in the future.

1. The inefficiency and negligence of the Regulatory Bodies

When analyzed in details the role of financial markets regulatory bodies around the globe, especially in countries where the crisis was created and developed, it is noted a sleepy kind of movement in terms of oversight and especially efficiency regulation of all new spaces established in financial market development,¹⁸ because of the rapidly developing use of derivative instruments and structured financing. The low level of financial industry regulation, compared with the high speed of its development is already a widely accepted opinion in many reports, academic studies or economic initiatives taken in recent years.

Although there are only few in number, critics of incapacity and in some cases of the regulators negligence see the main cause of development of the financial crisis to the failure of regulators to predict and prevent it, accusing mainly the American central bank, Federal Reserve, for its wrong policies in terms of monetary policy by overestimating the real estate market.¹⁹ While others see it as the failure of international cooperation between regulators in order to prevent such crises.²⁰ Moreover, there are those who strongly demand for a legal accountability of the top executives of regulators as a good way to prevent such irresponsibility in the future.²¹

However in all cases, there is a common opinion that if the regulators would have been wakeful to cover the above mentioned problems, the level of crisis would have been a few times lower, or would not have been felt at all, at least not at global level.

¹⁷ Posner, (2008), “A Failure of Capitalism: The Crisis of ’08 and the Descent Into Depression”, Harvard University Press, US, *cituar në* Rauch, (2009), “Capitalism’s fault lines”, *The New York Times newspaper*, 14 May 2009, <http://www.nytimes.com/2009/05/17/books/review/Rauch-t.html>

¹⁸ Davis, (2009), “Five Financial Crisis Lessons, Still Unlearned”, <http://english.caing.com/2009-12-24/100102739.html>

¹⁹ Baker, (2009), “The Financial Crisis: A Failure of Regulators, Not Regulations”, *Center for Economic and Policy Research* (CEPR)

²⁰ Davis, (2009), “Five Financial Crisis Lessons, Still Unlearned”, <http://english.caing.com/2009-12-24/100102739.html>

²¹ Morgenson, (2009), “But Who Is Watching Regulators?”, *The New York Times newspaper*, 12 Shtator 2009, http://www.nytimes.com/2009/09/13/business/13gret.html?_r=1&partner=rss&emc=rss

2. Rating Companies, complicit but not punished

According to many analysts and researchers, another group of economic actors considered as both responsible in creating the financial crisis are also Credit Rating Agencies (CRA)²². As already mentioned, these companies play an important role in the securitization process, as they assess the risk of innovative instruments before they're offered to portfolio investors for sale. The assessment impact of these companies to investors' decision-making process is very important because it is supposed that they are not experts of portfolio management, but they constitute their decision-making depending on the level of risk that these securities hold. Thus, if a CRA, estimates with the highest grade “*triple A*” (AAA) the securities issued by a SPV, then the investors trend to include them in their portfolio will increase.

The weakest point of this process, criticized also by scholars and economists, is the conflict of interest²³ that the CRAs have against SPVs or with the structured financing originators because they give advice on methods that should be used for repackaging different securities in order to decrease as much as possible the risk created from portfolio securities issued from SPVs. Then, as the second step of the process, after the instruments are repackaged, before delivered to the market they take a risk assessment by the same CRA. Thus, this practice led to such situations that although risk assessment was the maximum for certain innovative instruments, the crisis highlighted that they held a great level of risk creating a negative impact on portfolio investment made either by individual investors and various financial institutions around the world.

Also, another criticized aspect of the CRAs, was their performance. Many of these agencies have been targeted by critics, because they reacted by changing the risk assessments of several securities, only after something happened in the market (ex-post).²⁴ Therefore CRAs did not give any signal to the investors before (ex ante), so the latter would have the opportunity to react in time and make the right investment decisions.

What is to be noted and considered a real problem is the fact that even though operating in a regulated and supervised market,²⁵ although there is a considerable criticism on them, or an already certified responsibility, the CRAs were not called accountable by regulators because of being complicit on this crisis. It was a completely different situation in the case audit company's crisis due to the “make up” of balance sheets for Enron and WorldCom companies. In that case, the responsible persons and the beginners of these

²² Hamilton, (2009) dhe Petroff, (2008)

²³ Portes, (2008) dhe Petroff, (2008)

²⁴ Portes, (2008), “Ratings agency reform”, <http://www.voxeu.org/index.php?q=node/887>

²⁵ According to American legislation, CRAs have been considered as Self Regulatory Organizations (SROs), standing outside the scope of regulatory authorities supervision. However, because of the increase to their influence in the funding process, American Congress decided to adopt the Law on CRA Reform in 2006. Under this law, CRA market regulatory body is the Securities and Exchange Commission (SEC). While in the European Union, due to the bankrupt of the Parmalat company, the Committee of European Securities Regulators Securities (CESR) in 2005 published a paper entitled “Technical Assistance to the European Commission on possible proceedings to regulate the CRA”. Although there are nearly five years that this material has been proposed, nothing has advanced. (See Hamilton, 2009 and UNCTAD, 2008)

abuses faced the law, while the largest auditing company of that time in the world, Arthur Andersen, went bankrupt in record time, because of losing its credibility in the market.

3. Although government intervention was necessary in the end, it should have been preventive

Many argue the intervention of governments and state institutions in terms of minimizing the negative effects created from the crisis as an argument to prove the failure of free market economy. They use it as a pretext for increasing the impact of state intervention to the economy by proposing a slightly reformed method on the Keynesian philosophy.

I do believe that it must be admitted by all that the virtual economy development and structured financing came up to a critical point where the government intervention to stabilize the situation and create a minimum of security was necessary. This is mainly due to the fact that the financial markets are established and their function relies entirely on “trust” and confidence that economic operators have to its security. Therefore, in such a moment where trust felt down and the market structure could hardly stand, it would be a big shock if these operators would leave the system.

Considering the reasons mentioned above, we think that the crisis was not caused by the failure of “*laissez-faire*” model, but mainly due to a kind of negligence of government and regulatory structures to prevent abusive situations or new models and speculative financial instruments. According to neo-liberal philosophy, the government must be present in the economy just to ensure conditions for the free and fair competition development through effective surveillance and legal regulation, while market and economy then arrange itself based on the laws of supply and demand. As stated above, the process had problems right here, as was confirmed that supervision had been inactive and completely passive, while legal regulation was many steps behind the trend of rapid market development.

What needs to be done now, is to learn from mistakes and manage the situation correctly instead of dealing with “mission the impossible”, going once again back to the debate on the need for state intervention in the economy, because this model has already proven non-efficiency for decades. In this context, it is seen that the governments of the countries most affected by the financial crisis have started to make maximum efforts to coordinate work on reshaping the new global financial architecture, considering the International Monetary Fund as a leader in this process. Also, the establishment of the Financial Stability Board (FSB), in Basel Switzerland, was done precisely to give a more active and central role in coordinating the work of the financial markets regulators in different countries.²⁶ On the other hand, efforts are made at the national and international level to strengthen more the role or influence of regulators in supervising the market (*the so-called process of adjustment*), as well as work has started work to revise the legal and regulatory framework in order to cover all possible rooms for abuse or uncontrolled speculation in financial markets²⁷. The financial reform package presented by president

²⁶ Davis, (2009), “Five Financial Crisis Lessons, Still Unlearned”, <http://english.caing.com/2009-12-24/100102739.html>

²⁷ For further detail see Hamilton, (2009), Salvatore, (2009), UNCTAD, (2008), Hamilton, (2008)

Obama in the U.S goes in the same line. Thus its objective is to drastically reform the financial market in the country by increasing the regulatory oversight role and also by reducing the operation area of financial intermediaries to take part in speculative transactions which are out of scope of their licensing and expertise.

However, it is very important to say that while drafting such policies, governments of developed countries or governments of other countries directly affected by the financial crisis should be careful between the process of regulation and de-regulation. This means that trying to regulate the markets and global financial architecture, they should make sure not to prevent the normal development of the market on the principles of free and fair competition. The debate over the advantages of de-regulation is an old debate and its positive effects have already been proven in the market, despite the doubts created because of the latest financial crisis. The ability of the architects of the current reforms should be in terms of finding the optimal level between the need for regulation— so not to face similar crises— and the need to give breath the market to increase at normal rates.

Why was Islamic finance not influenced?

In the middle of this global "financial tsunami", the Islamic world and its funding model were less influenced from international financial crisis. According to the Asian Development Bank (ADB), Islamic finance has reached an annual average increase of more than 15%, approximating a value of about US\$ 1 trillion worldwide. This has turned this sector as one of the fastest growing segments in the international financial system.²⁸

The reasons given for this phenomenon are numerous and we must say that most of them are made by scholars and economists, which belong to this religion or that live in these countries. However, all these reasons derive more or less at the same points which we will try to explain below.

Islamic economics is not based on any interest (riba) because it constitutes a violation of religious doctrine and the principles on which the philosophy of Islamic finance is based on. Thus, at a time when the economics of finance in developed countries considers money and monetary values like any other good or goods that are traded in exchange of a profit, the philosophy of Islamic finance considers money as a tool that should be completely based on assets (musharakah)²⁹ in order to create real value added to the economy. Also, other researchers explain the failure of free market economy by the use of high-scale speculations (maysir), as a way of benefiting from change in market prices for a specified period of time.³⁰

Another argument thought by scholars that the Islamic finance was not impacted by the latest financial crisis, is the principle of *risk diversification* (mudarabah)³¹ between financial intermediaries (*banks, Islamic or other types of funders*) and client counterpart

²⁸ Hassan, (2009), "The Global Financial Crisis and Islamic Banking", *The Islamic Foundation*, United Kingdom

²⁹ Hassan, (2009), Fariduddin, (2009)

³⁰ Khan, (2008), "World Financial Crisis: Lesson from Islamic Economics",

http://www.twocircles.net/2008oct11/world_financial_crisis_lesson_from_islamic_economics.html

³¹ Hassan, (2009), Fariduddin, (2009) dhe Institute for Islamic Banking, <http://www.islamic-banking.com/>

in the transaction (depositor and the beneficiary of the loan for business).³² Given that, in this model the financial intermediary takes the risk over, because he is more conservative in terms of project funding by carefully calculating the failure probability. While in the economics of finance, financial intermediaries do not prefer to take risk on themselves, but they charge all their risk to the loan makers benefiting from the entrepreneurial ability of economic operators. The tendency to maximize the amount of profit not only from the revenue of funded projects, but also by speculation makes financial brokers in developed financial markets to be less prudent and faces several problems in quantitative and qualitative criteria.

For these reasons, many economists, finance scholars and Islamic economics scholars see the application of the same model on the international financial architecture as a safe way for well functioning of the global finance and as a guarantee for preventing big financial crisis in the future.³³

Is Islamic Finance a solution?

Before we give our opinion it must be said that the Islamic economic philosophy did support neither capitalism, nor socialism. However, according to the researchers in this field, both systems share similar values with Islam.³⁴

Based on the above mentioned characteristics of Islamic finance, it must be point out that the model of Islamic economics has quite positive sides, especially in terms of supporting on the real economy and on assets or regarding the phenomenon of risk-diversification between financial intermediaries and stakeholders in a financial transaction.

However, on my opinion, the weakest point of this system is refusing (for religion purposes) the using the so called “*money cost*” (or the pay of use) or generally known as “*interest*”. This essential instrument to the development and progress of the financial economics is the key instrument that has financially supported the global economic growth since in the early times,³⁵ and later it was further developed with the increase of trading volume in different countries of the globe. The use of this instrument provides liquidity in the economy as well as enables a more efficient allocation of resources and production factors in the economy.

Precisely for these reasons, but also for the fact that Islamic finance model itself has not yet found all the possible alternatives that could replace the role of *interest* in economics of finance³⁶ we must say that the replacement of the current system with the Islamic model still remains something seems difficult from economic thinkers or policymakers worldwide. Even if the strong points that make Islam model attractive, such as risk

³² Khan, (2008), “World Financial Crisis: Lesson from Islamic Economics”, http://www.twocircles.net/2008oct11/world_financial_crisis_lesson_form_islamic_economics.html

³³ Hassan, (2009), Al Nasser, (2008)

³⁴ Abdul Hassan, (2009), “The Global Financial Crisis and Islamic Banking”, *The Islamic Foundation*, United Kingdom

³⁵ The first traces of the use of interest were found in the Bible, where Israeli preached application of interest to borrow money granted only to those who were not brothers of the same religion. see The Holy Bible, International Bible Society, , <http://niv.scripturetext.com/deuteronomy/23.htm>

³⁶ Khan, (2008), “World Financial Crisis: Lesson from Islamic Economics”, http://www.twocircles.net/2008oct11/world_financial_crisis_lesson_form_islamic_economics.html

diversification or transactions support in assets, are economic phenomena which in the economics of finance and free market economy are offered from specific economic intermediaries such as Venture Capital Investment Fund.

Despite what was mentioned above, the important role of Islamic finance in the development of global economy, like a complementary segment of all other mechanisms developed in years, can not be denied. This comes because the lack of such a funding system would leave out of the global financial system, significant funds originated from physical or legal entities which are guided in their activity by Islamic religion principles.

Conclusion

The world crisis that arose from the real estate markets in U.S.A and that later on was quickly transferred in the financial markets and in real goods markets, except the unimaginable financial cost it created a very strong and unprecedented shock to the international financial system. This crisis, which due to its negative effects is compared with the crisis of the Great Depression in 1929, has put in discussion even the functioning model of the social and economic order in nowadays. Many famous scholars defend the idea that the economic capitalist system of the free market is over; they think about the need to review the reorganization of this system through a clear social approach according the Keynes market theory for state intervention into the economy.

Despite this approach there are very few people who tend to watch this phenomenon from another point of view. So instead of loading the guiltiness on the “*laissez-fair*” economy, they think that maybe it should be searched at the instructional mechanisms that cover a very important function regarding the maintenance of financial system nationally and internationally. According to our point of view, which refers to the neo-liberal approaches, it is not capitalism or free market economy the one that failed but it’s regulators who showed the lack of capability to prevent such crisis. According to the theories and the line of neo-liberal thinking, one of the very few roles that the government has to play in the economy is providing equal conditions for all economic operators to make their transactions in term of a full free and fair competition. In the free market economy, the government plays this role through the regulators, which are the independent institutions that mainly protect the interest of the consumers through a strict supervision and strict legal regulation always updated with the conditions and latest developments of the market.

According to my opinion, this is the crucial point where the actual financial world regulators failed, by not following step by step the quick development of the financial markets, the evolution of the financial structure and the creation of many innovative instruments. The combination of this factors as well as their connection with many other external factors brought a large gap between what is called a real economy and the virtual economy caused because of the very fast development of the structured financial instruments. For this reason and paradoxically, the crisis came and took by surprise not only the regulators, but many economists and finance scholars.

From this entire whirlpool that was created by the “*financial tsunami*”, it was noticed that the international markets or the model of financial system based on Islamic religious dogma was affected a bit or not at all. This came mainly because of the conservative nature that this type of development model has, basing its activity on principles such as:

no-interest applied, risk diversification, and reliance of financial activity on tangible assets. This kind of philosophy kept the financial institutions, which use this model, away from the waves and the effects of international financial crisis.

However despite this phenomenon as well as even though a lot of researchers of the Islamic financial model have proposed this system as the most acceptable solution for a better growth and wealthy international finance, still this alternative is not considered as a solution. This happens mainly because the Islamic finance model does not have all the possible alternatives to replace many important tools used in the economics of finance. However Islamic finance is seen as a segment of international finances with a high development potential and as a complementary part of financial global architecture, without whom many funds with the origin of the Islamic religion would have been left out of the market mechanisms.

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