

# “Social and Economic Impact of Islamic Finance”

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- Allah says repeatedly in Quran that there is no change for His words.
- He made Riba (interest) among worst sins; those who devour Riba will be in eternal hell fire; the act of Riba is an act of war against Allah and His Messenger P.U.H.
- Allah decided to destroy wealth-based on Riba and to increase sadaqat.
- Islamic finance, free of Riba, unjust appropriation of wealth, gambling (maisir), and all other prohibitions mentioned in Quran and Sunnah is most sound finance that is inherently stable and conducive to economic prosperity and social and economic justice.
- Zakat, a pillar of Islam, reduces tremendously poverty and therefore the need for the poor to borrow and pay interest.

- Money and finance constitute a pillar of economic activity.
- An economy cannot function without money and finance.
- Economic growth is based on real capital accumulation, the faster capital accumulation, the higher economic growth.
- Sustained economic growth has generated higher employment, higher incomes, and reduced poverty.
- Money is a stock of wealth: medium of exchange and store of value.
- The role of financial intermediation is to mobilize savings and to allocate it to most productive investment.

- **Rising prominence world-wide of Islamic finance**, in the wake of recent financial crisis, in the quest for stability and prevention of collapse and disorder. Islamic finance is considered as a stable financial system capable of promoting sustained growth of income and employment.
- Prohibiting interest, speculation, and debt trading, Islamic finance is equity-based finance and establishes one-to-one mapping of financial and real sectors of the economy.
- That is, it is based on real trade and production activities.
- **The financial sector cannot expand beyond the real economy, and is immune to un-backed credit expansion** and speculation that are characteristics of conventional finance and that have destabilized even the most sophisticated and complex financial systems.

- Recurrent financial crises in recent and distant pasts across countries established that **conventional finance is inherently unstable** (e.g., Minsky).
- Irving Fisher (1933) claimed that only a financial crisis causes an economic recession and mass unemployment. **He reviewed 49 causes susceptible of causing a crisis. He firmly asserted that none could cause an economic crisis, except debt.**
- There is no country that has been spared financial collapse. The Japanese 1992 crisis and the 1997-98 Asian crisis are reminders of the instability of conventional finance.
- Financial tremors occurred frequently in England, the United States, and other western countries during past centuries.
- **Each financial crisis was followed by steep decline in real incomes, massive unemployment, and protracted period of financial disorders.**
- **The recent crisis has pushed unemployment rates in advanced economies from 4% to over 10%. Mass unemployment and financial disorders following the Great Depression 1929-1935 escalated into a world war in 1939 leaving behind massive devastation in Europe and Japan.**
- **Mass unemployment has been equated to a significant loss in output and social welfare.**

- Conventional banking system cannot survive on its own and needs government bailouts.
- The recent financial crisis showed that the cost of bailouts exceeded \$15 trillion in advanced countries. Bailouts were seen to perverse speculative gains and socialize losses.
- While banks are saved from collapse, the cost of bailouts is born by workers and fixed income group in form of inflationary tax.
- Workers and poor classes are robbed and punished for sins they did not commit.

- Conventional finance is highly inflationary. Contrary to Phillips curve view, inflation decreases output.
- Based on paper money, conventional banking creates credit without limit, called fictitious credit, and causes immense financial disorders and speculative bubbles.
- Central banks print money at will, set interest rates to near-zero bound, fuel inflation and exchange rates instability, and precipitate bank failures.
- Inflation could become hyperinflation as experience had shown in many European, African, and Latin American countries. Inflation erodes real incomes and spreads poverty and social unrest and strikes.
- In many countries, real incomes fell to 10% pre-hyperinflation level. Food price inflation in 2007 have increased malnutrition and caused food riots in many vulnerable countries.

- Low income countries followed a conventional finance system; they fell into prolonged debt trap and extended economic stagnation. Their infrastructure deteriorated beyond repair. **Their unemployment rates are about 25%-30% of the labor force.**
- **Absolute poverty in these countries exceeded 50%-60% of the population and translated into a dramatic deterioration in social indicators, mainly health, nutrition, and education.**
- **In many middle-income countries, unemployment rates have averaged 14%-20%. Joblessness is pervasive among university graduates. Social unrest and crimes are widespread, inflicting social cost on societies.**
- **Islamic finance is immune from the devastating consequences of conventional finance.**
- **It preserves steady growth path for the economy and maintains employment and social welfare. Debt and interest-debt contracts are absent. Therefore, there are no debt crises in Islamic finance.**
- **Furthermore, there is no credit multiplication and creation of money-out-of-thin air. Inflation is absent and price stability is preserved. Hence, real output is always rising.**

- **Social injustice caused by inflation, deprivation of workers and the poor, is not allowed in Islamic finance.** Islamic finance is equity-based; savings is allocated to investment in most efficient way and in a competitive way.
- It is remunerated the rate of profit in the economy. Savings is invested in productive capital accumulation and the dynamics of growth generate more savings and more economic growth.
- **The economic growth pattern associated with Islamic finance is a balanced growth. It does not allow for internal or external disequilibrium.**
- Internal disequilibrium is defined by fiscal deficits as well as private sector deficits when both government and private sectors are allowed via credit and debt to spend above their revenues. It does not allow for external deficits.
- **The economy does not import unemployment and therefore occupies most of its labor force, providing thus ample employment and contributes to reduce poverty.**

- The fallouts of the recent financial crisis have not receded yet. Leading central banks have set interest rates to near zero bound and have injected trillions of dollars in liquidity created ex-nihilo with the aim to re-inflate bubbles and protect borrowers. Un-backed liquidity is an unjust form of wealth redistribution.
- Instability in financial markets has intensified. The price of gold has soared to \$1360/ounce, shattering record levels, and indicating strong inflationary. Expectations, great loss of confidence in reserve monies, and flight to safety.
- Prices of main food products have risen by over 50% in 2010 and would translate in high food price inflation. The risk of worsening economic and social impact of unfolding crisis is very high.

- There are no signs that leading central banks will renounce money destruction and have even become entangled in exchange rates war.
- Uncertainty remains high and implications to world trade, economic growth, and employment could be seriously negative.
- Many prominent economists in early 20<sup>th</sup> century, including adepts of the Austrian school and the authors of the 1935 Chicago plan, have called for a financial system that abolishes debt and interest-based debt contracts and establishes 100% reserve banking system.
- Their theories were in many respects very close to the principles of Islamic finance.

- **Countries now have an educated choice** based on their own experience as well as experience in other countries. Conventional finance has been dubbed as inherently instable finance and a source of chaos. If countries aspire to durable economic growth, durable employment, and social justice.
- Then Islamic finance offers a stable path for achieving these goals. They will spare themselves the depressing consequences of inflation, price distortions, and economic inefficiencies.
- **Countries that promote Islamic finance are in fact establishing a financial system that secures durable growth, high and durable employment, price stability, enhanced social justice, and receding poverty.**
- In sharp contrast, countries that promote conventional finance cannot avoid recurrent financial collapse, unsustainable debt, violent instability of asset markets, rampant inflation, large fiscal deficits, unorthodox money policy, massive unemployment, and growing social injustice.



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