Crisis of capitalism and the quest for a lasting solution

Capitalism

By Shadab Fariduddin

ABUL FAZL in his article "Crisis of Capital: what is the lasting solution?" (*Encounter*: March 28) extensively analysed the causes behind the current crisis in his usual thought-provoking style. His thesis that capital creates surplus by retaining the value created by the working class assumed new meaning in the current crisis, as this value-sucking function was performed on a global scale and caused the crisis.

The article explained the crisis well; however the expose relating to "the lasting solution" was rather scant and strange. Scant, because a reader could find no solution, and strange, because the Schumpeter's prediction that "socialism was destined to ... conquer the world" sounded as if the dead (socialism) would rise from its grave to replace the moribund (capitalism). The prediction has not come true. Indeed the reverse has happened: most of the communist states have abandoned the cherished ideology and embraced capitalism. At the end of cold war, Fukuyama declared victory in 1992, in his *End of History and the Last Man* , of "secular free-market democracy" over socialist ideology following dismemberment of the Soviet Union.

Hugo Chavez's socialist rhetoric , nationalisation and public welfare schemes may lead one to believe that socialism is emerging again. But such attempts by him and a few others pose no threat to capitalist system and its institutions in the near future What else then can qualify as "the lasting solution?" Answer: Islamic Banking and Finance (IBF).

Eighteen banks in the US alone have filed for bankruptcy. Iconic investment banks, once the most mighty financial forts, are all either dead or have been taken over by commercial banks or the government. Insurance companies, pension funds, and all sorts of financial services have been crippled beyond recognition. Investment giants such as Merrill Lynch, Goldman Sachs no longer have independent existence; they have either merged with commercial banks or simply gone bankrupt. Europe is no exception. Banks fell from grace there too.

Blackstone Group estimates that between 40-50 per cent of global wealth may have been destroyed in the current crisis. Over three trillion dollars are being pumped in to overcome the "credibility crisis".

In this global mayhem of severe proportions, not a single Islamic Bank has failed. Yes, in some cases they have heavily written down their balance sheets. Some may have even suffered losses. But none drowned in the tsunami of reckless lending that was created by financial derivatives, sub-prime loans and speculative trading of shares, bonds and commodities. At the core of the meltdown is unbridled use of derivatives to generate quick returns. Derivatives also allowed banks and fund managers to hoodwink regulatory controls.

John Aglionby of the *Financial Times* has this to say about IBF: "Islamic financial institutions do not pay interest and require transactions to be backed by real assets. Their assets comprise only a few per cent of the global banking industry but they have suffered less than their conventional counterparts because they did not deal in subprime mortgages or complex structured products." Islamic Finance does not allow creation of derivatives. The underlying must be known and certain before the asset can be sold or bought. That is precisely the reason that IBF is also known as "asset-backed banking". Islamic finance also allows for risk-sharing between the banks and borrowers. There is no room for interest, speculation or gambling — ills that caused current meltdown.

The asset-backed banking has resulted from a most vibrant and intense intellectual discourse emanating from Islamic world in the last 30-odd years. Scholars propounded theories, expounded concept, practitioners joined them to create working models, risk-taking entrepreneurs created new banking institutions and governments created facilitative regulations. As a consequence, Islamic finance is now the fastest growing industry segment — globally.

Modern Islamic finance and banking started in 1960s in Egypt. As is the case for any industry, Islamic banking and finance had a modest start and progressed slowly. The real growth has come only over the last 10-15 years. Islamic finance and banking industry now holds total assets of $600bn growing at an annual long term rate of 15 per cent. More than 400 Islamic financial institutions are now working in over 75 countries including the non-Muslim ones. The biggest Islamic bank in the world — Saudi Arabia's Al Rajhi Bank — has an asset base of $28 billion, still only a fraction of the $2 trillion boasted by the Citigroup, the largest conventional bank in the world. This indicates the future potential of Islamic banking which is at its early growth stage and is poised to witness rapid expansion.

Islamic Financial Services Board (IFSB) projects the market size to reach $2.8 trillion by 2015. Considering that not only the 1.3bn Muslims but the entire world is the potential target market for Islamic finance, the estimates look realistic. Indeed a small but growing segment is of non-Muslims in countries like Japan, Germany, the UK and Australia who prefer to use Islamic financial products for quality, service or other reasons. Even governments in Japan and Germany have resorted to Islamic modes of project financing for public sector projects.

Islamic finance has a great pull for practitioners and scholars alike, both Muslims and non-Muslims. Dubai, Qatar and Kuala Lumpur aside, even London, Honk Kong, New York, Singapore and Mauritius now want to be the centres of Islamic financial services. Harvard and Rice universities have dedicated research centres in Islamic finance.

These countries and institutions may be driven by the capitalistic instinct of exploiting another opportunity created by faith-preference for capital. But the merit of Islamic finance as being more fair and safe is attracting attention — and admiration. The current crisis of capital has only accentuated the inherent merit of Islamic finance.

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This new paradigm is also the hotbed of Islam's intellectual revival as it offers a tantalisingly attractive solution to modern-day problems. Islamic finance is also the only working model of a collective system that has now become a reality. As opposed to romanticism of the past, it has a pragmatic present-day appeal. Finally, as a philosophical and intellectual construct, Islamic finance contributes to today's Muslim mind to the civilisation.

It may be a matter of pride for some that Pakistani scholars and practitioners, led by Justice retired Taqi Usmani, are at the forefront of creating and cementing the paradigm of Islamic finance. For the first time in the last five hundred years, Muslims have become producers of workable modern knowledge instead of just consumers of western thoughts and philosophies.

IFB is now striving to move into second-generation of true-to-spirit products based on equity financing or musharikah, whose closest counterpart in capitalism is venture capital (VC) mode of financing. Under VC financing, capital comes in the form of equity and shares risks and reward with the labour in a true value-creation process. Interestingly, the VC firms in the US and Europe have withstood the meltdown whereas private equity outfits that resorted to derivatives and debt have been battered badly. In other words, equity-capital has fared well as compared to debt-capital during the meltdown: the model of risk-sharing equity financing, or musharaka in Islamic Finance, has retained people's confidence.

It is true that IBF suffers from many imperfections and there are misconceptions about it in the minds of consumers, borrowers, scholars and regulators. Yes, Islamic finance may seem to be a look-alike of conventional banking. Yes, Islamic finance is currently based on manoeuvring around the spirit of Shariah, or excuses to structure its offerings. Yes, it is a fact that true-in-spirit mudarabah (participation or trust financing) and musharakah (equity participation) have yet to be practised upon by Islamic banks and financial institution. Yes, more than 90 per cent of all lending by all Islamic banks in the world consists of weaker modes of financing such as ijara (hire-purchase, lease financing), murabaha (cost-plus financing), and Sukuk (asset-backed bonds). There is one key enviable merit even in all these imperfections of Islamic finance: they unshakably adhere to "real value". If such an imperfect system is able to weather the mother of all crises of the capital, it leaves little doubt that a perfect Islamic Finance indeed offers the true "lasting solution". ■

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