

# The Global financial Crisis: Is Islamic System a Potential Solution?

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## Abstract

The world today is in need for a good and rational financial system aftermath the last tragic global crisis through applying Islamic financial system which discards the arrogance, injustice and greed of capitalist system as well as other contemporary economic systems. The biggest mistake of Western capitalism is to bet on interest rates as a tool for financing and the intended negligence of warnings of senior western economists, from the seriousness of the divesting effects of this capitalistic system. This study recommends the solution to this crisis is by applying the main stream system of self-financing model, which implies the participation between the surplus and needy groups which creates the mutual benefit for the two groups; this model is being used by Islamic Banks, and also to concentrate investments in productive projects, not on investing on money and unreal securities and derivatives such as futures and other nonproductive tools. The prime objectives of this study concentrate on the global financial systems and policies which caused the Global Financial Crisis in addition to their implications upon the economies of many countries. Then research will focus on the role and importance of Islamic Economic System to avoid this crisis in the future as well as other financial and economical problems.

## 1. Introduction

The financial crisis that toppled in the monetary system and banking sector in late 2008 in the United States with a significant impact on the various sectors of the U.S. economy. Effects were extended to various countries of the world and to varying degrees, making governments intervene to rescue their economies through monetary and fiscal policies, laws and procedures that will reduce the financial crisis effects on the citizen and the economy in particular which has become the economic crises plaguing the different regions of the world every now and then, and for one reason or another, it has become the controversial and interesting issue for experts and businessmen. However, the shocks that occurred in South Asia and South America, far off from the last property crisis which turned the economic balance of power and left the economies bear the losses after the rise of economies worked for them throughout the years (Calvo, C., 2010). 2008 Global Financial Crisis is considered by many economists to be the worst financial crisis since the Great Depression of the 1930s. It resulted in the threat of total collapse of large financial institutions, the bailout of banks by national governments, and downturns in stock markets around the world. In many areas, the housing market also suffered, resulting in evictions, foreclosures and prolonged unemployment. The crisis played a significant role in the failure of key businesses, declines in consumer wealth estimated in trillions of US dollars, and a downturn in economic activity leading to the 2008–2012 global recession and contributing to the European sovereign-debt crisis. The active phase of the crisis, which manifested as a liquidity crisis, can be dated from August 7, 2007, when BNP Paribas terminated withdrawals from three hedge funds citing due to a complete evaporation of liquidity.

The world: the Great depression in 1929, the Japanese crisis in 1990, the Mexican crisis and has witnessed repeated crises, it almost not getting out of one crisis until it falls in another, examples are the sharp decline in the value of its currency (Paiza) in 1994, and Barings Bank in 1995, the crisis in South east Asia in 1997, technology companies crisis and the bankruptcy of a Enron company in 2000, and many other major companies in 2005, and finally the global financial crisis in 2008 or the named hurricane financial crisis.

**Capitalism** is an economic system based on free market and open competition and the profit motive and private ownership of the means of production, based on the capitalist system, prices, profits and losses and the rights of private property; and encourage capital investment per capita private and business sector, and compared with the economy, which is controlled by the government, investors in these private companies (ie shareholders) are the owners of these companies and known as capitalists. In this system, the individuals and companies have the right to own and use wealth to earn income and buying and selling and get labor for wages and government control of certain minimal or non-

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existent. Is the organization of the labor market and the economy mainly through market forces where prices and profits are that dictate where and how resources are used and allocated. Most of Western Europe and the U.S. as well as the United States follow the capitalist system(Phelps,E.,2007),.

**Socialism** is an economic and political system based on public ownership of the means of production. Socialist entrenched concepts of equality among workers, rather than the size of achievement and assessment of the amount of time workers take in the production process instead of the value of product. This system also makes individuals dependent on the state for everything starting from food to health care. The overall goal of socialism is to maximize the wealth of the country, and minimize the suffering of members of the community through public control over the industry and social services. Socialism is the alternative to capitalism, where in capitalism the private sector is a monopoly of the means of production, as well as profit taker from the production. Socialism has Become a strong international movement in the early nineteenth century. As the industrial revolution has brought about major changes in the methods of production, capacity, and has led to a decline in working conditions. China, Vietnam and Cuba are examples of socialist societies in the modern era. these systems have been toppled in the twentieth century and capitalism has replaced socialism, as happened in Czechoslovakia, East Germany and the Soviet Union. However, Government programs of capitalist systems include some socialist principles such as social security and social welfare (Steven Kreis,S,2000).

**Islamic Financial System** has become a major global financial system with over 300 institutions involved in both Muslim countries and international financial markets. Assets managed in accordance with the Islamic law are worth over \$200 billion, including financing facilities made available by banks and investments by mutual funds that have been screened for Islamic Themes (shariah) compliance. Just three decades ago even the strongest advocates of Islamic finance could not have envisaged that such progress would have been possible in the context of an international financial system that was dominated by western Capitalism which implies an interest based methods of financing. In increasingly global financial markets, Islamic banking can increase its credibility by introducing common reporting standards. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1991 to prepare and issue auditing, good governance, ethical and shariah standards, as well as shariah rules for investment and financing instruments. The Bahrain Monetary Agency and the Central Bank of Sudan require all Islamic banks under their jurisdiction to meet these standards, and Islamic banks elsewhere comply voluntarily with the AAOIFI standards, often because their shariah advisors sit on the AAOIFI board. In 2000 the Saudi Arabian Monetary Agency told Islamic banks and Islamic subsidiaries of conventional banks operating in the Kingdom to use AAOIFI standards. To date AAOIFI has issues eighteen accounting standards, four auditing standards, four governance standards, five shariah standards and four shariah rules, in addition to a code of ethics. Increasing convergence in Islamic financial practice will undoubtedly increases client confidence in the industry and facilitate inter-bank transactions between shariah compliant institutions(Khan,T,2012).

## **2. Literature Review**

### **Late Global Financial Crisis**

The world has witnessed since the nineties of the last century many developments and shifts of relations in many international nations, in particular the dominance of the unipolar system who pursued a policy of force and the polarization and the rule of transnational corporations that have sought to achieve financial gain through their monopolistic control on the resources of the world nations and plunder their wealth and resources, this unipolar system was led by the United States who sought to control most countries in the world through the deployment of military bases and launching wars and the destruction of nations, especially the developing countries. The recent revolution of scientific and technological developments, especially the communication and Computer sectors have caused drastic and deep changes in many fields such as finance, economic, political, social, cultural and even military. In this sense, the international financier George Soros has warned in his book (the Crisis of Global Capitalism) that the global financial system led by the United States companies is moving towards collapse, which requires countries of the world to reconsider the prevailing capitalist system and work to fix . Samir Amin, The Arab economic expert has also warned that the continuation of the new world order who pursue its policies of financial inspired by the doctrine of the free market as a treatment being inclusive will lead to the disintegration of the capitalist world in the foreseeable time and will undermine the pillars of this system, and that this capitalism led by the U.S.A. and its greed, avidity and monopolies have created a crisis which has aggravated the countries of the world these days(Amine,S,2009).

### **Causes of the global financial crisis**

The financial crisis began as the U.S. “subprime” crisis in the summer of 2007 spread to a number of other advanced economies through a combination of direct exposures to subprime assets, the gradual loss of confidence in a number of asset classes and the drying-up of wholesale financial markets. In this process it came to expose “home-grown” financial imbalances in a number of advanced economies, typically characterized by an overreliance on wholesale funding sources by the banking system and asset bubbles in residential property markets. The crisis has raised questions in the minds of many as to the wisdom of extending mortgage lending to low and moderate income households. It is important to note, however, that prior to the growth of subprime lending in the 1990s, U.S. mortgage markets already reached low and moderate-income households without taking large risks or suffering large losses.

In most emerging markets, mortgage finance is a luxury good, restricted to upper income households. As policy makers in emerging market seek to move lenders down market, they should adopt policies that include a variety of financing methods and should allow for rental or purchase as a function of the financial capacity of the household (Gwinner, W, and Sanders, A, 2008). There is still no full agreement among policymakers and researchers on what caused the build-up of financial imbalances globally. While most commentators concede that supervision and regulation were lacking with hindsight and efforts to strengthen regulation are well underway, strong disagreement persists on whether it was overly accommodative monetary policy from 2001 that fuelled the build-up (Taylor, 2007). Financial markets with their tools and derivatives were developed to be the hedging tools, but have become the primary economic objective, but not the real economic productive markets (Shah, A, 2013).

### **Consequences of the global financial crisis**

#### **Financial and Economic consequences**

Late crisis has caused a significant loss of bonds and securities values, therefore this has decreased the purchasing power and investment of an important segment, in which the wealth of employees and individuals has been diminished or even evaporated. Also

there was a high diminish of liquidity circulating in the market due to the devaluation of securities market values, and the interbank distrust as certain banks were involved in the loosing securities. daily lending or other types of lending between banks have diminished. depositors were cautious to deposit for their fear of the banks’ bankruptcies, and this is resulted into lower liquidity which caused general reluctance in consumer spending. Lending operations had been drastically decreased or even stopped due to lack of liquidity and trust between dealers and the fear of loans to finance their operations, due to the high cost of loans. Also, banks have declined to grant neither commercial nor personal loans in spite of whatever guarantees. Consequently, this has caused a negative impact on production, consumption, and this has led to economic stagnation and then contraction. Thus There was no doubt that the financial results were the main factors affecting the economy and are the leading factors to recessions and perhaps to states of collapse of many economies which affected mainly the consumers who are considered as the main financing and funding of operations on daily bases for international financing credit of credits and guarantees being necessary to the continuity both the domestic and international trade in medium or long-terms. The economy usually enters a recession and perhaps a state of collapse as a result of shrinkage in the natural values of the assets and financial contraction of the money supply, which reflects a negative effect on consumption and production (Allen, F., et al, 2009).

#### **Effect of Global Financial Crisis on Developing Countries**

Many studies have revealed the depth and complexity of the impact of the global economic crisis on the lives of developing and poor countries worldwide. The late crisis had hit poor countries through a number of transmission channels, each with their own rhythm and severity. Some impacts are already receding while others are still to strike. The first developing countries to experience the crisis were those with the most globally integrated financial sectors. Workers selling food on the street, doing piecework in the home and picking through waste were affected alongside workers in the factories as the demand for their services dropped and more people joined their ranks. Remittances from migrant workers in rich countries were also hit, though not as badly as anticipated. Finally, with an even greater lag time, comes the impact on government spending in poor countries and donor aid budgets – it is yet to be seen whether rich country governments will stand by their aid promises, or force poor countries and people to pay the price of the rich world’s financial folly. Generalizations are risky with such a complex picture, but overall the crisis has primarily hit East Asia through trade and labour markets, with mass layoffs in supply chains; Sub-Saharan Africa and the Pacific Islands, the impact has been mostly via commodity exports and reductions in trade tariffs; Latin America and Eastern Europe have suffered the highest degree of financial contagion and have seen the largest falls in GDP, while Central Asia has been hard hit by its dependence on the Russian economy, which suffered both from falling oil prices and a

banking crisis. South Asia has been largely insulated from the crisis, with Sri Lanka the worst affected country in the region(Oxfam,2009).

The world economic crisis affected countries in the Middle East and North Africa (MEANA) in much the same way that it affected developed and developing countries of the World. Aggregate real GDP growth of the Gulf Cooperative Council (GCC) economies dropped to 0.8% in 2009 from a robust 7.2% in 2008. Inflation in the GCC economies dropped to 2.5% in 2009, from 11.1% in 2008. Banks had liquidity problems, and most GCC countries had housing bubbles that burst. Housing prices dropped by 52% in the Emirate of Dubai, by 35% in Qatar, and by a whopping 62% in Kuwait. financial systems in MENA countries have not been highly vulnerable to the crisis so far due to their limited integration with global financial institutions, the impact of the global recession on the real economy can be significant in many MENA countries. In fact early signs point to declines in growth rates in the fourth quarter of 2008 in many countries, and growth projections for 2009 are lower than 2008 levels in all MENA countries with the exception of Qatar and Yemen where 2009 GDP growth will be powered by expanded capacity in the production of liquefied natural gas. As a whole, the MENA region is projected to grow at 3.3% in 2009 down from 5.5% in 2008. This is a significant mark down. However, MENA is expected to be less impacted by the global recession than most other developing regions, notably Eastern Europe & Central Asia, and East Asia & Pacific.

The impact of the crisis goes beyond economic aggregates. In some countries, households and workers are being impacted directly. For example, Egypt's quarterly growth fell to 4.1% in Dec 08 (compared to 7.7% previous year) and job creation fell by 30% (unemployment rose to 8.8%). Due largely to the cancellation of several construction projects in Dubai and the resulting job loss, it was reported that in March several hundreds of migrant workers left the emirate daily(Zoellick ,R,2009).

### **3. Islamic financial system**

#### **Introduction**

The repercussions and negative effects of the global financial crisis did not significantly affect the activities of Islamic banks as compared with other conventional banks, but in a limited level depending on the nature of the activity of the specific Islamic bank; as Islamic banks do not deal in default swaps and large speculation compared with European and American banks because these transactions are against Islamic Shariah and ungodly shall not be handled.

#### **Foundations Of Islamic Finance**

The Islamic financial system is rooted in the rules and norms of Islam, and in particular Shariah law, which emerges out of the Qur'an, and the sayings of Prophet Mohammed(PBUH) (Peace and Blessing Upon Him), the Sunnah(Tribute in Islam). In Shariah(law) there are two broad concerns that structure the practices of Islamic banking and finance and provide some points of contrast with conventional banking and finance. Firstly, interest (Riba) is viewed as exploitative and unfair in Islam. The prohibition of Riba does not mean that money may not be lent under Islamic law, but merely rules out what might be considered unearned profit. The provider of capital is not permitted to fix a predetermined rate of interest, but should be allowed an adequate return by having a financial stake in the project to be undertaken. That is why money is not considered a commodity in Islamic economics but rather a bearer of risk. The popular interpretation of Riba(usury) is that it is one and the same with the concept of Usury, and is therefore unlawful and forbidden. Instead of Riba the concept of profit and loss sharing is practiced; essentially the concept of sharing risk, as opposed to transferring it.Secondly, excessive risk or uncertainty (Gharar); Islamic financial institutions forbid investments into gambling, but also certain kinds of businesses, especially those involved with products which are regarded as Haram such as pork, alcohol, prostitution and unethical entertainment is unacceptable. Gharar is the ambiguity and uncertainty present in a contractual relationship, to the extent that it might provide one of the parties of a contract with an unfair advantage over the other. In Islamic financing, any contract undertaken where Gharar(uncertainty) exists is null and void. Gharar is also the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling (Mysir)( Ali, Amal El Tigani,2011). Another important factor in distinguishing Islamic financing is its emphasis on the trading of goods and services and its advocacy for profit and risk-sharing in businesses supported partnership arrangements. This stands in sharp contrast to the credit- or loan-based financing of conventional banks. By virtue of these characteristics, the Islamic banking and financial system offers prudent financing options, being asset-backed and equity-based. Islamic banking offers promising potential for providing all segments of the population with alternate avenues for saving and investment(Sami Tamer – 2005). Also Islamic Shariah discourages speculation and stresses the qualities of Islamic financing practices, which is asset based. A key aspiration in Islamic financing is a close coupling of the financial and the real economy. Islamic finance always encourages the financiers to invest in promising projects, to share profits and losses with

entrepreneurs and, in so doing, promote development. Money is to be tied to real (material) assets to make them grow. It cannot be used as a commodity nor be allowed to be used as collateral. It is worth to note that The Islamic banking and financial system allows risk management and provides confidence through the open disclosure and transparency of the roles and responsibilities defined in the Islamic laws of contract. In Islamic financing strategies to minimize and manage risk involve integrating such risk into real activities. In contrast, conventional banking and capitalistic financial system allows for the commoditization of risk, leading to proliferation through multiple layers of leveraging and disproportionate distribution. This may (indeed did) result in higher systemic risks, increasing the potential for instability and inequitable concentration of wealth (Mohammed Nurul Alam, 1995).

### **Principles of Islamic Financial System**

Awareness of Islamic Finance is rising and there is a universal demand for a fair and just system. Islamic finance represents financial activity that is consistent with the principles of Islamic law, which prohibits unethical, immoral, speculative activities including interest, gambling, and uncertainty. An Islamic bank is a banking business whose aims and operations do not involve any element disapproved by the law of Islam. While prohibitions are few and specific in nature, all other financial and contractual arrangements are open to negotiation. These prohibitions are :

- 1- Prohibition of usury.
2. Prohibition of sale of ambiguity and gambling.
3. Prohibition on dealing in the things religiously Forbidden (alcohol, adultery, etc.).
4. Profit and loss sharing.
5. Prohibition of securitization.

### **Islamic Banks and Globalization**

. That Islamic banks are able to achieve a significant competitive advantage on conventional banks, and as the globalization requires the liberalization of trade and banking, thus speeding up the process of competition in the domestic and international markets, the Islamic banks are able to cope with the risks of globalization through its profitability by monitoring and controlling and reducing operating expenses, in addition to the introduction of the Internet which is used to provide all banking services to its customers through accurate and sites to enhance the security market share growth in the local and international banks. The main reason behind the tumbling of stock indexes and high fluctuation of oil prices is that all world economies are based on usury.

No one expected that the greatest economic and military power in the world prone to collapse at any moment and will soon collapse because they are overwhelmed and have wronged most countries of the world, adding to that the prayers of oppressed or martyrs or the call of hungry person who has been boxed wrongfully and oppressed, and these wrongfully international investors must know that such dealings of greed that trade winning is with God rules. The Islamic banks were not exposed to aggregative effects caused by the global economic crisis as they were not dealing with financial instruments associated with the illegal and unethical methods, which do not fit the Islamic Sharia (law). In addition Islamic Banks lack the ownership of usury securities. However, Islamic banks though their financing they share the risks of the investing parties.

Despite the passage of more than 400 years on the western banking system, yet it lacks three important principles:

1. Policy of maintaining liquidity on the one hand and the real yield and profitability on the other hand.
2. Following rational policies to manage credit risk.
3. Capital adequacy so that the financial institution can face any doubtful or bad debts. While on the other hand Western banking institutions, investment ,and insurance companies have only focused on maximizing profitability based on greed and exploitation. On the other hand, the experience of Islamic banks did not exceed 40 years and have achieved great successes in the size of investment productivity to reach 2 trillion. It is worth to note that the Islamic economic system is might be a potential substitute and possibly an appropriate contemporary economic system..It is a Modern system takes investors away from interest risk and is built on the foundations of faith and funding based on real investment associated directly with real productive projects and not through phony financial investments.

Britain tended to start its first Islamic bank in 2004 by opening accounts in accordance with Islamic law where Lloyds TSB First Bank Classic in Britain became the first bank who started to open accounts for business in line with the principles of Islamic law, the bank aimed to attract thousands of entrepreneurs and owners of small and medium Muslims enterprises without the usury interest and the prohibition of gambling and financing liquor industry. There are two million Muslims in Britain, and the amount of money Islamic funds in Britain is in the range of 18 billion sterling pounds. On the global level, the volume of Islamic funds in 2008 amounted to about 3,500 billion dollars, and now in 2013 they are more than 4000 billion. The value of the Islamic finance industry for the year 2009 is estimated by a

trillion dollars and the estimates for the next three years until the year 2011 amounting to more than three trillion dollars, this is an opportunity to present the Islamic economic system to an alternative system of the contemporary economic systems. In the U.S., The volume of Islamic institutions are about 40 institution. These institutions have suffered any problems in U.S.A.as compared with other conventional U.S. banks. It is worth to note that in the program called: beyond the news ,presented by Al-Jazeera International Corporation on its 27/3/2009 session, The Vatican Pop has called for the application of Islamic finance system. in a bid to get out of the global financial crisis and restore the confidence in the Western banks.

#### **How Western Nations Look at Islamic financial system**

Dan Taylor, a British financial expert has published a research on the Sharia Banner(Al Sabil- Online Net) stating that Islamic banks are more attractive to investors because they with safe investments, have effective risk management, and provide greater capacity to cope with risks arising from liquidity shortages. Altman, a former board member at the collapsed Lehman Brothers Investments said that the future will be in the interest of Islamic banks in the light of the late in capabilities experienced by several major U.S. investment banks, given the alternative to Islamic banks.

In a statement to Gordon Brown the former British prime minister who was also the finance minister, has said that Islamic banks are safer and their portfolios are protected by real assets and yielding good on the economy, strapped projects are solid and strong, stressing that his country is keen to see London to be a financial center for Islamic banks, indicating that work is underway to enact legislations and laws to facilitate the achievement of this goal.

The Italian researcher Loretta Napoleoni crossed the belief that «Islamic finance can save the Western economy» she said in an interview with The Lucky Italian news «Islamic banks could become a suitable alternative to the traditional conventional ones of any Western banks. As with the collapse of the stock markets and loan crisis in the United States, the traditional conventional banking system appears to crack down.

French Senate announced that the banking system which depends on the rules derived from Islamic laws would be comfortable for all Muslims and non-Muslims. The French Senate demanded annexation of the Islamic banking system to the banking system in France, where it stressed that Islamic financial system is blooming and is applicable in France. In this sense to UAE, Dubai Islamic Bank, which was founded in 1975 Plans to establish the first legal consulting company in the world. It will be specialized in providing legal and financial services compliant with Islamic law and resolve problems faced by companies of the world. The Islamic banking system is a realistic alternative, and hopefully is the only financial system needed to rescue out of the ailing financial system from the current crisis, no doubt that the interest usury is the basis of fluctuations occurring in the capitalist economy and also to get out of this current crisis, as previously stated by imposing strict control by Central banks on all banking units, and reduce the administrative corruption at the top management of World monetary institutions. There are many senior Western economists, led by Keynes and his colleagues Simmons and Minsky concluded that the optimal and more efficient use of resource is when the interest rate gets to zero which is the same as Islamic economic system. Many calls began to override votes in the West, calling for the application of the foundations of the Islamic economy after the failure of the conventional economic systems (capitalist and socialist and mixed) to achieve a better life for mankind and for the exit as soon as possible out the dark tunnel.

#### **4. Voices in the West, which called for the application of the foundations of Islamic economics are**

1- Bovyis: editor of Challenger magazine : In an editorial, on 5/10/2008, entitled (the Pope or the Koran) that caused a tidal wave of controversy and reactions in economic circles.The writer questioned about the morality of capitalism and the role of Christianity as a religion and the Catholic Church in particular in devoting capitalism and to justify the interest leniency, pointing out that this bad economic behavior has claimed humanity into the abyss. Author has approached his cynicism to the church stand and petitioning the Pope Benedict XVI, via saying: I think we need more in this crisis to read the Koran instead of the Bible to understand what is happening around us and to our banks because if he tried to login our banks to respect what is stated in the Quran's teachings and the provisions and applied these themes to solve our financial crises and disasters caused by it. It worth to conclude that the money does not give birth to the money.

2- Roland Askin: editor of the newspaper (Le Journal de Finance):pointed out the need for the application of Islamic law in the financial and economic sphere to put an end to the crisis rocking the world markets as a result of the illegal manipulation of the rules dealing and excessive speculative practices. In his article, which was entitled: (Has Wall Street been qualified to embrace the principles of Islamic Sharia(law)?), Askin introduced the risks to capitalism

and the need to expedite the search for alternative options to save the situation, and made a series of exciting proposals in their forefront is applying the principles of Islamic law despite the conflict with Western traditions and religious beliefs.

3- Many confessions from wise economic Westerners to alert to the seriousness of the situation, which leads to replace the capitalist system with more liberal alternative options. These options are in their entirety seek the Islamic alternative. In her recent book, entitled (economy Jackal), the Italian researcher Loretta Napoleoni referred to the importance of Islamic finance system and its role in saving the Western economy, she considered that «the responsibility of the emergency situation in the global economy in which we live today as a result of rampant corruption and speculation that dominate the market, has led to doubling the economic defects», adding that «the balance in the financial markets can be reached through the Islamic finance system.

4- Napoleoni felt that Islamic finance is the most dynamic financial sector in the global financial world. She explained that the «Islamic banks could become a suitable alternative to Western banks, as with the collapse of the stock market these days and the loans crisis in the United States, the traditional banking system began to crack and needs profound radical solutions.

4-Since two decades, French Nobel laureate in economics Dr. Morris has referred to the structural crisis in the global economy, led by the savage liberalism; adding that the world economic situation is on the edge of a volcano, and ailing to collapse under the pressure of the multiple crisis (debt and unemployment). He suggested two conditions for the way out of this crisis and to restore balance. He postulated to modify the interest rate to zero limits and reviewing the tax rate to about 2%, which corresponds exactly with the abolition of usury and the percentage of Zakat (Islamic Tax) in the Islamic financial system.

6- The French Nobel laureate in economics Morris Alee referred to the structural crisis in the global economy, led by the savage liberalism, adding that the economic situation is on the edge of a volcano, and is threatening to collapse under the weight of the double crisis (debt and unemployment). He suggested out of the crisis and restore balance two conditions modify the interest rate to zero limits and reviewing the tax rate to about 2%, which correspond exactly with the abolition of usury and the percentage of Zakat in the Islamic system.

## 5. Japan's Experiment

Japan is the world's largest creditor nation, generally running an annual trade surplus and having a considerable net international investment surplus. As of 2010, Japan possesses 13.7% of the world's private financial assets (the 2nd largest in the world) at an estimated \$14.6 trillion. As the first nation to experience the zero bound in modern times, Japan was an early pioneer in developing unconventional tools and strategies. At the zero lower interest rate, risk management becomes extremely important. The major feature of the recent monetary policy in Japan has heavily relied on the so-called policy-duration effect. Even after short-term interest rates fall to virtually zero, a central bank can continue to ease monetary policy by committing to maintaining zero interest rates for a considerable period of time or to providing an ample monetary base to reduce short-term interest rates to zero. Japan has taught us that slashing rates to zero and beyond is a lot easier than returning them to normalcy. Japan is on its sixth central-bank governor since its bubble burst in 1990, and like his predecessors, Haruhiko Kuroda is doubling down on quantitative easing. Politicians, bankers, investors and businesspeople alike get addicted to free money all too easily and clamor for more. Japan's experience suggests very low rates to be going around for a long time. So researchers are asked to study how the nature of economics and capitalism will be altered by most Group of Seven nations maintaining zero-rate policies for another decade or more. The "liquidity trap" that deadens the benefits of monetary easing is morphing into a "stimulus trap," which is much harder to shake (Pesek, W., 2013).

### Japan's Zero bound and its Limits to monetary policy

zero bound, monetary policy encounters three constraints :

- 1- there are costs associated with non-conventional tools, which means they cannot simply be used without limit, though the appropriate limit will vary based on the outlook and balance of risks.
- 2- there is a limit on how far the expectations channel can be exploited, it isn't reasonable to expect that policies that affect expectations many years in the future will have a powerful impact today.
- 3- monetary policy is only one leg of the stool necessary to generate a vibrant and sustained economic expansion as the health of the financial system is critical. For without it, the monetary transmission, channels will be impaired and monetary policy will be less effective in influencing the cost and availability of credit.

### **Lessons from the Japanese experience**

- 1- Managing expectations is critical in the execution of monetary policy at the zero bound. This includes expectations about the central bank's objectives for inflation and the economy, and expectations about how the central bank will use its tools in the future to achieve these goals.
- 2- In managing expectations, good communication is essential. Expectations will not be well anchored when communications are muddled or inconsistent, or when a central bank acts in ways that are not consistent with its guidance.
- 3- Actions speak louder than words alone. Thus, there is an important role for asset purchases that ease financial conditions to support growth and keep inflation expectations well anchored.
- 4- Policy instruments interact so that policy as a whole exceeds the sum of its parts.
- 5- At the zero lower bound, risk management becomes extremely important. In particular, because the costs of getting stuck in a liquidity trap with chronic deflation are high, a central bank should put substantial weight on avoiding this outcome.
- 6- Constraints imposed by the zero bound limit what monetary policy can accomplish by itself. This increases the importance of complementary fiscal, financial, and structural policy actions. Credible fiscal policies, actions to ensure a healthy financial system, and structural reforms that lift the potential for growth are very important(Dudley,W.,2013).

### **6. Previous Studies :**

**Hoshi,T,et al**, have explored the idea that financial distress is costly because free-rider problems and information asymmetries make it difficult for firms to renegotiate with their creditors. researchers presented evidence that Japanese firms with financial structures in which these problems are likely to be small perform better than other firms after the onset of distress. In particular, they showed that firms in industrial groups and with close financial relationships to their banks, suppliers, and customers invest more and sell more after the onset of distress than nongroup firms. They found similar results for nongroup firms that nevertheless have strong ties to a main bank(**Hoshi,T,et al,1990**).

Adamu,A, examined the influence of the Global Financial Crisis on Nigerian economy. It was discovered that the financial crisis will cause fall in commodity prices, decline in export, lower portfolio and FDI inflow, fall in equity market, decline in remittance from abroad etc. It was recommended that the federal government should come up with intervention policies that will minimize these effects and jumpstart the economy and that business operator should learn to do things using resources at their disposal to develop and expand at manageable level to stem the tide of the crisis(Adamu,A,2011).

Dash,A. and Mallick,H examined whether contagion effects exist on Indian stock market, during the current financial crisis originated from the US. Researchers used stock returns in BSE and NASDAQ as representatives of Indian and US markets respectively. In order to recognize the contagion effect, they tested whether the mean of the DCC coefficients in crisis period differs from that in the pre-crisis stable period. The identification of break point due to the crisis is made by Bai-Perron (1998, 2003) Structural break test. Empirical findings show that there has been a significant increase in the mean of correlation coefficient between the markets in the crisis periods compared to the pre-crisis period. This proves the existence of contagion between the US and Indian markets and urges to find the channels of the contagion effect..

Bernanke,B et al, studied the success in reducing inflation and, consequently, the average level of nominal interest rates has increased the likelihood that the nominal policy interest rate may become constrained by the zero lower bound. So the central bank would rely on "non-standard" policies . To assess the potential effectiveness of such policies, researchers analyzed the behavior of selected asset prices over short periods surrounding central bank statements and estimated the non arbitrage models of the term structure for the United States and Japan. There was some evidence that central bank communications can help to shape public expectations of future policy actions and that asset purchases in large volume by a central bank would be able to affect the price or yield of the targeted asset(Bernanke,B et al,2004).

Bowman,D.,et al examined the effectiveness in promoting bank lending of Quantitative Easing Policy (QEP), of the Bank of Japan's injections of liquidity into the interbank market., Researchers identify a, positive, and statistically significant effect of bank liquidity positions on lending, suggesting that the expansion of reserves associated with QEP likely boosted the flow of credit. However, the overall size of that boost was probably quite small due to : 1- the estimated response of lending to liquidity positions in our regressions is small. 2- much of the effect of the Bank Of

Japan's reserve injections on bank liquidity was offset as banks reduced their lending to each other. 3- the effect of liquidity on lending appeared to have held only during the initial years of QEP. Bank Of Japan has opposed inflation targeting, with economists in the Bank arguing that there are no clear instruments to get out of deflation, and a mere announcement without instruments would not convince market participants to change their inflation expectations. But, others in the bank have suggested that the commitment to keep the zero interest rate policy until the inflation rate becomes stably above zero has similar effects to inflation targeting(Ito,T.,& Mishkin,F.,2006).

Okina,K.,& Shiratsuka,S have analyzed the behavior of Japan's yield curve and examined the effectiveness and limitations of monetary policy commitment under zero interest rates in the sample period we use (from March 1998 to February 2003). The policy-duration effect was found to be highly effective in stabilizing market expectations for the path of short-term interest rates, thereby reducing longer-term interest rates and flattening the yield curve; however, it failed to reverse deflationary expectations in financial markets. Monetary policy alone is unable to reverse deflation, when coupled with low economic growth(Okina,K.,& Shiratsuka,S,2004).

Oda N.,&Ueda,K conducted an empirical investigation of monetary policy in Japan in the zero interest rate environment that has held sway since 1999. Researchers focused on the

effects of the zero interest rate commitment and of quantitative monetary easing on medium- to long-term interest rates in Japan. In the study we apply a version of the macro-finance approach, involving a combination of estimation of a structural macro-model and calibration of time-variant parameters to the yield curve observed in the market. Researchers decomposed interest rates into expectations and risk premium components and simultaneously extracted the market's perception of the Bank of Japan's (BOJ's) willingness to carry on its zero interest rate policy. Researchers tentatively concluded that the Bank Of Japan's monetary policy since 1999 has functioned mainly through the zero interest rate commitment, which has led to declines in medium- to long-term interest rates. They also found some evidence that, up until the end of

2003, raising the reserve target may have been perceived as a signal indicating the BOJ's

accommodative policy stance although the size of the effect is not large(Oda N.,&Ueda,K,2005).

Hoshi,T., and Kashyap,A. Found that During the financial crisis that started in 2007, the U.S. government has used a variety of tools to try to rehabilitate the U.S. banking industry. Many of those strategies were also used in Japan to combat its banking problems in the 1990s. There are also a surprising number of other similarities between the current U.S. crisis and the recent Japanese crisis. The Japanese policies were only partially successful in recapitalizing the banks until the economy finally started to recover in 2003. From these unsuccessful attempts. Researchers derived eight lessons. In light of these eight lessons, we assess the policies the U.S. has pursued. The U.S. has ignored three of the lessons and it is too early to evaluate the U.S.policies with respect to four of the others. So far, the U.S. has avoided Japan's problem of having impaired banks prop up zombie firms (Hoshi,T., and Kashyap,A,2010).

## **7. Islamic financial system is the key to the solution of the global financial crisis:**

The Islamic economic system is a totalitarian system features itself out from other systems such as capitalism and socialism and mixed economy, The provisions of the Islamic economic system include the present life and the hereafter. Islam calls for to the application of the economic system, which emphasizes the development of money and invest it in the forms of welfare and the common good, and prohibits monopoly ,compactness, greed, and prohibition of interest on Islamic laws and regulations and once western economists are convinced with this solution, they would welcome it and apply it quickly as it saves them from drowning in the financial loss. Once this plan succeeds in resolving the crisis it will convince the Western economists and investors to consider the application of Islamic financial laws and might extend to other areas such as criminal, inheritance ,and others. There is a Quranic appeal by great Almighty, saying:( O, People of the Bible our Messenger has come to show you much of what you are hiding of your book and he forgives you much.Brigh light has come to you from God, and the book is clearly shown Where Allah(God) would bless his followers and gives his good pleasure to ways of peace and get his followers out of darkness into the light with his permission, and guide them to the straight path (verse: 15-16,Sourat Al Maida]. The Islamic economy is able to resolve all the previous financial crises that have been mentioned in this study; as well, it is also able to resolve the new financial crisis that emerged in 2008, by relying on the principles and foundations of the Islamic financial system:

1. Islamic themes call investors to stay away from usury and Forbidden Transactions such as monopoly and compactness of money and encourage companies through sales, and the application of the economy without usury in financial transactions.

2. Islamic rely on formulas to the real estate and the sale of Murabaha(profitability) and post Bittamleek(ownership), this formula has been applied where the American Finance House away from usury and strict adherence to the provisions of the Islamic Sharia(law).

3. The application of the securitization process according to Islamic law so that it does not rely on the sale of religion to religion, but will depend on the assets in kind already exist and can also be securitized debt when construction, relying on instruments of peace and istisna(manufacturing) and Murabaha.

4. The development of a global accounting controls to review the operations of banks and financial institutions with the intensification of the role of the state in control in the context of economic freedom restricted Halal and Haram so that justice prevails and rejects injustice and exploitation, and non-infringement because the money is the money of God and human beings trust worthier of this money directed to what pleases God in the service of preachers of God.

5-To limit the deals with derivatives as it lead to double the debts and obligations, and use Islamic formats in dealing such as Salam(a derivative) and clear all the financial markets from forbidden commodity practices and to refrain from practicing the modern methods such as derivatives and means that do not conform with Islamic law such as the short selling,forwards,and futures deals, margin trading ,trading currencies on credit and to hedge funds owned by the wealthy only. Also refrain from investment by borrowing because they depend on the rate of interest (usury), illegal gambling and all financial practices that are contrary to the provisions of Islamic Sharia (rules).

6- To peer application in word and deed: Economy ethics and the application of the spirit of Islam.In the early ages the ethics of Muslim merchants had attracted many nations and countries to convert to Islam, such as Indonesia and East Asia in general. Prophet Mohammed, The Messenger of Allah( peace be upon him and grant him salvation) says as narrated from Abu Hurayrah(an early follower): «I am but sent to complete favor of morality». The Islamic economy is no guile or tricked or unfairness or gamble or bet or a monopoly, but the sincerity and honesty and earn halal.

The bottom line is that there is a vast and large difference between distinguished Islamic economy system and other conventional economic systems, namely capitalism, socialism. It is worth to note that the most important characteristics of the Islamic economic system is the set of rules that ensure the security and stability of financial transactions and the minimal rates to risk exposure as compared with rules that are available under the capitalistic system. It is clear that the Islamic economic system is based on moral values and regulations that deny fraud ,gambling, and monopoly. in addition, the Islamic economic system is also based on the principle to participate in the profit and loss during the carrying out of buying and selling. Its rules are governed by Shariah(Islamic law). As well the Islamic system prohibits all kinds of fictitious business operations and securitization (selling debt through issuing stocks).Islamic system includes many facilitative rules that prevent forcing debtor to fulfill compulsive disorder. Islamic law embodies the law of Islamic banking which prohibits interest contracts and transactions that are uncertain, while it advocates acceptance of risk-sharing, profit sharing and encouraging ethical investments that benefit the community. The Islamic legal theory with respect to public and private spending requires that a consumer spending and investment should be based on production and the prohibition of securitization principle, which includes sales of non-real debt.

## **8. Conclusions and Recommendations:**

### **Conclusions**

What distinguishes the latest global financial crisis that it has spread quickly to all countries of the world, without exception. This crisis has caused panic and great fear for investors and speculators and caused increases in unemployment rates in many countries of the world. The recession began to appear in a large number of countries where wealth's have been eroded and bankruptcies occurred in a large number of countries in the world. It is worth to note that the negative effects of the global financial crisis and its impact on Islamic banks was very weak as compared with other conventional banks scattered throughout the world. However, The three contemporary conventional economic systems have failed to introduce any optimal solutions or acceptable exits. In this sense there must be an optimal outlet for this crises through the application of Islamic economic system. On these basis, what is required of us as financial theorists and economists is to take this opportunity and campaign for Islamic Financial System. In this regard, Financial scholars and economists in the Muslim world should cooperate in partnership with all organizations and Islamic governments to make a plan to solve the late economic crisis and to present a solution based on Islamic principles.

## Recommendations

There are several measures to gradually reduce this financial crisis can be summarized as follows:

1. Not to deal with interest as a means of investment.
2. To implement corporate governance in a rational way to protect investors and bridge the gap between the company's board of directors and the executive management in the sense of having transparency and accountability for any financial and other errors.
3. Setting realistic Legislations to ensure stability and protection of the market and to ensure greater confidence for savers and investors and bank management.
4. Commitment and militancy in the application of control standards as they are the guarantee for the market efficiency, investor and dealers rights alike.
5. Securities Authority in each country is required to supervise the application of tools and foremost accurate financial rules.
6. Achieve safety and security and to provide an appropriate environment for the domestic and international investors.
- 7- . The establishment of specialized departments to control and manage risks. Subordinates of these departments should report directly to the Risk Management Committee of the Board of the company's management.
- 8- Governments should provide insurance on bank deposits to protect savers from any future risks.
- 9- Governments should help troubled financial institutions to merge with other financial institutions.
- 10- Activating the role of the government's financial role through applying the principle of intervention to regulate and control the financial market mechanisms and the behavior of its players.

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