

Western capitalism. Islamic finance is a system based in shari'ah law. Central principals include a prohibition against charging interest and a code of ethics for investments – for example, barring investments in prostitution. Napoleoni said these principals are actually quite similar to the principles of classical economics. Though the concept was first raised in the 1950s, it didn't take off until the 1970s, when the oil crisis brought the necessary capital to oil producing countries. "Islamic finance is the product of two major crises of Western capitalism, the 1973-74 oil crisis and 9/11. And it is almost ironic that this system could help us to get out of the current crisis."

One thing Napoleoni said the West can learn from Islamic finance is to balance profit with social responsibility. "A bank should be a profit organization, but the moment in which social role is forgotten and the profit role takes over, then a bank is actually working against the people who are putting their money into the bank, the clients. Now that, of course, in Islamic finance could not happen, because there is this partnership between the client and the banks. There is a social commitment within finance which we had before, but we lost it."

Another lesson from the Islamic system is striking a balance between flexibility and oversight. All Islamic bonds must be approved by a committee of scholars and bankers. At the same time, the bonds can be used to finance anything within the limits of shari'ah law.

Napoleoni said developing a new model based on Islamic finance may be the solution to the current economic crisis. "It is a crisis of confidence, and the solution is to bring back the confidence. But how do you bring back the confidence to a system which is based basically on a pyramid scheme? And this pyramid is collapsing."

"I really think that we are at a junction, and this junction could be very positive for us," she said, "We've got to be open-minded if we want to carry-on going ahead. Otherwise we'll get stuck, and otherwise we'll really be in a serious crisis, and then something new will come only from the ashes of what we have constructed before."



The University of New Mexico's International Studies Institute sponsored on Oct. 20, 2008 Dr Loretta Napoleoni's lecture on "The Global Financial Crisis," as the keynote of ISI's lecture series, "Global Instability: Causes, Consequences and Cures." The talk was based on her book *Rogue Economics*. We are reproducing with her due permission & acknowledgement, the extracts of this talk posted at University of New Mexico's website. Ed.

### The Crisis

"This is the major crisis that Western capitalism is facing since 1929," said the economist Loretta Napoleoni. Napoleoni traced the current crisis to a shift from "a nation state to a market state" – that is, from a focus on the welfare of citizens to growth of business. "Now, what is happening today, the credit crunch, is actually linked to the fact that this state did not regulate finance for fifteen years."

She also attributed some of the severity of the crisis to the war on terror. "The war on terror... turned out to be a total financial folly. And part of the problem of what we are facing today – not that it created the credit crunch, absolutely not, but it weakened the defenses of the American economy to deal with a crisis like that."

She said that financial regulations in the Patriot Act led international investors to get out of the dollar and invest in other currencies. "What's happened after 9/11 is that the tough regulations imposed by the monetary authority, coupled with the suspicious attitude that the US had toward Muslim investors, convinced many investors from oil countries to repatriate their funds."

Explaining the concept of rogue economics, Napoleoni said, "In times of great transformation, economics moves much faster than politics, and politics can't keep pace with the economy. And it is in these particular circumstances that the economy becomes a rogue force." She suggested that while these circumstances can lead to great destruction, as with the fall of the Roman Empire, they can also lead to great progress, as with the industrial revolution.

### The Solution

Napoleoni said there are some differences between the current crisis and the Great Depression that make her optimistic. One difference is the presence of relatively stable economic systems outside of

swaps markets, suffered a liquidity crisis and the two US investment banks, Goldman Sachs and Morgan Stanley were converted to bank holding companies. The US Senate on October 1, passed \$700 billion bailout bill plan. Federal Reserve Board on October 6 announced to provide \$900 billion in short-term cash loans to banks and on October 7 made emergency move to lend around \$1.3 trillion directly to companies outside the financial sector. The Internal Revenue Service (IRS) relaxes rules on US corporations repatriating money held overseas in an attempt to inject liquidity into the US financial market. Central banks in USA, England, China, Canada, Sweden, Switzerland and the European Central Bank cut rates in a coordinated effort to aid world economy. On October 11 Dow Jones Industrial Average capped its worst week ever, with its highest volatility day ever recorded in its 112 year history. Paper losses on US stocks totaled \$8.4 trillion from the market highs of 2007. The US declared injection of \$250 billion of public money into US banking system.

The G7, a group of central bankers and finance ministers from the Group of Seven leading economies, met in Washington and agreed to urgent and exceptional coordinated action to prevent the credit crisis from throwing the world into depression, however, the G7 did not agree on the concrete plan that was hoped for. The leaders of the 20 of the world's largest economies met in Washington DC and agreed to cooperate with respect to the global financial crisis and to support and reform the international economy. On November 25 the US Federal Reserve pledged \$800 billion more to help revive the financial system. On December 1, the National Bureau of Economic Research officially declared that US economy had entered recession in December 2007. President elect's team is already working for a \$ 1 trillion worth economic stimulus plan.

The capital Markets so far lost \$30-35 trillions in 2008. Real estate also lost \$30-35 trillions. Financial institutions lost \$3+ trillions. It prompted a substantial injection of capital into financial markets by the United States Federal Reserve, Bank of England and the European Central Bank. The British government launched a 500 billion pound bail out plan aimed at injecting capital into the financial system and nationalized most of the financial institutions in trouble. Many European governments followed suit. Central banks of several countries so far have injected \$8+ trillions. Just to understand the size of the crisis compare the impact of present crises in one year which is around \$80 trillion with the total Insured catastrophe losses (earthquakes, tsunamis, man-made disasters etc.) between 1970 to 2007, which were only \$745 billions.

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## THE GLOBAL ECONOMIC CRISIS AND ISLAMIC FINANCE

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### Introduction

The global financial crisis began in July 2007 with a liquidity crisis in the United States due to loss of confidence of investors in the value of securitized mortgages. TED spread, an indicator of perceived credit risk in the general economy, spike up in July 2007, remained volatile for a year, then spiked even higher in September, 2008, deepening the crisis, as stock markets worldwide crashed and entered a period of high volatility, and a considerable number of banks, mortgage lenders and insurance companies failed, including the two United States Government sponsored enterprises (GSEs), Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), which were placed into conservatorship run by FHFA. Beginning with bankruptcy of Lehman Brothers on September 14, 2008, the financial crisis entered an acute phase marked by failures of prominent American and European banks. Merrill Lynch was purchased by the Bank of America, the American International Group (AIG), a significant participant in the credit default

\* Loretta Napoleoni is an economist, journalist, and author whose books include: *Modern Jihad: Tracing the Dollars Behind the Terror Networks* (Pluto, 2003); *Terror Incorporated: Tracing the Money Behind Global Terrorism* (Penguin, 2004) and *Rogue Economics: Capitalism's New Reality (Seven Stories, 2008)*. She has served as a Fulbright scholar at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies in Washington DC and a Rotary Scholar at the London School of Economics. An expert on financing of terrorism, Loretta advises several governments on counter-terrorism. She is senior partner of G Risk, a London based risk agency.