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Post-Crisis Political Economy: Neoliberalism or Islamic Alternative?

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Abstract

The global financial crisis that unfolded since the end of 2006 has shaken the very foundation of the Western free-market economic system. Its fundamental regulatory principle of the separation of state and market is now seriously discredited. The objective of this article is to argue that the economic principles of Islam can provide a better alternative to the free-market system. Firstly, an Islamic economic system is highly integrative where the purpose and interest of the state and the individual citizen overlap and are complimentary to each other. So, market and state are rather inseperable in Islamic political economy. Secondly, the free-market system is fundamentally oriented to the philosophy of unlimited consumption, that is – greatest number produces greatest happiness, which demands production and appropriation of resources beyond needs. But the Islamic economic philosophy puts restrictions on unnecessary consumption, thereby capping competition over resources. These two essential principles in Islamic political economy are highly interdependent on state and individual agency of a human being. Therefore, once the economic needs and purpose of the state and the individual citizen are properly enmeshed, it produces a balanced market system. Islamic political economy has moral regimes and instrumental structure for economic behavior that reinforce each other.

Keywords: global financial crisis, neoliberalism, New Financial Architecture, Islamic financial system

1. Introduction

The recent US and global financial crisis has jolted the very foundation of the New Financial Architecture (NFA). The NFA is built on the philosophy of liberalism which originated in the UK in the eighteenth century, and became institutionalized in the post-World War II international economic system. The basic philosophy of liberalism is separation of the state and the market where the market is left alone on its natural forces of demand, supply and price that work as regulatory regimes. Any imbalance created in their relationship is to be counter-balanced by the "invisible hand" of the human nature of cooperation. After the end of the Cold War, 'market economy' was formalized through "Washington Consensus" which advocated policies to reduce inflation and fiscal deficits, privatization, deregulation, and open market economy. This meant the market was to be separated completely from the state. The system that emerged came to be known as the New Financial Architecture (NFA). However, the recent financial crisis has forced many staunch advocates of the free market economy to heavily intervene into the market abandoning the non-interventionist policy of NFA. Does this mean an end of the free market economy and the NFA? Does it indicate a need for fundamental rethinking of the Western free market economic ideology?

This article argues that utilitarianism as the basic and fundamental philosophy of the Western market mechanism is faulty. Utilitarianism frees individuals from the state control which produces incompatibility between individual, market and state- the three fundamental institutions of political economy. The paper argues that the philosophy of Islamic political economy is far better than utilitarian liberalism because it creates a balance between these institutions which can ensure stability in political economy.

2. Theoretical Approach

Institutionalism is a popular theory in social sciences. Its application is across the board including political science and economics. Ushering a path braking approach against behavioralism and rational choice, March and Olsen (1984) presented the theory of institutionalism arguing that individuals are always parts of greater institutional frameworks and they behave according to institutional rules and prescriptions. This fundamental argument has been subsequently elaborated by many in political science (March & Olsen 1989; 1994; Brunsson & Olsen, 1993; Olsen & Peters, 1996) and economics (North, 1990; Alston, Eggerston & North, 1996; Khalil, 1995).

Since its origin, the theory has taken various shapes according to the approaches it has been looked at. Peters (1999) has identified at least seven approaches to institutionalism which are normative (March & Olsen, 1984), sociological (DiMaggio & Powell, 1991; Scott, 1995; Zucker, 1987), international regimes (Rittenberger, 1993), interest groups (Knoke, Pappi & Tsujinaka, 1996; Kickert, Klijn & Koopenjaan, 1997), historical (Steinmo, Thelen & Longstreth, 1992), rational choice, and empirical. This variation is indicative of the fact that the term means differently to different scholars.

The most famous of these approaches is normative institutionalism advanced by March and Olsen in a series of studies (1984; 1989; 1996). They argue that the best way to understand political behavior is through a "logic of appropriateness" that individuals acquire through their membership in institutions. They contrast this normative logic with the "logic of consequentiality that is central to rational choice theories" (Peters 2000: 2). According to March and Olsen individuals' behavior is shaped by normative standards of the institutions with which they are attached and tied to instead of human desire to maximize individual utilities. In such an institutional setting human behavior is reflected in collective form rather than individual unit. The institutions are social repositories of norms, rules and values which the individuals acquire through membership and inculcate through social interactions and engagements. According to March and Olsen, human behaviors take shape of 'appropriateness' to the overall institutional environment rather than the concern of utilitarian 'consequentiality' of individuals' actions.

Another approach that is relevant to analysis in the article is historical institutionalism. The argument of this approach is "that the policy and structural choices made at the inception of the institution will have a persistent influence over its behavior for the remainder of its existence" (Steinmo, Thelen & Longstreth, 1992). This approach is akin to "path dependency" theory in political science and international political economy which explains the stability and persistence of rules and policies.

This theory of institutionalism can explain the fault lines in free-market capitalism displaying how the separation between state, individual and market distorts market mechanism leading to market failure. The theory of institutionalism can be used to explain both conventional and Islamic approaches to international political economy.

3. Genesis of the Crisis: Sub-prime Default to Credit Crunch

The immediate source of the crisis is thought to have originated in the housing industry in the USA (Sowell, 2010). The US financial institutions such as commercial and investment banks, insurance companies and credit organizations lent billions of dollars in *sub-prime lending* to the so-called Ninja mortgages – no income, no job or assets, or the borrowers having no or little creditworthiness (Shiller, 2008). With interest rates at historic low in 2004, loans against the Ninja mortgages skyrocketed as individuals and institutions were eager to purchase overvalued assets. Forced by competitive pressures to generate higher profits, many banks heavily underpriced risks in lending. Many of these mortgages were bought and subsequently used by the ingenious financial institutions to create new complex instruments like Collateralized Debt Obligations (CDOs), which helped them hide many of the risks away from their balance sheets and from rating agencies and regulators. Financial institutions also issued Credit Default Swaps (CDS's) to insure these CDOs (Morris, 2010). But in the same year, interest rates began to rise pushing the real estate prices down. Consequently, towards the end of 2006 the Ninja borrowers began to default on the mortgage payment, creating a cascading chain of losses for financial institutions that held CDOs and/or issued CDS's leading to sub-prime default crisis (Foster and Fred, 2009). The lending institutions registered billions of dollars in loss. In

February 2007, the US operation of the HSBC sacked top chiefs due to mushrooming of the sub-prime debts, and on April 2, the New Century Financial, the second largest sub-prime lender, filed for bankruptcy.

By mid-2007, financial institutions began to foreclose their debt related losses causing panic for the lenders. On July 19, 2007, the U.S. Federal Reserve chairman declared that the sub-prime crisis could cost $100 billion, sending a shockwave into the money markets around the world. Giant financial institutions such as Bear Stearns, Citigroup, and Goldman Sachs began revealing their losses alerting the market about consequences of further lending. Since mid-2007, financial institutions virtually stopped lending as they were registering billions of dollars in loan defaults. This led to a situation in which there was a lack of funds available in the credit market, or the creditors were unwilling to lend anymore, making it difficult for borrowers to obtain financing. This situation was called *credit crunch* (Timeline, 2008; Krugman, 2009; Roubini & Stephen, 2010).

4. Global Extent of the Crisis

In today's world, financial institutions are highly interdependent. They invest in other institutions, buy up shares and own stakes in other corporations, make portfolio investment in the share and stock exchanges around the world. Therefore, a crisis in one institution has a contagious effect on others. This is how the US credit crunch affected other large economies especially in Europe and other developed countries. In the US, by November 2008, as many as 24 banks and a number of giant multinational corporations such as Merrill Lynch and Lehman Brothers in the US were liquidated, and some other institutions have been bailed out by the government.

The second hard hit region is the European economies. The UK, Germany, Norway, Denmark, the Netherlands, Iceland, France, Spain, Italy and many other countries have injected billions of dollars into the market, nationalized private banks and institutions and ensured private depositors. Table 1 lists the top 23 institutions in the American and European economies that have been seriously affected.

Many of the developed countries including the US, the UK, Germany, Spain, Japan and Singapore have officially entered recession. Non-Western economies have not been directly hurt by the crisis, though major stock exchanges in India, South Korea and Mexico have tumbled seriously. The aftermath of the crisis loomed a long shadow on the growth performance of the developing countries in the subsequent years (Alcorta & Nixson, 2011; Terazi & Secil, 2012).

Table 1. Major countries and companies affected by the crisis

Countries	Companies
USA	HSBC (US), New Century Financial, Bear Stearns, American Home Mortgage Corp., Countrywide Financial, Merrill Lynch, Citigroup, Carlyle Capital, Wachovia, Freddie Mae and Fannie Mac.
UK	Northern Rock, Barclays, Alliance & Leicester, Royal Bank of Scotland
Germany	Hypo Real-Estate
Iceland	Kaupthing, Landsbanki, Glitnir
Switzerland	United Bank of Switzerland (UBS)
Netherlands	Fortis
France	BNP Paribas, Societe General

Source: Prepared by the author from various sources.

5. Response of the Free Market Economies to the Crisis

The most interesting aspect of the crisis is the response of the Western free market economies to overcome the shock. The neoliberalist West has consistently forced the Third World countries to adopt market economy to qualify for financial support from the Western countries and international institutions such as the World Bank and IMF. Even during the devastating Asian financial crisis in the late 1990s, the Western countries, the World Bank and IMF severely criticized Malaysia's "Mahathirism," or its interventionist policies in the market. They made democratization and market economy as strict pre-conditions for non-Western countries to enter the World Trade Organization (WTO).

However, despite their strict position on the principle of market economy, the Western governments have acted contrarily, and in the fashion of "Mahathirism" during the recent crisis (Pesek, 2008). Elliott (2011) has described the response in the follwoing terms:

> The winter of 2008-09 saw co-ordinated action by the newly formed G20 group of developed and developing nations in an attempt to prevent recession turning into a slump. Interest rates were cut to the bone, fiscal stimulus packages of varying sizes announced, and electronic money created through quantitative easing. At the London G20 summit on 2 April 2009, world leaders committed themselves to a $5tn (£3tn) fiscal expansion, an extra $1.1tn of resources to help the International Monetary Fund and other global institutions boost jobs and growth, and to reform of the banks. From this point, when the global economy was on the turn, international co-operation started to disintegrate as individual countries pursued their own agendas. 9 May 2010 marked the point at which the focus of concern switched from the private sector to the public sector. By the time the IMF and the European Union announced they would provide financial help to Greece, the issue was no longer the solvency of banks but the solvency of governments."

The US, the UK, Germany, Iceland and many other OECD member countries have come forward with billions of dollars in rescue packages to bail out private companies. The US

offered $700 and $800 billion in separate rescue packages, respectively, in September and November 2008. This is in addition to bailing out some of the largest companies such as the AIG, and Freddie Mac and Fannie Mei. In the European economies, the UK has nationalized the Royal Bank of Scotland and injected $850 billion to partially nationalize seven other banks (Perry, 2008). Iceland has completely nationalized four of its largest banks, while Germany and Benelux countries have nationalized the Hypo-Real Estate and Fortis, respectively (Capell, 2008; Wilson, 2008). The non-Western developed economies also acted similarly. For example, Japan injected more than $100 billion into the economy; Australia $2.4 billion; Hong Kong $200 million, and Taiwan $3.6 billion (Zachariahs, 2008). According to the Government Accountability Office (GAO) of the United States, the estimated total loss incurred from the crisis is $22 trillion (Financial crisis…2013).

Serious debate over such a protectionist or socialist-like policy did not gain any momentum because of the fear of a bigger worldwide economic catastrophe. Even leading liberal economists such as Paul Krugman and Joseph Stiglitz have endorsed such part-nationalization path through "equity injection" saying: act now, think later. Joseph Stiglitz observed, "[W]e had become accustomed to the hypocrisy. The banks reject any suggestion they should face regulation, rebuff any move towards anti-trust measures – yet when trouble strikes, all of a sudden they demand state intervention: they must be bailed out; they are too big, too important to be allowed to fail" (Stiglitz, 2008). This appears to be a devastating blow to the free market economic system (Sorkin, 2009).

6. What is Wrong with the Market Mechanism?

The modern neoliberal economics is based on the classical liberalism of Adam Smith, David Ricardo and others. However, the neoliberal philosophy is very much contaminated by the moral danger that the classical liberalists warned against. For example, Adam Smith (1999[1776]:88) cautioned that:

> The interest of the dealers… in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they naturally would be, to levy, for their own benefit, an absurd tax upon the rest of their fellow-citizens… It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

This warning refers to the moral dimension of the market economy in the absence of strong regulatory authority. The economic and financial systems are much more advanced today than any period in the past. In the same way state and financial institutions are much well-ordered,

sophisticated and systematic with carefully craved rules and regulations. Yet despite the presence of such developed institutions and systemic mechanism, the market failed dramatically to the extent of historic Great Depression. The question is why?

Observers believe that there are a number of reasons that have corrupted the market mechanism. Some believe that the entire NFA is deeply flowed as a system. Crotty (2008: 3) has argued that there are five fundamental flows in the system, which are:

> "1) the theoretical foundation of the NFA – the theory of efficient capital markets – is very weak and the celebratory narrative of the NFA accepted by regulators is seriously misleading; 2) widespread perverse incentives embedded in the NFA generated excessive risk-taking throughout financial markets; 3) mortgage-backed securities central to the boom were so complex and nontransparent that they could not possibly be priced correctly; their prices were bound to collapse once the excessive optimism of the boom faded; 4) contrary to the narrative, excessive risk built up in giant banks during the boom; and 5) the NFA generated high leverage and high systemic risk, with channels of contagion that transmitted problems in the US subprime mortgage market around the world."

There are a number of points made very clear in these reasons. First, the current financial crisis is a slap of the separation of state and market where regulatory independence of the market has created a greedy profiteering tendency in the financial institutions ('dealers' in Adam Smith's term) that wanted to make unscrupulous profits (Gorton 2010). These institutions manipulated the market-play through unsound speculation, overvaluation of properties, and untraceable hedge funds in the absence of proper regulatory regimes. These are driven by the utilitarian ethics of unlimited accumulation of wealth and profit to insatiable demand. It is in the sense that the interest of the institutions overtaken that of the market or public (Friedman, 2012; Allison, 2012; FCIC 2011).

Second, the natural human greed for unlimited wealth is intoxicated by the opportunity of easy credit and the prospect for infatuating profit. The fundamental market ethics being utilitarianism, the individuals and market believed in the philosophy of unlimited consumption and spending. The real estate boom in the USA was a direct consequence of such individual greed of consumption. It was again made possible by the near no-interest credit supply from the banks and financial institutions. The greed of consumption was thus fueled by easy access to credit (Krager, 2012; Schiller, 2012, Jenkins 2012).

Thirdly, the transaction of capital, properties and portfolio investments were in most cases completed against either virtual or speculative or non-existence of the real properties. Individuals and institutions traded properties on speculations while the ownership remained fluid and untraceable. This was aided, strengthened and institutionalized by sub-prime lending, CDOs and CDS. The result was that transactions were taking place, monies were circulated and consumed, yet the real existence of the properties remained non-existent (Friedman & Kraus, 2011; Kolbe 2010).

And, finally, the lack of a regulatory regime that underscores the responsibility of the market

players and hold them accountable for adverse effects of competition on the public played an important role in the market failure. The liberty extended to the market to play on its own separated it from state control. The financial institutions wanted to make bigger score at low transaction cost and regulatory risk of being held legally accountable for any default or breakdown. In other words, the infatuation of greed made the institutions and individual players immune from moral and legal consequences (Foster & Magdoff, 2009; Davies, 2010).

In the wake of the current crisis, many suggest a reshuffling of the operating mechanism of the international economy, especially the World Bank and IMF, and look for a new paradigm of financial system (Soros, 2009). This appears to be unavoidable at this juncture. Experts have suggested various solutions to the problem emphasizing the need for greater and tighter control and surveillance mechanism. The former head of the IMF Horst Kohler suggested that:

> The only good thing about this crisis is that it has made clear to any thinking, responsible person in the sector that international financial markets have developed into a monster that must be put back in its place. We need more severe and efficient regulation, higher capital requirements to underpin financial trades, more transparency and a global institution to independently oversee the stability of the international financial system. (*Financial Times*, "Kohler attacks markets 'monster.'" May 4 2008).

Similarly, James Crotty has suggested that "radical regulatory reform adequate to its difficult task requires two substantial changes: 1) a qualitative change in the vector of political forces impinging on the 'what should we do about reforming financial markets' political debate that help end the domination of the lords of finance on this issue; and 2) rejection of the theory of efficient capital markets that helped create and sustain the NFA, and reliance instead on the time-tested, realistic theory of financial markets developed by Keynes and extended by Minsky. We are not likely to achieve the first unless we achieve the second" (2008: 56). Clearly, three things are suggested here – need for the political forces or states, rejection of the neorealist NFA, and bringing back the Keynesian hegemonic stability system. However, the fundamental questions remain that can reforms within the aura of utilitarian neoliberalism guarantee financial system's stability? Do we need an alternative philosophy to utilitarianism in the first place for the system to function more efficiently?

7. An Islamic Alternative?

Can Islamic finance, a system of banking rooted in the principles of *Shariah* (Islamic socio-legal system), be an alternative to the free-market utilitarianism? Without venturing into the details of Islamic finance here, a clear affirmative answer to the question is ideologically substantive. However, the instrumentality for an Islamic financial system to be a ready and a complete alternative to the existing system is apparently premature (Moore, 1997; Vogel, 1998). Yet, progressively the Islamic finance has been gaining ground worldwide, and developing into a viable alternative. There are a number of trends that substantiate the rise of Islamic finance as an alternative.

Islamic financial system is ideologically and philosophically more ethical, pragmatic and balanced; institutionally more rigorous; and socially and legally more accountable. First of all, ideologically speaking Islamic economic system does not prescribe unlimited utilitarianism and consumerism (Khan, 1994; Ahmed, 2002; Ahmed & Hoque, 2011). Trading and transaction are natural and undeniable. Profits generated through natural trading and transactions are legitimate (Wilson & Iqbal, 2005). However, Islam places ethical regulations on consumption and utility of goods and their values. In terms of consumption, its principles are – not beyond capacity (NBC), not beyond means (NBM), and not beyond needs (NBN). Such principles impose self-regulations on the economic behaviors of the individuals. These principles negate the market practice of sub-prime or NINJA lending and borrowing.

Secondly, Islamic economic and financial system is systematically more rigorous. Its basic principle of trade and finance is that goods cannot be traded without having its real existence, and equally, financing for goods without existence or real and instant ownership is illegal (Clement & Wilson 2004). This places restrictions on both trading partners in terms of selling and buying goods, thereby, eliminating speculative transactions. These principles also eliminate collateral mechanisms of CDOs and CDS.

Thirdly, Islamic system prohibits manipulative and unscrupulous transactions in which the sellers intentionally make profit and inflict loss on the buyers. This principle reduces the risk of default on the part of the clients (Ahmed & Khan, 2001). It also controls the behavior of short term profit-making transactions; thereby, both sides in transaction remain socially and ethically responsible to each other (Ahmed & Chapra, 2002).

These fundamental mechanisms are heavily dependent on state-market-individual interdependency. None on these agents are independent of each other. Rather, all these agents have mutual controlling power on each other. Because all these agents act under the same rules and principles, they are mutually reinforcing. Firstly, the market regulatory rules are part of the same Shariah that the state is under obligation to enforce. Therefore, market is in no way separate from the state. Secondly, the individuals are to follow the same Shariah rules at personal transactions; therefore, they are bound by the same market mechanism. In this ways, state, market and individual agents are bound by the same regulatory principles. All these agents act according to institutional prescriptions of the 'logic of appropriateness' of the Shariah rather than individual self-benefit at the cost of others. Above these principles, there is also an extra-human accountability factor that has the strongest controlling power on market mechanism. This factor is accountability to God on the part of individual as well as the state. That the individual and state authorities are separately accountable to the same God makes all the agents harmoniously follow the same principles. This 'invisible hand' of God is in fact more powerful than the 'invisible hand' of Adam Smith as a balancing force in market mechanism.

Definitely, the moral and individual self-regulatory controlled economic behaviors with extra-institutional accountability factor at work, the Islamic economic and financial system has its superiority in controlling the market. The three-way accountability to God, society and state is the most powerful and balancing 'invisible hand' in Islamic political economy that makes it

an alternative to the Western liberal or neoliberal economic ideology. It is precisely because of this logically balanced system that many of its principles are being incorporated in the conventional economic system today, especially after the devastating years of the current global financial crisis. A number of such trends can be referred to here.

First, apart from its steady growth in the Muslim world, Islamic finance has been adopted by many giant institutions such as the HSBC, Standard Chartered, the UBS, Citibank, Moody's, Goldman Sachs, ABN AMRO and Kleinwort Benson (Global Note, 1999).

Second, at the government level, some of the Western countries have officially incorporated principles of Islamic finance in their public financial policies. For instance, the US Treasury Department recently announced its intention to teach "Islamic finance" to US banking regulatory agencies, Congress and other parts of the executive branch, in collaboration with Harvard University Islamic Finance Project. On November 6, 2008 the US Department of Treasury had itself offered a seminar on "Islamic Finance 101" to institutionalize the move (Schlling, 2008). In the UK, where more than 26 banks offer Islamic financial products, the British government is attempting to transform London into the Western world's centre for Islamic finance (Quinn, 2008).

And finally, an Islamic index at the Wall Street and Dow Jones Islamic Market (DJIM), with more than 75 licensees and over $800 billion in assets, indicates an alternative market operating and competing progressively at the global level. These all are indicative of a viable alternative mechanism of finance and market that can potentially create a moral economy safeguarding the public goods. However, a much more systematic and innovative development in Islamic finance is needed for it to become a global alternative.

8. Conclusion

The philosophy of the free market economy lies in its separation from government intervention. The fundamental argument behind the philosophy is that the market forces can face and fix their own problem naturally. However, the credibility of free-market capitalism or the so called New Financial Architecture (NFA) of the post-Cold War has been seriously eroded by heavy government interventions all over the world, and especially in the highly industrialist free market economies, into the market in the wake of the ongoing financial crisis since 2007. This contradictory behavior indicates that the existing free market global financial and economic system has serious shortcomings. This article has found that numerous researches since 2007 have generated a consensus that uncontrolled and unlimited utilitarian philosophy of consumptionism and profiteering tendency propel the market forces to behave competitively in pursuit of unscrupulous profit. Furthermore, lack of legal, social and moral accountability puts the system at all-time risk. Therefore, the system requires a fundamental shift in its basic philosophy. Can the system be revised remaining within the philosophy? Can the systemic revision remaining with the liberal philosophy prevent such financial catastrophe in future? Skeptics are of the opinion that an entire philosophical reorientation is needed. But what that could be?

Many scholars argue that the Islamic financial system can offer a solid alternative in this regard. They justify this by providing the facts that Islamic economic and financial regulatory mechanism offers a more balanced and accountable market environment in which the individual, market and state share similar goals; follow the same regulatory principles; and remain responsible to the same extra-human 'invisible hand' of God. A clear triple helix of legal bindings, moral imperatives and social liabilities control the economic behaviors of the agent. In this way, Islamic economics is controlled by mutual and interdependent institutional checks and balance. Furthermore, the three behavioral patterns of the Islamic economic system namely- not beyond needs, not beyond capacity and not beyond means- work as strong regulatory regimes for individual behaviors. Therefore, this article has argued that with such a balanced state-market-society interdependent mechanism, Islamic economic and financial system can make a substantial contribution to the future paradigm of international political economy.

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