

From the Great Depression to the Present
Global Financial Crisis:
Systemic flaws in investment financing.

Seif I. Tag el-Din

Professor, Islamic Economics & Finance.
Markfield Institute of Higher Education,
Leicestershire, UK

Purview of the paper

- This global financial crisis (GFC) echoes the same systemic flaws in investment financing that gave rise to the 1930s great depression (GD).
- Shedding light on profound structural changes caused by the 1933 Glass-Steagall Act
 - against traditional bank intermediation
 - in favour of money and capital market ***disintermediation***.
- Major events between the GD and the GFC have contributed to radical shifts of profitability from productivity-based traditions to highly leveraged speculation.

Islamic diagnosis of the GFC

- This crisis in the Islamic perspective relates to two major sources:
 - 1) an inherently destabilising force of the interest rate as it strictly separates investment and financing decisions.
 - 2) an ever-widening distance between capital markets and productive sectors due to unrestrained financial engineering that feeds on short term speculative returns.

How we approach the problem

- To portray the inherently depressant and destabilising force of interest rate, the paper presents Fisher and Tobin Separation Theorems.
- The second problem has resulted in outmoding traditional concepts of investment, financing and liquidity.
- In recent studies, it emerged that financial derivative constitute 80% of total global liquidity.
- Thus, the world economy behaves as if it were a big gambling casino having producers of goods like sellers of nuts and crisps!

Deep concerns with cyclical stability: has there been an exaggeration?

- For the first time since the eighteenth century's industrial revolution, the 1930s GD brought cyclical movements to the attention of economists.
- Nonetheless, M. Friedman played down deep concerns with cyclical stability.
- Rival schools of economic thought sprang during the twentieth century to grapple with how to achieve long-term growth and stability simultaneously through fiscal and monetary tools.

No, there hasn't been an exaggeration !

- The claim that growth and stability are attainable simultaneously has not stood the test of time.
- The \$700 billion bailout package of the American Administration, alone, is equal to all compensations paid by insurance companies within ten years against earthquakes, floods and famines in the whole world.

Lessons From Glass-Steagall Act

- An important lesson: interest rates cannot be left free to competitive forces.
- Glass-Steagall ACT 1933 had the most profound impact on the evolution of the US banking system from the GD to the present.
 - Prohibited payment of interest on demand deposits
 - Imposed interest rate ceilings on time deposits.
 - barred commercial banking from all risky investments except for safe return Government Treasury Bills.

Cont.

Lessons from Glass-Steagall Act

- Another important lesson: *prudent banking regulation is all about low risk assets to match guaranteed liabilities.*
- Glass-Seagull Act has driven home the idea that liberal risk-taking was not in the nature of conventional banking.
- Deterrence of banks from excessive risks continued to bother regulatory authorities about how capital adequacy.
- Efforts crystallised in Basel I, II Accords.

Why G-S Act failed?

- Simply, re-shaped the financial market to the advantage of money markets and capital markets and the disadvantage of traditional banking intermediation.
- ***Disintermediation*** has then become the norm – even after the scrapping of the Act in 1999.
- Cost-effectiveness disabled commercial banks from regaining their leading traditional roles as sole conduits of funds from surplus to deficit agents.
- The G-S failed because it handled the symptom of the GD (excessive banking competition over interest rates) rather than the root cause of the crisis (interest rate volatility).

This is well acknowledged

- Leibowitz (2008) explained the recent mortgage meltdown as an immediate result of adjustable-rate mortgages (ARM) introduced by the US during the 1980s.
- “Subprime loans were fine as long as the housing market continued to boom and interest rates did not rise”, noted Maha Hui-Lim (2008).
- “ ... crises frequently emanate from the financial centres with transmission through interest rate shocks and commodity price collapses”, emerged from a panoramic survey of eight centuries financial crisis (Reinhart and Rogoff (2008)) .

Speculative leveraging:

How it has damaged the real economy

- Not only financing initiative shifted away from traditional banking, but also traditional investment in human and productive resources outmoded.
- Disintermediation + capital market deregulation = capital released from the 'limbo' of heavily regulated intermediaries to broader horizons of speculative gains across world financial centres.

New concept of liquidity !

- Traditionally, 'liquidity' formed a regular pyramid with M1 at the base, M2 at the middle and M3 at the apex of the pyramid.
- The new concept of liquidity is based on securities derived from underlying assets, to outmode traditional speculation on original stocks .
- Liquidity, according to David Roche, is representable through an inverted pyramid where M1 and M2 together represent only 1% of global liquidity, followed respectively by 'broad money' (9%), securitised debt (10%) and financial derivatives (80%).

Implications of Separation Theorems

- Fisher's Separation Theorem:
 - Interest rate is a depressant on productivity
- Tobin's Separation Theorem:
 - Interest rises cause profit margins to become thinner and riskier.
- In both cases, profitability and interest rates are strictly negatively correlated.

Conclusions

- Abolition of interest makes financing and investment hardly distinguishable decisions – this also invokes important ethical values !
- Clamping down on *gharar* drives capital markets away from unproductive speculation
- Islamic finance re-positions the debt/ equity inverted pyramid to a regular shape where massive equity supports little debt.
- Clamping down on leverage ratios is needed not only in the banking sector but across the board of all corporate financing.

Introduction

- For the first time since the eighteenth century's industrial revolution, the 1930s Great Depression (GD) brought cyclical movements to the attention of economists.
- Yet, Friedman, among others, led the world into believing that deep concerns with cyclical stability were exaggerated.

