

Speculative Capital: An Islamic View

Yousef Khalifa Al-Yousef
Professor of Economics
Department of Economics
College of Business & Economics
United Arab Emirates University
E.mail: Subhanah@emirates.net.ae

This paper is prepared for presentation at the 6th International Conference of Islamic Economics and Banking to be held at Jakarta, Indonesia during 22-24 November 2005

Abstract

The present paper attempts to show that speculation as being practice today in financial and foreign exchange markets is nothing but a new version of Gharar(risk) that is prohibited in an Islamic context because it is an unnecessary risk that results in a redistribution of existing wealth rather than creating new wealth. After the introduction, Part 2 establishes the relationship between Gharar, global finance, and speculative capital. Part 3 presents an analysis of the socio-economic costs of speculative capital especially during the recent crises in Mexico and South East Asia. Then in Part 4, the paper discusses three leading paradigms for dealing with the detrimental effects of speculative capital in the coming years. Part 5 concludes.

1. Introduction

“When I was young, people called me a gambler. As the scale of my operations increased I became known as a speculator. Now I am called a banker. But I have been doing the same thing all the time.”

Sir Ernest Cassell, banker to Edward VII¹

There is no doubt that in today's world, the movement of goods, services, capital, technology, ideas and to a lesser extent labor is becoming easier, faster, and cheaper, that is the world is becoming more integrated or globalized. Whether countries or regions gain or loose from this global game depends, among other things, on the resources they bring to the game, how they use them, and how they play this game vis-à-vis the rest of the world. In this paper, our objective is to look at one aspect of financial capital globalization, namely, speculative capital which, according to many observers, contributes to the lion's share of trade in currency and financial instruments in today's markets. We want to show that speculation as it is practiced in today's financial and currency markets , is nothing but one form of Gharar² (risk or uncertainty) that is prohibited in Islam, and in the process to point out to the high cost³ that is being inflicted on the global economy by speculative capital in recent years. This cost is yet another reminder to us all that, whenever we tress pass the boundaries drawn for us by Allah Almighty, in any sphere of life, then there is a price to be paid in one form or another and there is a lesson to be learned about the rightfulness of Allah's message. " Soon will We show them Our Signs in the (furthest) Regions(of the earth), and in their own souls, until It becomes manifest to them That this is the truth. Is it not enough that Thy Lord doth witness All things? (41:53).

With this background in mind, the rest of the paper is divided into four parts. Following the introduction, Part 2 analyses the nature of the relationship between the three key concepts in the present paper namely, Gharar , global finance , and speculative capital . Part 3 assesses the socio-economic costs of speculative capital with a special focus on the last twenty years, of course, subject to the available data. Part 4 evaluates the cures that are being suggested in the economic literature on how

¹ Quoted in Chancellor, Edward(2000) *Devil Take TheHindmost: A History of Financial Speculation*, A Plume Book. New York.

² Abu Hurairah (May Allah be Pleased with him) narrated that the Messenger of Allah (PBUH) forbade a transaction determined throwing stones , and the type involving deception (Gharar){Sahih Muslim} .

³ For example , it has been estimated that the Asian Crisis alone has reduced global output by \$2 trillion in 1998-2000 which is about 6% of global GDP.

to deal with speculative capital and financial markets volatility both nationally and globally. And Part 5 concludes with the salient points of the analysis.

2. Gharar, Global Finance , and Speculative Capital

In Arabic *Gharar* means risk or an act whose outcome is unknown, uncertain, or not disclosed. It has been prohibited in an Islamic context because it is a form of gambling that takes place in trade rather than the common gambling that is usually associated with games. The following Quranic verse confirms the unlawfulness of intoxicants and all forms of gambling in an Islamic context.

" O ye who believe! Intoxicants and gambling, (Dedication of) stones, And (divination by) arrows, Are an abomination, - Of Satan's handiwork: Eschew such(abomination) That ye may prosper".(5:93).

However, Islam does not prohibit all kinds of risk otherwise life will cease to exist as we know it because most if not all economic transactions have some degree of risk and therefore we need to distinguish between the lawful and the unlawful risks. To begin with there is what might be called business risks that are inherent in all forms of economic transactions be it in trade, investment, or services and these risks can neither be calculated with any degree of certainty nor can they be avoided and thus considered lawful in an Islamic context . For example, economic agents like farmers, car producers, real estate developers, and others start their economic endeavors by incurring the costs of production without knowing the price at which they will sell their products in the future. In other words they are taking a risk by initiating an enterprise where resources are employed productively in the hope of realizing the gains from selling these products with a profit. A second form of risk that is also encountered in many spheres of life is the pure risk which can be assessed to a certain degree of accuracy using what is known as the " Principle of large numbers" or "the law of averages". For example, if you are in the export-import business, then you know that you can lose your goods if the ship carrying them gets wrecked or if these goods are confiscated in a war zone or if they are damaged in transit. Also, if you drive a car then, you know how costly a car accident can be to an individual who does not have any kind of insurance, and if you or someone you know has been through a large operation or an endemic illness, you know the magnitude of the treatment costs. These and similar risks that people are exposed to in all walks of life are pure risks that bring losses without gains and therefore individuals try to minimize them through all kinds of insurance schemes(Siddiqi, 1985:13-25). Moslem scholars are , however, divided

on the nature of this risk which has in turn lead the majority of them to prohibit modern commercial insurance as a hedge or protection against such kind of risk. The last form of risk and the one which concerns us in this paper, is unlike the other two, is neither necessary for the day to day economic activities nor a value-adding activity. Instead, it is the kind of risk that is taken for its own sake and where the gains of one party is a loss to another. It is this form of risk(*Gharar*) that is synonymous to gambling and is unequivocally condemned by the Holy Quran as was mentioned earlier. Examples of activities and transactions that are prohibited because of its Gharar element include , among others, the sale of unborn-she camel (*Bay Habal-al-Habal*), the sale of fruits before ripening (*Mukhabarah*), buying on the basis of touching a commodity (*Mulamasah*), throwing a commodity toward a buyer without giving him the opportunity to touch, see, or know it better (*Munabazah*), the sale of the product of many years, two sales in one contract (*Bayatien-fi-Baiyah*) , conditional sale (*Bay-wa-Shart*), sale with loan (*Bay-wa-Salaf*), the sale of goods before obtaining possession, the sale of what can not be delivered, the sale of non-existent, and the like(Ibn Rushd,2003:179-192).It is clear that in all these examples the outcome of the transaction is uncertain or has a Gharar(risk) element. Generally speaking the uncertainty(Gharar) here can be about a traded object, its price or weight, its description, its size, or the time of its delivery. In other word, an uncertain activity is an activity that is not based on clarity and knowledge, but rather on chance which results in disputes and misunderstanding among members of society. Also, Gharar can be in the essence of the contract or in the object of the contract. The former occurs when the wording of the contract implies uncertainty as in the case of two sales in one, down-payment, and touch and toss sales; while the latter form occurs when there is ignorance about the genus of the object to be traded, its species, attributes, quantity, essence and time of delivery of the object. However, we need to qualify the preceding statements by saying that *Gharar* is tolerated under certain conditions which include the following: **First**, when the *Gharar* element in a transaction is negligible as in renting an apartment for a month where the month can be thirty days or only twenty nine days. **Second**, when Gharar can not be avoided as in the case of buying a house without having seen its foundations .**Third**, Gharar is permitted when a contract is deemed essential to the well being of society as in the case of the business risks that were discussed previously and *Salam* sale is an example of such such risk . **Finally**, when Gharar does not affect the principal object of the transaction at hand like selling

the unborn animal with his mother and selling fruits that are not yet ripen with the trees.

At first glance, one might argue that the preceding activities or lets say prohibited forms of *Gharar* are rare in the modern economy and they are different from the activities in our computerized and highly monetized modern economic systems. Yet , and despite the sophisticated nature of today's financial and foreign exchange markets , they still have a great deal of the prohibited or the gambling-induced risk as will be clear from our discussion of speculative capital next.

So what is speculative capital and how does it relate to the prohibited risk (Gharar) in an Islamic context? or what do speculators do for that matter? It is well documented that early speculators were gamblers who used to bet on the odds of short-term movements in the prices of goods or as one author puts it " No one hedged eggs or butter in the Merc's early days . The main concern of those who traded futures was to ensure the fulfillment of the contracts; the hedging interest simply was not there.

Instead , dealers merely looked for speculative profits in accumulating butter and eggs ,hoping that profitable years would more than offset the losing ones”

(Tamarkin,1993:p.47). The same thing can be said about today's speculators who do not only bet on the odds of short-term movements in the prices of goods but also on movements in the exchange and interest rates. According to a leading international economists " Speculators are said to take **a short position** when they sell foreign currency forward without at the same time owning an equivalent amount of this currency (*that is, they sell what they do not have*) in the expectation of buying it at a lower spot rate when the contract matures”(Kreinin,2002:245).

However, speculative capital did not gain prominence until the fall of the Bretton Woods system which extended from 1945 to the mid-1970s (Eatwell and Taylor, 2000:1). Under this system , exchange rates between major currencies were fixed in terms of the dollar whose value was fixed to gold at thirty-five dollars per ounce and the international flow of capital was subject to a number of restrictions including, among others, limited capital flows, trade management , strong regulation of banks and the financial system , and the fine-tuning of the economy through the use of fiscal and monetary policy(Bellow et al,2000:2). Under such a system, a citizen of country A can not easily buy a stock or bond in country B, most of the foreign capital available to third world countries came from official sources , foreign direct investment in developing countries was confined to mineral resources like oil, and commercial bank

lending and portfolio investment were minimal (Singh,1999:11). With the reconstruction of Europe and Japan and the Korean and Vietnam wars, this dollar-based system meant a large outflow of dollars that will be held by foreigners and which the U.S might not be able exchange for gold at the agreed price of \$35 per ounce in the future hence the falling confidence in the dollar and the shift of the U.S balance of payments from surplus to deficit (Triffen , 1960). In 1971 with a spiraling inflation and a growing deficit , the Nixon Administration decided to devalue the dollar and announced that it will no longer redeem dollars for gold thus declaring the death of the fixed exchange rate system (Gilbin,2001:234-239). Then, in 1974, the U.S abolished all restrictions on international capital flow following the footsteps of Canada , Switzerland , and Germany during 1973 and to be followed by Britain in 1979 , Japan in 1980 , France and Italy in 1990, and Spain and Portugal in 1992. (Eatwell and Taylor ,2000:3).

Both the end of the fixed exchange rate and the liberalization of trade in capital have increased the volume of international capital flows to an unprecedented magnitude. For example, the daily foreign exchange trading grew from about \$10-20 billion per day in 1973 , to about \$80 billion in 1980 , to \$880 billion in 1992, and again to \$1260 billion in 1995 (Eatwell and Taylor, 2000:3-4).

But what is the nature of this capital flow? Is it contributing to productive investment and to economic stability or it is no more than hot money that is in search of quick gains regardless to its detrimental effects on the health of the world economy? Lets us answer this question by quoting the exact words of leading economists and policy makers starting with Lord Keynes who said that “Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes the by product of the activities of a casino, the job is likely to be ill-done.(Keynes,1936:159).The same view is echoed by a contemporary economist who states that most of current trade in currency is not related to buying and selling of goods and services or as he puts it " ...the trade in currency has very little to do with international trade, which accounts for just two percent of the global currency movements" adding that "In the current phase, financial flows are rarely associated with the flows of real resources and long-term productive investments. These flows are largely liquid and are attracted by short-term speculative gains,and can leave the country as quickly as they came"(Singh,1999:7). Similarly, Eatwell and Taylor, two

prominent economists, argue that " By far the greatest part of currency trades are very short-run. Since they are not undertaken for the finance of trade in goods or services or long-run investment, these short-term trades must be based on expectations of the gains or fear of the losses that may result from changes in the value of financial assets. In the broadest sense, they are speculative, made in hope of capital gain, or to hedge against potential capital loss , or to seek the gains of arbitrage" (Eatwell and Taylor,2000:4) . Lawrence Summers who was deputy to Rubin and succeeded him as treasury Secretary during the Clinton Administration describes the liberalization of financial markets in the following words "The freeing of financial markets to pursue their casino instincts heightens the odds of crises.... Because unlike a casino , the financial markets are inextricably linked with the world outside, the real economy pays the price(Summers and Summers,1989).And in his recent book on Globalization , Joseph Stiglitz, winner of the 2001 Noble Prize in economics states that " Westren banks benefited from the loosening of capital market controls in Latin America and Asia , but those regions suffered when inflows of speculative hot money (money that comes into and out , often overnight, often little more than betting on whether a currency is going to appreciate or depreciate) that had poured into countries suddenly reversed.This abrupt outflow of money left behind collapsed currencies and weakened banking systems" (Stiglitz, 2002:7). In another place, he argues that " capital market liberalization entails stripping away the regulations intended to control the flow of hot money in and out of the country--short-term loans and contracts that are usually no more than bets on exchange rate movement . This speculative money can not be used to build factories or create jobs –companies don't make long-term investments using money that can be pulled out on a moment's notice—and indeed , the risk that such hot money brings with it makes long-term investments in a developing country even less attractive" (Stiglitz, 2002: 65-66). This dominance of speculative over productive capital is also confirmed by a distinguished Professor of international economics who argues that " There is no doubt that the volume of currency trading has mushroomed relative to trade. At the turn of the millennium, the value of currency trading was only six times greater than the value of world trade in goods and services . By 1995, currency trading was about 50 times the value of world trade. Put simply, much currency trading occurs for reasons other than to provide liquidity for world trade" (Carbaugh,2004: 389).

This growing speculation in today's financial markets is, however, best described by another economist who says that "The western financial system is rapidly coming to resemble nothing as much as a vast casino (Strange, 1998:1). Even Oliver Stone, the famous film director produced his film "Wall Street" to depict the madness in financial markets which, according to the movie, is dominated by greed and fails to serve the interests of the majority of Americans.

I hope that the preceding quotations of the exact words of many prominent economists and policy makers prove beyond any doubt that speculative capital which is dominant in today's financial and foreign exchange markets is a form of gambling or Gharar that does not only fail to contribute to the development of real resources and long-run investment but is also destabilizing and costly.

3. Socio-Economic Costs of Speculative Capital

Since the fall of the Bretton Woods arrangements there have been at least eight financial crises most of which were in emerging markets. All forms of financial crises (currency, banking, or both)⁴ are costly due to lost output, distributional effects, or inefficiencies resulting from the misallocation of resources. Now, since the majority of these crises were triggered, in large part, by speculative capital, then a brief discussion of the chronology and consequences of some of these crises could give us some idea about the cost of speculative capital to the world economy. More specifically, our focus will be on the Mexican crisis of 1995 and the Asian crisis of the years 1997-1998.

The Mexican Crisis

In the 1990s, Mexico received about \$91 billion of foreign capital in just four years which amounted to about 20% of all net capital inflows to developing countries. This financial boom, however, was not reflected in the real economy because, during the financial boom years, GDP growth rate was negative which has exacerbated the already bad conditions of 40% of the work force being unemployed and about half the population being poor both resulting from the structural adjustments imposed by the IMF and the World Bank to tackle the debt crisis of the 1980s. Included in these reforms was the liberalization of both trade and capital accounts (Bello et, 2000:10-11). These policies were complemented by fixing the exchange rate of the peso to the

⁴ A currency crisis happens when an attack on a given currency by speculators results in its devaluation, while a banking crisis is caused by bank runs or other developments that result in closure, takeover, merger, or large scale assistance by the government to some financial institutions (World Bank, 1998:124-125).

American dollar to protect foreign investors from any decline in the value of their investments resulting from devaluation. Finally, the interest rate was kept at a much higher rate than in the U.S and other neighboring countries to entice investors to borrow where the interest rate is low (other countries) and to invest where it is high (Mexico). The phenomenal inflow of capital has increased domestic consumption most of which was imported while at the same time causing a real appreciation of the currency which lowered exports thus raising the current account deficits to about 8.5% of GDP in 1994. These developments led some investors to pull out of the market while encouraging speculators to "bet" on the devaluation of the peso to deal with the current account deficit leading to a floatation of the peso by late December 1994. This floatation resulted in the peso losing about 50% of its nominal value that is after the central bank has spent about \$4.5 billion of its reserves to protect it. (Bello et al, 2000:12). Some sources estimate the costs of the financial crisis to Mexico, which has the ninth-largest economy in the world and produces 2% of the global output, to be about 20% of the country's GDP (Duncan, 2003:213). The cost of bank bail out alone was about \$50 billion (Roubini and Setser, 2004:53).

The Southeast Asian Crisis

The revaluation of the yen in the mid-1980s relative to the dollar and other major currencies forced many Japanese manufacturers to relocate much of their labor-intensive production to Southeast Asia. Accordingly, between 1985 and 1990, about \$15 billion of Japanese direct investment poured into the Southeast Asian region. It was the prosperity created by these investments that attracted speculators in the early 1990s especially in the light of the crisis in Mexico and the low interest rates in the industrial countries. Again, Thailand, like Mexico adopted the policy package prescribed by the IMF and the World Bank of liberalizing capital and financial markets, fixing the Baht relative to the dollar, and maintaining a high domestic interest rate relative to that in the industrial markets (Bello et al, 2000:13). As a result, net portfolio investment was around \$24 billion in the three years preceding the crisis in 1997 with another \$50 billion in the form of loans to Thai banks and firms. This liberalization of capital and financial markets proceeded along a similar track as in South Korea, Indonesia, and Malaysia though at different speed and sequencing of the measures (Desai, 2003:113). All in all, the above policies that were adopted by the countries in the region have led to the increase of net private capital flows to these

countries (Thailand, Indonesia, Malaysia, Korea , and the Philippines) from \$37.9 billion in 1995 to \$97.1 billion in 1996 (Bello et al ,2000: 14).

And here as in Mexico, the fixing of the exchange rate while protecting investors from devaluation, has nevertheless made these countries' exports less competitive internationally because when the dollar appreciated in 1995-96, the currencies of the region appreciated with it leading to higher export prices and a worsening in these countries' current accounts. The problem of falling exports was made worse by the fact that most of the incoming capital was speculative capital looking for high and quick return and thus was concentrated in stocks, real estate, and consumer financing instead of being invested in manufacturing or agricultural. With a glut in the real estate market and a zero growth in the exports of Thailand and Malaysia in 1996 a current account deficit became eminent resulting in a falling investors' confidence and a beginning of capital reversal similar to that of Mexico in 1995. An already bad situation was made catastrophic by speculators who were gambling on the inevitable devaluation of the Baht by the Central Bank hence their sale of huge amounts of Baht in return for dollars. For example, It was reported that on 10 May 1997, hedge funds have bet \$10 billion against the baht in a global attack. The Bank of Thailand lost all of its \$38.7 billion of foreign reserves in an effort to protect the baht but in vain because on 2 July 1997 the Baht was devalued and as a result lost 50% of its value in few months. Similar waves of capital flight hit countries like Indonesia, Malaysia and other East Asian countries. The outflow of capital, in turn, led to the collapse of currencies, the fall in stock prices, and a steep decline in economic growth. Also, the fear of contagion caused the Russian ruble to be in turmoil in August 1998 and the Brazilian real in January 1999. Per capita income fell to almost one-third its 1996 level in Indonesia while the fall in other Asian countries ranged from a quarter to nearly half of the 1996 levels(Bhagwati,2004:199).According to Bhagwati, the most persuasive advocate of free trade among today's economists, the Asian crisis was " precipitated by panic-fueled outflows of capital , was a product of hasty and imprudent financial liberalization, almost always under foreign pressure , allowing free international flows of short-term capital without adequate attention to the potentially potent downside of such globalization" (Bhagwati, 2004:200-201). More generally, what we are witnessing in the globalization of finance over the last three decades is a global financial system that is not subordinated to the real economy , that is because a financial system's main objective should be , in the words of Alan

Greenspan, Chair of the U.S Federal Reserve " To facilitate the production of goods and services"(Eatwell and Taylor,1998). In other words, it is no use having a financial sector that has a life of its own or an end rather than a means thus leading to a less efficient real sector.

From the above, it is clear that the Mexican and the Asian crises were marked, like all other post-Bretton Woods financial crises, by a number of features beginning with the liberalization of the capital account, the deregulation of the financial system which lead to a sharp increase in capital inflows followed by an equal sharp capital reversal and speculators attacks on the national currency all combined with bank and corporate failures and policy makers giving up on currency pegs after trying to defend it through higher interest rate and other measures like capital controls as in the Malaysian case (UNCTAD,1998:53-58). However, it is worth noting, though, that while the crisis in Malaysia was less severe and it was confined to the currency alone, in the other three countries (Korea, Thailand, and Indonesia) , on the other hand , it was deeper and was a combination of currency and banking crisis. This was due to two major policy differences. The first is that, unlike the other three countries, Malaysia did not finance its current account deficit through short-term external debts but through both equity portfolio and direct foreign investment where creditors shared the risk with debtors and did not destabilize the economy by pulling out their money. The second is that during the crisis, the Malaysian government imposed capital controls to stem the tide of speculative capital thus reducing the pressure either on reserves or on the exchange rate caused by movement of capital outside the country.(Roubini and Setser, 2004:156).

These financial crises are also costly as can be seen from the loans that were promised or given to the countries that have asked for assistance , namely, Thailand , South Korea , and Indonesia. For example, the loans that were provided by the IMF, the World bank , Japan, the Asian Development Bank , and others were estimated at \$18 billion for Thailand, \$36 billion for Indonesia , and \$58 billion for South Korea . This financial assistance amounts to 505 percent of Thailand's quota at the IMF , 490% of Indonesia's quota, and 1939 percent of the Quota of South Korea .(Desai, 2003:214). The cost of Indonesia's bail-out of its banking system was about 56% of the country's GDP(Roubini and Setser,2004:57).These bail-outs, however, do not only encourage speculative activities, but it also reduces the incentives both of creditors to adopt sound lending policies and borrowing governments to implement effective regulation.

4. Paradigms of Global Financial Reform

It has been shown in the preceding analysis that the globalization of finance that characterized the world monetary system during the last thirty years was marked by excessive and destabilizing volatility caused, in large part, by speculative currency trade that was made possible by financial deregulation and capital-account liberalization that took place in most developed and many developing countries following the collapse of the Bretton Woods system. The speculation in the foreign exchange markets have been costly, for it has resulted in policy disruptions, credit curtailment, production decline, rise in unemployment, increase in poverty and other costs. The severity of the financial crises that have struck financial markets in the late 1990s and the high socio-economic costs that they have inflicted on the world economy have prompted many scholars and policy makers of all ideological persuasion to propose a variety of measures to curb the flow of speculative capital . These proposals fall under the following three categories or paradigms.

A. Fine-Tuning

The first of these paradigms is what we call here the **fine-tuning** paradigm which is held by most industrial countries and international institutions such as the IMF and the World Bank. According to this view, the current financial system is sound and need no significant reforms and it attributes the recent financial crisis in Mexico, East Asia, and others to the flawed nature of these countries' financial sectors (Noland et al,1998:11).Accordingly, in order to minimize the future recurrence of these financial crises, the proponents of this view argue that many countries of the world, especially developing countries, have to fine-tune their economies through tougher bankruptcy laws to eliminate moral hazard , increased transparency , strict adherence to the core principles of the Basle Accord on banking supervision, and more inflow of foreign capital both to rescue banks in crisis and to stabilize the domestic financial system by making foreign interests part of it. Aside from it's simplistic diagnosis of the recent financial crises which took place in many countries with strong fundamentals and highly developed financial institutions⁵, the present view tends to implicitly encourage speculation through its support of some government intervention to "bail out" falling

⁵ According to some sources , the Asian countries (Indonesia, South Korea, Malaysia , and Thailand) had a growth rate ranging between 7 and 9 percent during 1991-96 , low single-digit inflation, saving rates between 30 and 35 of GDP and 32-41 ratios of investment to GDP. They also had budget surpluses except South Korea (Desai, 2003:89).

speculators least they bring down with them the whole global financial structure as was the case in Mexico and Indonesia.

B. Restructuring and Regulation

A second view on how to deal with the havoc that has befallen many world economies over the last thirty years is that which can be called the **restructuring and regulation** paradigm. Unlike the previous school of thought which has full confidence in the working of the market and thus considers any form of intervention in the financial system as leading to a loss of efficiency, the present view is premised on the assumption that current financial and foreign exchange markets are not functioning optimally and thus intervention in these imperfect markets may improve efficiency rather than the opposite. Accordingly, the holders of this view propose a number of measures including different forms of capital controls and regulations to reduce the probability of financial crisis. For example, in the 1970s, James Tobin proposed a transaction tax, later to be known as the Tobin tax, on capital inflow and outflow at all key points of the world economy. The objective of this transaction tax was to improve the efficiency of financial markets in allocating resources by discouraging short-run capital flows with revenue-generation as a by-product (Ul Haq et al,1996:5)⁶. Others like Eatwell and Taylor argue that while finance is an essential lubricant that keeps the world engine of economic growth moving, it is a highly volatile lubricant that can lead to a destruction of the engine of economic growth that it is lubricating(Eatwell and Taylor, 2000:208).Accordingly, financial markets should be regulated on the macro-economic level through capital controls and other direct interventions and on the micro-economic level through a strict supervision of banks, securities firms, insurance companies, and financial markets in general (Eatwell and Taylor,2000:209). Also, to implement macro-economic regulations, they suggest the creation of what they call a World Financial Authority that can complement the present regulatory role of international institutions like the IMF, the World Bank, and the WTO which they think should play their role in a less dogmatic way by giving some leeway to national development endeavors, that is, they should not insist on a“one model fits all “ (Rodrik,1998).

C. Global Finance in an Islamic Context

⁶ Other controls include ceiling on foreign equity participation in domestic firms, licensing, differential regulations applying for domestic and foreign firms regarding their establishing and operation, restrictions on repatriation of capital and different kinds of restrictions on residents' foreign holdings of assets.

The paradigms that we have discussed so far, though differ in their diagnosis and suggested solutions for the current economic problems such as financial instability, they nevertheless share the same worldview that focuses on this life and its material gains (i.e. a secular view). However, our third paradigm or what we call here the Islamic paradigm looks at both financial instability and all socio-economic problems from a somewhat different perspective. That is, it has its own worldview that we need to understand before exploring its implication for speculative capital and its impact on the stability of global finance so let's start with a brief exposition of this Islamic Worldview.

A Value-based Worldview

Financial crises is only one of many problems that modern societies are facing as they enter their third millennium., other problems include: corruption, crimes, pollution, poverty, inequality, civil wars, drugs, high divorce rate, psychological diseases, school drop outs, child and spouse abuse, alcoholism, illegitimate children, Aids and suicides (Huntington, 1996:304). All these problems result from human behavior that is, they are self-inflicted. Looked at from an Islamic perspective, these problems are a manifestation of the weakening if not the break down of the value system that guides modern secular societies and give them purpose. Values are the backbone of all civilizations and thus when a society or a civilization starts to experience a moral decay, then deterioration in politics, education, culture, and the economy follows. This is so because true and authentic values motivate normal people and make them excel in all spheres of life. In other words, values constitute a form of accountability that stems from within the individual himself and lead him to do what is good and to abstain from doing bad as the holy Quran tells us "By the Soul, and order Given to it; And its enlightenment As to its wrong And its right; Truly he succeeds That purifies it. And he fails That corrupts it!" (91:7). Such values can not, however, be prescribed by individuals for individuals since they will definitely be distorted by whims and desires and limited by time. Therefore to make these values free of these shortcomings, they must be enjoined by the Creator himself (Should he not know-He that created? And He is the One That understands the finest Mysteries (and) is Well-acquainted (with them) (67:14). To Moslems, these values are part and parcel of a worldview that is based on the belief that our universe and everything in it is created by One God who is omnipotent and man is his vicegerent on earth and his ultimate purpose is to worship God in everything he says or does. And to facilitate his mission

in this life, as his knowledge and experience in this life expands, he is given the revealed Message and the tradition of the prophet(PBUH) to guide him through his journey and to protect him from leaning to all forms of extremism both materially or spiritually. He is also reminded that sooner or later he will die and then he will be resurrected on the day of judgment where he will be rewarded or punished on what he did or did not do in this life. He is also advised to put greater emphasis on the life hereafter which is superior to this life as the Holy Quran makes clear “ Day(behold), ye prefer The life of this world; But the Hereafter is better and more enduring “(87:16) and “ Those who rest not their hope On their meeting with Us, But are pleased and satisfied With the life of the Present. And those who heed not Our Signs,” (10:7-8). Within this worldview , Moslems are also guided in all spheres of life , sometimes in a detailed way as in the laws of inheritance , but in most cases general principles are laid down and the details are left to be filled by scholars subject to changing needs and circumstances like the form of government , the structure of the economy , and the administrative system and others.

This very brief exposition of the Islamic worldview implies that the cost-benefit horizon of a believer in making his daily decisions extends beyond this life to the life hereafter which makes him more inclined to do good rather than bad deeds in this life because of his factoring in of the lasting costs and benefits in the day hereafter

Values and financial markets

Having presented the reader with the Islamic worldview , it is now time to show how this world view and the principles derived from it impact on economic activities in general and on financial markets and speculative capital in particular . In their quest for efficiency and equity, modern secular systems rely heavily on external checks and balances to guide and improve the behavior of economic agents. However, recent scandals and bankruptcies in leading American enterprises like Enron , World.com and others did not only underscore the limitations of external accountability but have also encouraged many leaders in the business community to add what they call “ Ethics Courses” as part of business training. Whether or not these courses will make a difference remains to be seen. By contrast, the accountability that results from the religious moral guidance is internal and more lasting. Therefore, in what follows I will try to show how the Islamic worldview ingrains in the hearts and minds of its followers a moral guidance and a set of incentives to enable them to use the resources of this world more efficiently and with greater equity thus contributing to

development and stability in this life and salvation in the day hereafter . The Islamic worldview begins with the recognition of human's inclination towards all forms of wealth and ornaments but appeals to his goodness not to indulge in worldly goods and urges him to do good that will benefit him on the day here after .“ Fair in the eyes of men Is the love of things they covet: Women and sons; horses Branded(for blood and excellence); And(wealth of) cattle And well-tilled land. Such are the possessions Of this world's life; But in nearness to God Is the best of the Goals(To return to)(2:14). After recognizing that it is normal for man to like and desire worldly goods but with modesty and with an eye on the day hereafter, the Islamic worldview reminds the believers that everything in this life belongs to God and thus when using the resources at their disposal, they should , as all trustees would do , abide by the commands of God who is the ultimate owner of these resources “ Believe in God And His Apostle, And Spend(in charity) Out of the (substance) Whereof He has made you Heirs. For , those of you Who believe and spend (in charity),- for them Is a great Reward” (57:7). Then following this injunction, believers are instructed to fulfill their roles as vicegerents by striving to explore their universe, exploit its resources, and understand its laws and use them in development and progress in a way that maintains harmony among the different elements of this universe “.....It is He Who hath produced you From the earth and settled you Therein....”(11:64). Then, Man is told that as he proceeds to build his civilization on earth he must abide by a basic principle, namely, that all forms of economic activities should be devoid of all forms of injustices and should be consensual “ O ye who believe! Eat not up your property Among yourselves in vanities: But let there be amongst you Traffic and trade. By mutual good will...”(4:29) . From these general principle, the Islamic worldview proceeds to more specific injunctions about the use,exchange, and distribution of resources. The first of these is the prohibition of interest(usury) as a major form of injustice as the following Quranic verse makes crystal clear “ O ye who believe! Fear God, and give up What remains of your demand For usury , if you are Indeed believers. If ye do it not , take notice of war From God and His Apostle: but ye turn back, Ye shall have Your capital sums: Deal not unjustly, And ye shall not Be dealt with unjustly”(2”278-279).The implication of this injunction is that countries with current account deficits will replace debt-financing, which was an important factor in the recent financial crises,with equity portfolio and foreign direct investment which are conducive to both the spread of risk among all the concerned parties and to a more stable and growth-

inducing forms of investment (Roubini and Setser, 2004:84). A second injunction which is especially relevant to our present topic prohibits intoxicants and all forms of gambling because of their poisonous effects on the relations of individuals with each other “ O ye who believe! Intoxicants and gambling, (Dedication of) stones, And (divination by) arrows, Are an abomination, Of Satan’s handiwork: Eschew such (abomination), That ye may prosper (Quran). This prohibition of all forms of gambling means that financial markets activities will be relocated from trade in hot money and in search of quick return to long-run and more productive investments. In a third injunction Moslems are warned against another abuse of resources and that is hoarding wealth instead of spending it in the way of God “And there are those Who bury gold and silver; And spend it not in the Way of God: announce unto them A most grievous penalty” (9:34). A fourth injunction commands the believers to pay a specified fraction of their wealth in the form of Zakah (alms) to one or more of eight needy groups” Alms are for the poor And the needy, and those Employed to Administer (the funds); For those whose hearts Have been (recently) reconciled (To Truth); for those in bondage And in debt; in the cause Of God; and for the wayfarer : (Thus is it) ordained by God, And God is full of knowledge and wisdom (9:60) A fifth injunction urges the faithful to use every thing at their disposal to seek salvation on the day of judgment while at the same time enjoying with modesty the lawful utilities and goods in this life and being kind and generous to others as a way of showing gratitude to Allah Almighty “ But seek , with the (wealth) Which God has bestowed on thee, The Home of the Hereafter, Nor forget thy portion in this World: but do thou good, As God has been good To thee , and seek not (Occasions for) mischief in the land (28:77). Also, a sixth injunction describes true believers as those who spend with moderation without going to extremes” Those who, when they spend Are not extravagant and not Niggardly, but hold a just (balance) Between those (extremes)” (25:67).

By blending together the spiritual and the material, this life and the life hereafter, production and distribution, the lawful and the prohibited, these injunctions provide its followers with a code of conduct that provides them in their capacities as parents, teachers, businessmen, politicians , etc.... with the yardstick with which to assess their activities and rectify their mistakes as they proceed with their life on earth thus making them aspire to be both efficient and honest or in the words of Allah Almighty

“ Said one of the (damsels): “O my (dear) father ! engage Him on wages: truly the best Of men for thee to employ is strong and trusty “ (28:26).

And in its wider impact on the whole economy, this Islamic framework is more conducive to both prosperity and stability because by prohibiting speculative capital and all forms of gambling, interest-based transactions, harmful goods and services, and by imposing Zakah, inheritance and other distributional mechanism , and by encouraging moderation and prohibiting extravagance , the Islamic paradigm leads to the following results.

First, the relocation of resources from speculative capital to more productive and job-creating ventures like direct investments which in turn leads to more stable financial and foreign exchange markets. *Second*, as capital shifts to more productive and long-run investments, there will be more jobs and larger production of goods and services which will result in higher rates of economic growth and lower inflation rates. *Third*, the payment of Zakah will induce higher demand, especially from the poor segments of society, for the increased output of goods and services resulting from the productive investment of world capital. *Finally*, the increase in supply and demand will mitigate poverty and reduce the income inequality that exists in many developing countries today, many of them are Moslem countries.

5. Conclusions

The present paper contends that the major cause of the recent financial crises that have struck the world economy over the last three decades is speculative capital which is nothing but a form of *Gharar* or uncertainty that is prohibited in the Islamic context centuries ago even before financial markets as we know them came into existence . In other words, the high cost of speculative capital or *Gharar* that was incurred by the world economy following the financial crises in Mexico , East Asia , or Russia, and other places is another vindication of the viability and infallibility of the Islamic injunctions that are derived from the Holy Quran and the Tradition of the Prophet (PBUH). It is also a reminder that Man needs the guidance of his creator as he fulfills his role as a vicegerent of God on earth and without this guidance he is always subject to being lead a stray by his whims and desires or the limitation of his mind and experiences as attested to by the many failures of our time in all spheres of life.

REFERENCES

- Bhagwati, Jagdish.(2004) *In Defense of Globalization* , Oxford University Press, New York.
- Carbaugh, Robert .(2004)*International Economics*,Ninth Edition, Thomson-South-Western.
- Desai, Padma(2003) *Financial Crisis, Contagion, and Containment: from Asia to Argentina* .Princeton University Press, Princeton, New Jersey.
- Duncan, Richard(2003)*The Dollar Crisis: Causes. Consequences, Cures*, John Wiley & Sons (Asia) Pte Ltd, Singapore.
- Eatwell, John and Lance. Taylor(2000), *Global Finance at Risk*, the New Press: New York).
- _____ (1998) *International Capital Markets and the Future of Economic Policy*, Centre for Economic Policy Analysis (CEPA) Working Paper Series III, Working Paper No.9, New School for Social Research, New York, September)
- Gilbin, Robert(2001) *Global Political Economy*, Princeton University Press, Princeton.
- Huntington, Samuel (1996) *The Clash of Civilizations and the Remaking of the World Order*. Simon & Schuster. New York.
- Ibn Rushd, Abu-al-walid(2003) *The Distinguished Jurist's Primer: Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, Vol.II. Translated by Professor Imran Ahasan Khan Nyazee, Reviewed by Mohammad Abdul Rauf. The Center for Muslim Contribution to Civilization. Garnet Publishing.
- Keynes, John (1936) *General Theory, Collected Writings*, Vol.7, 159: London: Macmillan/Cambridge University Press for the Royal Economic Society.
- Kreinin, Mordechai (2002) *International Economics: A Policy Approach*, South-Western, Ninth edition,
- Noland , Marcus , LI-Gang Liu, Sherman Robinson, and Zhi Wang(1998), *Global Economic Effects of the Asian Currency Devaluations*, Institute for International Economics, Washington , DC.
- Roubini, Nouriel and Brad Setser(2004) *Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies*. Institute for International Economics, Washington D.C.
- Rodrik, Dani (1998) "Who Needs Capital Account Convertibility "in Stanley Fischer *et al* , *Should the IMF Pursue Capital Account Convertibility* , Princeton University Press, Princeton.
- Siddiqi, Mohammed (1985) *Insurance in an Islamic Economy* , The Islamic Foundation: United Kingdom.
- Singh, Kavaljit(1999) *The Globalization of Finance: A citizen's Guide* , Z Books Ltd, New York and IPSR Books , Cape Town,
- Stiglitz, Joseph.(2002) *Globalization and its discontents*, W.W. Norton & Company .
- Strange, Susan (1998) *Mad Money*. Manchester: Manchester University Press.
- Summers, Lawrence and Victoria Summers(1989),"When Financial Markets Work Too Well: A Case for Securities Transaction Tax," *Journal of Financial Services Research* 3.
- Tamarkin, Bob (1993) *The Merc: The Emergence of a Global Financial Powerhouse*, New York: Harper Collins.
- Triffen, Robert (1960)., *Gold and the Dollar Crisis: The Future of*

- Convertability*. New Haven: Yale University Press
- Ul-Haq, Mahbub, Inge Kaul, and Isabelle Grunberg (1996) *The Tobin Tax: Coping with Financial Volatility*, Oxford University Press. New York.
- UNCTAD (1998) *Trade and Development Report*, U.N., New York and Geneva.
- Walden Bellow, Nicola Bullard, & Kamal Malhotra (2000), (Eds.) *Global Finance: New Thinking on Regulating Speculative Capital Markets*, Zed Books Ltd.).