

FINANCIAL INSTABILITY HYPOTHESIS (FIH) OF MINSKY: CONTEXTUALIZING THE ROLES OF ISLAMIC COMMERCIAL AND SOCIAL FINANCE

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Abstract

The main subject of this paper is to discuss some issues in Minsky's Financial Instability Hypothesis (FIH) and relate them with Islamic finance position in enhancing the stability of financial system. The methodology used in the paper is descriptive analysis. It describes a particular concept, namely the financial instability hypothesis and then analyses, applies and compares that concept with other concept, i.e. the Islamic finance concept. It is shown in the paper that Islamic finance, both in its commercial and social aspect, can play its role in stabilizing financial system. The significant contribution of the paper is by bringing together the hypothesis of Minsky with Islamic finance theory and practice. It should be stated here, however, that among the limitations of the paper is that the reference on Minsky's point of view is mostly based on his brief article entitled "The Financial Instability Hypothesis" without referring to his vast writings on various topics directly or indirectly related to his notion of Financial Instability Hypothesis.

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I. INTRODUCTION

Hyman Philip Minsky is well-known for his financial instability hypothesis. The hypothesis simply says that the stability is unstable. Here he means that during the period of prosperity and stability, the capitalist economic system would develop its own destabilizing factors which are inherent in the system. Minsky's thought has been popular among the scholars especially after the recent financial crisis which seems to vindicate the hypothesis. It is with this background that the paper attempts to relate the popularity of Minsky's financial instability hypothesis with the trending Islamic finance industry.

The aim of the paper is to discuss the hypothesis and then puts the Islamic finance theory and practice into its context by evaluating its stabilizing role in the financial system. The paper first summarizes the notion of Financial Instability Hypothesis. It is then followed by some remarks by Janet L. Yellen, the present governor of the Federal Reserves. From her remarks the paper addresses three inter-related issues, namely interest-bearing hedge borrowing, speculative banking nature, and deregulation issue, which contribute the destabilization of the financial system. While discussing the three issues, the paper inserts here and there the role of Islamic finance as a counter-destabilization agent amidst the unstable financial system.

Although the stressing of the paper is more on the role of Islamic commercial finance, towards the end of the discussion the paper includes the role of Islamic social finance. The zakat and cash-waqf have the potentials to contribute to the stabilization process through debt reduction mechanism and *ribawi*-avoidance financial transaction. The paper finally provides some recommendations to the financial authorities in general and to Bank Indonesia in particular to adopt certain measures to enhance the financial stability as discussed in the paper.

II. MINSKY'S FINANCIAL INSTABILITY HYPOTHESIS

Hyman Philip Minsky (1919-1996) was an American economist who remained in the fringes during his lifetime. Although he authored

many books,² it was his conception of “The Financial Instability Hypothesis” (1992) which made him popular among the scholars. The recent sub-prime financial crisis has been a spectacle for his posthumous reputation. Ultimately, the phrase “financial instability hypothesis” is attributed to him and for which Minsky is best known. The phrase, which is the very title of the eight-page essay, is repeated not less than 11 times in the article. Here are the eleven sentences which contain the terminology of “financial instability hypothesis” inside the article (italic is mine):

1. The *financial instability hypothesis* has both empirical and theoretical aspects.
2. As economic theory, the *financial instability hypothesis* is an interpretation of the substance of Keynes’s “General Theory”.
3. The *financial stability hypothesis* also draws upon the credit view of money and finance by Joseph Schumpeter.
4. Key works for the *financial instability hypothesis* in the narrow sense are, of course, Hyman P. Minsky.
5. The theoretical argument of the *financial instability hypothesis* starts from the characterization of the economy as a capitalist economy with expensive capital assets and a complex, sophisticated financial system.
6. The *financial instability hypothesis* incorporates the Kalecki – Levy view of profits, in which the structure of aggregate demand determines profits.
7. The *financial instability hypothesis*, therefore, is a theory of the impact of a debt on system behavior and also incorporates the manner in which debt is validated.
8. In contrast to the orthodox Quantity Theory of Money, the *financial instability hypothesis* takes banking seriously as a profit-seeking activity.
9. The first theorem of the *financial instability hypothesis* is that the economy has financing regimes under which it is stable, and financing regimes in which it is unstable.
10. The second theorem of the *financial instability hypothesis* is that over periods of prolonged prosperity, the economy

2 The titles of his books, for example, are “John Maynard Keynes” (1975), “Can “It” Happen Again? Essays on Instability and Finance” (1982), “Stabilizing Unstable Economy” (1986), “Induced Investment and Business Cycles” (2004). Some of his articles are compiled in a book titled “Ending Poverty: Jobs, Not Welfare” (2013). To read other articles by Minsky, we can access to (10 October 2016): http://digitalcommons.bard.edu/hm_archive/

transits from financial relations that make for a stable system to financial relations that make for an unstable system.

11. The *financial instability hypothesis* is a model of a capitalist economy which does not rely upon exogenous shocks to generate business cycles of varying severity.

The sentences numbered 2, 3, 4, 6, and 8 above are a kind of literature review. The rests are his discourse. Coherently almost all reviews and commentators agreed on Minsky's main contribution on the taxonomy of finance; the Hedge, the Speculative and the Ponzi Finance leading to credit bubbles and financial crisis. The background of his hypothesis is the Keynesian capitalist economic system which he considered to be inherently unstable. The source of instability is endogenous in the system, generating business cycles time and again. The culprits are not only private sectors who are known to be profit maximizers, but also regulators who become complacence and start deregulating. All the economic agents; consumers, producers, governments and foreigners, without an exception, are contributing in this development leading to financial disasters. As a matter of the fact, the system is faulty.

The process is as follows: In times of prolonged capitalism's prosperity, the "herd behavior" of economic agents turned rationality into "irrational exuberance" of Shiller (2000). In due course, the hedge borrowers progressively develop into speculative borrowers and eventually become Ponzi borrowers. The financiers are more than happy to provide funds for those borrowers, regardless of prime or sub-prime borrowers. Lenders and borrowers are in the same boat of euphoria. That is in the private sector side. In the public sector, the story is almost the same. The euphoria of private sector comforts the regulator by relaxing the prudential regulation. Only when the credit bubbles become more visible and have reached their obvious dangerous levels, the markets start responding. The supply of funds now being reduced and cost of borrowing rises. The central bank then interferes with regulatory restrictions. By then it is already too late and out of control. In fact, according to Minsky, the government intervention is the one which pushes the speculative unit financing into Ponzi financing. He states:

"...if the economy with a sizeable body of speculative financial units is in an inflationary state, and the authorities attempt to exorcise inflation by monetary constraint, then speculative units will become Ponzi units..." (p. 8).

Yellen's Remarks

When credit bubbles have been created, the intervention of regulator becomes dilemmatic. On the one hand it will drag the speculative borrowers into Ponzi ones, as Minsky predicted, and on the other hand this intervention could be a stabilizer for the whole financial system. Janet L. Yellen (2009), not long ago before helming the Fed, was of this view. In her speech on the annual conference commemorating Hyman Minsky, she stated that "monetary policy that leans against bubble expansion may also enhance financial stability by slowing credit booms and lowering overall leverage" (p. 11).

How come a government intervention is good and bad at the same time? This shows the paradox of the system when the bubbles have emerged. The problem is the bubbles are endemic in the capitalist economy. Of course, the term 'bubble' is not by Minsky, as we will not find it in his article. However, a similar connotation can be compared therein. Minsky pointed out that "...the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy is a deviation amplifying system" (p. 7). This "deviation amplifying system" is nothing but the bubble.

Destabilizing bubbles are part and parcel of the financial system in the capitalist economy. In fact, according to Yellen (p. 1), the central view of Minsky's hypothesis is "the asset price bubbles". These bubbles emerged everywhere regardless whether the countries adopted accommodative monetary policies or otherwise. Although normally the bubbles would emerge in the countries adopting accommodative monetary policies, there is also evidence that "bubbles appeared in many countries that did not have highly accommodative monetary policies" (p. 3). These bubbles create an illusion of a sense of safety even among the hedge borrowers. "Many of those who thought they were in the hedge category

were shocked to discover that, in fact, they were speculative or Ponzi units" (p. 4).

Yellen is right in pointing out that even Minsky himself might have failed to imagine the mix between the hedge, the speculative, and the Ponzi. Minsky is clear-cut in his category about the good (hedge finance), the bad (speculative finance), and the ugly (Ponzi finance). He always thought that the dominance of hedge borrowers over the rests keeps the equilibrium well without harming the system. Minsky (p. 7) in this regard is believing that "if hedge financing dominates, then the economy may well be an equilibrium seeking and containing system."

That is a very interesting conditional statement from Minsky which has been spotted by Yellen (p. 4) as "a new wrinkle that even Minsky may not have imagined." Now, let us have a look further at his description of the hedge finance units. This is very significant, for from here we will relate with the concept of Islamic finance. He described hedge financing by saying (p. 7):

"Hedge financing units are those which can fulfill all of their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit."

The meaning of the above expression is that what he considered as the hedge borrowers are those who capable to make debt payments, both the interest and the principal, from the current cash flows of their investments. To give an example, in financial markets, assume a business issues bonds to raise \$10 million and agree to pay 5% coupons for 5 years and then repay the principal after 5 years. The business would then need to have at least \$2.5m (\$0.5m interest + \$10m/5 years principal) in annual cash flows to be classified as a hedge borrower. Or in financial intermediaries, it is like a person who borrows to buy a home and every month pays back from his income some of the principal and interest he owes. This is true from the borrowers' side.

As for the lenders' side, take the financial intermediaries for example. Is there any bank that fits to be characterized as the hedge finance? The commercial banks, by the normal standard,

belong to speculative finance units, no more hedge finance units. These are some of the reasons: Firstly, compared to manufacturing companies normally banks are highly leveraged. Their liability structure is far from equity financing. This excludes banks from a hedge finance unit as per Minsky's description above. Secondly, by its nature banking business is speculative. Demand deposits are actually short term debts that are continuously being rolled over, whereas much of the banks' assets are illiquid and longer terms. "If a relatively small amount of loans are not repaid, this can seriously affect the level of equity and leave the bank technically insolvent" (Casu, Girardone, & Molyneux, 2006, p. 204). Thirdly, there is always a tendency of mismatch between banks' assets and liabilities, be they maturity mismatch, interest-rate mismatch, or currency mismatch.

Combining the borrowers' and the lenders' sides, there is a kind of asymmetric financial level between the two. On the one hand the level of borrowers fits to be at the hedge finance unit, while on the other hand the lenders are at the speculative finance unit. When the normal banks are at the speculative finance stage, then the most important financial intermediaries in the economy are about to emerge as Ponzi financial units. Here is the role of the central bank to regulate the banking system not to fall into the Ponzi finance. But again according to Minsky's hypothesis, the prolonged period of economic stability will eventually induce government to relax the regulation and start deregulating.

From the above discussion we can summarize three important situations leading to instability and the systematic risk of the financial system. The first situation is the existence of the so-called hedge borrowers. The second one is the role of the banking system with more characteristics of speculative finance unit. The last one is the deregulating aspect of the government. Let us now evaluate all these three situations with the concept of Islamic finance.

The First Situation

From the Islamic finance point of view, Minsky's description of the hedge borrowers naturally falls under the spell of interest (*ribawi*) transaction which is not Shariah compliant. He considered the

hedge finance system is quite stabilizing and not harmful to the whole financial system. This is in fact where the Islamic finance differs from his view. Prominent scholars of Islamic finance unanimously agree that the interest is immoral and inherently destabilizing (Usmani, 2003; Chapra, 2007; Siddiqi, 2008). The interest (*riba*) is corrupting the financial system. El-Diwany (2003), for example, compares interest and the concept of entropy and highlights the contradiction between the laws of interest and the laws of nature. He illustrates the impossible consequence of compound interest by giving example of a person, living in the year 20 AD, who borrowed 100 loaves of bread. When the interest rate was just 5% a year, by the year 1995 AD the total amount of debt outstanding and now due for payment would be $100(1+0.05)^{1975}$ loaves of bread. The amounts are more than seven hundred thousand billion billion billion billion loaves of bread.

One remarkable fact regarding the size of this repayment amount, *reductio ad absurdum* though it may be, is that there would not be sufficient bread available to meet it, even if every person who has since lived on Earth were to have produced and successfully stored ten million loaves of bread per day for life. Repayment would in fact still be impossible even if the original lender had charged a more lenient 2.5% interest per year (El Diwany, p. 11)

Shaukat and Alhabshi (2015) also argue that interest (*ribawi*) bearing debt finance propels the non linearities in the system's behavior and hence destabilizing. By non-linearity it indicates "the occurrence of those events which were deemed as highly improbable or never occurring" (p. 36). This occurrence of what they termed "black swan" is unpredictable and this would in turn become the internal source of instability. This unpredictable system's behavior perhaps has its own psychological basis in what el-Gamal (2006) called "human time inconsistency". He claimed that "it is well documented in psychological and behavioral economics research that humans exhibit fundamental forms of irrationality in time preference" (p. 55). He illustrated that most individuals would prefer \$105 in twenty years rather than \$100 in nineteen years, but prefer \$100 today rather than \$105 in one year. So an interest rate of 5 percent looks adequately low for the current time, but high for further time in the future. The myopic human nature would propel

excessive borrowing behavior as time goes by. This should explain the psychological basis of Minsky's hypothesis about the shift from the hedge borrowers into speculative borrowers and eventually into Ponzi borrowers in the long run.

Referring to El-Gamal's analysis (p. 56) the Minsky's hedge borrower showing this type of time preference, for example, will borrow \$100 today and plan to have savings to pay the principal plus the interest of \$5 over the year. However, once the future comes and becomes the present, the same individual would borrow even more as he perceives the present consumption is more valuable than future consumption. The hedge borrower might now be under illusion that he will have more savings to pay off the bigger principal and more interest. When the future turns into the present the psychological cycle to borrow more and more comes again and the cycle never stops. Some of them would fall under the prey of greedy lenders who ruin their lives. This is exactly what had happened with the credit card defaulters in the modern societies.³

The view of Islamic finance with regard to borrowing on interest (*riba*), regardless whether it is a hedge borrowing type, is categorically negative. In this regard religious injunction could function as a supreme regulation to prevent myopic and short-sightedness of human behavior against the time and the abuse of credit availability at his own individual cost. In fact not only Islam which is against the interest bearing loans, but other major religions are doing the same too. One, nevertheless, can argue that government regulations are undertaking the same thing to prevent individuals from borrowing excessively or becoming prey of the predatory lenders. Is government financial regulation not enough? To counter the argument, I would like to quote a good answer from El-Gamal:

...regulators care primarily about the general health of the financial system – their concern about financial health of specific individuals being secondary at best. Thus, regulators may allow certain types of transactions that are hazardous to a few individuals, based on the

3 To view a real example of credit card defaulter, we can read the following news (accessed at 10 October 2016): <http://www.stuff.co.nz/business/world/77409732/From-riches-to-rags-how-credit-card-debt-destroyed-a-family>

trade-off between that particular group's well-being (which is not their primary mandate) and overall systematic well-being...(p. 55)

So from the Islamic finance point of view the interest (*ribawi*) dealing-hedge borrower is not good enough to protect the financial system from destabilization. When Minsky condones the hedge borrowers who are able to pay the principal and its interest, the Islamic finance does not allow this interest. Islamic social finance considers borrowings and loans must be interest-free loans (*qard al-hasan*) and this can be extended into *zakat* and *waqf* alternatives. When it turns into Islamic commercial finance, interest-bearing loan would be converted into profit sharing modes (*mudarabah* and *musharakah*) or credit sales (*murabahah*). By following religious injunctions in addition to government regulations, Islamic commercial and social finance would enhance the stability of the financial system.

The Second Situation

Now let us move to the second situation, namely the characteristic of banking system as speculative finance unit. Unlike the role of banking in the orthodox quantity theory of money, Minsky's hypothesis claimed that it "takes banking seriously as a profit-seeking activity" and labels the bankers as "merchants of debt" who need to be innovative to assure profits (p. 6). However, Minsky seems to be inconsistent in this regard.⁴ On the one hand he described banks as the hedge units, and yet, on the other hand, his description of speculative unit fits the banking business characteristic. To him the speculative unit is the unit which needs to "roll-over" its liabilities and characterized as the unit that cannot repay the principal out of income cash flow (p. 7). This exactly reflects the banking business characteristic in its asset-liability management. I already indicated earlier that Janet L. Yellen had spotted 'a new wrinkle' which Minsky may have not imagined in his hypothesis.

⁴ In this article Minsky included banks under the hedge units. He said, "Governments with floating debts, corporations with floating issues of commercial paper, and banks are typically hedge units." (p. 7). But in another article he included the commercial banks under the speculative units. He said, "Commercial banks are speculative institutions." See his article entitled "Global Consequences of Financial Deregulation" (p. 10). This article is available at (11 September 2016): http://digitalcommons.bard.edu/hm_archive/378/

This new wrinkle, according to Yellen, is related to the fancy methods of financial engineering and innovations. With these new financial products banks assumed that they are in the hedge category, while they are in fact in the speculative or even Ponzi category (Yellen, p.4).

With financial innovations and financial engineering to support their balance sheet banks are now under the illusion of low risk. These innovations include financial derivatives designed to hedge against risks. These derivatives are quite recent phenomena. Financial futures, for example, are relatively new as they were just created in 1975. Approaching their creation, Mishkin (2016, p. 285) pointed out that for the first time "officials at the Chicago Board of Trade realized that if they created future contracts in financial instruments, which are called financial derivativesthey could be used to hedge risk." Without realizing the consequences, these derivatives are in fact detrimental to the financial system in the long run. Warren Buffet (2003) characterized them as 'time bombs' and 'financial weapon of mass destruction'.

This 'hedging illusion' induces banks to perceive that as if they belong the hedge finance units, while in fact they are in the speculative units. Banking is indeed a very risky business vulnerable to not less than 25 types of risk (Casu *et al.*, pp. 259-277). One of the major risks in banking is the liquidity risk in the balance sheet. It is created by the mismatch between the size and maturity of assets and liabilities. To overcome the maturity mismatch, for example, the management has to roll-over its short-term liabilities of their demand deposits especially when deposit outflows occur. Otherwise there will be a bank run if a bank cannot meet depositor demands. It is a well-known fact that a bank does not have enough cash to fulfill major withdrawals at the same time, let alone all withdrawals. Banks basically cannot repay the principal from their short-term income cash-flows. This is precisely the characteristic of speculative unit by Minsky.

Some scholars such as Mills and Presley (1999) also affirm that in order to make profits banks rely on the confidence of depositors in the redeemability of their deposits. In effect banks "gamble that....depositor confidence hold, in order to remain solvent and liquid" (p. 85). Unfortunately, banks cannot predict the demand for

deposit withdrawal in extreme circumstances. In this situation, even “a solvent bank may be unable to honor its commitments by being locked-in to longer-term assets. If this is anticipated, rational depositors will ‘run’ to avoid repayment delay” (p. 86). In that circumstance only the bail-out from the government will save the survival of a bank. In the worst case, when the bank run develops into a bank panic, this originally liquidity risk eventually turns into a systematic risk leading to financial crisis.

Some other scholars, such as Hassan (2014, p. 43) ascribed the safety deposits as “a function of efficient bank management and the alertness of the regulators, supplemented by adequate deposit guarantee schemes.” Of course the banks and the regulators have prepared themselves with the hedging mechanism through deposit insurance. However, according a World Bank researcher, at the macro level “deposit insurance can exacerbate moral hazard problems in bank lending, making systems more fragile..... This is ironic since deposit insurance is supposed to make the systems more stable, not less” (Demirgüç-Kunt, 2014). The research has shown that deposit insurance does not guarantee the stability of the financial system in the long run.

In fact the insurance business itself is also a speculative business.⁵ Mills and Presley (pp. 90 -91) likewise analyzed the supply side of the deposit insurance which apparently faces an inherent dilemma, as bank run can only be prevented when 100 percent coverage of deposit is granted. This, however, can only be given by a government loan guarantee to depositors, giving them less incentive to monitor their bank’s excessive risk taking and creating moral hazard problem. Eventually deposit insurance agency resorts to some kinds of coinsurance by limiting the sums guaranteed. This predicament created problems in US banking system as the absence for large coverage deposits triggered corporate depositors and other banks to initiate ‘runs’ against suspect banks. Deposit insurance “is now blamed for much of the fragility of the US banking system, particularly in the Savings and Loan (S&L) sector” (p. 91).

5 The inter-link between banking and insurance speculative business can be viewed in the Wall Street Journal in the case of AIG, one of the biggest insurance companies in the world. Available at (22 September 2016): <http://www.wsj.com/news/articles/SB10001424052748704201404574590453176996032>

As a speculative business, the serious profit-seeking bank in fact has become the link between the hedge finance and the Ponzi finance. The bank itself is already on the side of speculative finance. It is just a matter of time when the bank would transform into a Ponzi finance. In this regard only the government regulation can prevent this eventual dangerous transformation. However, when the government itself now starts deregulating, characterized by Minsky as the merchants of debt, banks are now ready to jump into Ponzi finance to seek for the profits.

What about Islamic banking? Is it not a speculative business either? The answer is certainly positive. However, theoretically speaking Islamic banks would be less susceptible to instability compared to the conventional banks. A World Bank policy research working paper has notified this advantage. It says:

In the *theoretical version*, Islamic banks would at face value be less susceptible to instability than their conventional counterparts. This comparative advantage is rooted in the risk sharing feature where banks participate in the risks of their counter-parties, and investment depositors share the risks of the banking business. Direct market discipline is embedded in this risk-sharing principle. In the theoretical model, any negative shock to an Islamic bank's asset returns is absorbed by both shareholders and investment depositors. While depositors in the conventional system have a fixed claim on the returns to the bank's assets as they are paid a predetermined interest rate in addition to their guaranteed principal irrespective of the bank's profitability, holders of profit sharing investment accounts in the Islamic system share in the bank's profits and losses alongside the shareholders, and hence are exposed to the risk of losing all or part of their initial investment (El-Hawary, Grais, & Iqbal, 2004, p. 17).

Unfortunately at the practical level there is a divergence from profit and loss activities to other modes of financing. Even within the profit sharing mode itself the practice of distributing profits adjustment such as using the profit equalization reserve, has 'neutralized' the risk-sharing advantage towards a kind of

displaced commercial risk (p. 18). In this 'smoothing' practice, "the institution as *mudarib* forgoes part or all of its share of profits and passes these to the customer, commonly to match the investment yields offered by competitors in the market" (Bhambra, 2007, p. 204).⁶ A recent empirical study done by Verbeet (2014) shows that at the practical level "Islamic banks are not any more stable than conventional banks" (p. 77). Potentially, however, Islamic banks should be more stable than their conventional counterparts. The same research, which used a sample of Malaysian conventional and Islamic banks and two British conventional banks, showed that large Islamic windows operating in conventional banks are more stable than pure Islamic or pure conventional banks in this dual banking system (p. 79). An earlier working paper of International Monetary Fund (IMF) prepared by Čihák and Hesse (2008) also found that "Islamic banks, while relatively more stable when operating on a small scale, are less stable when operating on a large scale" (p. 21). The paper covered individual Islamic and commercial banks in 18 banking systems with a substantial presence of Islamic banking.

There are three conclusions that can be derived from the above researches. First, the small size full-fledged Islamic banks are still more stable than the same size of pure conventional banks. Second, the big Islamic windows provide more stability. Third, stability of big Islamic banks is not higher than the stability of conventional banks. So theoretically and potentially, Islamic banks can be more stable than their conventional counterparts. At the practical level and under certain conditions, the existence of Islamic banks could be the stabilizing agents within the instable speculative banking system.

The Third Situation

We already discussed the problem with interest in conventional hedge borrowing and the bank's speculative nature. All of them contribute to the instability of the financial system. Now let us

⁶ According to her, this practice of 'smoothing' will create problem to the regulator as well. There will be uncertainty in trying to establish a regulatory framework for a product that is not treated consistently or according to theory across the industry. (p. 204)

move to the third situation leading to similar instability and the systematic risk of the financial system. It is the deregulation issue.

Minsky has indicated that government played a major role as "refinancing agents" for financial institutions in the modern world. This greater involvement, however, "may make the system behave differently than in earlier eras" (p. 5). Minsky was also known for his post-Keynesian view,⁷ supporting government intervention in financial markets and opposing financial deregulation. He (Minsky, 1986) wrote a specific article on the deregulation issue entitled "Global Consequences of Financial Deregulation." Interestingly in this article he equated regulation with deposit insurance by saying that "...regulation is the other side of the coin of deposit insurance" (p. 20) which has moral hazard dimension, as we discussed earlier. The question is, why government eventually fall into deregulation? Minsky answered that it is because "the regulators live in the same environment as the regulated" (p. 21). The illusion of low risk perceived by the banks is also experienced by the regulators. In his own words, Minsky pointed out that, "...decrease in the risk aversion or in the perception of risk by financing units is accompanied by greater permissiveness by the regulators" (p. 21). In our earlier discussion, we have shown that the financial innovations are conducive for such environment responsible for the illusion of low riskiness.

It should be noted that the deregulation that Minsky talked about is the one which happened in the most advanced economies, especially in the US. The systemic factor has played a major role in inducing the deregulation in those countries. But the same deregulation can also happen in the emerging economies for different reasons. A study done by Bennett (1999) on banking deregulation in Indonesia, for example, shows that "how the banking deregulation program pursued by the Indonesian government since 1983, and in particular since the reforms enacted in 1988, left the banking sector vulnerable to a system-wide collapse" (pp. 8-9). Reviewing the regulation process, the article highlights that;

7 For his Post-Keynesian view, we can read, for example (at 12 September 2016): http://digitalcommons.bard.edu/hm_archive/336/ and http://www.levyinstitute.org/pubs/conf_june10/Keynes-Minsky-PKs.pdf

In general, the banking deregulation program in Indonesia involved opening up a previously state-bank-dominated sector to increased private competition and reducing direct government control over basic banking practices, such as the setting of interest rates and the allocation of loans (p. 19).

In fact the condition of the deregulation program in the emerging economies is worse compared to that in the advanced economies. The reason is that the regulatory infrastructure is less effective in the emerging economies in the first place. With regard to those countries, the article points out that, "the regulatory framework of the banking system was underdeveloped and the regulators themselves were understaffed and poorly trained to provide adequate external supervision" (p. 21)

We can see from the above discussion whether the financial deregulation program is exercised in the advanced economies or in the emerging economies, the long term impact is the same, namely financial instability. Mishkin (2016), for example, suggested that the two types of economies require enhanced regulatory framework. For the advanced economies, they even need a more synchronized global financial regulatory framework (p. 330), while for the emerging economies they need more prudential regulation and supervision of banks (pp. 355-356). As the financial sector is already among the most heavily regulated sectors in the country, enhancing the regulation is again needed to improve the stability of the financial system.

III. ISLAMIC FINANCE VIEW ON THE CURRENT FINANCIAL REGULATION AND DEREGULATION

Sometime ago in January 2011 I used to write a brief article about the recent sub-prime financial crisis and its impact on Islamic banking. As the article has certain relevancies here, let me reproduce some excerpts of that writing:

We know that financial deregulation might have contributed to the recent financial crisis, but government regulation that condones debt trading would not be able to prevent the same crisis in the future. Similarly a

financial strategy under the name of securitization would not stop the crisis either, though it would distribute the risk. In Islamic banking and finance we have the discipline of Shariah. Firstly, Shariah prohibits *riba* and of discounted sale of debt. Secondly, it proscribes uncertainty and speculative financial dealings, such as financial derivatives. Thirdly, Shariah does not give much freedom to financial market trading as it does to the real market trading of goods and services. Thus, with the Shariah discipline Islamic financial institutions have more protective belts with which to face financial crises compared to its counterpart where the discipline is based on government regulations that condone practices such as debt trading. On the other hand Shariah discipline places limits on the freedom of contract in financial markets. Human behavior may change regulations through deregulations, but in the Shariah there are certain unchanging constraints. It thus serves to strengthen government regulation and enhance financial strategy in the long term.⁸

I stated above that Islamic finance has more protective belts compared to the conventional finance in term of the regulatory protection. The former is regulated both by the government and the Shariah, whereas the latter is regulated only by the government. When Islamic financial institutions truly follow the Shariah, the preventive measures that prompt to financial risks would be minimized. For example, there are ample injunctions in the Shariah which prohibit unbundled sales of risks (*gharar*). Even when the government regulatory allows some aspects of risk trading, such as financial derivatives, the Islamic commercial financial institutions would avoid them, making them less exposed to the risks.

Complying to the established religious injunction in addition to government regulations can be labelled as paternalism. It is true, when the Shariah regulation governs the behavior of Islamic finance, it can be charged as the paternalism in the sense of

8 We can read this writing in (accessed at 5 October 2016):
<http://www.iflibrary.org.uk/Newsletter/LIBRARY%20E-NEWSLETTER%20January%2012.pdf>

venerating the paternalistic image of God, the Lawgiver. This type of behavior or discipline is not without reasons. The rationale behind this type of paternalism is that, as El-Gamal (p. 46-47) pointed out "when God forbids something that contains some good, ... it must be because of the potential for greater hidden harm..... [as] humans may be lured by the apparent benefits and thus lose sight of the greater harm." For example, Shariah has categorically prohibited *riba* (trade in credit) and *gharar* (trade in risk), though government allows them by regulating and setting the limits. In this situation Islamic finance would exercise its paternalism and its own rationality, giving the system additional protective belts. "While financial regulators seek to limit the scope of credit and risk trading to prevent systemic failures, Islamic jurisprudence introduces injunctions that aim to protect individuals from their own greed and myopia" (El-Gamal, p. 48).

Looking from a different perspective, Islamic finance would perceive government regulation and the Shariah injunction as two interrelated measures but with different behavioral impacts. From the Islamic finance point of view the government regulation is a sort of narrow-based discretionary government policy, while the Shariah injunction is a kind of broad-based constitutional concept of state policy. Government policy refers to incidental interference with budgetary measures (fiscal and monetary policies) while the state policy adds all ethical values and constitutional directives that make up for an on-going pursuit of socio-economic well-being. Setting of interest rates (*riba*), for example, is a matter of government policy, namely monetary policy. But the same interest rate (*riba*) is perceived as a matter of constitutional law from the Islamic finance point of view. Hence Islamic finance would not go against the constitution which prohibits interest (*riba*). This behavior of Islamic finance will guarantee more stability vis-a-vis the deregulation issue. As constitutional law cannot be deregulated easily, sticking to avoid *riba* and *gharar*, for example, would enhance the stability position of Islamic commercial and social finance institutions within the conventional financial institutions.

We said earlier that enhancing the regulation is needed to improve the stability of the financial system. Why? Mishkin (pp. 273-274) interestingly provides at least three reasons for it. Firstly, financial institutions have strong incentives to avoid existing

regulations in their search for profits. So the regulators always face a moving target. They are playing cat-and-mouse with financial institutions. Secondly, precise detailed regulation is always needed. Unless the regulators get the regulation just right, they are unable to prevent excessive risk taking by the financial institutions. Thirdly, regulated financial institutions may lobby politicians to bend the regulations to go easy on them. Mishkin himself is pessimistic about finding out the solutions to overcome the above problems. "For all of these reasons, there is no guarantee that regulators and supervisors will be successful in promoting a healthy financial system." (p. 274).

The common factor to these three reasons in fact lies on the human behavior which cannot be governed by equally man made law. Therefore, there must be a law higher than the man made law to govern human behavior. This law, from the Islamic finance point of view, is the Shariah law. This religious law which prohibits interest (*riba*), for example, is actually a universal law agreed upon by all great religions. Islamic financial institutions, be they the commercial or social finance institutions, are supposed to be more disciplined and committed as they are governed by the religious law of Shariah. This behavior in turn would enhance the stability for the financial institution itself and ultimately for the financial system as a whole.

IV. THE POSITION OF ISLAMIC COMMERCIAL AND SOCIAL FINANCE

When we say Islamic bank or Islamic finance in the above discussion we refer mostly to Islamic commercial bank or Islamic commercial finance which have more distinctive features than the conventional commercial counterparts. These special features could make Islamic commercial finance less vulnerable to risks than conventional finance. In the case of Islamic commercial banks, for example, they have distinctive features which offer more comparative advantages in absorbing certain types of risks. Čihák and Hesse (p. 6) have pointed out a number of features of those advantages. Similarly with regard to Islamic commercial finance which is broader than merely Islamic bank, the former has distinctive features different from the conventional finance. According to recent study by

Haneef and Smolo (2014) these distinctive features which are “deeply rooted in the teachings of the Shari’ah (Islamic Law), proved to be a blessing for the IFI..... [as] the crisis had a limited effect on Islamic Finance” (p. 21).

In fact, according to the same research (p. 36), the recent global financial crisis has given an opportunity for Islamic financial industry to take a leading role in making the financial system better. The paper suggested two important steps so that the Islamic commercial finance could play the leading role: One, Islamic commercial finance should promote more equity-based products and implement the ethico-legal principles⁹ when offering debt products. By the ethico-legal principles, the research means “the ethical considerations to legal requirements”... such as not to “skillfully deploys various marketing tactics to lure customers to seek loans and other debt financing from the bank” (p. 31). Two, the regulatory and supervisory bodies should develop and implement new standards based on the ethico-legal principles on the entire financial services industry to avoid the arbitrage between conventional and Islamic financial sectors.

As for the Islamic social finance, according to 2015 report of Islamic Research and Training Institute (IRTI) – Islamic Development Bank (IDB), it includes zakat, waqf, micro-finance and philanthropic financing.¹⁰ It is very obvious that one category of the recipients of zakat is the individuals who are trapped in debt (al-gharimun). As debt is the main reason for individual bankruptcy, like in the case of credit card defaulter in our earlier example, settling the debt or at least decreasing the debt burden will help individuals and in turn the society as a whole. Islamic financial institutions as the zakat payers can also channel their zakat funds to their own customers who happen to have financial insolvency.

A waqf, another form of social finance, provides for flow of benefits on a sustained basis. Unfortunately in the IRTI report above, there is no information about the practice of cash waqf in

9 This observation on ethical business has equally been addressed by Archer and Karim in their concluding remarks of a book edited by them entitled “Islamic Finance – Regulatory Challenge” referred to above. The two said: “A major advantage of the *Shari’ah* in this respect is its insistence on the ethical dimension of business.” (p. 406).

10 See Islamic Social Finance Report 1436 H (2015) by IRTI. Available at (9 October 2016): <http://www.irti.org/English/News/Documents/ISLAMIC%20SOCIAL%20FINANCE%20REPORT%202015.pdf>

contemporary Muslim world. In history, however, the waqf had played a major role in social finance (Çizakça, 2000; Singer, 2008). Many articles have been written on cash-waqf as well, such as Ahmed (2007), Chowdhury, Ghazali and Ibrahim (2011), Ali (2014), and Arshad, Haneef, Ghani, and Mohammed (2014). Recently, a theoretical study about cash waqf as an alternative to *riba*-based financing for the contemporary Muslim world has been done by Ahmad (2015). The study concludes that financing through cash-waqf, if efficiently regulated, is "capable of replacing Micro Finance Banks whether Islamic or conventional" (p. 72).

Even without replacing them, if the cash waqf and the Islamic micro finance could co-exist, the financial system would become more stable. The most recent study on cash waqf by Ascarya, Rahmawati and Sukmana (2016) on various models of cash-waqf-financing in fact proposes a combination of cash-waqf and the Indonesian version of Islamic microfinance BMT (Baitul Mal wat Tamwil). In this article the research suggests that the regulator should give the Islamic microfinance BMT a right to manage its assets and liabilities by its own institution like other financial institutions. Currently the regulation in Indonesia does not allow Islamic microfinance BMT to manage its balance-sheet freely, especially on its asset investments. However, according to this research, an independent balance-sheet management of the BMT's cash-waqf would enhance the liquidity and hence reduce the asset-liability mismatch. In turn, the micro financing, the real sector financing and the BMT assets would also grow. The research concludes that in effect "the overall growth would make the BMT stronger, more stable and more resilient against the external shocks" (p. 46).

Klapper and Zia (2009), in their development research in the World Bank, have linked the financial literacy and the financial stability. As the grassroots and the poor section of the society would access to financing, become more bankable and more financially literate, all this in turn would enhance the financial stability. Through the ethico-legal principles' regulation that we have talked about earlier, such as via customer protections and financial educations, the large section of the society including the grassroots, would eradicate their financial illiteracy. The more

financially literate the customer the more stable the financial system. The reason is simple; less asymmetric information.

V. CONCLUSION

The paper has discussed the concept of Financial Instability Hypothesis propounded by Minsky together with the remarks by the present Fed governor, Janet L. Yellen. Financial instability is inherent in the capitalist economy due to financial bubbles' creation and burst. The bubbles are formed by human psychology and myopic sight guided only by his bounded rationality. Human being needs paternalism from Religion to transcend his rationality. This is where the concept of Islamic finance arises, combining financial rationality and the religion of Islam. The hedge finance that Minsky talked about, for example, satisfies the human rationality, though it is not up to the level of Religion, since this type of finance is based on interest (*riba*) which is rejected by all religions. Moreover, the banking system created from this rationality has been identified as speculative finance system. This system needs very stringent regulation in order not to develop into a Ponzi financial system. However, as long as the regulation comes from the bounded rationality of human being, this prudential regulation can always be deregulated. According to Islamic finance's point of view, the prudential regulation will be enhanced and fixed by the Shari'ah discipline and commitment. Since regulation would act as a regulatory policy, the Shari'ah would act as a constitutional law of the Islamic financial institutions. This approach will stabilize the financial system in the long run, provided there is a coherent regulatory system to avoid arbitrage between Islamic and conventional financial sectors. Islamic commercial finance has propounded this theoretical aspect since its very inception. It has also shown its practical and empirical evidence as a stabilizing agent for the financial system as a whole to a certain extent. Another dimension of Islamic finance is Islamic social finance with zakat and cash waqf in its core. With it, the issue of indebtedness and financial illiteracy could be properly addressed. Solving indebtedness leads to more solvency and financial literacy means less asymmetric information. Both surely would contribute to the financial stability.

VI. RECOMMENDATIONS TO FINANCIAL AUTHORITIES

Based on the above discussion, the paper would suggest the following points based on the ethico-legal principles to enhance financial stability. *Firstly*, the rational prudential regulation should take into consideration the established religious injunctions such as prohibitions of *riba*, *gharar* and gambling (*maysir*) in the banking and financial transactions. If it is not possible to eliminate them completely, it should have a gradual long term plan towards it. *Secondly*, the authorities should give equal opportunities and supports to Islamic commercial and social finance to grow within the present financial system, as there is evidence that they can become the stabilizing agents in the dual financial system. *Thirdly*, the financial institutions should provide financial education to their customers to reduce financial illiteracy as part of their CSR. *Fourthly*, the central bank and the financial authority should regulate the Islamic financial institutions to abide by their theoretical principles more towards equity financing than the debt financing. *Fifthly*, especially for Indonesia's case, the regulators should give a try for the BMT-cash-waqf microfinance to manage its balance-sheet independently.

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