From a Debt Ridden Economy to a Real One: An Islamic Perspective

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Abstract

This paper has studied the harmful effects of debt on the three economic agents: consumers, business and government. The detailed analysis shows that heavy dependence on debt leads to bankruptcy for individuals, businesses and even for governments. This paper finds a non-linear relationship between debt to asset ratio and economic well-being of individuals. Economic well-being increase at lower levels of debt to asset ratios and reaches an optimal level. Further increase in this ratio leads to decrease in the economic well-being.

It is recommended to minimize the level of indebtedness and promote self-sufficiency at all levels. There is need to develop financial capabilities of people, to extend debt advice and debt management, and to develop social institutions providing debt solutions.

Keywords: Consumption, Public Debt, Corporate Debt, Personal Debt

1. Introduction:

After the financial crises of 2008/2009, the nucleus of the discussion of academicians, policy makers and gurus of financial markets was debt deflation, Minsky moments and Ponzi schemes. They have the conclusion that outflows should be less than the inflows. Outflows more than the inflows have many negative implications on the society(1), economy, as well as on the state(2).(3) explained the triple structural dimension, i.e., state, debt and power and concluded that debt makes the debtors as sinner and creditors as saints. If we look around the world, we will be distressed that most of the economies are built around debt. It is considered necessary for the three economic agents, consumers, businesses and governments to function on debt. There is a whole area of business that entirely depends on debt. Underlying assumption is that debt is a necessary condition for daily commerce and drives towards a successful economy. An average household is trapped in this lifelong vicious circle of debt and interest repayment. A heavy consumer debt adversely affects the health of an economy when it forces consumers to spend less (4).

The main function of money is to facilitate the transactions of real goods and services. The Quantity Theory of Money states that given the velocity of money, money supply should be just enough to facilitate the transaction of real GDP. For a given level of GDP and velocity, if the money supply increases, it will only lead to inflation. Unfortunately, recently the monetary sector has been losing the link with the real sector. Monetary and financial sector is much bigger and increasing at a much higher rate than the real one.

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Increasing dependence on plastic and virtual money rather than paper money has encouraged borrowing and increased indebtedness of the society. Even businesses are encouraging people to buy product on credit.(5)

The problem is that people have shifted toward demanding things now rather than saving for them. In turn, they are willing to borrow beyond their means without doing the proper research. It is too easy to get credit. A lot of people don't think about future and tend to buy on credit, even though they will be paying huge interest rates in future.

Some levels of credit may be acceptable or even necessary. However, in certain situation credit falls down when it is goes out of control, reaching debt levels that can never be repaid. Debt may be a necessary evil for a national economy, however, it should stay at a minimal level and my not become a norm in personal lives. In cases when one has to resort to debt one should make every effort to repay it at the earliest convenience.

The issue of debt is closely related to morality so it should be seen in the context of a moral viewpoint. If morality is taken out of consideration in the issue of debt it results in trivializing this issue and close our eye to the long-term damage caused by it. (3) states that: "Creditors are prone to be seen as "saints," debtors as "sinners." Virtue is attached to the former (prudence, hard work), and vice to the latter (fecklessness, laziness). This kind of language puts at stake dignity, honor, and mutual respect. It arouses base as well as noble emotions, including resentment, grievance, and rage. The moral and emotional dimensions of debt are intimately intertwined."

Banking sector's powers to increase money supply through credit creation are leading the economy away from stability. Because of partial required reserve system, banks create huge levels of credit. Many Islamic economists are in favor of imposing a hundred percent reserve system thus taking away the ability of banks to create money. According to them it brings more stability to the system.(6)

Banks have become professionally skilled in packaging and repackaging debt into whatever form due to its lack of tangibility. A good example of the phantom nature of debt are derivatives. These securities have no real value, however, they are traded and rated as real commodities. This is a kind of fiscal time bomb orthe Ponzi scheme that reached a tipping point in the financial crisis of 2008.(7)

According to the debt deflation theory of Minsky, the current financial system is inherently unstable. It is the leading factor behind the business cycles. Minsky identifies three income-debt relations for economic units: hedge, speculative and Ponzi finance. Hedge institution is the one who can pay all their financial obligations, principal and interest with their cash flows. The speculative units have enough cash to pay for the interest expenses but not the principal. The Ponzi units are not in the position to cover either, so they have to either sell their assets or further borrow to meet their meet their financial obligations. This will decrease the prices of assets causing debt deflation. A financial system will be more stable if it contains more of hedge financing. However, larger portions of speculative and Ponzi

financing units will lead to an unstable financial system.[8]

The rest of the paper is organized as follows: Section 2 discusses the optimal policy about public debt and corporate debt. Section 3 talks about different aspects of personal debt. Section 4 discusses some solutions to the personal debt problem and section 5 concludes.

2.1 Harmful Effects of Public Debt on Economy:

A certain level of debt has been considered necessary for developing economies to finance their development projects. The developing nations generally don't have resources to finance these projects but they are vital for their long term growth. So debt provides them a way to achieve their goals.

However, an unwanted side of this debt facility is that some nations become dependent on these loans that apparently are offered at easy terms. A part of these loans are deducted at sources for the outrageous salaries of technical experts provided by the donor country. Another part is wasted in providing perk for the bureaucracy and high official. Eventually a small part of the loan is spent on the project. However, in the long run this accumulated debt becomes a national responsibility and has the moral implications on the economy[9].

Studies show that these enormously accumulated debts lead to decrease in the growth rates of these countries. Sometimes it also leads to bankruptcies of nations. The debt does not nurture economies rather it suffocates them and instead of raising growth rates it shrinks them. Many studies like[10],[11],[12],[13] come to the conclusion that external debt negatively affects economic growth.

The debt-to-GDP ratio is the debt as a percent of the total country's production, or GDP. For the US this ratio was $16.6 trillion as of June 2013. That made the ratio greater than 100%, raising alarms for policy-makers. Interest on the debt was $454 billion in fiscal year 2011, the highest ever. The interest on the debt in the fiscal year 2013 budget is $248 billion. Checherita and Rother [14] study the impact of debt on GDP for ten European Union nations and find out a non-linear relation between the two. According to their results, after about 90-100% of debt to GDP ratio has a negative impact on long term growth they also find that the annual change of the public debt ratio and the budget deficit-to-GDP ratio are negatively and linearly associated with per-capita GDP growth. They propose debt reduction to support longer-term economic growth prospects.

Maghyereh [15] studied the link between debt and growth rate for Jordanian economy and found that external debt below the 53 percent of GDP had a positive relationship with GDP and the relationship became negative for higher levels of debt ratio. [16] studied the same relationship in the context of Jamaica and found even a lower threshold level of debt which was 21 percent of GDP. Debt was positively associated with productivity below that level, but became negative and significant above that level. He also found that doubling of public debt reduced productivity growth by about 1.5 percent. [17] found that for the case of Pakistan public external debt had negative relationship with per capita GDP and investment and confirmed

the existence of "Debt Overhang Effect".

A debt becomes an issue of national security if a greater part of it is owed to foreign creditors. As of September 2012 for the US, foreigners held $5.455 trillion, or roughly one third of total U.S. debt. China holds $1.155 trillion and Japan owns $1.131 trillion. The oil exporting countries are the third largest holders, at $267 billion, with Brazil next at $251 billion. The Caribbean Banking Centers are fifth, holding $240 billion.

Table1

Public Debt Composition in Developing Countries

	1994	1999	2005
	DD/Y ED/Y TD/Y DD/TD	*DD/Y ED/Y TD/Y DD/TD*	*DD/Y ED/Y TD/Y DD/TD*
Simple Average			
EAP	0.13 0.46 0.58 0.30	0.13 0.43 0.55 0.34	0.15 0.35 0.50 0.38
ECA	0.170.28 0.46 0.35	0.15 0.32 0.47 0.36	0.17 0.19 0.36 0.43
LAC	0.14 0.58 0.72 0.24	0.17 0.39 0.56 0.33	0.23 0.39 0.62 0.40
MNA	0.42 0.49 0.91 0.45	0.36 0.42 0.78 0.43	0.40 0.34 0.73 0.56
SAS	0.25 0.35 0.60 0.41	0.26 0.34 0.59 0.42	0.31 0.33 0.64 0.47
SSA	0.20 0.84 1.05 0.25	0.33 0.78 1.12 0.32	0.25 0.67 0.92 0.30
Total	0.19 0.55 0.75 0.30	0.22 0.47 0.69 0.35	0.23 0.40 0.64 0.40
Weighted Average			
EAP	0.10 0.08 0.18 0.46	0.13 0.06 0.19 0.71	0.18 0.05 0.23 0.80
ECA	0.27 0.29 0.56 0.46	0.20 0.32 0.52 0.45	0.20 0.14 0.34 0.50
LAC	0.15 0.21 0.36 0.40	0.25 0.22 0.47 0.49	0.30 0.14 0.44 0.66
MNA	0.54 0.54 1.08 0.47	0.38 0.39 0.77 0.48	0.40 0.26 0.66 0.59
SAS	0.40 0.14 0.55 0.77	0.44 0.11 0.55 0.81	0.55 0.08 0.63 0.87
SSA	0.43 0.36 0.79 0.73	0.38 0.33 0.71 0.67	0.26 0.19 0.45 0.65
Total	0.22 0.21 0.43 0.48	0.24 0.19 0.43 0.59	0.27 0.11 0.39 0.69

Note: The 1994 average covers 85 countries, the 1999 average covers 103 countries and the 2005 average covers 97 countries. The regional abbreviations are: EAP: East Asia and Pacific; ECA: East Europe and Central Asia; LAC: Latin American and Caribbean; MNA: Middle East and North Africa; SAS: South Asia; SSA: sub-Saharan Africa. DD/Y is domestic public debt divided by GDP, ED/Y is external publicdebt divided by GDP, TD/Y is total public debt divided by GDP, DD/TD is domestic public debt dividedby total public debt.

Table 1 from [18] summarizes the public debt composition of groups of developing countries over time. It shows an increasing dependence of developing countries on debt over time.

For an economy, high levels of debt lead to adverse impact on investment and economic growth. One explanation of these adverse effects is called "debt overhang" theory. It implies that: "if there is a probability that country's future debt will be more than its repayment ability then anticipated costs of debt-servicing can depress the investment" [19]. This argument gets its support from the "Debt Laffer Curve", according to which "as long as the country has capacity to service its debt the investors would invest. But when they see that country is facing difficulties to

meet its debt obligations then they fear that government would increase taxes in order to service its debt obligations. That tends to slow down investment. However, the extent to which private investment is discouraged by debt overhang depends on how government generates resources to finance debt service obligations" [20].

Similarly, "if a greater share of foreign capital is used to service the external debt, very little will remain to finance investment and growth, this channel is known as the "crowding out" effect. Due to high real interest rates, the terms of trade of the indebted country will worsen and investment decline because of decreasing availability of resources for financing investment and growth and poverty reduction". Hence, "by reducing the total investment directly and complementary private expenditures indirectly, the cost of debt servicing of public debt will crowd out the public investment expenditure" [21].

2.2 Harmful Effects of Corporate Debt:

A minimal level of debt is considered necessary for a business organization. However, a firm with high level of leverage is considered risky. A higher debt to equity ratio leads to negative effect on stock price. It is also a well-known phenomenon that leverage firms have more chances to become bankrupt comparing with the non-leverage firms.

Several papers study the link between debt and financial performance of a firm. Tausif et al.[22] study the effect of corporate debt in the textile sector of Pakistan. They find that the return on equity is positively related to debt to asset ratio at lower debt levels. However after reaching an optimal debt-to-asset ratio of 56 percent, this relation becomes negative. Zhou, et al. [23] empirically estimated the relationship between the debt and corporate performance for Zhejiang family owned listed firms. They concluded that "firms' debt financing is negatively correlated to corporate performance; current debt and long term debt both show a significant negative correlation to corporate performance; selection of debt financing has no significant relation to corporate performance."

3.1 The Role of Consumption in an Economy:

Consumption is considered an important component of aggregate demand. Islam permits consumption within some boundaries. Spending on necessities is permissible but lavish spending on luxuries is not appreciated.

As stated in Holy Quran:

"Eat and drink, but waste not by excess, for God loveth not the prodigals".[24]

"Squander not wastefully, surely the squanderers are the devil's brethren."[25]

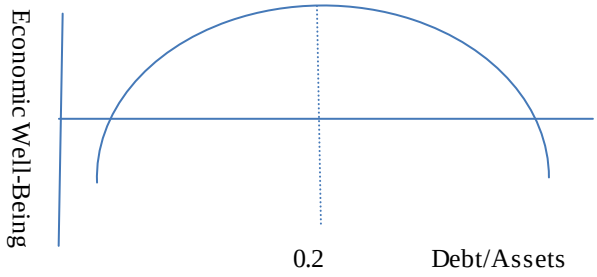
A healthy level of consumption is imperative for healthy aggregate demand. Occasionally economic policy makers face the need to increase consumption expenditure in order to increase aggregate demand.

However, most Muslim countries are facing the over-population phenomenon. There is one positive aspect of this overpopulation that it ensure healthy consumption pattern. Consumption does not need to be artificially increased. Especially debt-induced consumption is highly undesirable.

3.2 Personal Debt:

Just like public debt and corporate debt, some reasonable level of personal debt is acceptable and in some cases desirable especially for investment in education, durables, and mortgage, etc. This paper proposes to estimate the relation between personal debt to assets ratio with economic well-being. This relationship is hypothesized to be non-linear with economic well-being increasing at lower debt to asset ratios before reaching an optimal level. This optimal debt to asset ratio is expected to be around 20 percent. After this optimal level, any further increase in this ratio leads to decrease in economic well-being.

The optimal levels of the degree of indebtedness are higher in the case of government debt because the governments are expected to role the debt indefinitely and don't have to pay back in reality. Companies also have relatively higher levels of optimal debt ratios because of their profit earning capabilities. Individuals, however, don't have that much latitude so they have limited capacity to become indebted.



3.3 Injunctions of Islam about Debt from a Borrower's Side:

There are many injunctions in Quran and Hadith that encourage extending loan or extending the maturity of a loan. However, it would be highly counter factual to conclude that Islam encourages debt taking.

Unnecessary dependence on debt at any level, personal or government is not appreciated in Islam. It is advised to stay within one's own means.
The Prophet Muhammad (Peace be upon him) used to say in his prayer:

"O Allah, I seek refuge with You from sin and heavy debt". Someone said to him: "Why so often you seek refuge from heavy debt!" He said: "When a man gets into debt, he speak and tells lies, and he makes a promise and breaks it". (26)

Also the Prophet said that *"The person in debt will not enter Paradise until the debt is paid off"*. (27)

According to the Prophet: *"The soul of the believer is held hostage by his debt in his grave until it is paid off",* (28)

Also Prophet (Peace be upon him) said *"Whoever contracts a debt intending to repay it, Allah will repay it on his behalf, and whoever contracts a debt intending to waste it, Allah will bring him to ruin"*.(29)

In another Hadith the Prophet Muhammad (peace upon him) said, *"The best among you are those best in paying off debt" and "procrastination (delay) in repaying debts by a wealthy person is injustice"*. *(30)*

3.4 Encouragement of Consumption Loans by Banks:

Partial reserve requirement by the central banks gives enormous power to commercial banks to create debt. They sell fiat money on interest rates favorable to them. However, economists are now realizing that credit derived from fiat is neither wealth nor capital. Keynes rightly concludes that fiat induced credit is the destruction of wealth and not its creation.

Commercial banks promote consumer loans for purchase of cars and durables. Consumers are encouraged to buy new models of cars very often by offering them good deals. This leads to unnecessary consumption expenditures.

Unfortunately the Islamic banks are also blindly following the conventional banks' policy of extending too much debt by encouraging people to buy on credit. They try to imitate the financing tools used by conventional banks after some cosmetic changes and changing their names to Islamic ones. Extensive use of Murabaha, Tawarruq, financing educational, medical, and vacation expenses are just a few examples. This practice has the same effect of pushing a society under debt without regards of what will happen in future.

3.5 Encouragement of Consumption Loans by Installment Companies:

There are a lot of companies encouraging sale of consumer durable goods on easy installments. The consumers have to pay higher prices on installments which sometimes amount to 100 percent interest rates. On one side it helps some needy people who cannot afford to buy on cash. On the other hand, however, it also encourages trade of some durables which are purchased without real need. This leads to accumulated debt on the part of consumers.

3.6 Encouragement of Consumption Loans by Credit Cards:

The idea of credit cards is to facilitate transactions without the need to carry cash in the pocket. The slogan of the credit card is that it "takes the waiting out of wanting". However, it has become a lucrative business to extend short term consumption loans at very high interest rates. There is a psychological effect of credit card where buyers misinterpret their credit limit to be their purchasing power. They pay the minimum payment required each month and keep postponing the repayment of this loan. Due to high interest rates, this leads to accumulation of debt at enormous levels.

Taking an example of a developed nation, it is observed that the credit card debt of the average American household ranges from $8000 to $15,000. Total household debt including mortgage and home equity loans has hit an average of 136% of annual household income. There were approximately 1.4 million bankruptcy filings in 2009, and 1.5 million in 2010. One in every 45 homes in America received a foreclosure filing in 2010.

According to CSE[31] "people in the UK owed £1.43 trillion including mortgage lending, an average of £54,000 per household, up from £29,000 a decade ago. Consumer debt trebled since 1993, reaching £158 billion in 2013. Each year more than 130,000 people declare bankruptcy or some other form of insolvency".

According to a report by National Bank of Abu Dhabi[32]"currently, the UAE runs, per person, close to $95,000 (Dh 348, 650) as indebtedness. Almost half the UAE residents — or nearly five million people — are part of the active credit population. Between March 2014 and March 2015, consumers in the UAE received a total of Dh1.3 trillion ($355 billion) in personal loans. The amount of loans granted to UAE residents in the first quarter of 2015 increased by 6.5 per cent compared with 2014".

3.7 Unequitable Distribution of Wealth due to Interest on Debt:

The debt also leads to disruption of equitable distribution of wealth because of interest rate. Resources are extracted from mass and become concentrated in the hands of few wealthy people or institutions. Quran Says:

"God deprives usurious gains of all blessing, whereas He blesses charitable deeds with manifold increase". (33)

And [remember:] whatever you may give out in usury so that it might increase through [other] people's possessions will bring [you] no increase in the sight of God whereas all that you give out in charity, seeking God's countenance, [will be blessed by Him:] for it is they, they [who thus seek His countenance] that shall have their recompense mul-tiplied! (34)

Because of usury, economic activity starts to shrink and eventually harm all economic agents including lender.

3.8 Harmful Impact of Debt on Low-Income People:

Debt problem is especially more serious in case of low-income families and getting worse overtime. Under the influence of media, the society is blindly becoming materialistic and the low-income families try to buy luxury items at every cost. High levels of indebtedness lead to anxiety, stress and depression, family breakdown, and joblessness. Increasing frustration due to elevating income inequality leads to social crimes. These problems can be avoided by developing financial capabilities of people, by extending debt advice and debt management, and by developing social institutions providing debt solutions.

"Debt psychological" is a big issue, people are sometimes so ashamed of their debt situation so they are not able to discuss with their close friends or with their family members. And consequently they are becoming the psycho-patients. Debt pressure also reduces the efficiency of the debtors. People are becoming isolated and live under stress.

4. Some Actions to Combat the Problem of Rising Private Debt Levels:

This paper proposes to adopt a few of the following action to combat the problem of rising personal debt levels.

4.1 Restructuring the Financial System:

Tackling excessive debt problem requires a strong commitment and new positive vision and approach. It should focus on meeting the needs, wants and choices of people and families first. The focus of this paper is to explores how innovative financial technologies and targeted investment in existing organizations to develop new financial products and services designed around the consumer demand of low-income households.

4.2 Building Financial Capability of People:

Financial Capability is defined as "a person's ability to make positive financial decisions and maximize their financial wellbeing, based on the information and choices they are given, such as how they manage their money or when choosing financial products or services" [35]. Developing financial capability includes skills to create a monthly budget, planning for emergencies and to calculate the cost and choose between various financial and physical products. It is not sufficient to know but need to establish attitudes towards money and debt. An advice service about financial matters needs to be established. Quran denounces entrusting money to people who can't manage it. As stated in Holy Quran:

"And do not entrust to those who are weak of judgment the possessions of wealth which God has placed in your charge for [their] support; but let them have their sustenance the reform, and clothe them, and speak unto them in a kindly way". [36]

4.3 Savings:

There is a misperception among people that emergency is an abnormal situation and does not need to be prepared for in advance. However, saving is a buffer that can prevent people from spiraling into debt when they are confronted with unexpected expenses such as unemployment, serious illness, accident etc. The problem is that low-income households save less than average.

4.4 Affordable Credit Facilities:

Low income people are in greater need of short-term loans because of their irregular incomes and low levels of savings. Society needs to establish institutions that may extend credit to needy people without interest. There are many welfare institutions in Pakistan that extend interest free loans like Akhuwwat Foundation, Al-Khidmat Foundation etc. However, these institutions need to establish higher levels of transparency in their dealings.

4.5 Cooperative Insurance:

Insurance provides a means of smoothing over the cost of unexpected events and losses. Although low-income households are more likely to experience events that might be covered by insurance policies, they are the one who generally less likely to purchase the insurance policies. Most insurance are unsuitable for low-income people because they become ineffective even if one installment is missed. Cooperative insurance companies should be established that may tailor their program to cater for low-income people. Quran says:

"But rather cooperate and help one another in furthering virtue and God-consciousness, and do not help one another in furthering evil and enmity". [37]

5. Conclusion:

This paper studies the harmful effects of debt at consumer, business and government levels. Mounting debt level is becoming a big problem due to its size relative to the holder's disposable income, their inability to repay it, and because of the impact it can have on their health, relationships and life. It has been shown that

higher levels of dependency on debt lead to psychological and economic destruction. The high-cost credit quickly spirals out of control and illegal moneylenders exploit people.

The solution to the debt problem includes discouraging debt at all levels and promoting self-sufficiency. Temporary prosperity through debt should not be purchased at the price of future economic destruction. Special attention should be focused on developing financial capabilities of people, by extending debt advice and debt management, and by developing social institutions providing debt solutions.

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