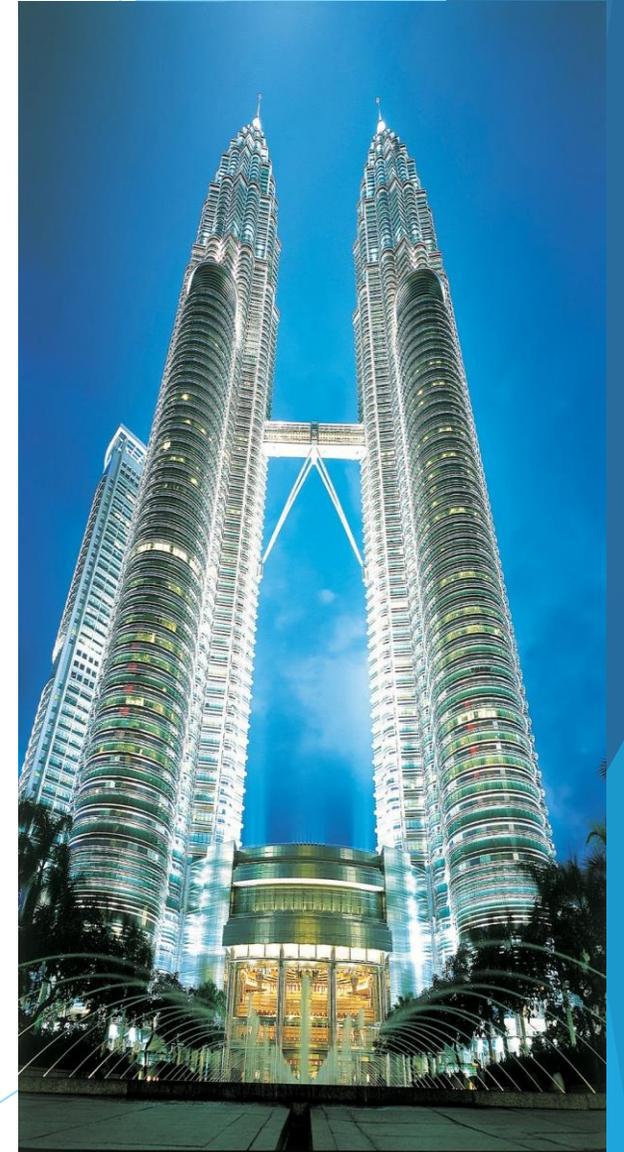




**UNIVERSITY
OF MALAYA**
FACULTY OF BUSINESS AND ACCOUNTANCY

FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT: REASONS FOR FINANCIAL CRISIS AND UNEQUALITY

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Thomas Jefferson the third US President (1743 – 1826) quote:

"I believe that banking institutions are more dangerous to our liberties than standing armies."

*"If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks...will **deprive the people of all property until their children wake-up homeless on the continent their fathers conquered....** The issuing power should be taken from the banks and restored to the people, to whom it properly belongs.*

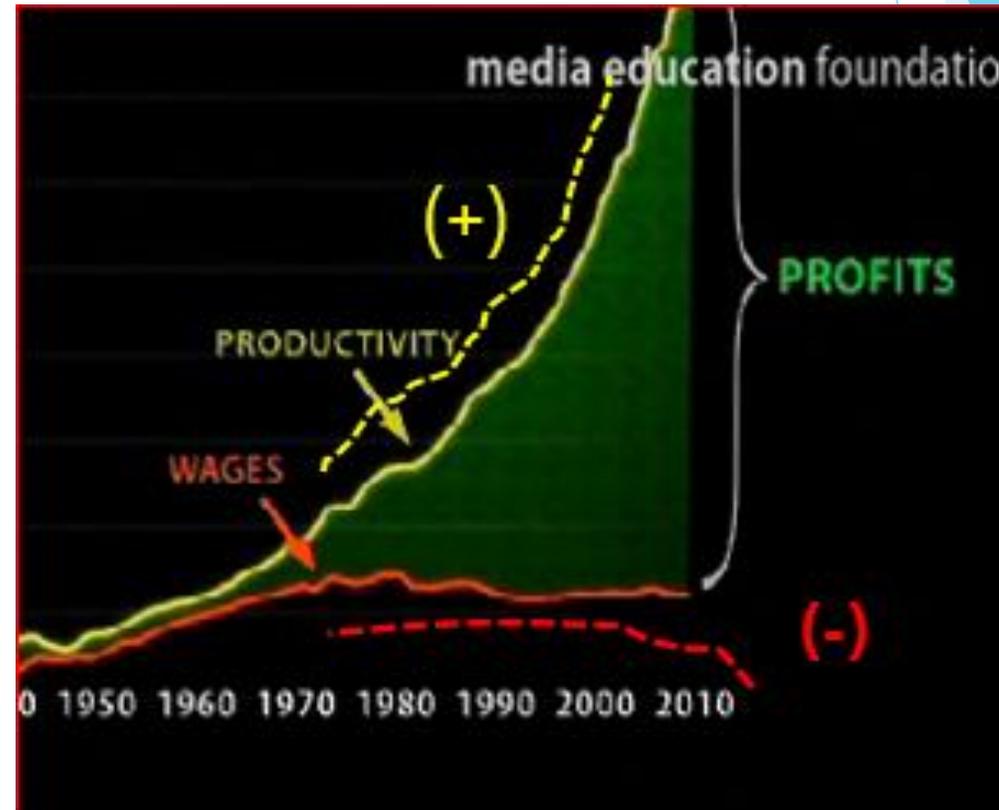
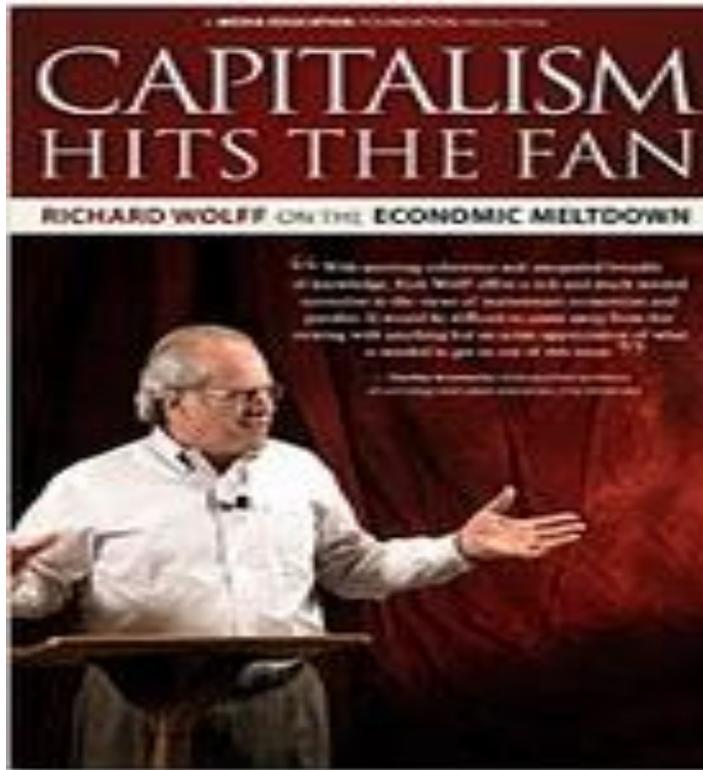
FROM BANKING CRISIS TO ECONOMIC CRISIS

Professor Richard Wolf

"This crisis did not begin in the financial markets and it hasn't ended there."

Cont.,

MAIN CAUSE OF THE UNJUST DISTRIBUTION OF WEALTH



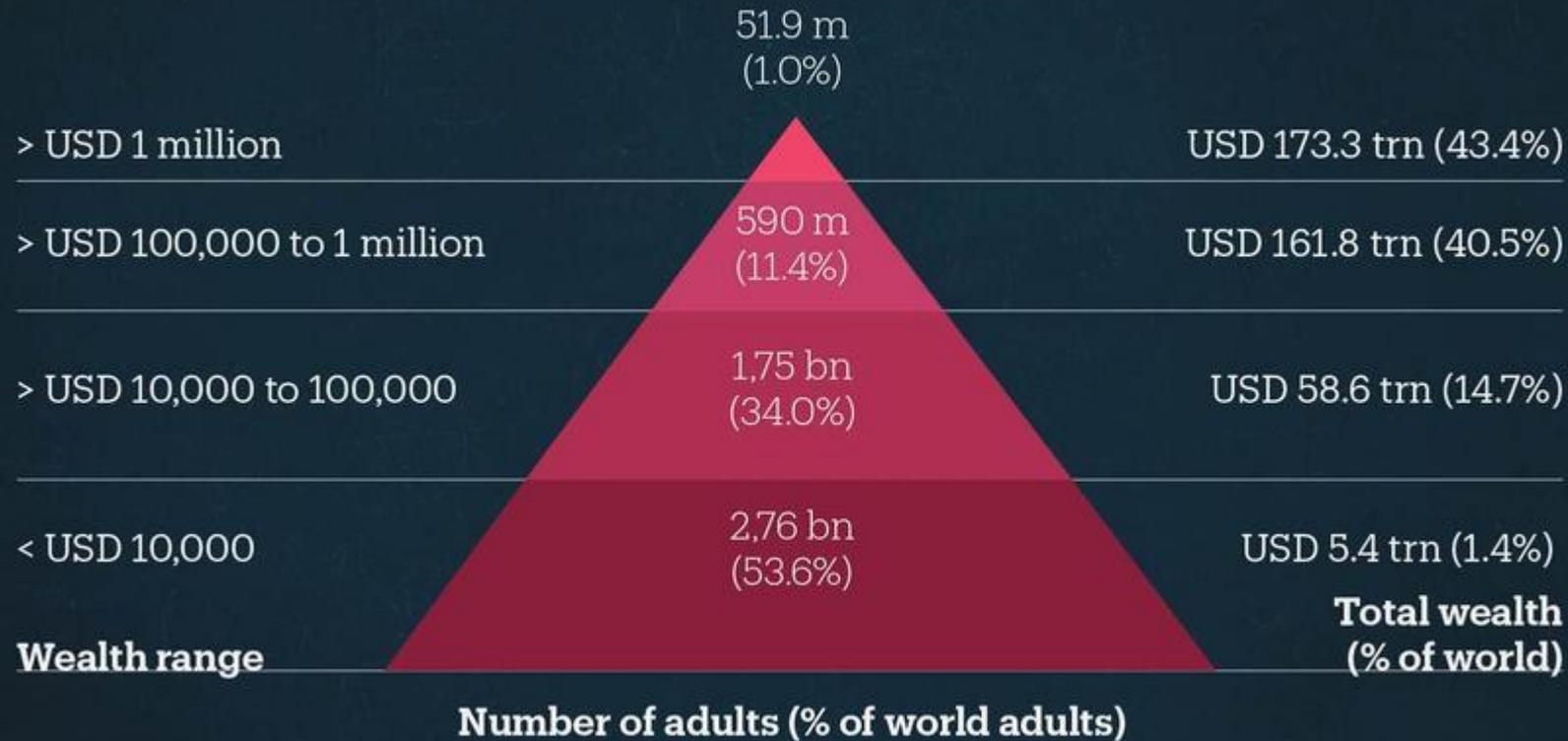
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THE PAST MAJOR **FINANCIAL CRISES**

- ▶ The Wall street crash of 1929 and Great Depression (1929-1939)
- ▶ The Secondary Banking Crisis of (1973-75)
- ▶ Japanese asset price bubble (1986-2003)
- ▶ The Black Monday (1987)
- ▶ Savings and loan crisis of the 1980s and 1990s in the U.S.
- ▶ Finnish banking crisis (1990s)
- ▶ Swedish banking crisis (1990)
- ▶ Economic crisis in Mexico (1994)
- ▶ 1997 Asian financial crisis
- ▶ Russian financial crisis (1998)
- ▶ Argentine economic crisis (1999-2002)
- ▶ Sub-prime mortgage crisis (2007-2010)
- ▶ Icelandic financial crisis (2008-2012)
- ▶ Ireland crisis 2009
- ▶ Russian financial crisis of 2008-2009
- ▶ Automotive industry crisis of 2008-2010
- ▶ European Sovereign Debt Crisis

GLOBAL WEALTH 2019

The global wealth pyramid end-2019



ACTUAL GLOBAL WEALTH DISTRIBUTION in 2020

According to a Credit Suisse report, global household wealth has remained 'unscathed' despite the pandemic.

Top 1 percent of households own 43 percent of global wealth while the bottom 50 percent own only one percent.

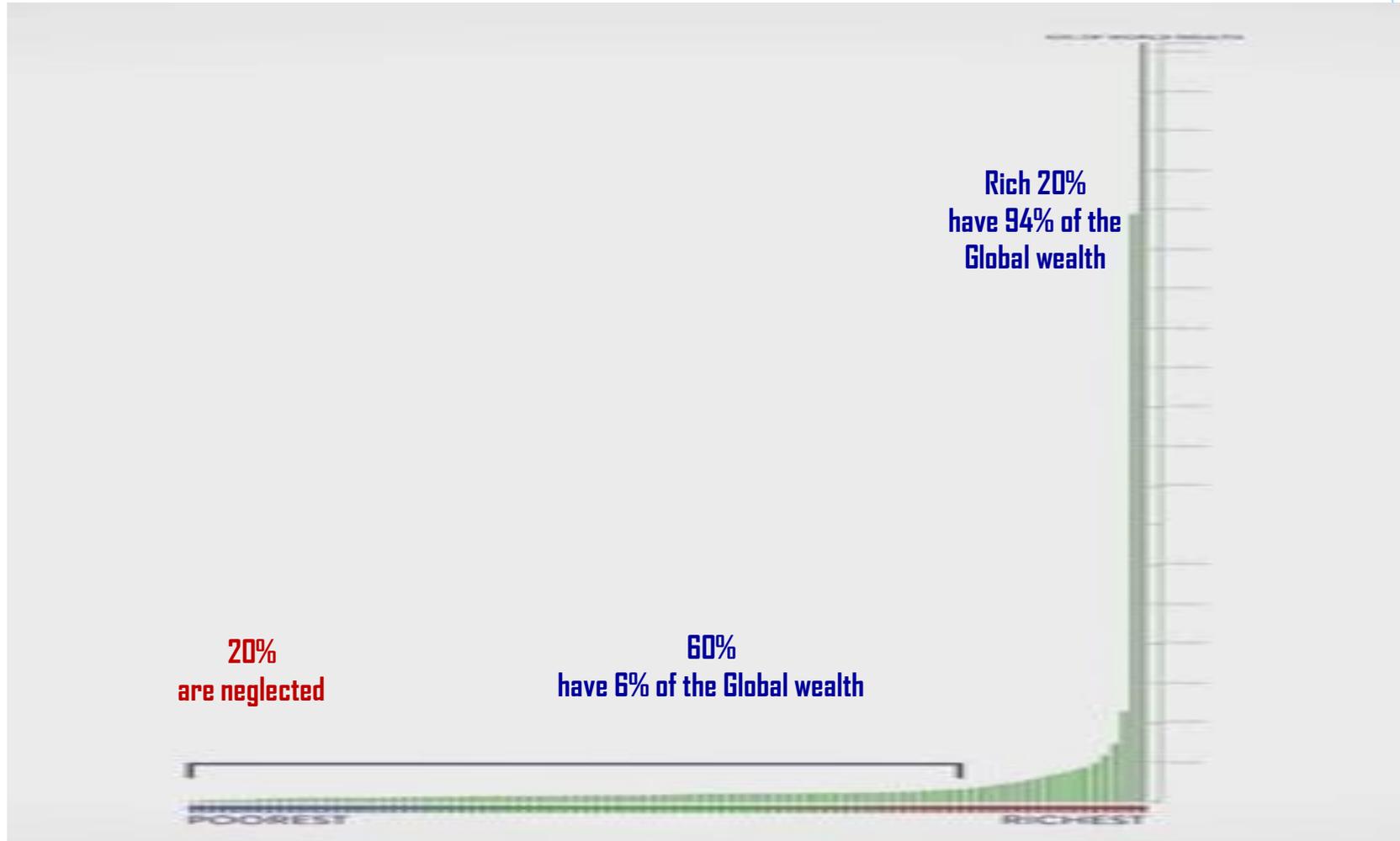
That top-tier one percent amounts to 52 million people who are all millionaires in net wealth (after debt).

Within this elite fraction are 175,000 ultra-wealthy people (those with over \$50 million in net wealth), or 0.1 percent, who in turn own 25 percent of the world's wealth.

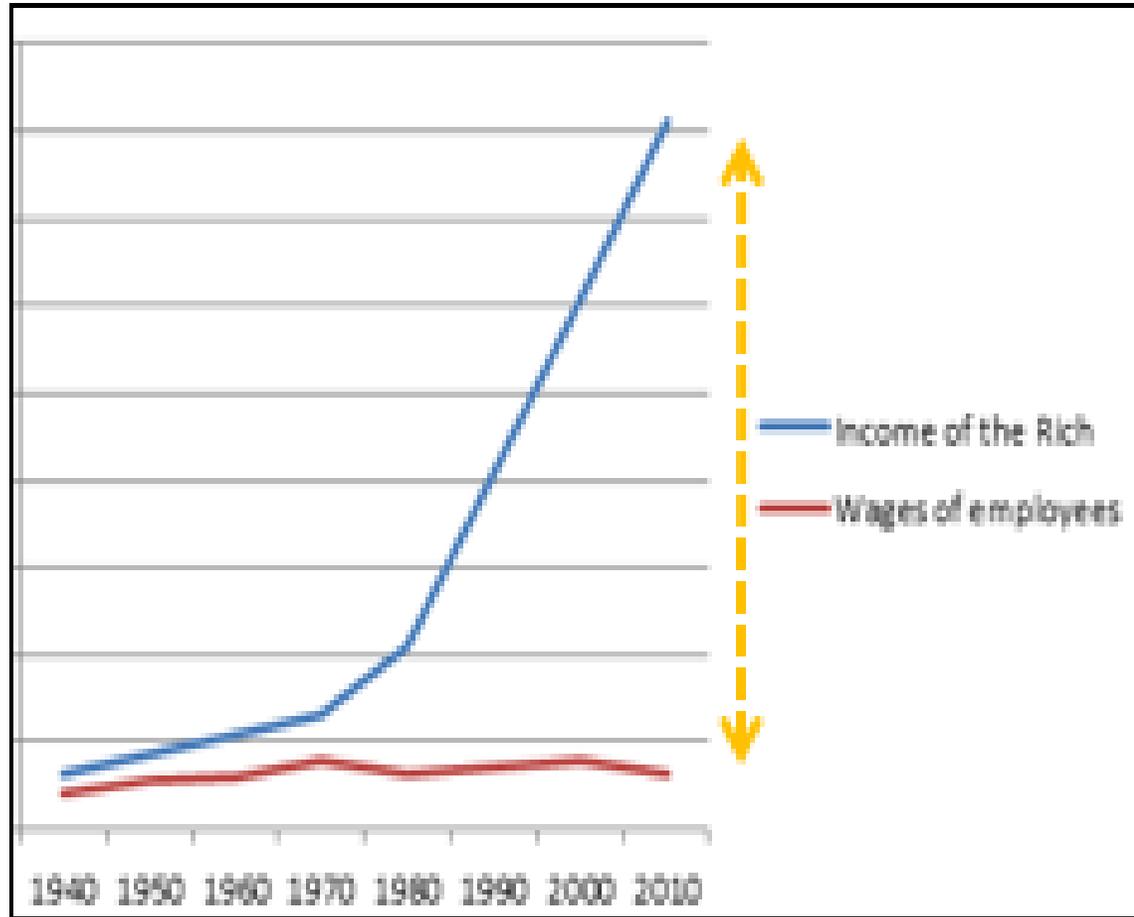
wealth

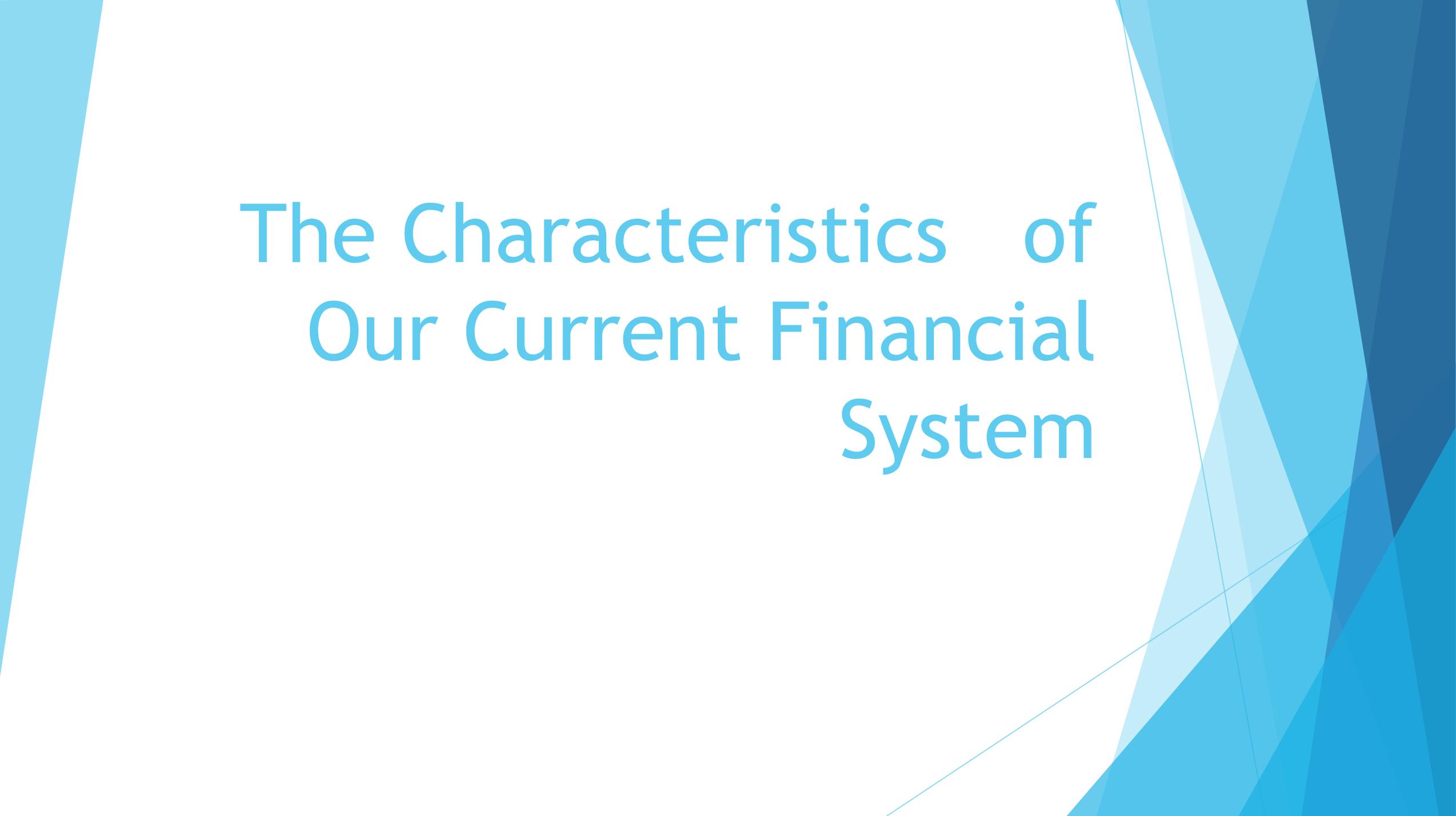


THE OVERALL GLOBAL WEALTH DISTRIBUTION



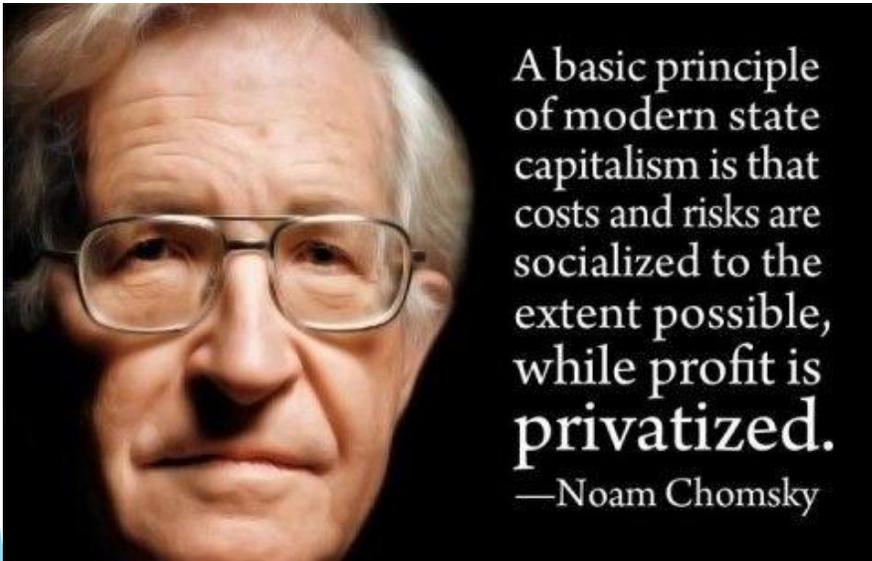
WHAT CAUSE THE GAP BETWEEN THE RICH AND THE POOR?



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The Characteristics of Our Current Financial System

Conventional Financial System and Its Features:



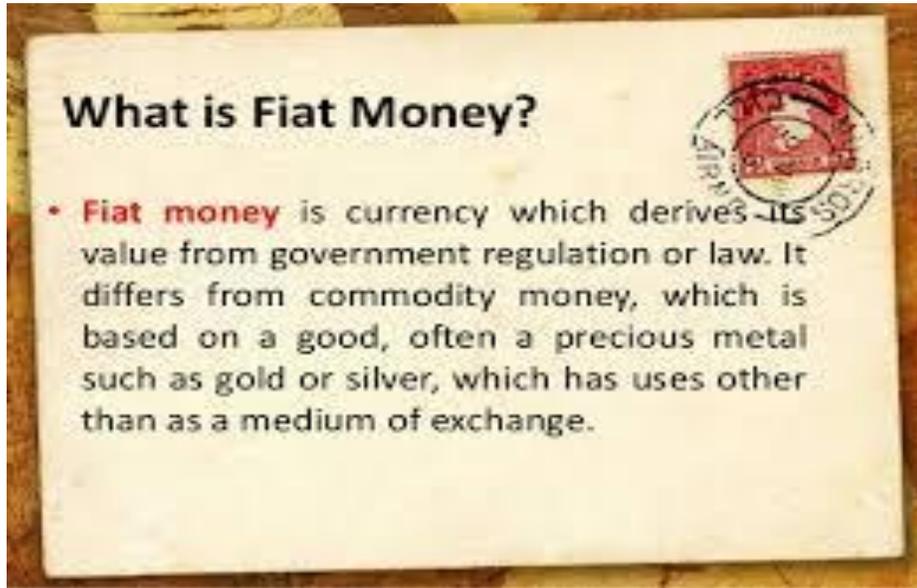
- ▶ Banking Institutions play a very important role in both capitalist and socialist economic systems.
- ▶ They act as main financial intermediaries in a country's financial system - connecting the borrowers with the savers and lending money at interest.
- ▶ These banks adopt an interest-based fractional reserve system which makes them very prone to financial crisis.
- ▶ Fiat money or paper money is used as a medium of exchange and store of value.

The Contemporary/ Conventional Financial System

- ▶ 3 Main Features
 - ▶ Fiat Money as a Means of Exchange
 - ▶ The Fractional Reserve System
 - ▶ The Interest-based Debt

1. Fiat money as a means of exchange

- ▶ Money serves as a means of exchange, a unit of accounting and a store of wealth.
- ▶ **Deutsche Bank's Jim Reid contends that the fiat currency system "is inherently unstable and prone to high inflation."**
- ▶ Rolnick and Weber (1997) study the relationships between money, inflation and output in 15 countries operating under a commodity standard and economies operating under a fiat standard. The growth rates of various monetary aggregates under fiat standards are more highly correlated with inflation and with each other than under commodity standards.
- ▶ Bordo et al (2007) perform a research on price stability in gold standard and fiat money and their study shows that the classical gold standard illustrates long-run price stability where else fiat money regime is associated with significantly higher price instability in long-term.



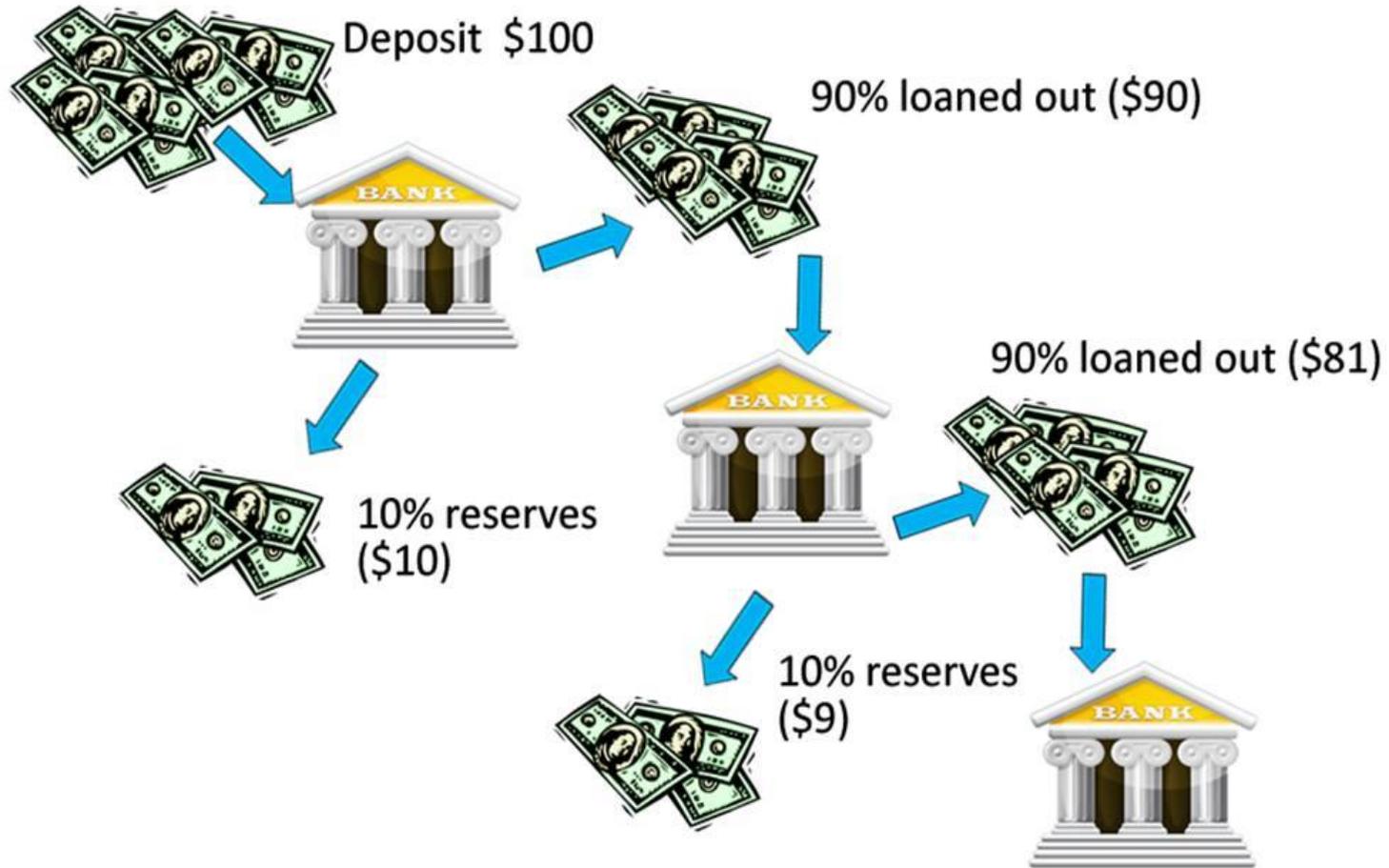
Fiat money are fiduciary papers that are issued by the country's monetary authorities (government or state and its central banks).

The US Dollar is an example of **fiat money** or **fiat currency**. Fiat money basically means that the currency has no intrinsic value (nor can it be redeemed for precious metals or something of intrinsic value). Rather, the currency is only backed by the goodwill of the government that issues it.



2. The Fractional Reserve System

- ▶ How does it work?



Academic literature on bank liquidity creation is vast.

Bryant (1980), Diamond and Dybvig (1983) and Donaldson, Piacentino, and Thakor (2015) focus on bank liquidity creation on the balance sheet either on liability or asset side or both.

Greenbaum and Thakor (1993), Holmstrom and Tirole (1998) and Kashyap, Rajan, and Stein (2002) on the off- balance sheet.

Several studies provide theoretical link and empirical evidence on the relationship between liquidity creation and future financial crises

STATEMENT OF JOSEPH T. SALERNO, PH.D., PROFESSOR OF ECONOMICS, LUBIN SCHOOL OF BUSINESS, PACE UNIVERSITY

The harmful effects that FRB has on the overall economy:

First, fractional reserve banking is inherently inflationary. The issue of money substitutes unbacked by cash expands the money supply and drives up prices.

Second, the lending of unbacked money substitutes artificially reduced interest rates below market equilibrium rates. This causes businesses to make unwise and wasteful investments and households to indulge in overconsumption.

It destroys wealth, and it creates financial bubbles that end in recession and financial crises.

Liquidity creation by other financial institutions and markets

▶ **Investment banks:**

- ▶ Transforming previously illiquid nontraded shares into traded securities that are liquid via initial public offerings and seasoned equity offerings.

▶ **Mutual funds:**

- ▶ Issue shares that provide investors access to small denomination claims against diversified baskets of securities.
- ▶ Provide access at lower transactions costs to investors than if they had to invest in the individual securities themselves.

▶ **Insurance companies:**

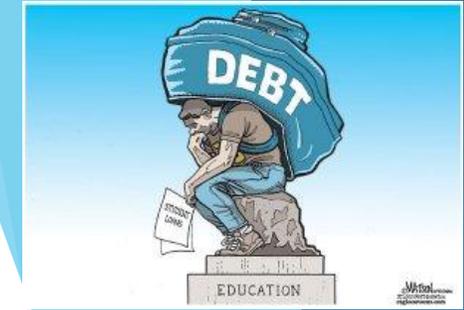
- ▶ They destroy liquidity on net because they often invest in liquid assets and issue relatively illiquid insurance policies, although they do provide valuable risk-reduction services to their policyholders.

▶ **Other shadow banks, such as hedge funds, private equity funds, and other financial firms that engage in bank-like activities.**

▶ **Stock, bond, and other capital markets provide platforms for relatively illiquid claims on companies and governments to be traded and become liquid.**

3. The interest-based debt

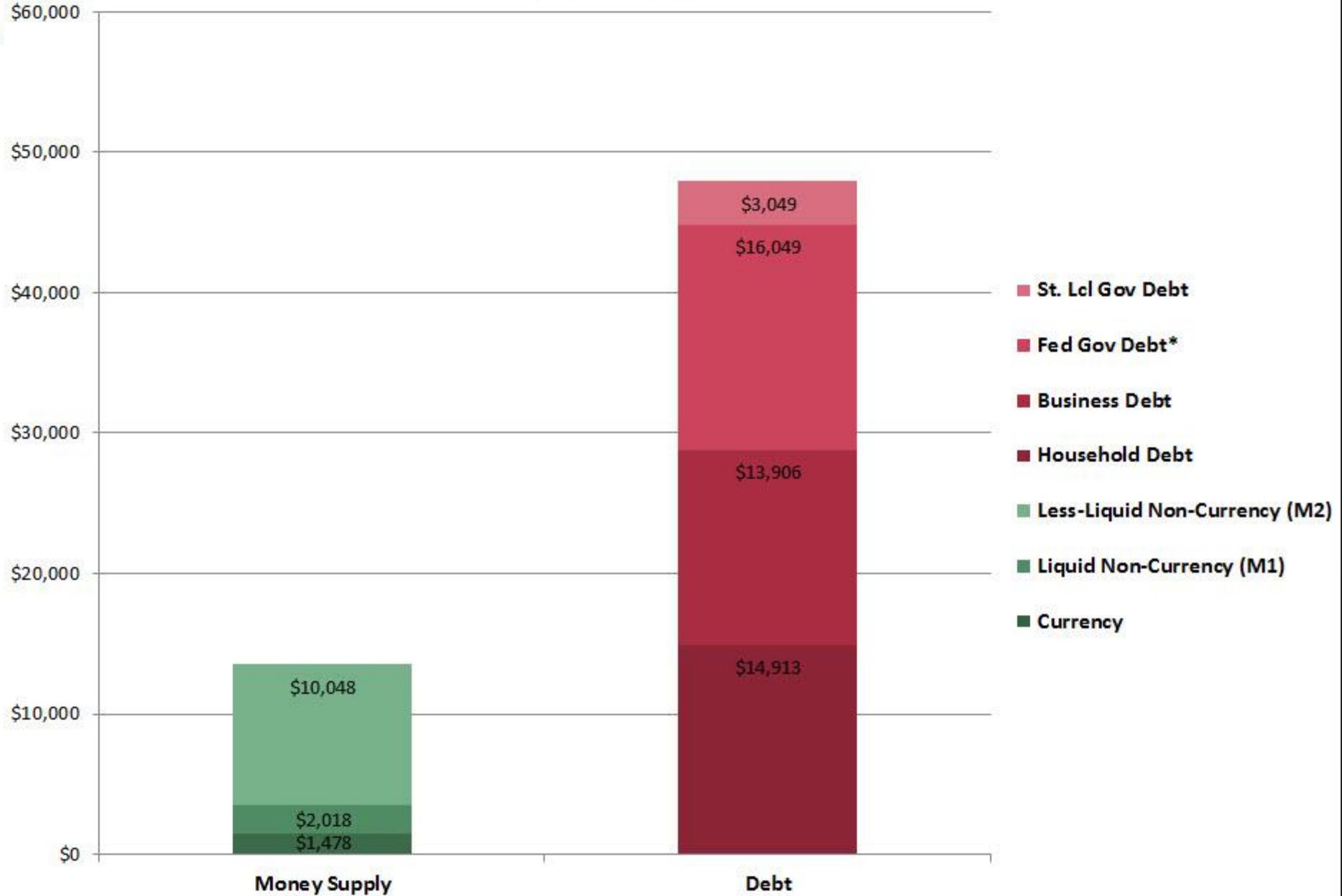
- ▶ Interest is a prominent feature of the current global monetary system.
- ▶ Prior to the 2007- 2008 crisis, private debt grew far faster than nominal GDP:
 - ▶ The United States at 9% per year,
 - ▶ United Kingdom at 10% per year
 - ▶ Spain at 16% per year.
- ▶ Subsequently, private leverage— the ratio of private credit to GDP— significantly increased.
 - ▶ UK grew from 50% in 1964 to 180% by 2007.
 - ▶ US grew from 53% in 1950 to 170% in 2007.
- ▶ More recently the pattern has been repeated in emerging economies.
 - ▶ South Korea's private leverage grew from 62% in 1970 to 155% before the Asian financial crisis of 1997: it is now even higher at 197%.
 - ▶ The ratio of Chinese debt to GDP has grown from 124% in early 2008 to more than 200% today.



U.S. Money Supply Versus Debt

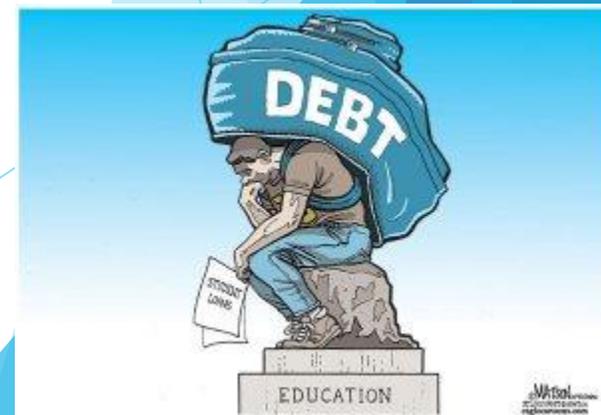
as of June 30, 2017

Billions
of Dollars



Continue..

- ▶ Interest-based debt contracts do contribute to growth in investment and consumption.
- ▶ But the very character that makes them valuable also makes them potentially harmful.
- ▶ 4 related features of debt contracts that make them potentially dangerous.
 - ▶ 1. Debt contracts can fool us into ignoring risks.
 - ▶ 2. They are susceptible to “sudden stops” in new credit supply
 - ▶ 3. The sharp fall in asset price can further depress both confidence and credit supply.
 - ▶ 4. The falling asset prices can produce a deflationary debt overhang effect.



1) Debt contracts can fool us into ignoring risks

- ▶ In contrast of equity, a debt contract has a high likelihood of one specific return— the debt paying off in full and with pre-specified interest— and there is no possibility of an upside above that fixed return. But there is a small probability of a very significant downside.
- ▶ This pattern of return tends to induce myopia, or as the economist Andrei Shleifer and colleagues have labeled it, “local thinking”: investors in good times assume that full payout is not only likely but certain, and they exclude from their consideration the possibility of loss.

2). Debt markets can be susceptible to “sudden stops” in new credit supply

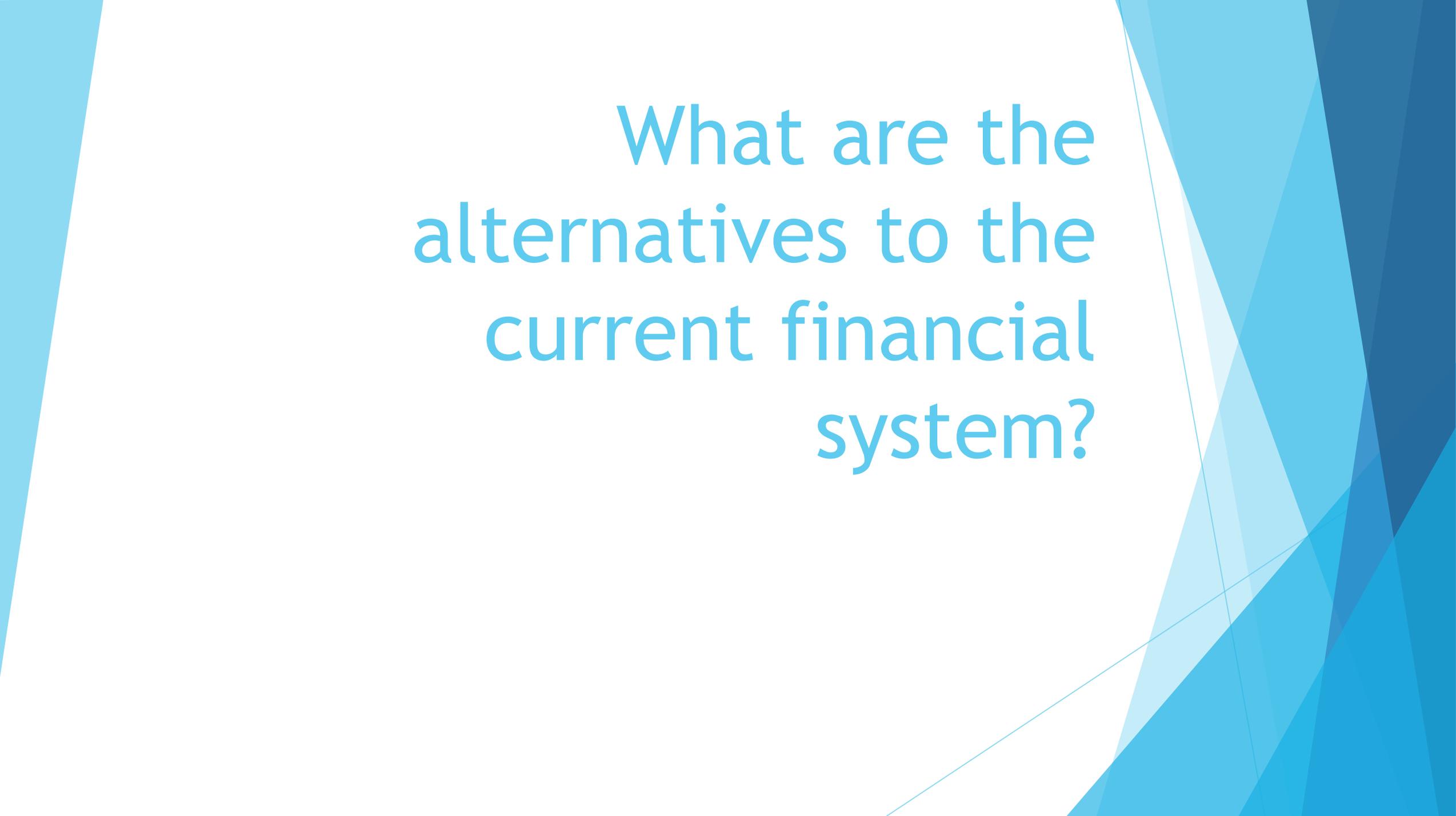
- ▶ Investors or bankers may suddenly become unwilling to lend new money.
- ▶ They may initially issue bonds or give bank loans on excessively easy terms and then deny them at almost any price.
 - ▶ Credit supply in Ireland grew on average at almost 20% per year from 2004 to 2008; from 2009 to 2013 it contracted by about 1.3%.
- ▶ Sudden stops in debt finance are far more harmful than in equity finance, because of the specific maturity of debt contracts and the need for debt rollover.
- ▶ A more debt-intensive economy— in particular, one with extensive short-term debt commitments— is more vulnerable to sudden falls in investor confidence or to sudden reductions in bank lending capacity than an equity intensive one would be.

3) Falling asset price induced by a sudden stop in confidence and credit growth.

- ▶ Fire sales resulting from default and bankruptcy will lower prices for the assets of failing companies.
- ▶ Reduction in credit supply makes those asset price falls more widespread, as companies and households are less able and willing to buy assets with credit.
- ▶ And reduced asset prices can impair the solvency of banks, leading to yet further constraints on credit supply.

4) Deflationary debt overhang effect.

- ▶ Falling asset prices can produce a deflationary debt overhang effect.
- ▶ Borrowers find themselves overleveraged and cut consumption (in the case of households) and investment (in the case of businesses) in an attempt to reduce their debts and ensure their solvency.
- ▶ But the combined impact of this behavior by multiple households and companies depresses aggregate demand, economic growth, asset prices, and confidence.

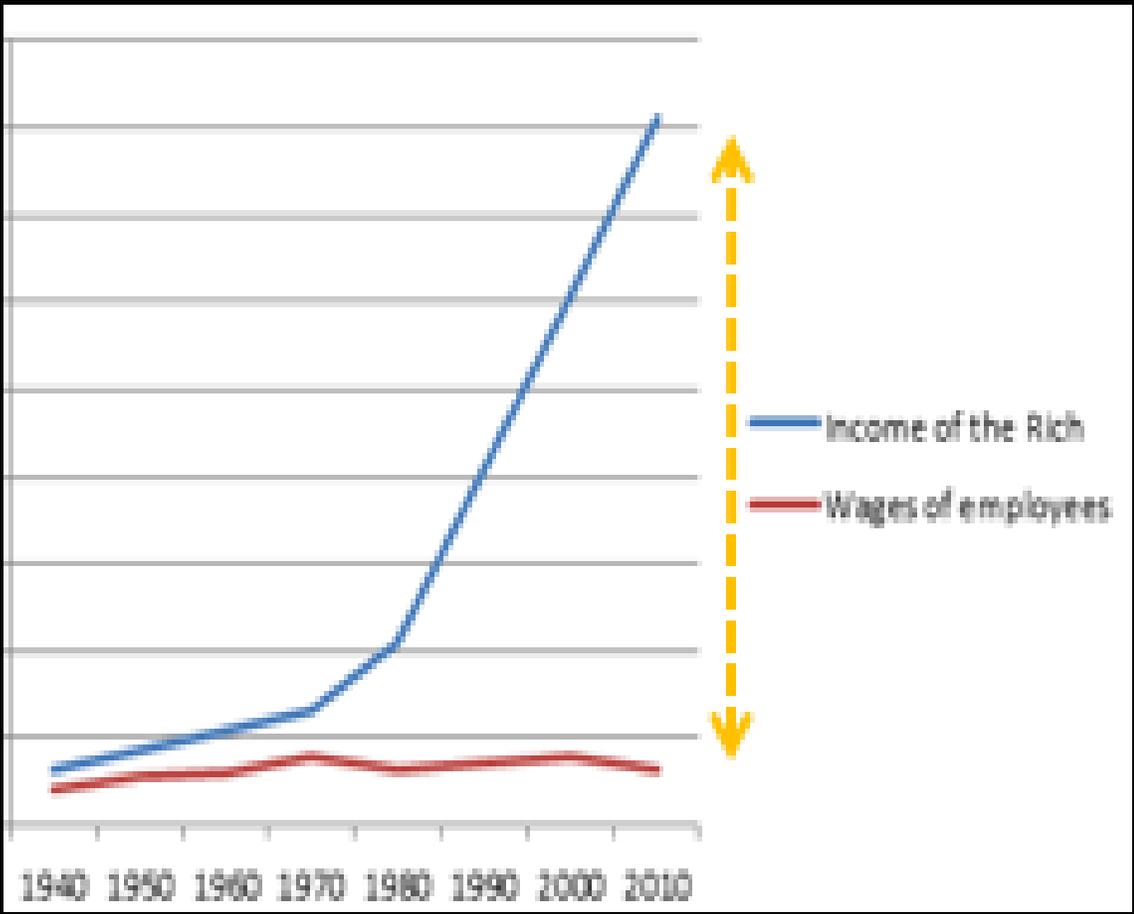
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What are the
alternatives to the
current financial
system?

PART 2: SOME ALTERNATIVES TO THE CURRENT FINANCIAL SYSTEM

- ▶ MOVING FROM A FRACTIONAL RESERVE BANKING TO AN EQUITY FINANCING BANKING
 - ▶ John H Cochran in his paper titled “ Equity-financed banking and a run-free financial system” explains the benefit of equity-financed banking over FRB.
 - ▶ He reiterates that “Bank and Shadow banks must get the money they use to hold risky and potentially illiquid loans and securities overwhelmingly from run-proof, floating-value assets - common equity mostly, some long term debt”.
- ▶ MOVING FROM INTEREST-BASED BANKING SYSTEM TO INTEREST-FREE BANKING SYSTEM
 - ▶ Islamic banking system is an interest-free banking system.
- ▶ ALTERNATIVE FINANCE such as FINTECH companies
 - ▶ Examples of alternative financing activities through 'online marketplaces' are reward-based [crowdfunding](#), [equity crowdfunding](#), [revenue-based financing](#), online lenders and [peer-to-peer consumer and business lending](#).

HOW ISLAMIC FINANCE CAN HELP TO REDUCE THE INCOME GAP BETWEEN THE RICH AND THE POOR?



The poverty incidence in the Muslim countries is comparably high. Most of the Muslim countries fall into the low or lower-middle income countries and some are highly indebted (Chowdhury & Mukhopadhaya, 2012). The number Muslim people in the world is about 1.6 billion that represents about 22% of the global population (World-Bank, 2015). Based on the new poverty indicator (as \$1.9 income per day) about 650 million Muslim people are leading impoverished life in the current world (El-Zoghbi & Badawi, 2015). That suggests, about **84% of the global poor are Muslim.**

Table 2: Ten Most Muslim Populated Countries in the World

Rank	Country	Poverty Incidence	(Less than \$ 1.90/ day)
1	Indonesia	38.27m people	(15.90% of the total population) (2011)
2	India	262.80m people	(21.25% of the total population) (2011)
3	Pakistan	14.36m people	(8.30% of the total population) (2010)
4	Bangladesh	70.00m people	(43.7% of the total population) (2010)
5	Nigeria	85.40m people	(53.47% of the total population)
6	Egypt	N/A	
7	Iran	63,700 people	(0.08% of the total population) (2013)
8	Turkey	190,400 people	(0.26% of the total population) (2012)
9	Algeria	N/A	
10	Morocco	958,400 people	(3.13% of the total population) (2007)

MAJOR ISLAMIC FINANCIAL INSTITUTIONS & PRODUCTS

Distributive Financial Institutions

- i. Bai* /Trade & business
- ii. Al-Qard Hassan – institutions that do not charge interest

Re-Distributive Financial Institutions

- i. Compulsory Zakah (Give to less fortunate)
- ii. Voluntary Waqf (Give to contribute to society)

Distributive Financial Institutions

i. **BAI' / TRADE: AN ALTERNATIVE FINANCIAL INSTITUTIONS TO RIBA**

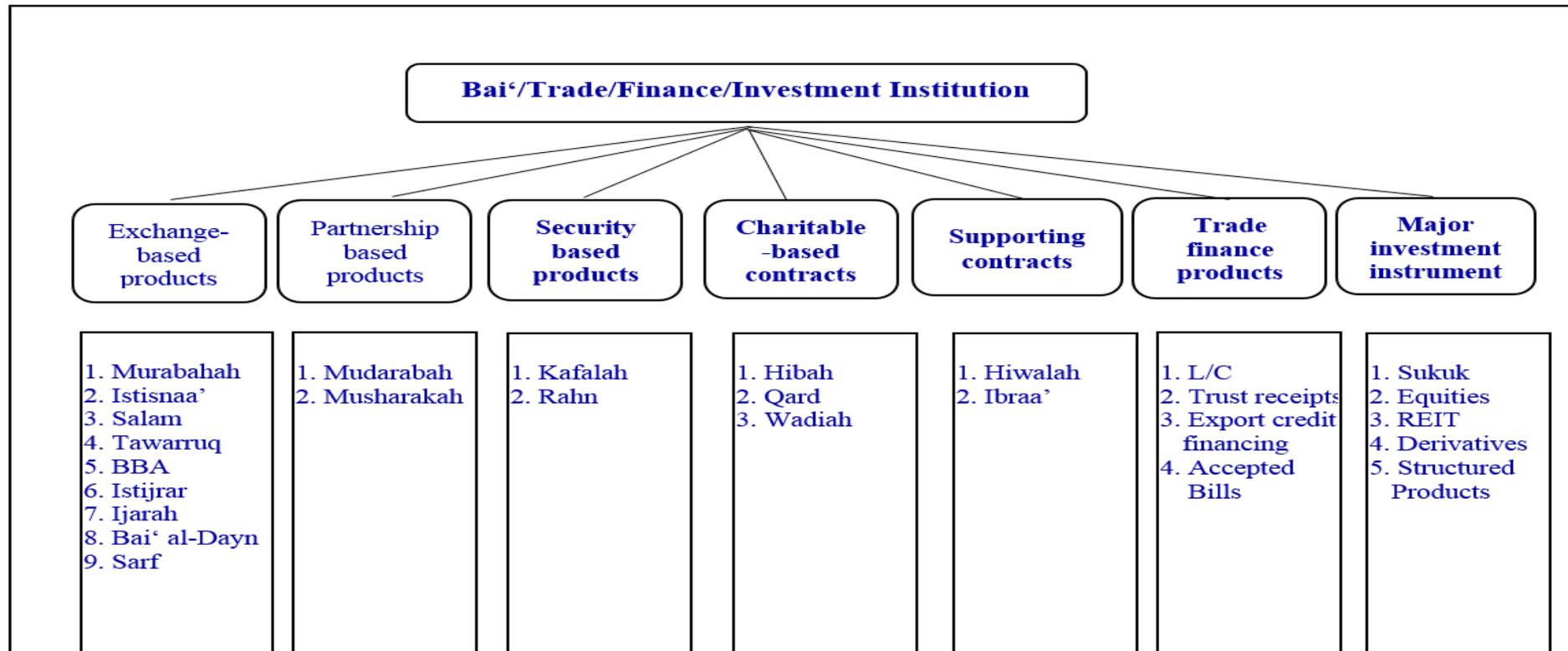
Allah has permitted trading and forbidden *Riba* (usury). (2:275)

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

Bai' / TRADE: ALTERNATIVE FINANCIAL INSTITUTIONS TO INTEREST / RIBA

(27 FINANCIAL PRODUCTS)

In the last five years, Islamic finance has grown by 15 to 20 percent annually, with an estimated \$270 billion in assets controlled by approximately 300 Islamic banks in more than 25 countries.
 (Bahrain, Malaysia, Indonesia, Sudan Syria, Kuwait, Qatar, Oman and Dubai)



ii. QARD HASSAN : AN ALTERNATIVE FINANCIAL INSTITUTION TO RIBA

مَنْ ذَا الَّذِي يُقْرِضُ اللَّهَ قَرْضًا حَسَنًا فَيُضَاعِفَهُ لَهُ
أَضْعَافًا كَثِيرَةً

*Who is he That will loan to God A beautiful loan, which God Will
double unto his credit And multiply many times?*

(Surat al-Baqarah 2:245)

Al-Qard Hassanl is the only Islamic Financial Institution for lending in Islam and which is also an alternative institution to riba.

***QARD HASSAN* & EQUITABLE DISTRIBUTION OF WEALTH**

Recently three Islamic banks in Bahrain, Indonesia, Sudan and Oman succeeded to lend qard hassan to the poor and needy besides, Lebanon QH Association and Akhuwat/interest-free microfinance in Bangladesh.

Table below gives the list of loan products offered by AKHUWAT
(Source: Akhuwat website (<http://www.akhuwat.org.pk>)(accessed on Nov 10, 2014)

No.	PRODUCT NAME	LOAN RANGE US DOLLARS	ECONOMIC & SOCIAL BENEFITS
1	Family Enterprise Loan	100-300	To establish business
2	Liberation Loan	500(max)	To get rid of loans with high interest rate
3	Education Loan	250(max)	For education of dependents
4	Health Loan	100-200	To bear the financial cost of health care
5	Emergency Loan	50-100	To bear losses in business, health care, expense machinery repairs, motor vehicle repair, veterinary expense and admissions fee
6	Housing Loan	300-700	Renovation of houses
7	Marriage Loan	200(max)	Marriage of daughter/sisters
8	Silver Loan	500 (max)	Expansion of business (eligible clients are only those who have completed three or more borrowing cycle from AKHWAT)

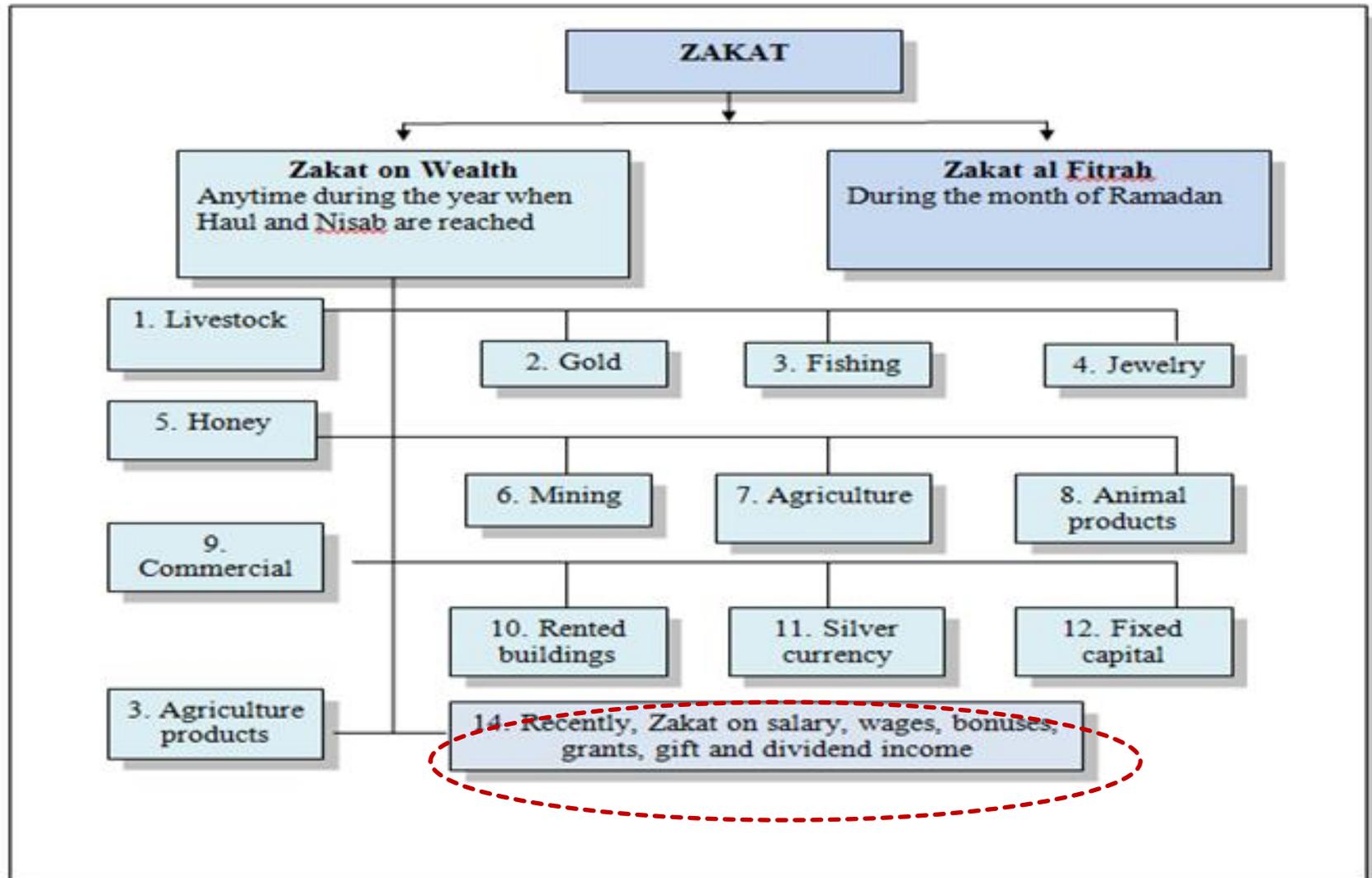
Re-distributive Financial Institutions

i. ZAKAH: AN ALTERNATIVE FINANCIAL INSTITUTION TO RIBA

وَمَا آتَيْتُمْ مِنْ رِبَا لِيَرْبُو فِي أَمْوَالِ النَّاسِ فَلَا يَرْبُو عِنْدَ اللَّهِ
وَمَا آتَيْتُمْ مِنْ زَكَاةٍ تُرِيدُونَ وَجْهَ اللَّهِ فَأُولَئِكَ هُمُ الْمُضْعِفُونَ

"And that which you give in gift (to others), in other that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allah; but that which you give in Zakat seeking Allah's Countenance, then those they shall have manifold increase." (Surat al-Rum, 30:39)

ZAKATABLE WEALTH

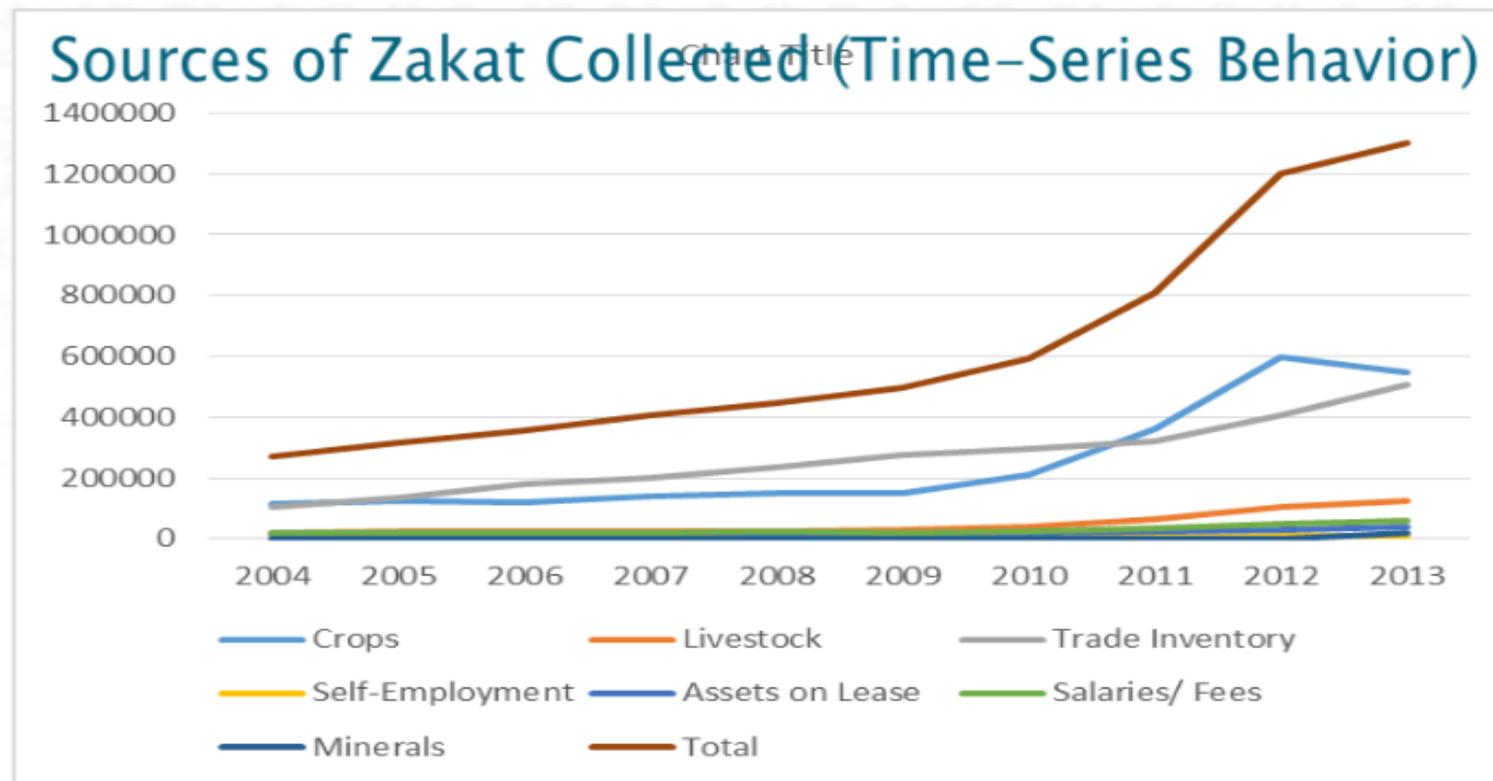


ZAKAH & EQUITABLE DISTRIBUTION OF WEALTH

FINANCIAL PRODUCTS	ECONOMIC & SOCIAL BENEFITS <i>(if compulsory taken)</i>
1. <i>Faqir/Poor</i>	● circulating the wealth from the have to the have not
2. <i>Miskeen/Needy</i>	● satisfying the needs of the poor
3. <i>'Amil/Zakah Manager</i>	● ending hunger and ensuring food security for all
4. <i>Muallafah Qulubuhm/ Converts to Islam.</i>	● empowering the poor and needy ● assisting the debtors
5. <i>Fi ar-Riqab/Liberating Slaves/Captives</i>	● ending all forms of poverty ● securing the country
6. <i>Gharimin/ Debtor</i>	● encourage travelling for seeking knowledge and enhance the tourist sector
7. <i>Fisabilillah/for the Sake of Allah</i>	● hence, reducing the gap between the rich and the poor
8. <i>Ibnus Sabil/Those who are stranded during a Journey</i>	

COLLECTION OF ZAKAH

Zakah collection increases throughout the years. A study by the World Bank and the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) estimated global zakat funds reached \$550 billion to \$600 billion per year. Meanwhile, the official zakat institutions only managed \$10 billion to \$15 billion per year.



Country	Under Government	Private	Collection
Algeria	Ministry of Islamic affairs and Awqaf		Voluntary
Bangladesh	Ministry of religious affairs (Islamic foundation)	Private institutions and banks	Voluntary
Bahrain	Ministry of Justice and Islamic Affairs	Private charities	Voluntary
Egypt	Al-Azhar	Private charities and banks	Voluntary
Indonesia	Government	Private	Voluntary
Iran		Shia'a Imam related agencies	Voluntary
Iraq	Prime minister - diwan of Sunni waqf + diwan of Shia'i waqf. (before that zakat was collected by ministry of Islamic affairs for all Muslim)		Voluntary
Jordan	Ministry of Islamic affairs		Voluntary
Malaysia	Majlis Agama Islam MAI		Voluntary
Morocco	There is a legistave for establishing zakat fund since 1998 but has not been activated till the date.		Voluntary
Nigeria		NGO	Voluntary
Oman	Ministry of Islamic Affairs (department of zakat)	Private charities and funds	Voluntary
Pakistan	Ministry of Islamic Affairs (Central Zakat Fund)		Voluntary
Sudan	Government Diwan al Zakah		Compulsory
Syria		Private institutions (charities) and Islamic bank	Voluntary
Tunisia	Law of establishing Bait Al zakat is under discussion at the Parliament		Voluntary
Turkey		Some private agencies	Voluntary
Yemen	Ministry of finance		Voluntary
Saudi Arabia	Ministry of finance		Voluntary
Kuwait	Ministry of Islamic affairs (Awqaf)		Voluntary
UAE	Prime Ministry		Voluntary

ERADICATE POVERTY & ELIMINATE EXTERNAL BORROWING/

Country	Muslim Population 2005-2015** (Million)	Poverty 2010-2015 (%)	Rich people Million	Middle class Million	Rich class \$1000 as zakat/yr Billion USD	Middle class \$100 as zakat/yr Billion USD	Total estimated zakat collection from salaries Billion USD	Total Borrowing for Poverty Eradication (1970-2014)* Million USD
Afghanistan	30.5	35.8%	6.1	13.5	6.1	1.35	7.45	536
Algeria	38.7	25%	7.7	21.3	7.7	2.13	9.83	N/A
Bangladesh	135.1	26%	27	73	27	7.3	34.3	14,466
Bahrain	0.91	N/A	0.2	0.5	0.2	0.05	0.25	N/A
Chad	7.9	46.7%	1.6	2.6	1.6	0.26	1.86	1,065
Egypt	77.7	25.2%	15.5	42.6	15.5	4.26	19.76	2,267
Indonesia	218	11.3%	43.6	150	43.6	15	58.6	3,559
Iran	77.1	18.7%	15.4	47	15.4	4.7	20.1	N/A
Iraq	33	18.9%	6.6	20	6.6	2.0	8.2	N/A
Jordan	4.4	14.4%	0.9	2.9	0.9	0.29	1.19	428
Malaysia	18.3	1.7%	3.7	14.3	3.7	1.43	5.13	0
Morocco	32	8.9%	6.4	25.5	6.4	2.55	8.95	68
Nigeria	83	46%	16.6	28	16.6	2.8	19.4	7,219
Oman	3.2	N/A	0.6	2.2	0.6	0.22	0.82	N/A
Pakistan	172	22.3	34.4	99	34.4	9.9	44.3	14,364
Senegal	13.5	46.7%	2.7	4.5	2.7	0.45	3.15	3,463
Somalia	10.4	73%	2.1	0.7	2.1	0.07	2.17	376
Sudan	29.9	46.5%	5.8	10	5.8	1	6.8	1,193
Syria	20.61	35.2%	4.1	9.2	4.1	0.92	5.02	46
Tunisia	10.8	15.5%	2.2	7	2.2	0.7	2.9	170
Turkey	73.9	3.7%	14.8	56	14.8	5.6	20.4	1,207
Yemen	24.2	54%	4.8	6.3	4.8	0.63	5.43	2,548

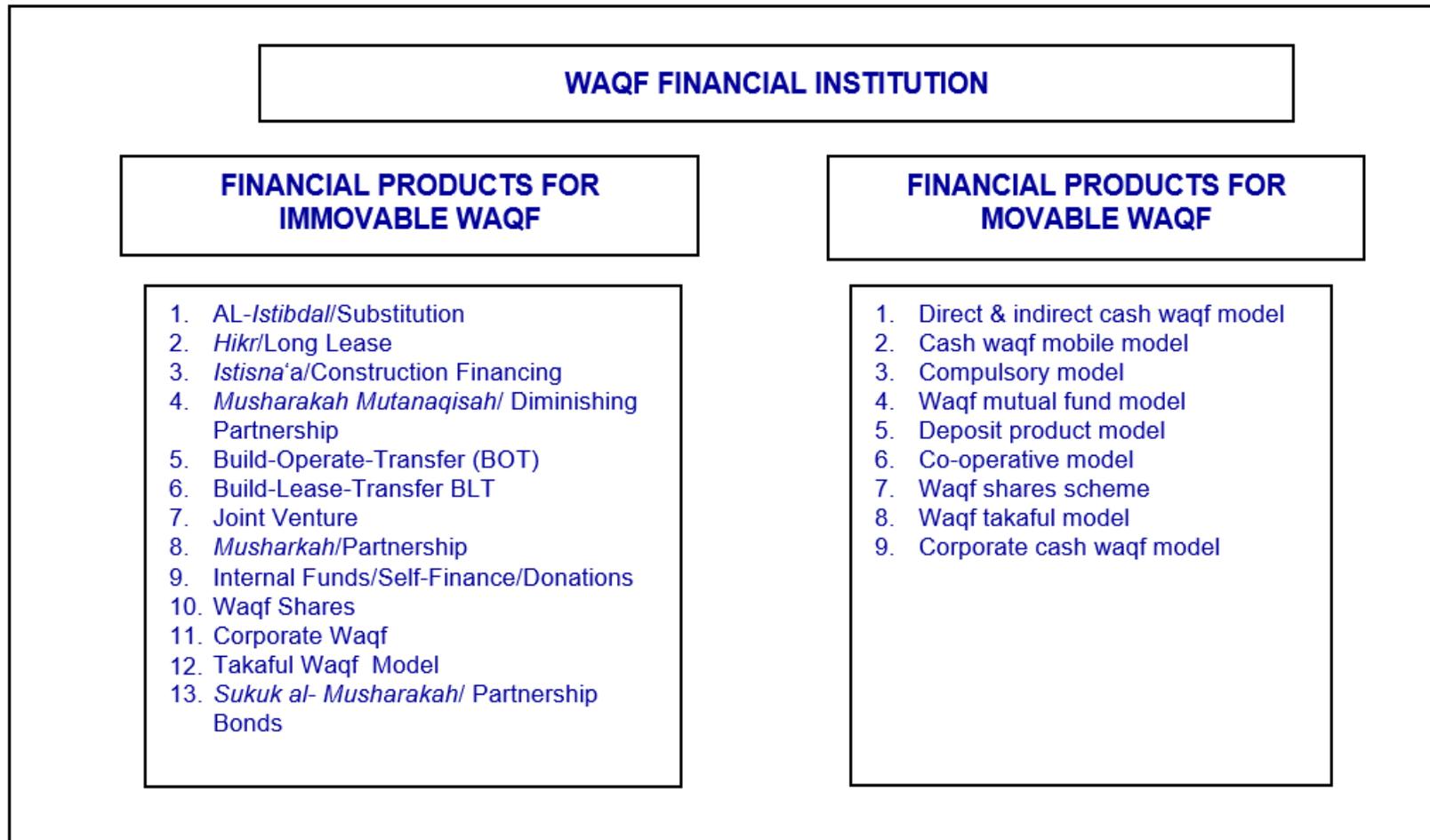
ii. WAQF: AN ALTERNATIVE FINANCIAL INSTITUTION TO RIBA

يَمْحَقُ اللَّهُ الرِّبَا وَيُزِيهِ الصَّدَقَاتِ وَاللَّهُ لَا يُحِبُّ كُلَّ كَفَّارٍ
أَثِيمٍ

*"Allah will deprive usury of all blessing, but will give increase for
deeds of charity..." (Surat al-Baqarah 2: 276)*

WAQF & ITS FINANCIAL PRODUCTS

Most of the waqf properties in Muslim countries are underdeveloped including in Malaysia. It is estimated that waqf potentials of Muslims in the form of cash money is RM 3 trillions per year (Kurniawati, 2008).



WAQF & EQUITABLE DISTRIBUTION OF WEALTH

FINANCIAL PRODUCTS	ECONOMIC & SOCIAL BENEFITS
Immovable Waqf (only 2% of idle waqf properties had been developed)	<p>Through classical and innovative financial products, idle waqf properties are developed into;</p> <ul style="list-style-type: none">● schools, colleges, libraries, and universities hence providing education and jobs for the mass.● clinics, laboratories, and hospitals, hence providing health care besides opening jobs of the mass● guest houses and hotels hence, enhance the tourist sector besides providing jobs for the mass● shops, supermarket, malls, commercial center and commercial towers hence providing goods and services besides opening jobs of the mass● residential area and residential towers hence sheltering the mass● In addition, all these developed waqf properties generate regular income for the poor and the needy.
Movable Waqf (not yet fully utilized)	<p>Through the creation of cash waqf all sectors have been financed; healthy sector, education sector, agriculture sector, industrial sector and build basic infrastructure.</p>

CONCLUSION

- ▶ A capitalist banking system as a source of financing requires endless economic growth even when actual standards of living remain constant.
- ▶ It is unsustainable and contributes greatly to the widening income gap between the rich and the poor over the last fifty years.
- ▶ Unlike an equity-based and riba-free banking system, an interest-based system is inherently inflationary, unstable, unfair and crisis prone.
- ▶ With an equity-based and riba-free banking system, lenders and borrowers become partners in business activities as well lenders become donors whenever contributions are needed in a community.

- ▶ Lastly, the role of government is extremely vital for the smooth running of any country's financial system.
- ▶ Important for the country's financial system to be governed by supervisory body of a government of high moral standards in order to eradicate poverty, create jobs, maximise economic growth, establish an equitable distribution system and achieve socio-economic justice.



Q & A >>>

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