

## Investigating the Real but the Least Talked Reasons for the Global Financial Crisis

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**Abstract:** The Global Financial Crisis of September 2008 is triggered by a dramatic rise in mortgage delinquencies and foreclosures in the United States. With its destructive consequences for financial markets and institutions around the globe, it has exposed *pervasive weaknesses* in the current global financial system. The US housing collapse is often cited as having caused the crisis and the loose U.S. monetary policy is criticized for making the cost of credit negligible, thus encouraging high levels of leverage and causing a hypertrophy and bubbles in the financial sector. What is clear from the crisis is that the current global financial system is vulnerable because of intricate and highly-leveraged financial contracts and operations mainly based on derivatives and *interest rates*. Rating the reasons for the crisis and dealing with the financialization process of the economy, this paper argues that the main reason for the crisis is *interest* based transactions of derivatives; mostly being a zero-sum game, thus not producing any economic value, rather than being a result of win-win action. It then suggests that financial operations be based on real assets, producing real values, not on illusory ones.

**Key Words:** Global Financial Crisis, US Mortgage Crisis, Mortgage Backed Securities (MBS), interest rate, real assets, derivatives, financial bubble, financialization.

### 1. Introduction

The term financial crisis broadly refers to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. Many financial crises were associated with banking panics, recessions, stock market crashes, the bursting of other financial bubbles, currency crises, and sovereign defaults. The current global financial crisis that began in July 2007 when a loss of confidence by investors in the value of securitized mortgages in the United States resulted in a liquidity crisis that prompted a substantial injection of capital into financial markets by the US Fed, Bank of England and the European Central Bank. In September 2008, the crisis deepened, as stock markets worldwide crashed and entered a period of high volatility, and a considerable number of banks, mortgage lenders and insurance companies failed in the following weeks. The crisis of real estate, banking and credit in the United States had a global reach and affected a wide range of financial and economic activities and institutions including the stock exchanges and derivative markets that experienced steep declines. Liquidity problems, harder credit facilities, devaluated assets, increased public debt due to the provision of public funds to the financial services industry and other affected industries, and the devaluated currencies have been the outstanding symptoms of the crisis.<sup>1</sup> Almost everybody agree on that the current crisis is the biggest in scale that the world has experienced since then. Unlike at the time of the Great Depression, when governments were slow to take countermeasures, the financial authorities of Japan, the United States, and Europe have been coordinating their response to provide financial institutions with infusions of public funds. This seems to have worked for now, causing the situation to become somewhat calmer. It is generally admitted that capitalism as a whole is speculative and inherently unstable. John Maynard Keynes believed that the market economy was unstable and that it was necessary to use monetary and fiscal policy to tame its instability (Katsuhito 2008).

The current financial system seems to be inherently plagued by persistent crises. According to one estimate, there have been more than 100 crises over the last four decades (Stiglitz 2003). Not a single geographical area or major country has been spared the effect of these crises. Even some of the countries that have generally followed sound fiscal and monetary policies have become engulfed in these crises (Chapra 2008).

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<sup>1</sup> Wikipedia contributors, "Financial crisis of 2007–2009," Wikipedia, The Free Encyclopedia, [http://en.wikipedia.org/w/index.php?title=Financial\\_crisis\\_of\\_2007%E2%80%932009&oldid=289330105](http://en.wikipedia.org/w/index.php?title=Financial_crisis_of_2007%E2%80%932009&oldid=289330105) (accessed May 12, 2009).

Although US mortgage crisis is often cited as having caused the crisis, the financial system was vulnerable because of intricate and highly-leveraged financial contracts and operations, a U.S. monetary policy making the cost of credit negligible therefore encouraging such high levels of leverage, and generally a hypertrophy of the financial sector. This paper first deals with the most touched reasons for the current crisis, taking the financialism, a new phase of the capitalism, then discussing the role of interest rate policies in the inherently crisisful nature of capitalism. Finally, it lists some suggestions with concluding remarks.

## 2. The Most Talked Causes of the Current Global Financial Crisis

As a matter of fact the present global financial did not take anybody by surprise. Few now doubt that the housing bubble in US was bound to burst or that a general financial crisis and a global economic slowdown were to be the unavoidable results. Warning signs were evident for years to all of those not taken in by the new financial alchemy of high-risk debt management, and not blinded, as was much of the corporate world, by huge speculative profits (Foster). Years ago, in August 2002, the analyst Dean Baker identified a housing bubble and wrote that from 1953 to 1995 house prices had simply tracked inflation, but that when house prices from 1995 onwards were adjusted for inflation they showed a marked increase over and above inflation-based increases. Baker drew the conclusion that a bubble in the US housing market existed and predicted an ensuing crisis (Baker). Baker's argument was confirmed with the construction of a data series from 1895 to 1995 by the influential the economist Robert Shiller, which showed that real house prices had been essentially unchanged over that 100 years (Shiller 2006). It later proved impossible to convince responsible parties such as the Board of Governors of the Federal Reserve of the need for action.

A common claim during the first weeks of the financial crisis was that the problem was simply caused by reckless, sub-prime lending. However, the sub-prime mortgages were only part of a far more extensive problem affecting the entire \$20 trillion US housing market: the sub-prime sector was simply the first place that the collapse of the bubble affecting the housing market showed up.

The ultimate point of origin of the great financial crisis of 2007-2009 can be traced back to an *extremely indebted* US economy. The collapse of the real estate market in 2006 was the close point of origin of the crisis. The failure rates of subprime mortgages were the first symptom of a credit boom tuned to bust and of a real estate shock. But large default rates on subprime mortgages cannot account for the severity of the crisis. Rather, low-quality mortgages acted as an accelerant to the fire that spread through the entire financial system. The latter had become fragile as a result of several factors that are unique to this crisis: the transfer of assets from the balance sheets of banks to the markets, the creation of complex and opaque (unclear) assets, the failure of ratings agencies to properly assess the risk of such assets, and the application of fair value accounting. To these novel factors, one must add the now standard failure of regulators and supervisors in spotting and correcting the emerging weaknesses (Fратиanni and Marchionne 2009).

*Subprime lending* is listed among the outstanding reasons. Subprime lending refers to financial institutions lending in ways which do not meet prime standards to an extent which puts the loans into the riskiest category of consumer loans typically sold in the secondary market. Proponents of subprime lending maintain that the practice extends credit to people who would otherwise not have access to the credit market. Some, like American Enterprise Institute fellow Peter J. Wallison, believe the roots of the crisis can be traced directly to sub-prime lending by Fannie Mae and Freddie Mac, which are government sponsored entities. On 30 September 1999, *The New York Times* reported that the Clinton Administration expanded mortgage loans among low and moderate income people.

*Deregulation* is cited as another reason for the crisis. In 1992, the US Congress weakened regulation of government sponsored enterprises Fannie Mae and Freddie Mac with the goal of making available more money for the issuance of home loans. More importantly, in 1999, the Congress passed the Gramm-Leach-Bliley Act, paving way to the increase in the complex and opaque financial instruments which are at the heart of the crisis.

*The housing bubble* grew up alongside the stock bubble of the mid-1990s (Foster). People who had increased their wealth substantially with the extraordinary run-up of stock prices were spending based on this increased wealth. This led to the consumption boom of the late 1990s, with the savings rate out of disposable income falling from five percent in the mid-90s to two percent by 2000. The stock-wealth induced consumption boom led people to buy bigger and/or better homes, since they sought to spend some of their new stock wealth on housing.

The next phase of the housing bubble was the supply-side effect of the dramatic increase in house prices, as housing starts rose substantially from the mid-1990s onwards. The collapse of the stock bubble helped to feed the US housing bubble. After collectively losing faith in the stock market, millions of people turned to investments in housing as a safe alternative. In addition, the 2001 recession led the Federal Reserve to continue to cut *interest rates*. Fixed-rate mortgages and other *interest rates* hit 50-year lows. To further fuel the housing market, Federal Reserve Board Chairman Alan Greenspan suggested that homebuyers were wasting money by buying fixed rate mortgages instead of adjustable rate mortgages (ARMs). This was peculiar advice at a time when fixed rate mortgages were near 50-year lows, but even at the low rates of 2003 homebuyers could still afford larger mortgages with the adjustable rates available at the time.

The bubble began to burst in 2007, as the building boom led to so much over-supply that prices could no longer be supported. Prices nationwide began to head downward, with this process accelerating through the fall of 2007 and into 2008. As prices decline, more homeowners face foreclosure. In cases where a home is valued far lower than the amount of the outstanding mortgage, homeowners may be able to simply walk away from their mortgage.

Another cause of the crisis was *miscalculation* of the level of risk inherent in the unregulated collateralized debt obligation and Credit Default Swap markets. Under this theory, banks and investors systematized the risk by taking advantage of low *interest rates* to borrow tremendous sums of money that they could only pay back if the housing market continued to increase in value.

The risk was further systematized by the use of false pricing model, Gaussian copula model, which will go down in history as instrumental in causing the unfathomable losses that brought the world financial system to its knees.

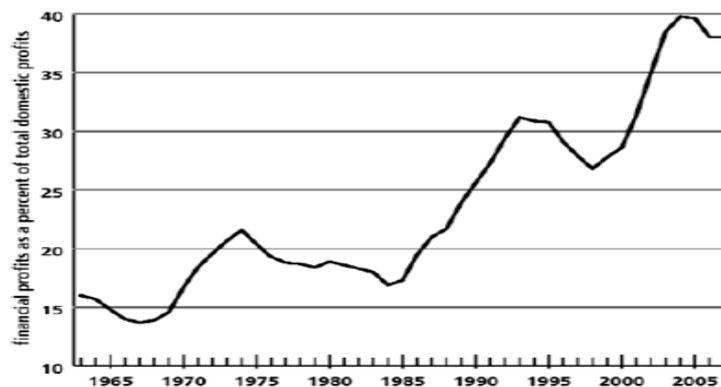
Different from the mainstream explanation, another analysis is that the financial crisis is merely a symptom of another, deeper crisis, which is a systemic crisis of capitalism itself. According to Samir Amin, an Egyptian economist, the constant decrease in GDP growth rates in Western countries since the early 1970s created a growing surplus of capital which did not have sufficient profitable investment outlets in the real economy. The alternative was to place this surplus into the financial market, which became more profitable than productive capital investment, especially with subsequent deregulation (Samir 1996). According to Samir Amin, this phenomenon has led to recurrent financial bubbles.

### 3. A Less Talked Cause: Financialization of the Economy

Foster argues that this crisis is not just another massive credit crunch but signals a new phase in the development of the capitalistic system, which is labeled 'monopoly-finance capital'. The bursting of two major financial bubbles in seven years points to a crisis of financialization, a progressive shift from production to finance that has characterized the economy over the last four decades (Foster). Paul Sweezy called it "the financialization of the capital accumulation process" just over a decade ago. It has been the main force lifting economic growth since the 1970s (Sweezy 1997).

The financial system is supposed to serve a range of functions in the broader economy. Banks and other financial institutions mop up savings, and then allocate that capital, according to mainstream theory, to where it can most productively be used. For households and corporations, the credit markets facilitate greatly increased borrowing, which should foster investment in capital goods like buildings and machinery, in turn leading to expanded production. Finance, in other words, is supposed to facilitate the growth of the "real" economy—the part that produces useful goods (like bicycles) and services (like medical care). In recent decades, finance has undergone massive changes in both size and shape (Vasudevan 2008).

Financialization is a process whereby financial markets, financial institutions and financial elites gain greater influence over economic policy and economic outcomes. Financialization transforms the functioning of economic system at both the macro and micro levels. Its principal impacts are to (1) elevate the significance of the financial sector relative to the real sector; (2) transfer income from the real sector to the financial sector; and (3) increase income inequality and contribute to wage stagnation. Additionally, there are reasons to believe that financialization may render the economy prone to risk of debt-deflation and prolonged recession (Palley 2007). The transformation in the system is reflected in the rapid growth since the 1970s of financial profits as a percent of total profits (see chart 1). The fact that such financialization of capital appears to be taking the form of bigger and bigger bubbles that burst more frequently and with more devastating effect, threatening each time a deepening of stagnation -i.e., the condition, endemic to mature capitalism, of slow growth, and rising excess capacity and unemployment/underemployment, is thus a development of major significance.



**Chart 1.** Financial profits as a percent of total profits (five-year moving average)

Source: Table B-91. Corporate Profits by Industry, 1959–2007, *Economic Report of the President, 2008*.

The term financialization is sometimes used in discussions of financial capitalism<sup>1</sup> which developed over several decades leading up to the 2007-2009 financial crisis, and in which financial leverage tended to override capital (equity) and financial markets tended to dominate over the traditional industrial economy.

Greta Krippner defines financialization as a “pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production.” Another definition by Dore is: “the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketised securities and particularly equities among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles” (Dore 2000)).

The basic mechanism of financialization is the transformation of future streams of income (from profits, dividends, or interest payments) into a tradable asset like a stock or a bond. For example, the future earnings of corporations are transmuted into equity stocks that are bought and sold in the capital market. Likewise, a loan, which involves certain fixed interest payments over its duration, gets a new life when it is converted into marketable bonds. And multiple loans, bundled together then “sliced and diced” into novel kinds of bonds (“collateralized debt obligations”), take on a new existence as investment vehicles that bear an extremely complex and opaque relationship to the original loans (Vasudevan 2008).

In his 2006 book, *American Theocracy: The Peril and Politics of Radical Religion, Oil, and Borrowed Money in the 21st Century*, An American writer Kevin Phillips presents financialization as a process whereby financial services take over the dominant economic, cultural, and political role in a national economy.” (p. 268). Phillips considers that the financialization of the U.S. economy follows the same pattern that marked the beginning of the decline of the American economy as Habsburg Spain in the 16th century, the Dutch trading empire in the 18th century, and the British Empire in the 19th century.



**Graph 1:** Share in GDP of US financial sector since 1860.

Source: "Financialization." *Wikipedia, The Free Encyclopedia*. 2 May 2009, 00:32 UTC. 21 May 2009  
<http://en.wikipedia.org/w/index.php?title=Financialization&oldid=287358015>.

The roots of financialization is traced to the rise of Neoliberalism and the free-market doctrines of Milton Friedman and the Chicago School of Economics, of which the politico-economic philosophy has been summarized as one in which “markets, private property and minimal government will achieve maximum welfare.” One of the most important impetuses to the rise of financialization was the end of the post-World War Two Bretton Woods system of fixed international exchange rates and the dollar peg to gold in August 1971. The demise of fixed exchange rates initiated a rapid rise in the level of foreign exchange trading (forex), leaping in the United States from \$110.8 billion in 1970, 10.7 percent of U.S. GDP, to \$5.449 trillion in 1980, 195.3 percent of U.S. GDP, meaning a 5 times increase. An April 1977 study found there was \$4.8 billion in daily forex trading, or around \$1.2 trillion a year. However, this study did not include all the trading in futures trading for various currencies. Currency futures were first created at the Chicago Mercantile Exchange (CME) in 1972, the year after fixed exchange rates were abandoned.

<sup>1</sup> Financial capital refers to the funds provided by lenders (and investors) to businesses to purchase real capital equipment for producing goods/services. Real capital comprises physical goods that assist in the production of other goods and services, eg. shovels for gravediggers, sewing machines for tailors, or machinery and tooling for factories. (Financial capital. (2009, May 19). In *Wikipedia, The Free Encyclopedia*. Retrieved 09:28, May 19, 2009, from [http://en.wikipedia.org/w/index.php?title=Financial\\_capital&oldid=290884469](http://en.wikipedia.org/w/index.php?title=Financial_capital&oldid=290884469))

Other financial markets exhibited similarly explosive growth. While the volume of trade in US equity (stock) markets was 13.1 percent of US GDP in 1970, it rose to 28.8 percent of U.S. GDP in 1990, and 144.9 percent of GDP.

Thus, derivatives trading -mostly futures contracts on *interest rates*, foreign currencies, Treasury bonds, etc had reached a level of \$1,200 trillion, \$1.2 quadrillion, a year. By comparison, U.S. GDP in 2006 was \$12.456 trillion.

Table 1 provides data for the annual amount of financial trading in U.S. financial markets, compared to GDP.

**Table 1:** Dollar value of trading in U.S. financial markets compared to GDP (Annual, in billions of dollars. Italics indicate estimates)

	1956	1960	1963	1966	1970	1980	1990	2000	2001
Equity Markets Trading	36	47	61	128	135	522	1,671	14,22	
U.S. government securities trading	276	473	722	1,091	1,391	4,840	26,688	67,05	
Futures Trading	150	165	203	250	330	5,584	152,717	343,13	
Foreign Exchange Trading	41	47	55	74	111	5,449	36,000		60,960
Corporate Debt Trading	19	35	56	90	na	821	3,972	3,96	
State and Municipal Bonds	12	23	37	60	112	542	2,622	2,11	
Options trading, on exchange	na	na	na	na	na	46	81	330	
Mortgage Derivatives	na	na	na	na	na	na	3,697	16,68	
OTC swaps, forwards, options	na	na	na	na	na				
TOTAL FINANCIAL TURNOVER	534	795	1,134	1,692	2,749	17,804	227,448	508,45	
U.S. Gross Domestic Product	425	526	603	770	1,039	2,790	5,803	9,817	
Turnover divided by GDP	1.256	1.511	1.331	2.198	2.647	6.383	39.194	51.79	
GDP as % of financial turnover	79.6	66.2	53.2	45.5	37.8	15.7	2.6	1.9	

Source: <http://en.wikipedia.org/wiki/Financialization>, May 19 2009

A dramatic shift is observed in types of futures contracts traded from 1970 to 2004. For a century after organized futures exchanges were founded in the mid-1800s, all futures trading was solely based on agricultural commodities. But after the end of dollar gold-backed fixed-exchange rate system in 1971, contracts based on foreign currencies began to be traded. After the deregulation of *interest rates* by the Bank of England, then the U.S. Federal Reserve, in the late 1970s, futures contracts based on various bonds / *interest rates* began to be traded. *The result was that financial futures contracts - based on such things as interest rates, currencies, or equity indices - came to dominate the futures markets.*

The average value for *interest rate* contracts is around ten times that of agricultural and other commodities, while the average value of currency contracts is twice that of agricultural and other commodities.

As a result of the process of financialization, Financial services have become a key industry in developed economies in which it represents a sizeable share of the GDP and an important source of employment. Those activities also played a key facilitator role to foster economic globalization. ... "The Reagan-Thatcher model, which favored finance over domestic manufacturing, has collapsed" (Meyerson 2009).

Emerging countries try also to develop their financial sector, as an engine of economic development. A typical aspect is the growth of microfinance / microcredit. *Microfinance* refers to the provision of financial services to low-income clients, including consumers and the self-employed (Joanna 2000). Microcredit is a part of microfinance, which is the provision of a wider range of financial services to the very poor.

Microcredit is a financial innovation that is generally considered to have originated with the Grameen Bank in Bangladesh (Cons and Paprocki 2008). In that country, it has successfully enabled extremely impoverished people to engage in self-employment projects that allow them to generate an income and, in many cases, begin to build wealth and exit poverty. Due to the success of microcredit, it is increasingly gaining credibility in the mainstream finance industry, and many traditional large finance organizations are contemplating microcredit projects as a source of future growth, even though almost everyone in larger development organizations discounted the likelihood of success of microcredit when it was begun. The United Nations declared 2005 the International Year of Microcredit.<sup>1</sup>

This recognized success brought also some negative reactions. In the Introduction to the 2006 book *Financialization and the World Economy*, editor Gerald A. Epstein writes:

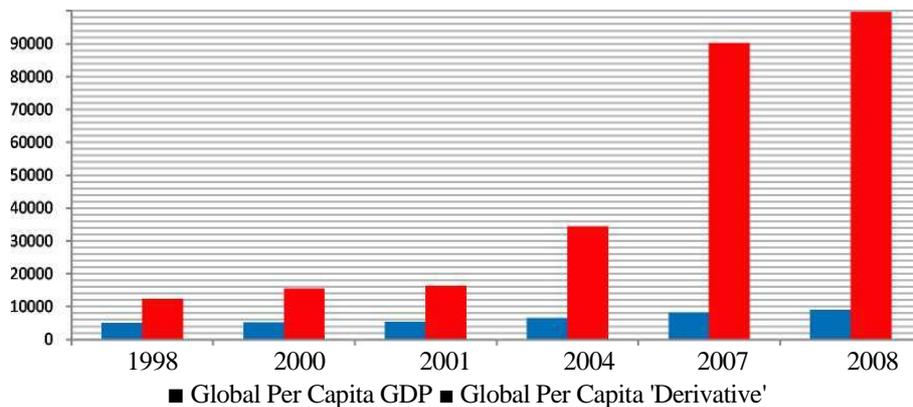
"... in the mid- to late 1970s or early 1980s, structural shifts of dramatic proportions took place in a number of countries that led to significant increases in financial transactions, real *interest rates*, the profitability of financial firms, and the shares of national income accruing to the holders of financial assets. This set of phenomena reflects the

<sup>1</sup> Microcredit. (2009, May 7). In Wikipedia, The Free Encyclopedia. Retrieved 12:14, May 19, 2009, from <http://en.wikipedia.org/w/index.php?title=Microcredit&oldid=288530976>

processes of financialization in the world economy... Finance benefits handsomely from the same processes that create economic crises and injure so many others. Hence the costs of financial crises are paid by the bulk of the population, while large benefits accrue to finance. ...Using the case of the US economy, Crotty argues that financialization has had a profound and largely negative impact on the operations of US nonfinancial corporations. This is partly reflected in the increasing incomes extracted by financial markets from these corporations; trends identified also by Duménil and Lévy and Epstein and Jayadev. For example, Crotty shows that the payments US NFCs paid out to financial markets more than doubled as a share of their cash flow between the 1960s and the 1970s, on one hand, and the 1980s and 1990s on the other... Financial markets' demands for more income and more rapidly growing stock prices occurred at the same time as stagnant economic growth and increased product market competition made it increasingly difficult to earn profits. Crotty calls this the 'neoliberal' paradox. Non-financial corporations responded to this pressure in three ways, none of them healthy for the average citizen: 1) they cut wages and benefits to workers; 2) they engaged in fraud and deception to increase apparent profits and 3) they moved into financial operations to increase profits. Hence, Crotty argues that financialization in conjunction with neoliberalism and globalization has had a significantly negative impact on the prospects for economic prosperity (Epstein). One of the most notable features of financialization has been the development of over-leverage (more borrowed capital and less own capital) and, as a related tool, financial derivatives. Financial derivatives are the financial instruments, the price or value of which is derived from the price or value of another, underlying financial instrument. Those instruments, which initial purpose was hedging and risk management, have become widely traded financial assets in their own. The most common types of derivatives are futures contracts, swaps, and options. In the past few years, the number and types of financial derivatives have grown enormously.<sup>1</sup>

A major unknown regarding derivatives is the actual amount of cash behind a transaction. A derivatives contract with a notional value of millions of dollars may actually only cost a few thousand dollars. For example, an *interest rate* swap might be based on exchanging the *interest* payments on \$100 million in U.S. Treasury bonds at a fixed *interest* of 4.5 percent, for the floating *interest rate* of \$100 million in credit card receivables. This contract would involve at least \$4.5 million in *interest* payments, though the notional value may be reported as \$100 million. However, the actual "cost" of the swap contract would be some small fraction of the minimal \$4.5 million in *interest* payments. The difficulty of determining exactly how much this swap contract is worth when accounted for on a financial institution's books, is typical of the worries many experts and regulators have over the explosive growth of these types of instruments.

The root causes of the US financial crisis are now well known, but excessive leverage and derivative trade featured prominently as one of the explanations. As the Figure 1 shows, global per capita derivative in 2008 outstripped global per capita GDP by a factor of 10, as opposed to a factor of less than 2 a decade ago. This trend highlights not only the rapidity with which derivative trade grew over the years but also the dangers of undertaking such colossal transactions without adequate underlying assets to back them.<sup>2</sup>



■ Global Per Capita GDP ■ Global Per Capita 'Derivative'  
**Figure 1:** World Per Capita Derivative and Per Capita GDP 1000

Source: BIS, IMF, World Bank

<sup>1</sup> In November 2007, commenting on the financial crisis sparked by the sub-prime mortgage collapse in the United States, writes that according to the Bank of International Settlements, the OTC market for Credit default swaps (CDS) jumped from \$4.7 trillion (TN) at the end of 2004 to \$22.6 TN to end 2006. From the International Swaps and Derivatives Association we know that the total notional volume of credit derivatives jumped about 30% during the first half to \$45.5 TN. And from the Comptroller of the Currency, total U.S. commercial bank Credit derivative positions ballooned from \$492bn to begin 2003 to \$11.8 TN as of this past June. (Doug Noland "Credit Bubble Bulletin: Road to Ruin", Asia Times Online, Nov. 6, 2007, available at [http://www.atimes.com/atimes/Global\\_Economy/IK06Dj01.html](http://www.atimes.com/atimes/Global_Economy/IK06Dj01.html))

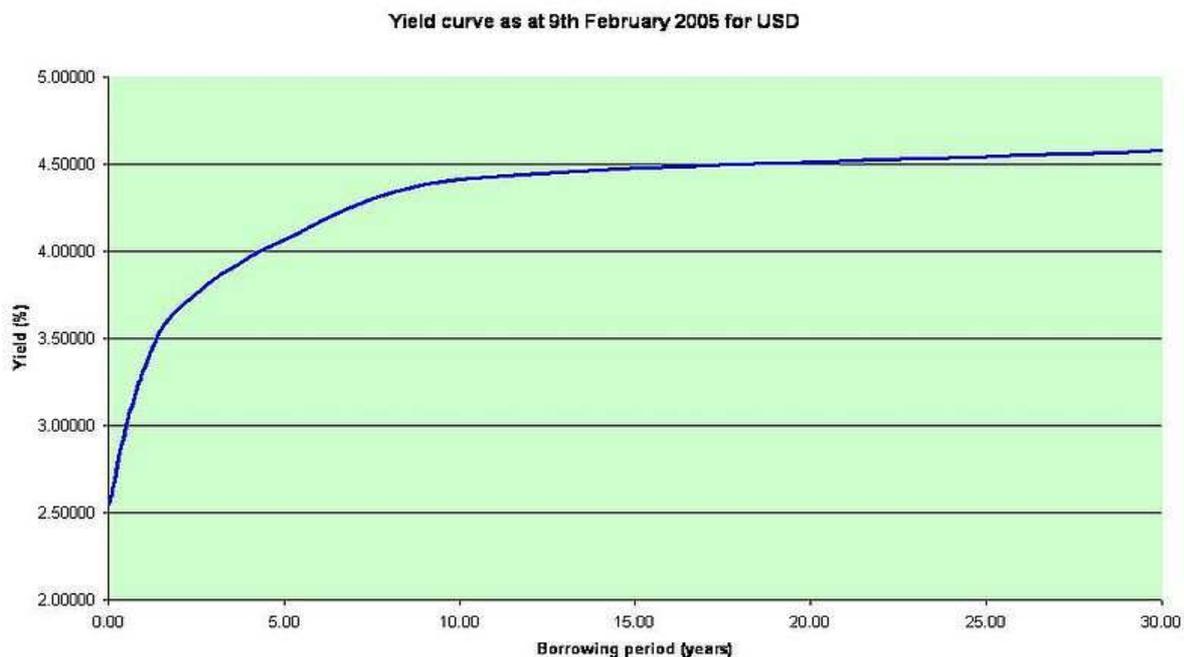
<sup>2</sup> Gulf One Investment Bank Research Bulletin, Vol. 2, No.1, January 2009.

#### 4. The Least Talked Cause: Interest Rate Policies

Economists of the Austrian School have proposed that the crisis is an excellent example of the Austrian Business Cycle Theory, in which credit created through the policies of central banking gives rise to an *artificial boom*, which is inevitably followed by a bust. Proponents of this theory have predicted the current financial crises, and argue that central banks should not be involved in debt markets.

The history of the yield curve from 2000 through 2007 illustrates the role that credit creation through *interest rate* policies by the Federal Reserve may have played in the on-set of the financial crisis in 2007 and 2008. Treasury yield is one tool of monetary policy.

The *yield curve* (also known as the term structure of *interest rates*) is the shape formed by a graph showing US Treasury Bill or Bond *interest rates* on the vertical axis and time to maturity on the horizontal axis (Figure 2). When short-term *interest rates* are lower than long-term *interest rates* the yield curve is said to be “positively sloped”. This in turn encourages an expansion in money supply and in turn favours debt induced bubbles. When long-term *interest rates* are lower than short-term *interest rates* the yield curve is said to be “inverted”. This favours a contraction in money supply. When long term and short term *interest rates* are equal the yield curve is said to be “flat”. The yield curve is believed by some to be a strong predictor of recession (when inverted) and inflation (when positively sloped).



**Figure 2:** Yield Curve

Source: Wikipedia contributors, "Yield curve," *Wikipedia, The Free Encyclopedia*, [http://en.wikipedia.org/w/index.php?title=Yield\\_curve&oldid=289286091](http://en.wikipedia.org/w/index.php?title=Yield_curve&oldid=289286091) (accessed May 14, 2009).

A positively sloped yield curve allows primary dealers (such as large investment banks) in the Federal Reserve System to fund themselves with cheap short term money while lending out at higher long-term interest rates. This strategy is profitable so long as the yield curve remains positively sloped. However, it creates a liquidity risk if the yield curve were to become inverted and banks would have to refund themselves at expensive short term interest rates while losing money on longer term loans.

Following the bursting of the Dot-com bubble in 2000 and the Stock market downturn of 2002 the US Federal Reserve reacted by sharply lowering short-term *interest rates*. The Fed lowered the Fed Funds target rate beginning in January 2001 at 6.5% to a nadir of 1% in June 2003. The Fed also held rates at this low level for an unusually long period of time (1yr) until June 2004. This prolonged period of stimulative Fed monetary policy created a very positively sloped yield curve. The yield on the 3-month T-bill reached its lowest point (0.88%) for the cycle in the late fall of 2003 while at the same time 30-year T-bond rates were in excess of 5%.

In June 2004 the Fed began to slowly increase Fed Funds rates and the yield curve slowly narrowed. Fed Chairman Alan Greenspan notably described this narrowing of spreads between short term and long term rates as a “conundrum” during testimony in February 2005. The chairman expected long term rates to rise in line with short term rates. However, the tightening of monetary policy caused by rising short term rates was slowing the economy and reducing demand for long-term borrowing.

The Fed raised Fed Funds target rates to a peak of 5.25% in June 2006. By October 2006 the yield curve on 90-day T-bills vs 30-year T-bonds was essentially flat indicating neutral monetary policy (neither stimulative nor contractionary). While the Fed maintained Fed Funds rates at this high level, long term rates began to fall causing the yield curve to become more and more inverted. The yield curve was most strongly inverted in March 2007 when concern about current inflation was reaching its peak.

The narrowing of the yield curve from 2004 and the inversion of the yield curve during 2007 indicated a bursting of the housing bubble and a wild gyrations of commodities prices as moneys flowed out of assets like housing or stocks. A commodity bubble was created following the collapse in the housing bubble. The price of oil rose to over \$140 dollars per barrel in 2008 before plunging as the financial crisis began to take hold in late 2008. A similar bubble in oil prices has preceded other historical economic contractions.

## 5. Vatican Offering Islamic Finance System to Western Banks

It should not take anybody by surprise that the Vatican offered Islamic finance principles to Western banks as alternative to capitalism to solve the worldwide economic crisis, with Daily Vatican newspaper, L'Osservatore Romano, reporting that Islamic banking system may help to overcome global crisis. Having resisted the interest for 1500 years in its 2000 years' history, the Vatican suggested that the banks look at the ethical rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. The newspaper drew attention of the banks to the ethical principles on which Islamic finance is based in order to bring them closer to their clients and to the true spirit which should mark every financial service. Author Loretta Napoleoni and Abaxbank Spa fixed income strategist, Claudia Segre, said in the article that Western banks could use tools such as the Islamic bonds, known as sukuk, as collateral. To them, sukuk may be used to fund the car industry or the next Olympic Games in London. They also said that profit share, gained from sukuk, may be an alternative to the *interest*. They underlined that sukuk system could help automotive sector and support investments in infrastructure area. Islamic sukuk system is similar to bonds of capitalist system. But in sukuk, money is invested in concrete projects and profit share is distributed to clients instead of interest earned. Pope Benedict XVI in an Oct 7 speech reflected on crashing financial markets saying that "Money vanishes, it is nothing" and concluded that "the only solid reality is the word of God." The Vatican has been paying attention to the global financial meltdown and ran articles in its official newspaper that criticize the free-market model for having "grown too much and badly in the past two decades." The Osservatore's editor, Giovanni Maria Vian, said that "the great religions have always had a common attention to the human dimension of the economy," Corriere della Sera reported today.<sup>1</sup>

Although the term 'interest' is the most condemned notion throughout history, it has been the factor that most affected the individual and social life of the humankind. Yet, it has been the foundation stone of capitalist liberal economy. The current financial crisis is the result of the bursting of financial bubbles that grew in the recent decades, and the most effective factor that has generated the bubbles is the interest, which is the backbone of modern finance. Interest bearing negotiable instruments and securities change hands without any limit. Trillion dollars' bonds' markets fluctuate upon any interest rate change and some earn billions of dollars in a few hours while others lose. One point hike in the interest rates pulls upward the debt stocks of a state, while an opposite move causes losses to the creditor. Interest has become the indispensable element of the modern economies, penetrating into their cells. Even the financial transactions seemingly irrelevant to interest are somehow hand in hand with it. For example, in futures contracts, what determines the spread, the difference, between spot and future prices is nothing other the interest. In short, interest makes the financial world for some a door to happiness and for some a door to misfortune. Why to be astonished by such a system producing crises? (Uslu 2008).

## 6. Conclusion

Though it is inherently the primary reason for business cycles, interest rates have not been criticized by the mainstream economics since it is taken for granted in spite of the fact that it is a problematic policy tool. But the truth is clear that the global financial system is quite volatile due to its being dependent on the mostly questionable interest rates. Since it is impossible for mankind to foresee the future, any interest rate which is determined according to the current supply and demand conditions should not be expected to be valid on the coming days ahead since these days will have their own supply and demand conditions that determine another interest rate, which may be highly different than the already fixed one, thus arising a deviation between the two. This deviation is one of the reasons for financial

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<sup>1</sup> "Vatican offers Islamic finance system to Western Banks", March 6, 2009, available at [http://www.worldbulletin.net/news\\_detail.php?id=37814](http://www.worldbulletin.net/news_detail.php?id=37814), May 20, 2009; "Vatican Paper Supports Islamic Finance. France Wants Its Share of Sharia Banking", available at <http://www.brusselsjournal.com/node/3819>, May 20, 2009; "Vatican backs Islamic finance", available at <http://www.newhorizon-islamicbanking.com/index.cfm?section=news&action=view&id=10751>, May 20, 2009.

bubbles and imbalances. We should remember that the equivalent of the term interest in Islamic literature is 'riba' which means 'growth' and 'bubble'. Since all the financial transactions as well as futures trading and currency futures are carried out on the basis of interest rates, all these transactions cause some deviation thus a bubble growing by the time. Giving an ear to the voice of the Vatican calling to the Islamic finance and ethics, we had better have a look at this option in order to have a solid and sound financial system. By the way, Islamic finance helps raise substantially the share of equity in businesses and of profit-and-loss sharing in projects and ventures through the *mudharabah* and *musharakah* modes of financing. Greater reliance on equity does not necessarily mean that debt financing is ruled out. Yet Islamic finance rather requires the creation of debt through the sale or lease of real assets through its sales- and lease-based modes of financing (*murabahah*, *ijarah*, *salam*, *istisna* and *sukuk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his ability to make the payment later. Islam has, however, laid down certain conditions that would help prevent excessive expansion of debt. Some of these are: 1) The asset which is being sold or leased must be *real*, and not imaginary or notional; 2) The seller must own and possess the goods being sold or leased; 3) The transaction must be a genuine trade transaction with full intention of giving and taking delivery; and 4) The debt cannot be sold and thus the risk associate with it cannot be transferred to someone else. It must be borne by the creditor himself (Chapra 2008). These basic principles no doubt need detailed explanation, not possible for the time being due to lack of space, since it has already exceeded its limits.

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