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Review

The 2008 financial crisis: A moral crisis of capitalism

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Both success and failure of free market economy could be explained through its understanding of human nature. Its great success in production comes from its principles based on "self-interested" human nature driven by animal souls and egoistic desires. The system achieves higher productivity by providing many incentives to motivate people whose goals are to maximize their interests. On the other hand, the failure of the free market system comes from its lack of moral principles to balance irrational and irresponsible decisions/behaviors of animal souls and ego. For that matter, the paper argues that the 2008 crisis was essentially a moral crisis of capitalism with its root going back as far as the Enlightenment. It suggests that during the crisis, the "invisible hand" of free market turned to "stealing hand" through market games driven by the irrational and irresponsible behaviors of politicians, creditors, and consumers. The paper concludes with few lessons learned from the crisis. First, the crisis created a great opportunity to acknowledge the need for moral values for efficient market system. Second, we should revise our assumptions of human nature and behaviors in economics and finance to include predictably irrational decisions of individuals. Third, we should include moral education in education system at K-12 levels, not at the college. Finally, we should revise our economic models to capture the importance of moral and spiritual capital as endogenous variables.

Key words: Moral economy, business ethics, financial crisis, free market, moral failure, Islamic finance.

INTRODUCTION

In 2008, capitalism did not face a serious crisis for the first time. In fact, according to one estimate, there have been over an hundred crises in the last four decades (Stiglitz, 2003). For that matter, the 2008 financial crisis is a historical, but not a rare occurrence. It bears the footsteps of other crises that emerged throughout the history of capitalism. However, the 2008 financial crisis is undoubtedly the greatest one since the Great Depression. According to the former Chairman of the Federal Reserve, Alan Greenspan, this was a "credit tsunami" (NPR, 2010). Starting with the crash of the U.S. housing and mortgage market in the summer of 2008, the crisis of trust in financial markets caused over a trillion dollar loss within a few weeks. Even the most liberal governments decided to intervene in the free market. The governments of developed countries used taxpayers' money to support the bleeding financial sector despite their discontentment. Within a few weeks, they injected $ 2.4 trillion into the market, but failed to stop the crisis. Some countries had to nationalize their major banks even though they were not pleased to be blamed for socializing financial system.

Three years later, it appears that we are recovering from the 2008 financial crisis without understanding its root causes. Unlike many economists, I do not think this was just an economic crisis. I see it as a major crisis/disease of capitalism. It is a "moral crisis" with its root going back as far as the Enlightenment. Like any other disease, the real solution is only possible if we deal with its root causes rather than relieving its symptoms such as high fever. Indeed, sometime temporary relief with general medicine could deceive the patient by giving a wrong signal and worsen the conditions in the long-term. In 1929, when the free market system failed, we came to the understanding that government intervention is necessary sometimes to deal with economic crises. Similar to the Great Depression, the 2008 financial crisis could be another great opportunity to understand and fix a major flaw of free market capitalism. This time both government and market failed. Therefore, government intervention alone could not offer real solutions. In this paper, I will explain the root causes of the 2008 financial crisis and offer solutions to prevent similar ones in the future.

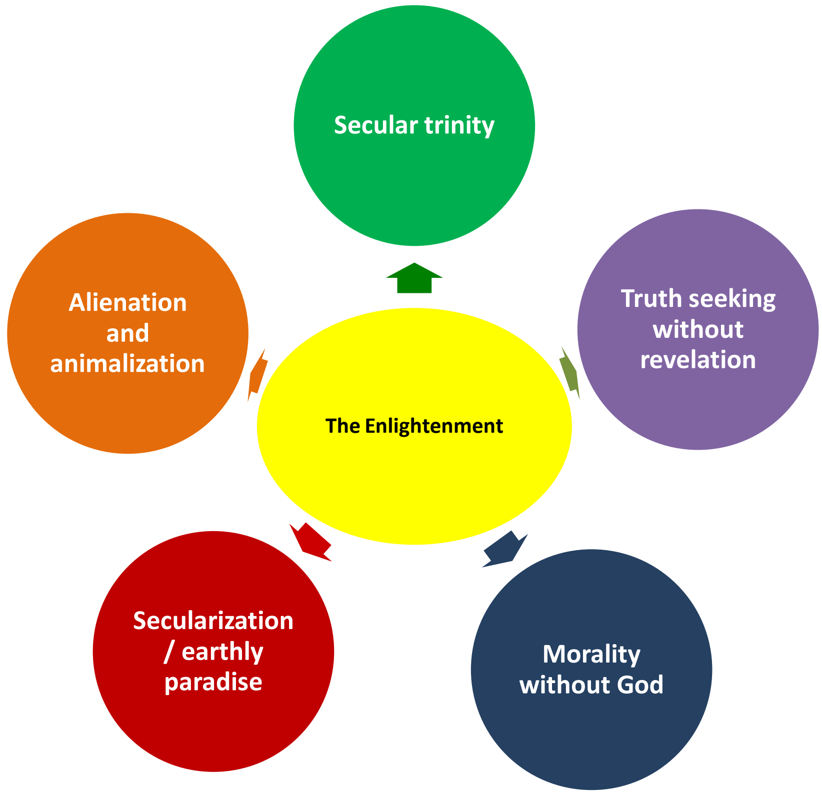

Figure 1. The pillar of enlightenment.

ENLIGHTENING THE CRISIS

The 2008 financial crisis did not occur in a vacuum. It emerged at the heart of global free market capitalism. It was imported to the entire world within weeks, if not days. Therefore, it is fair to characterize it as a crisis of capitalism. Indeed, The Economist ran a cover story in October 2008, titled “Capitalism is at Bay.” In its editorial, the voice of capitalism for over 165 years expressed concern that “economic liberty is under attack and capitalism, the system which embodies it, is at bay.” The Economist was not ready to declare the end of capitalism. Rather, it was calling for help to save capitalism: “Capitalism is at bay, but those who believe in it must fight for it. For all its flaws, it is the best economic system man has invented yet” (The Economist, 2008). Since capitalism as an economic system was the product of the Enlightenment, we need to examine the Enlightenment in order to understand the root causes of any crisis of capitalism including the recent one.

The Enlightenment was a project to release human minds from the chains of churches in the Dark Ages. In his famous essay titled as "What is Enlightenment?" Immanuel (1996) described the Enlightenment simply as freedom to use one's own intelligence. The Enlightenment thinkers believe that humans are generally good and perfectly rational. Therefore, they should shape their destiny, not the dogmas of churches. The thinkers ultimately succeeded to gain freedom for human minds. Their victory helped to remove the darkness in the Europe and replaced with the light of human minds. They did not stop there. They expanded their wars against all religions assuming that they are no different than Christianity in the Dark Ages. Indeed, they labeled religions as myths. Of course, in the age of reason, there was no room for myths. Ironically, even though they fought against the ancient mythos, they created modern ones. They put logos against mythos.

Figure 1 outlines the key components/pillars of the Enlightenment project. First, it was a project against Christian trinity. As historian Peter Gay (1996) asserts, the Enlightenment broke through "the sacred circle," whose dogmatic teaching had confined thinking. Most Enlightenment thinkers had difficulty to embrace logically inconsistent Trinitarian idea. They came up with an alternative explanation to explain the reality. I call it “secular trinity” because it mimics Christian trinity to a large extent. It consists of causation, nature, and chance. In other words, rather than explaining the reality as the work of Father, Son, and Holy Ghost, the Enlightenment thinkers offer deterministic cause-effect chains, Mother Nature, and chance as the determining forces behind the reality of the universe. Secondly, the Enlightenment was a project of truth seeking without revelation. For the

Enlightenment thinkers, human minds were the only source of knowledge. No need to seek guidance from divinely guided individuals because in reality, there is no evidence for any Divine Being. Thirdly, since God was dead, there would be no need for morality based on revelation. However, as strongly articulated by Kant, even without God, it is still possible to reach moral principles through reasoning (Reath and Timmermann, 2010). Thus, the Enlightenment is a project of morality without God. Fourthly, since God is dead, no need to aim for paradise in the hereafter. We are left with no option, but establishing a worldly paradise. In this regard, liberal capitalist economic system has been seen a great tool to accomplish such a goal. Finally, the Enlightenment is a project of alienation and animalization because as argued by Karl Marx capitalism alienates humans and treats him a sort of robot or thinking animal.

The Enlightenment project also redefined the purpose and meaning of life for individuals. It asked individuals to act free from the restrictions of churches and do whatever they consider is to be best for their interests. The main purpose is not to please God anymore; rather, it pleases the desires of animal souls. The Enlightenment thinkers reject the idea of being servant to God. Instead, they turn humans into the masters of the universe. The ultimate purpose is to gain control over nature, rather than living with her in harmony. The measure for morality is not the divine revelation anymore. It is internal compass of pain and pleasure or pure reason. Indeed, Bentham suggests that utility calculation should be yardstick for everything including what is good and what is bad (Bentham, 2007).

Even though this article discusses the dark side of the Enlightenment, it is important that we give credits to the Enlightenment project for the progress in science and technology in the last few centuries. Indeed, we are enjoying the great products of human minds freed by the Enlightenment. In the age of information, we understand that freed human minds could be more valuable than any natural resources including gold and diamond. That is why the countries with great investment in human capital are more advanced than those with rich natural resources. Even though we owe gratitude to the Enlightenment for modern science and technology, in my view, we cannot deny the fact that the children of the Enlightenment are on the verge of destroying the earth and its inhabitants (Greider, 2003). It has produced a “destructive technology”, an unsustainable consumer culture, and so many crises. In my view, this is because of the failure of morality in free market capitalism.

LAISSEZ-FAIR CAPITALISM

Capitalism emerged as an economic pillar of the Enlightenment project. The fathers of free market capitalism were strongly influenced by the Enlightenment thinkers. Indeed, the laissez-faire capitalism aims the freedom of market from any government intervention. It relies on the assumption that individuals follow their self-interest. According to Adam Smith, it is part of human nature to act on self-interest: “Every man is, no doubt, by nature first and principally recommended to his own care; and as he is fitter to take care of himself than of any other person, it is fit and right that it should be so. Every man, therefore, is much more deeply interested in whatever immediately concerns himself, than in what concerns any other man” (Smith, 1976). From his understanding of human nature, Smith concludes that “it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest” (Smith, 1976). In the Wealth of Nations, Smith argues that in order to enhance wealth, every man should be "free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of ... other (Smith, 1976).

If self-interested individuals who are allowed to make their own decisions, they will do whatever is best for them. The market mechanism determines what and how much to produce if we simply let everyone act based on his or her “self-interest.” Individuals will demand and supply the optimum amount of goods and services for their self-interest. Thus, supply and demand driven by self-interest work like an invisible hand pushing the market mechanism toward an efficient production and consumption. Since society is nothing other than the collection of individuals, overall what is good for each individual is also good for society. In other words, Adam Smith assumes no dichotomy between private and social interests. Therefore, he suggests that the invisible hand driven by supply and demand alone should decide on production and distribution of goods and services. There is very limited, if any, role for the government hand to get involved in this process.

While Adam Smith establishes his theory of supply and demand on self-interested human nature, Bentham shapes his utility theory on pleasure seeking and pain avoiding human nature: “Nature has placed mankind under the governance of two sovereign masters, *pain* and *pleasure*. It is for them alone to point out what we ought to do, as well as to determine what we shall do... They govern us in all we do, in all we say, in all we think: every effort we can make to throw off our subjection, will serve but to demonstrate and confirm it. In words a man may pretend to abjure their empire: but in reality he will remain subject to it all the while” (Smith, 1976). This means that we do not need to do anything other than letting individuals to follow their nature for utility maximization through exchanges in the market. The end result will be good for both individuals and society as a whole.

Another key assumption behind free market capitalism is rationality principle (Becker, 1978; Elster, 1986). The system assumes that individuals are rational. They make rational decisions to maximize their interests. In other words, they use their mind to make best the decisions for themselves. A rational person will choose the desirable option if he is provided freedom. In other words, if such a rational person thinks action A will result in X and action B will result in Y, and if X is more desirable (or valuable in the eyes of that person), he will choose A over B. It will not be rational for that person to choose B. The capitalist system assumes both consumers and producers are rationally seeking to maximize their utility (self-interest) in the market system. They reveal their rational decisions through their own preferences. Even the use of drugs is explained as purely rational decisions for utility maximization.

Free market capitalism based on key principles discussed above was indeed very successful in bringing efficiency in the use of economic resources up to the Great Depression in 1929. It provided right incentives to individuals to work efficiently in the free market. It made people to believe in no role for government in free market economy. However, the free market failed to offer solution to the Great Depression. Indeed, the madness of free market was the key factor behind the Great Depression. It was Keynes who first understood that the government intervention is necessary when market fails. It became clear to everyone that the laissez-faire capitalism has its own limit. Later, the concept of market failure was well-established in the literature acknowledging the fact that free market system could fail to produce best results under certain circumstances.

In short, in a free market economy, through the division of labor, self-interested and rational people use limited resources in a more efficient way compared to other economic systems. It is fair to say that the free market system has succeeded in the production of wealth because of its recognition of "self-interested" human nature. Indeed, we owe gratitude to the free market for many invention and innovation because of free competition ignited by the pursuit of self-interest. Therefore, if we would like to keep eating the fruits of the free market, we should make sure that we do not kill its soul. However, it is also important to recognize the failure of free market capitalism.

FAILURES OF FREE MARKET AND HUMAN NATURE

As David Hume writes in the introduction to A Treatise of Human Nature, "all the sciences have a relation, more or less, to human nature ... Even Mathematics, Natural Philosophy, and Natural Religion, are in some measure dependent on the science of Man since they lie under the cognizance of men, and are judged by their powers and faculties" (Hume, 2000). Indeed, every scientific field explicitly or implicitly relies on a certain theory/ understanding of human nature. Economics is no exception. In my view, as the success of the free market system comes from its better understanding of human nature, its failure also comes from its poor understanding of human nature related to animal spirit. Indeed, in his famous book (The General Theory of Employment, Interest and Money), Keynes argued that economic crises are generally caused by animal spirits: "Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits - a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities" (Keynes, 1936)

Alan Greenspan, in a TV interview, also argued that what brought everything down during the 2008 crisis was sheer greed behind human nature (Greenspan, 2008). "I made a mistake," Greenspan later said to the House Committee on Oversight and Government Reform, "in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms" (Kravitz, 2008).

In their recently published book, Animal Spirits, George Akerlof and Robert Shiller argue that without understanding and modeling human nature correctly, it is impossible to prevent major economic crisis like the recent one. They harshly criticize economists who do not blame animal spirits for the sake of the free market. They call for the inclusion of human nature into macroeconomics in order to determine the right government policies to prevent future economic crises. They agree with Greenspan that unpredictable human nature should be blamed for the current crisis: "People began to buy housing as if this were their last chance ever to buy a house (because they thought prices would continue to escalate beyond their means), and speculators began to make investments in housing, as if other people were going to think that they should buy now, at almost any price, because they would not be able to afford to buy a house later" (Akerlof and Shiller, 2009).

In my view, human nature consists of several interconnected selves as shown in the Figure 2. We are partially animal, partially thinking machine, partially egoistic, partially emotional beings. We have also moral and spiritual dimensions. Any theories and models related to human behaviors should include such comprehensive understanding into consideration. In this regard, I think that the success of free market system comes from its understanding of animal, reasoning, emotional, and egoistic selves, while its failure comes from its lack of understanding of moral and spiritual selves.

MADNESS OF FREE MARKET

According to Peter Ubel, the 2008 financial crisis is the

Figure 2. Multi-dimensions of self.

best example of free market madness.[1] It was madness because market players followed their greedy nature to maximize their short-term interests rather than following their mind. Politicians who acted upon the greed for votes, entrepreneurs who acted upon the greed for profit maximization, and consumers who acted upon the greed for pleasure maximization made the crisis inevitable. In Shiller's terms, "The chains of events… overly aggressive mortgage lenders, complaint appraisers, and complacent borrowers proliferated to feed the housing boom" (Shiller, 2008).

Market players did play their roles as expected by the law of supply and demand. They followed the lessons taught by free market capitalism. According to free market capitalism, consumers should pursue utility maximization through greater pleasant consumption; capitalist entrepreneurs should pursue profit maximization through greater profitable sales; and politicians should pursue vote maximization through greater popular policies. They all did what they expected to do before the 2008 financial crisis. The politicians relaxed the regulations for their self-interest with expectation of getting more votes by allowing more people to become homeowners. Indeed, Congress encouraged risky lending practices through government-sponsored giants, Fannie Mae and Freddie Mac, allowing them to exceed their lending capacity and pushing them to lower their lending standards. Meanwhile, the Federal Reserve did its part by keeping interest rates too low for too long.

Politicians relaxed the regulations for their self-interest with the expectation of getting more votes by allowing more people to become homeowners. Greedy entrepreneurs, taking advantage of the de-regulations and low interest rates, involved in excessive lending and with support of inaccurate rating securitized and sold their loans. They offered credit to individuals who could not afford to pay them back. They did so because they invented intelligent means to pass on their risk to a third party. Since they did not have to worry about the risk factor, it was in their best interest to offer as much credit as they could. Employees were rewarded for doing this. The hidden hand (self-interest) of the free market was paralyzed to provide the necessary discipline.

Mortgage originators who issued mortgages to sell them off to securitizers did not worry about repayment risk. They often failed to verify borrower's income with the IRS despite their ability to do so. They rather invented new instruments to repackage, sell and resell their mortgages in sophisticated ways to investors around the world. They were issuing mortgages to risky customers receiving their premiums and passing the toxic assets to the third parties. As seen in the As seen in Figure 3, from 1998 to 2008, the notional value (the value of a derivative's underlying assets at the spot price) of over-the-counter derivatives globally rose from $ 72 trillion to

[1] Peter Ubel's book, *Free Market Madness: Why Human Nature is at Odds with Economics--and Why it Matters*, was published by Harvard Business Press in January 2009. Ubel argues in this book that the economic crisis is due to the irrational aspect of human nature which caused free market madness.

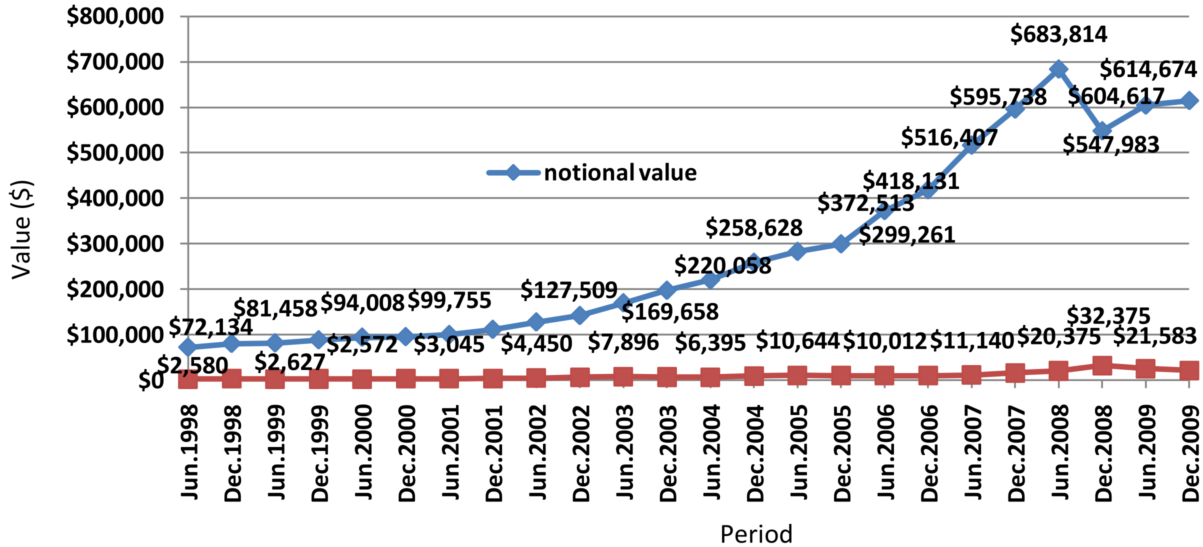

Figure 3. Outstanding over-the-counter (OTC) derivatives (in billion dollars).
Source: the bank for International Settlements (BIS) quarterly review, June 2009.

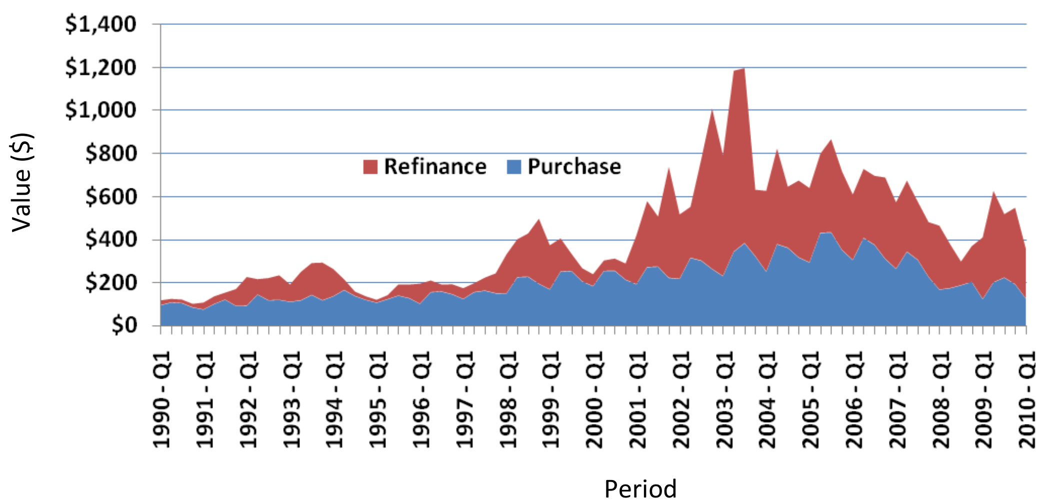

Figure 4. Mortgage Originations: 1-4 Family (in billion dollars). Source: Mortgage Bankers Association.

$ 684 trillion. The U.S. accounts for almost 40% of the global balance of outstanding derivatives. Disguised under the perfect scores from so-called independent credit rating agencies, mortgage originators were able to sell their toxic assets in the global market. Therefore, it is fair to blame excessive and imprudent lending for the 2008 crisis. Indeed, the excessive lending led to a boom in asset prices which in turn fueled an artificial rise in consumption and speculative investment.

Conspicuous consumers who took irresponsible credits in order to realize their “American dream” should receive their fair share in contributing to the 2008 crisis. What they were doing was quite rational, at least in the short run. They were largely driven by their animal spirit to maximize their interests. They were not going to miss the historical opportunity of having more fun with more credits. After all, it was a dream for them to have a big house and big car. They wholeheartedly participated in this game and enjoyed cheap credits. Even those with very low credit ratings were given opportunities to realize their dreams. Many purchased or upgraded their houses without any down payment. Some refinanced their houses to cash out money for vacation, cars, or electronic devices. They were racing to consume more. As seen in Figure 4, the quarterly mortgage origination for the 1-4 family homes made a big jump between 2001 and 2008. As a result, home prices and homeownership had boomed from the late 1990s up to 2007.

Economists should also be blamed as well because they did not foresee the madness of free market actors. This was mainly due to "the profession's blindness to the very possibility of catastrophic failures in a market economy…. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets – especially financial markets-…." (Krugman, 2009; Clement, 2007). Indeed, they were busy in developing elegant financial models such as Capital Asset Pricing Model (CAPM) assuming that investors rationally balance their risks against possible rewards while making investment decisions. With their flawed recommendation, the bubble got bigger and bigger. For instance, in a 2007 interview before the crisis, Eugene Fama, the intellectual father of the efficient market theory, stated that "the word "bubble" drives me nuts," and defended his theory even for the housing market: "Housing markets are less liquid, but people are very careful when they buy houses. It's typically the biggest investment they're going to make, so they look around very carefully and they compare prices. The bidding process is very detailed" (Clement, 2007).

With the increased demand for real estates, the price began to increase as expected by the law of supply and demand. The more credits consumers received, the more houses they demanded which caused housing prices skyrocketing. The existing homeowners took advantage of this game as well. They refinanced their houses to cash out the supposedly gained values of their assets. For few years, everyone was enjoying the benefits of the game. They were realizing their long-awaited dreams. Meanwhile, genius people worked diligently to cover up this game making it last longer. They were hired by financial institutions to come up with creative instruments to repackage the risky assets and sell them to third parties with a promise of net gain in the future. Disguised under the perfect scores from so-called independent credit rating agencies, they were able to sell their toxic assets in the global market. Supported by the infusion of global money, the housing market went wild with artificially busted demand. This was a perfect example of "free market madness." Even though everything was fine according to the law of supply and demand, they were not sustainable because they were not supported by changes in real economy. Therefore, the dream did not last long. In 2008, when the game began to collapse, the dream turned to nightmare for many individuals. It was like a suicide for free market capitalism because the system brought the disaster to itself with its miscalculation about human nature.

INVISIBLE OR STEALING HAND?

Adam Smith's famous metaphor of "invisible hand" is well-known among economists. Indeed, it is an extremely powerful metaphor explaining the strength of free market economy. According to Adam Smith, shaped by self-interested human nature, supply and demand is sufficient enough to deal with most if not all economic problems. However, as seen in the recent financial crisis, the invisible hand without moral compass could turn to a "stealing hand". In my view, the 2008 financial crisis was the greatest theft in the history of mankind. It was not seen as a theft perhaps because of the invisibility of the hand involved.

Let's begin with the definition of theft. For instance, according to the U.K. 1968 Theft Act, theft is "the dishonest taking of property belonging to another person with the intention of depriving the owner permanently of its possession." Thus, a person is guilty of theft if he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it.

Before and during the 2008 financial crisis, billions of dollars were taken away from people with the intention of depriving their owners permanently of their possession. Even though this was done through market exchanges based on mutual consent, it was a theft because of dishonesty. Even though this law does not describe dishonesty, it says what would not be dishonesty:

(a) if he appropriates the property in the belief that he has in law, the right to deprive the other of it, on behalf of himself or of a third person; or
(b) if he appropriates the property in the belief that he would have the other's consent if the other knew of the appropriation and the circumstances of it; or
(c)) if he appropriates the property in the belief that the person to whom the property belongs cannot be discovered by taking reasonable steps (except where the property came to him as trustee or personal representative).

Thus, according to the second criterion above, it is theft if a property is taken away from its owner without his consent if he knows "the appropriation and the circumstances of it." In my view, if people had knew the circumstances in which their money were taken from them through free market games before and during the 2008 financial crisis, they would not have given their consent. Therefore, it was a theft, but a complicated one committed by the invisible hand of free market.

Let's explain theft in free market through an example. Assume that you travel to a foreign country for the first time. You need to go to your hotel from the airport by taxi. You do not know anything about the taxi fare in this city. However, you have quite positive view of that country. Based on your readings and what you heard from others, you believe that the country has strong moral values and trustworthy legal system. Still acting cautiously, you first checked with few taxi drivers for the fare. All of them gave you a rate near to $80. You found out a person who looks educated and trustworthy. He tried to give you assurance by emphasizing his moral and religious values. After a tough bargaining you agreed with that

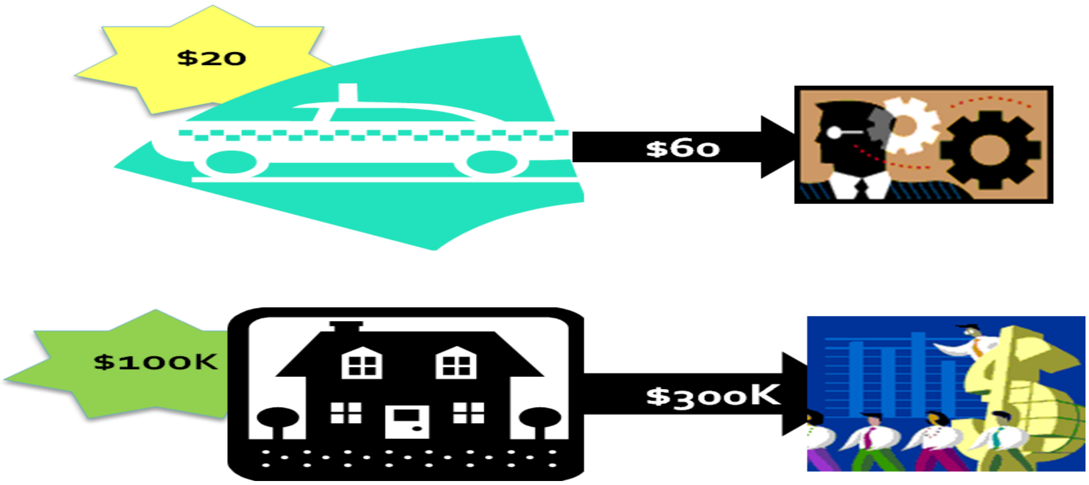

Figure 5. Cheating by a taxi driver vs. financial market driver.

driver for $ 60. You were quite happy with the price and the service. Now if you later on learned that you were charged $ 40 more just because you were a foreigner (with the imperfect information of the local taxi market), you would feel that you were cheated.

As seen in the Figure 5, there are several similarities between the cheating by the hypothetical taxi driver in the story above and the one by financial market drivers during the 2008 financial crisis. Firstly, they both look highly educated and very professional. Indeed, most financial market drivers received their diplomas from top universities like Harvard University, University of Chicago, Yale, etc. Secondly, while the taxi driver used his moral and spiritual values to give confidence to his customers, the financial market drivers used high rating scores from rating agencies to give similar message. Thirdly, while the trust in social and political system of the country above gave a false signal to the taxi customer, the trust in free market economy gave similar delusional message to the financial market customers. Fourthly, while the taxi driver (who was not owner, but a paid staff working on salary plus bonuses) was trying to maximize his benefit without thinking the long-term impact of his cheating act on the owner's revenue, the financial market drivers (who were working with very lucrative bonuses) were acting in a similar way to maximize their own bonuses. In short, on both cases afore mentioned, the market failed to produce the best result because of legal, but immoral behaviors of individuals.

Indeed, the condition for perfect financial tsunami was developed by immoral behaviors of free market drivers. Capitalist entrepreneurs pushed greed element of human nature for profit maximization. The animal souls were tempted for greater consumption in order to gain greater pleasures. The ego also was urged to get involved in this consumption race through demanding positional goods rather than functional goods. The players in the market were given great incentives to pursue their short-term interest at the cost of public interests. Even though what they were doing was legal, it was clearly immoral. Indeed, it was not quite different than stealing from others as explained above. The ultimate investors were deceived through free market game to invest in something which worth much less than its face value. For instance, as seen in Figure 5, they were told with the assurance from so-called independent credit rating agencies that an asset represented a property worth of $ 300K while in reality the value of that property was half of its artificially boosted market value. By doing this, they were literally stealing $ 200K from the ultimate investors. Indeed, many financial institutions, instead of providing services to real economy, were involved in highly sophisticated methods to earn money at the cost of others. They hired highly intelligent people to develop various kinds of derivatives to get money from people based on false promises. They were finding creative ways to make money out of exchanging secondary loan assets without adding anything to the real economy. Perhaps, it was the greatest redistribution of income through the free market in history. Of course, it was not fair, but who cared as long as it was legal and happening through the market.

MORAL AND SPIRITUAL CAPITAL

While the conventional financial market experienced a great tsunami in 2008, a non-orthodox market based on certain moral values performed quite well. I am talking about Islamic financial sector. Indeed, compared to its conventional counterparts, Islamic financial sector performed quit well during the crisis (Chapra, 2008; Hassan and Kayed, 2009b). This success ignited great interest and large debate on this largely ignored sector. Even the Vatican recommended Islamic finance model as a viable alternative to the conventional finance (Totaro, 2010).

The success of Islamic financial system might be

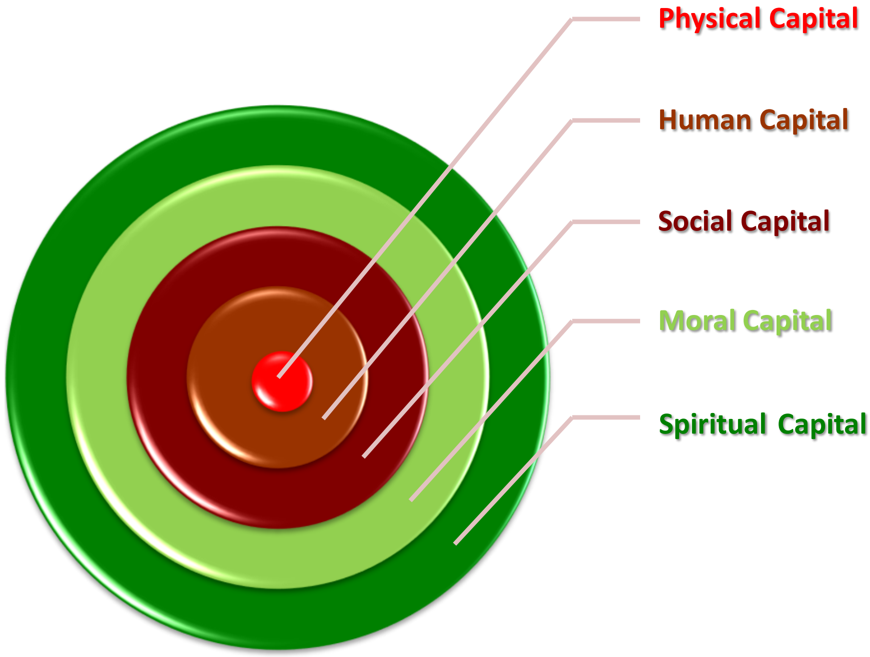

Figure 6. Resources needed for human satisfaction.

attributed its moral and spiritual principles and its comprehensive understanding of human nature (Aydin, 2010). Firstly, the Islamic worldview is based on the Tawhed (the oneness of God). God is not an abstract term; He is the basis for reality. The ultimate goal is not to maximize utility through gaining greater pleasures; rather, it gains the pleasures of God through living a morally and spiritually fulfilled life. Secondly, Islam sees human being as a khalifa (vicegerent) of God on the earth. Therefore, it does not allow perceiving human as a mere means of production or consumption. Rather, it sees everything as a means helping human to disclose his potential in order to fulfill his divine mission. Thirdly, Islam defines human nature not only consist of mind, ego, and animal soul; but also spiritual heart and conscience. Therefore, in Islamic terms, it will not be right to talk in a singular form when referring to self-interest. In other words, before acting on self-interest, we need to know whose interest we are acting on. Islam offers moderation in fulfilling the needs and desires of animal soul and ego; while putting more emphasis on the needs of the spiritual heart and the conscience. Fourth, Islam provides guideline to train and control animal soul and ego rather than following their desires. For instance, fasting in Ramadhan is training for animal soul and ego. Fifthly, Islam perceives worldly possessions as trust (amanah) rather than private ownership. Therefore, it sets certain restrictions in their use even if it is privately owned. For instance, it requires giving of zakah (mandatory almsgivings) and charity and forbids any kind of wasteful uses. Sixthly, Islam sets certain restrictions on market transactions to provide social justice (Hassan and Kayed, 2009a). For instance, it prohibits riba (interest) mainly because it does not see fair to make gain without making any contribution to the real economy. The moral law is the basis for Islamic economics and finance, not egotistical self-interest (Choudhury, 2007). Seventhly, Islam establishes personal accountability both in this life and in the hereafter in pursuing material possessions. It sets social responsibility for both individuals and corporate in term of serving to the good and forbidding the bad (Choudhury, 2007).

Due to its understanding of human nature, as seen in Figure 6, Islamic economics includes moral and spiritual capital in the list of resources needed for individual and societal well-being. In other words, from an Islamic perspective, human is not just animal with higher thinking ability. Human has multiple dimensions including intellectual, moral, and spiritual ones. Therefore, moral and spiritual values are as important as physical resources in the goal of fulfilling the needs and desires of humans. From this perspective, ignoring moral and spiritual needs would have economic consequences as seen in the recent crisis. Indeed, Dr.Choudhury, a leading scholar on Islamic economics, argues that “the predictions and scope of economics in its mainstream outlook, therefore, are almost always incorrect, evasive, unjust and inequitable. This happens because the primal foundations of morals, ethics and value are excluded from the economic calculus” (Choudhury, 2007).

Conclusion

As the success of free market capitalism could be explained through its understanding of human nature, namely self-interest and rationality, its failure also could be explained through its misunderstanding of human nature, namely greed and predictable irrationality. Due to its shortcoming in understanding human nature, during the 2008 financial crisis, “invisible hand” of free market turned to “stealing hand” through market games. In essence, this was a “moral crisis” driven by free market madness. The crisis was fueled by the irrational and irresponsible behaviors of politicians, creditors, and consumers.

Economics as a field suffered a major blow with the 2008 financial crisis due to the failure of its elegant models which rely on some inaccurate assumptions about human nature. If the profession is going to reclaim its reputation, it has to revise these assumptions and accept the fact that a capitalist free market economy has serious flaws and frictions even though it has many virtues in general. As Krugman says, economists “have to face up to the inconvenient reality that financial markets fall far short of perfection, that they are subject to extraordinary delusions and the madness of crowds” and they “have to acknowledge the importance of irrational and often unpredictable behavior, face up to the often idiosyncratic imperfections of markets and accept that an elegant economic “theory of everything” is a long way off. In practical terms, this will translate into more cautious policy advice – and a reduced willingness to dismantle economic safeguards in the faith that markets will solve all problems” (Krugman, 2009).

As the Great Depression revealed the imperfection of free market economy and forced economists to redefine the role for government, the 2008 financial crisis also revealed the predictable irrational and immoral aspects of individuals and forced us to acknowledge the need for moral values for efficient market system. It will be a great mistake if our response becomes limited to laws and regulations. Keynesian economic policy and increased government regulations could only provide a temporary relief. This is because regulations often lag behind the selfish and destructive behaviors of human minds. It is very likely that we will experience the similar crisis again and again until we eradicate its root causes. Therefore, we should revise our assumptions of human nature and behaviors in economics and finance to include predictably irrational decisions of individuals. We should include moral education in education system. Even though most business colleges now offer some kind of business ethic courses, this is not being sufficient. We need to start moral education at K-12 levels, not at the college. We should also revise our economic models to capture the importance of moral and spiritual capital as endogenous variables.

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