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ECONOMIC RESILIENCE DURING FINANCIAL CRISIS: ISLAMIC VS. CONVENTIONAL SYSTEM

Mahroof Ahmed
M.A. Economics HNBGU Uttarakhand, School of Humanity and Social Sciences

ABSTRACT **DOI No: 10.36713/epra20910** **Article DOI: https://doi.org/10.36713/epra20910**

Actually economics is in practice since ancient time even though it emerged as a discipline in 1776 when a book titled wealth of nation was written by Adam Smith in 1776. Arthashastra was written by Kautilya long ago which deals with governance, economics and military strategy. Almost all religions directly or indirectly talk about how resources should be allocated and wealth should be re distributed to avoid economic inequality and achieve a balanced economic development giving justice to all the individuals in the society. The present paper lays emphasis on Islamic aspect of economics especially in its approach to deals with problem of financial crisis. Further, this paper attempts to draw a comparison between Islamic and conventional system.

KEY WORDS: ***Islamic Economics, Conventional Economics, Riba, Mudaraba, Musharaka, Bai Muajjal, Salam, Istisna, Ijara***

Riba: Riba (or the rate of interest) is a debatable subject among scholars. Riba or rate of interest has a wide recognition in modern financial system as a major proportion of global banking system deals in lending and borrowing via interest rate. But, this riba or interest rate is strictly prohibited in Islam. As per Islamic shariah concept of riba is considered as evil act and thought of as a contributory factor to financial crisis. It is rejected on following ground:

Promotes Inequality: Riba promotes economic inequality. Because it allows those with capital to earn guaranteed returns regardless of their efforts, while those who borrow are burdened with debt and interest payments. Islamic viewpoint is that riba should be rejected and instead Islamic financial system should be promoted to ensure more equitable distribution of wealth.

Riba leads to Excessive Leverage in business which can lead to systemic risks and business failures. In finance, leverage means using debt to buy assets. After the 2008 financial crisis, many businesses failed because they had high levels of debt (leverage) and they could no longer sustain the payments of riba (https://www.blossomfinance.com) 3 April 2020.

Ethical and moral concern: The prohibition of riba is rooted in ethical and moral values, which can lead to a more just and sustainable economic system.

Risk sharing aspect: Islamic finance principles, such as profit and loss sharing, encourage a more collaborative and risk-sharing approach to finance, which can help to mitigate the risks associated with economic downturns but on the other side there is no such provision in riba where one of the two parties involved gets a guaranteed profit even though it does not make any effort. It has an upper hand only because it has capital pushing borrower in debt trap.

Avoiding Debt Based Cycle: Islamic finance, which prohibits riba, focuses on profit-sharing and risk-sharing mechanisms rather than fixed interest payments. This can help prevent the accumulation of unsustainable debt, which is a major factor in financial crises.

Emphasis on Real Economic Activity: Islamic finance lays emphasis on real economic activities rather than relying on speculative investments or debt-based income.

Mudaraba: it is a situation in which one party provides the funds while the other provides expertise and management. Any profit is shared between the two parties on a preapproved ratio, while loss is borne by the capital provider. Mudaraba is one of the most important modes of investing money, executed by prophet Mohamed(peace be upon him) before Islam with his wife khadeja, currently it is widely used by investors, banks and Islamic financial institutions. Mudaraba is also referred to as profit and loss sharing.

Shariah Rules in Mudaraba

According to primary and secondary sources of Islamic Sharia, regarding the conditions of the Mudaraba, there is a certain rules should be apply, to validate the contract from the sharia point of view, this rules are:

- The capital shall be known and delivered to the (Mudarib).
- Both parties agreed the share of both parties in the Mudaraba profit.
- The owner of the money (the client) shall bear the loss.
- Profits will be distributed after the capital is recovered.
- If there is any negligence or misconduct of the Mudarib (the bank) the bank shall bear the loss.
- In the case of continuing Mudaraba, the loss may be covered from the profit of another operation.
- The Mudarib should employ best efforts to accomplish the objectives of the contract and investment.

Musharaka: Is joint venture or equity participation between two (or more) parties to contribute to a particular investment enterprise, where profit is shared in accordance with the agreement between the parties, and loss is shared in proportion to relative shares of capital. Here, the bank provides funds, which are mixed with the funds of the business enterprise, and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios of the actual positive outcome, while the loss is borne by each partner strictly in proportion to respective capital contributions. In musharaka or in mudaraba, what makes profit permissible is that it is a ratio of the realized positive outcome at the end of the business, not the rate of return on the loan itself.

Murabaha: It is the most widespread mode, is the sale of a commodity by a bank to a client on mutually agreed profit. In a murabaha transaction, the bank finances the purchase of a good or asset by buying it on behalf of its client and adding a mark-up before reselling it to the client on a 'cost-plus' or ‘mark-up’ basis. What makes the murabaha transaction legitimate is that the bank first acquires the asset and in the process it assumes certain risks between purchase and resale. The bank takes responsibility for the goods before they are safely delivered to the client. The services rendered by the Islamic bank are therefore regarded as quite different from those of a conventional bank that simply lends money to the client to buy the good.

Bai muajjal: It is a credit (deferred) sale of goods where a bank purchases a commodity on behalf of a client and then sells it to the client at a profit. The payment of sale price is deferred for a fixed period and may be made in instalments.

Salam: It is a pre-paid purchase of goods in order to finance production by Islamic banks. Here the price of a future standard commodity is paid at the time of the contract, delivery taking place at a future date. This mode enables entrepreneurs to sell their output to the bank at a lower price in advance, thus having a ready purchasing power for pressing needs. The bank then orders the producer to sell output to usual client on its behalf.

Istisna: It similar to Salam is a contractual agreement for manufacturing nonstandard goods and commodities, allowing cash payment in advance and future delivery. It can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, and building of bridges, roads, and highways.

Ijara: It is an arrangement of leasing equipment, buildings or other durable assets to a client in return for initially agreed rental fee. Under this mode, Islamic banks buy the equipment or machinery and lease it out to their clients who may opt to buy the items eventually, in which case the monthly payments will consist of two components, i.e., rental for the use of the equipment and instalment towards the purchase price.

Aspects	Islamic Economics	Conventional Economics
I Foundation	It is based on shariah(Islamic law) and lays stress on justice, equity and prohibition of exploitation.	It is based on contemporary economic theories like classical, neo classical Keynes etc.
2 Interest (Riba)	Interest or riba is completely prohibited in Islamic economics on the ground the it can lead to economic vulnerability like 2008 financial crisis.	Central to the conventional financial system.
3 Risk	Encourages risk sharing. For example, mudarabah and musharakah	Often relies on risk shifting like securitization and derivatives.
4 Speculation(Gharar)	Prohibits excessive uncertainty (gharar) and gambling (maisir)	Speculation is legal and widespread in financial market.
5 economic policies	Monetary is not backed by interest rate and emphasizes zakat. Prohibits hoarding and redistribution.	Interest rate is key tool of monetary policy and advises tax spending policy to manage aggregate demand.
6 Banking	Asset backed ethical and shariah-compliant finance.	Debt – based profit maximization model is followed
7 Crisis Management	Emphasizes real economic activities and avoids over leverage.	Uses bailout, quantitative ease and monetary tools

CONCLUSION

To conclude one can say that Islamic economic relies more on moral and ethical aspect rather than conventional theories in dealing with economic affairs including financial crisis. It is based on justice equity principle and totally prohibits interest (Riba). It holds strong evidence in its favour from financial crisis of 2008 where interest found to be a major cause of economic downturn. It believes that system of interest of riba is not based on just because it gives almost one sided benefit to a party/individual who has capital who gets interest payment and doesn't take much pain. Trade of goods produce an economic value but trade of currencies or of financial instruments do not. Thus any income received through the exchange of goods is a real economic earning and it is the result of a positive-sum game. That economic activity is called trade and income is called profit. But any income made through the exchange of currencies or of financial securities or derivatives without linking them to any movement of goods is a virtual one, which is the result of a zero-sum game. That income is called interest. Different financial instruments can be exchanged for each other at any price if the transaction is on spot. That applies to the sale of financial instruments for money provided it is on spot.

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