Theoretical and Analytical Approach of Financial Stability: Islamic Perspective

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Theoretical and Analytical Approach of Financial Stability: Islamic Perspective

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Abstract: This paper theoretically investigates financial stability and assesses the impacts of central bank policies on the banking system. The Islamic finance system has empirically shown relative stability to the waves of the 2007-2008 international financial crisis and reduced volatility of global financial markets. By using the sharing rule and stochastic dominance, we prove that the investor's expected payoff in the stochastic return model is superior and falls between the expected payoffs of the investor and financier in the fixed return model, respectively. Financial instability can stem from banking and financial markets deviations, asset bubbles, and money market fluctuations. Current economic and financial theories, rooted in the risk-shifting and interest rate smoothing models, have proven inadequate. New principles are needed to address financial instability and mitigate the devastating impacts of financial crises. Western attempts to address financial instability will prove unattainable as long as they depend on banking interest and credit multiplier systems. From the Islamic economics paradigm, financial stability hinges on two key conditions: the prohibition of interest rates and the institutionalization of contractual finance in accordance with Islamic Shariah. We propose that synchronized (or desynchronized) interactions between financial and business cycles positively (or negatively) affect both the banking system and the real economic domain, leading to stable (or unstable) states. Given the financial system's prohibition of interest rates and the real economy's adherence to Shariah jurisprudence, we theoretically envisage that the series of procyclical and countercyclical behaviors of financial variables would contribute to improve the financial stability since the financial cycle is too close to real cycle.

Keywords: Financial stability, Synchronization, Financial cycle, Profit-Loss-Sharing finance, Shadow banking, Monetary policies, Policy reforms, Policy analysis.

JEL Classification: G2

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