



## **ON THE GROWTH AND STABILITY OF RISK SHARING BASED ISLAMIC FINANCE**

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\*The study is an expansion of the base papers by Abbas Mirakhor and Mughees Shaukat (2012, 2013) and by Mughees Shaukat, Abbas Mirakhor and Nouredine Krichene (2012, 2013).

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## ON THE GROWTH AND STABILITY OF RISK SHARING BASED ISLAMIC FINANCE<sup>1</sup>

### **Abstract**

Evidence has been mounting that the interest-based debt financing regime is under increasing distress. Evidence also suggests that the financial crises, whatever title they carried - exchange rate crisis or banking crisis – have been debt related crises in essence. At present, data suggest that the debt-to-GDP ratio of the richest members of the G-20 is expected to reach 120% mark by 2014. There is also evidence that out of securities worth US\$ 200 trillion in the global economy, no less than three-fourth represent interest-based debt. It is difficult to see how this massive debt volume can be validated by the underlying productive capacity of the global economy. This picture becomes more alarming considering the anemic state of global economic growth. There is great uncertainty with regard to interest rates. Although policy-driven interest rates are near-zero level, there is no assurance that they will not rise as the risk and inflation premia become significant. Hence, a more serious financial crisis may be in the offing and a general collapse of asset prices may occur. This paper argues that the survival of the interest-based debt regime is becoming less tenable, as is the process of financialization that has accompanied the growth of global finance over the last four decades. The above has

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resulted in an unprecedented increase in economic risks; generating (adverse) non-linearities in system's behavior. Such a behavior is nothing but a demonstration of the verse, "Allah obliterates riba ...." of the Quran. As a result, the search is on for a paradigm shift towards a less volatile and more resilient financing regime. The paper proposes risk sharing based Islamic financing as suitable alternative and also demonstrates empirically its better growth and stability characteristics by using advanced dynamic heterogeneous panel techniques.

**Keywords:** Financial fragility, Financialization, Black Swans, Islamic finance, Risk-Sharing, Institutional and incentive structure, Dynamic Heterogeneous Panel Techniques.