

Volume 2, Issue 2

Research Article

Date of Submission: 01 May, 2026

Date of Acceptance: 10 Jun, 2026

Date of Publication: 19 Jun, 2026

## The Economic Risks of Financial Speculation on the Global Economy: A Comparative Analysis between Conventional and Islamic Economic Perspectives

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**Citation:** Raheem, D. M. A. M. A. (2026). The Economic Risks of Financial Speculation on the Global Economy: A Comparative Analysis between Conventional and Islamic Economic Perspectives. *Int Rev Bus Trade Econ*, 2(2), 01-13.

### Abstract

This comprehensive paper investigates the profound economic risks and systemic harms posed by excessive financial speculation to the global economic system. It establishes a critical theoretical distinction between productive, real-economy-linked risk-sharing activities and non-productive, purely speculative financial practices that generate significant divergence between capital flows and tangible economic output. The research employs a comparative analytical framework, integrating mainstream conventional economic theory with the ethical and structural principles of Islamic economics. The analysis demonstrates how speculative excesses are primary contributors to the formation of asset price bubbles, heightened financial instability, speculative inflationary pressures, and severe capital misallocation. The study quantifies the staggering scale of speculative transactions relative to global real GDP, highlighting a deep structural imbalance. Furthermore, it conducts a rigorous evaluation of the Islamic economic paradigm—rooted in asset-backing, risk-sharing (*mushārahah*, *muḍārahah*), and the prohibition of excessive uncertainty (*gharar*) and pure monetary speculation (*maysir*)—as a viable alternative framework for financial stability. The paper concludes with a forward-looking scenario analysis on the potential macroeconomic and social outcomes of redirecting global financial activity toward productive, real-sector investments, alongside a set of integrated policy recommendations drawn from both conventional and Islamic economic thought.

**Keywords:** Financial Speculation, Asset Bubbles, Financial Instability, Real Economy, Islamic Economics, Risk-Sharing, Financialization, Global Financial Markets

**JEL Classification:** G10, G12, G15, E44, E31, Z12

### Introduction

The global financial architecture of the 21st century is characterized by an unprecedented expansion of financial markets, often decoupled from the rhythms and needs of the real economy—the sector responsible for the production of goods and services. Since the financial liberalization waves of the 1980s, the volume of financial transactions has dwarfed the growth of global trade and output [1]. The 2007-2008 Global Financial Crisis (GFC) served as a catastrophic testament to the dangers inherent in this model, where complex, speculative instruments like mortgage-backed securities and credit default swaps precipitated a collapse that required massive public bailouts and triggered a global recession. However, the post-crisis regulatory response, while substantial, has not fundamentally reversed the trend of financialization—the increasing dominance of financial motives, markets, and institutions [2]. Instead, liquidity injections and low interest rates have, in many cases, fueled new speculative cycles in equity, bond, and emerging cryptocurrency markets, raising persistent concerns about systemic resilience.

This study is motivated by the urgent need to critically reassess the role and scale of financial speculation. The core research problem lies in the systemic economic risks generated when speculative activities—driven by short-term profit motives, high leverage, and a disconnect from underlying asset value—become dominant over productive investment. The primary objective is to conduct a holistic analysis of these risks and to juxtapose the conventional financial system's inherent instabilities with the stabilizing principles of Islamic economics. The latter offers a paradigm grounded in ethics, real-asset linkage, and risk-sharing, presenting a compelling counter-model.

## The Paper Seeks to Answer the Following Key Research Questions

- How does conventional economic theory define and treat financial speculation, and how does this differ fundamentally from the Islamic economic perspective?
- What is the empirical magnitude of speculative activity in contemporary global markets relative to real economic output?
- Through what specific channels does excessive speculation generate asset bubbles, financial instability, inflation, and capital misallocation?
- How do the core mechanisms of Islamic finance—particularly the prohibition of pure speculation and the emphasis on risk-sharing—theoretically mitigate these systemic risks?
- What potential global economic outcomes could emerge from a significant reorientation of capital from speculative circuits to real-sector investments?

The central hypothesis is that the Islamic economic model, by structurally tethering finance to real economic activity and mandating risk-sharing over risk-transfer, provides a more robust institutional framework for mitigating the systemic risks and social costs associated with financial speculation, thereby promoting sustainable and equitable economic growth.

This research contributes to the literature in three significant ways. First, it provides an updated, post-GFC and post-pandemic synthesis of the scale and channels of speculative harm. Second, it offers a detailed comparative economic analysis—not merely an ethical one—between conventional and Islamic perspectives on speculation, translating Shariah principles into clear economic mechanisms. Third, it moves beyond critique to construct a “what-if” scenario analysis, modeling the potential benefits of a structural shift toward real-economy finance, thereby bridging theoretical economics with policy-oriented foresight.

## Conceptual Framework of Speculation

### Definition of Speculation in Conventional Economics

In mainstream financial economics, speculation is not inherently pejorative. It is defined as the act of conducting a financial transaction that entails significant risk of loss, with the primary expectation of substantial gains from short-to-medium term fluctuations in the market value of an asset, rather than from its underlying intrinsic value or long-term income generation [3]. The speculator provides liquidity and assists in price discovery by betting on future price movements. The line between “investment” and “speculation,” as famously noted by Benjamin Graham, is often blurred but hinges on the analysis of underlying value, the motive (income vs. capital gain), and the time horizon [4].

### Key Characteristics of Conventional Speculation Include

- **High Leverage:** The use of borrowed capital to amplify potential returns (and losses). This is facilitated by derivatives and margin trading.
- **Short-Termism:** A focus on technical analysis, market sentiment, and momentum over fundamental analysis of an asset’s productive capacity.
- **Risk-Taking for Capital Appreciation:** The primary goal is capital gains from price changes, not dividends, rents, or productive profits.
- **Acceptance of Gharar (Uncertainty):** Conventional markets operate within a framework that tolerates and manages, rather than prohibits, significant degrees of uncertainty and complex, opaque instruments.

Post-Keynesian economists like Hyman Minsky provide a more critical lens. Minsky’s Financial Instability Hypothesis posits that during prolonged prosperity, capitalist economies naturally transition from conservative “hedge” finance to speculative and ultimately destabilizing “Ponzi” finance, where cash flows are insufficient to service debt, relying entirely on rising asset prices—a dynamic fueled by speculation [5].

### Speculation in Islamic Economics

Islamic economics derives its principles from the primary sources of Shariah (Qur’an and Sunnah). Its financial framework is built on the foundational prohibition of *riba* (usury/interest), *gharar* (excessive uncertainty or ambiguity), and *maysir* (gambling, including speculative games of chance). Financial speculation is analyzed through this ethical-legal prism.

### The System Makes a Crucial Ontological Distinction:

- **Productive Risk-Sharing (Mushārah & Muḍārah):** This is encouraged and forms the cornerstone of Islamic finance. *Mushārah* is a profit-and-loss sharing joint venture partnership, while *Muḍārah* is a profit-sharing partnership where one party provides capital and the other provides labor/ expertise. Both tie financial returns directly to the success of a real, productive enterprise. The risk is shared, not transferred or hidden.
- **Prohibited Financial Speculation (Maysir & Gharar):** Any transaction where the gain of one party is contingent purely on the loss of another, without the creation of real economic value, is considered *maysir*. Similarly, transactions

involving excessive uncertainty regarding the underlying asset, its price, delivery, or existence are void due to gharar. This prohibition extends to:

- Selling what one does not own or possess (short-selling in its conventional form).
- Trading in debts at a discount (which involves *riba*).
- Derivatives contracts that are not fully backed by a genuine need for hedging a real asset (speculative derivatives).

It is important to clarify that Islamic finance does not prohibit risk management per se. A critical distinction is made between speculative derivatives (مسيمة) (and Sharia-compliant hedging instruments when used to mitigate genuine economic exposures. This nuanced differentiation is explored in detail in Appendix D.

### The Core Principles Underpinning this View are

• **Asset-Backing (Maal):** Every financial transaction must be linked to a tangible, identifiable, and permissible (halal) underlying asset or service in the real economy. Money is not a commodity to be traded for more money; it is a medium of exchange and a store of value.

• **Risk-Sharing:** Finance should be a partnership where financier and entrepreneur share both profits and losses, aligning incentives and promoting prudent investment.

• **Ethical and Social Welfare (Maslaha):** Financial activities must contribute to the real economy, promote equitable distribution of wealth, and avoid harm (darar).

Aspect	Conventional Economics Perspective	Islamic Economics Perspective
<b>Foundational Ethos</b>	Utilitarian/Efficiency-based; seeks to maximize returns and market efficiency, often viewing speculation as a necessary component.	Deontological/Ethical-based; financial activities must comply with divine law and promote social justice ( <i>adl</i> ) and welfare ( <i>maslaha</i> ).
<b>Treatment of Risk</b>	Risk is a commodity to be managed, priced, and transferred via sophisticated instruments (e.g., derivatives, securitization).	Risk is to be shared, not commodified or transferred in a way that severs the link to the underlying asset. Prohibition of selling risk independently.
<b>Role of Money</b>	Money is an asset class; it can be traded, rented (interest), and its future value speculated upon.	Money is a medium of exchange and unit of account; it has no intrinsic value and cannot be traded for more of the same with a premium over time ( <i>riba</i> ).
<b>Time Horizon</b>	Often short-term, driven by quarterly reports, high-frequency trading, and market sentiment.	Inherently longer-term, as returns are tied to the success of a real project or asset, encouraging due diligence and sustainability.
<b>Objective of Finance</b>	Maximization of private financial returns, often through financial engineering.	Mobilization of capital for real economic development, ensuring equitable distribution of wealth and stability.

### Key Differences between Conventional and Islamic Views

This fundamental divergence in first principles leads to radically different institutional arrangements and, as this paper argues, differential outcomes in terms of systemic stability.

### Data and Methodology

The study adopts a qualitative analytical methodology supported by stylized empirical evidence from BIS and IMF data.

**Econometric Model Specification** (These models are applicable in subsequent research.)

Model (1): Financialization and Real Output

$$\text{GDP}_t = \alpha + \beta_1 \text{FXTURN}_t + \beta_2 \text{DERIV}_t + \beta_3 \text{INV}_t + \beta_4 \text{OPEN}_t + \varepsilon_t$$

Where:

$\text{GDP}_t$  = Global real GDP growth rate (proxy for real output)

$\text{FXTURN}_t$  = Global foreign exchange market turnover / GDP

$\text{DERIV}_t$  = Global derivatives notional outstanding / GDP

$\text{INV}_t$  = Gross fixed capital formation (% of GDP)

$\text{OPEN}_t$  = Trade openness (% of GDP)

$\varepsilon_t$  = Error term

Expected signs:  $\beta_1 < 0$ ,  $\beta_2 < 0$ ,  $\beta_3 > 0$ ,  $\beta_4 > 0$

From an Islamic economic perspective, higher FX and derivatives intensity represents excessive gharar and maysir, which are expected to negatively affect real output growth by diverting capital from productive investment.

### 3.2 Econometric Model for Financial Instability

Model (2): Speculation and Macroeconomic Instability

$$\text{VOL}_t = \gamma + \delta_1 \text{FXTURN}_t + \delta_2 \text{DERIV}_t + \delta_3 \text{LEV}_t + \mu_t$$

Where:

$\text{VOL}_t$  = Financial volatility index (VIX or equivalent)

$\text{LEV}_t$  = Global financial sector leverage ratio

Expected signs:  $\delta_1 > 0$ ,  $\delta_2 > 0$ ,  $\delta_3 > 0$

This model captures the destabilizing role of speculative financial activity, consistent with Minsky's Financial Instability Hypothesis and the Islamic prohibition of excessive uncertainty (gharar).

#### Directions for Future Empirical Application

The econometric models presented above (Models 1 and 2) provide a theoretical framework for empirically testing the relationship between financial speculation, real output, and macroeconomic instability. While this study adopts a qualitative and stylized analytical approach, these models are designed for future empirical application. Below are suggested guidelines for operationalizing this research agenda:

#### Data Requirements and Sources

• **Dependent Variables:** Global and national real GDP growth rates (World Bank, IMF), financial market volatility indices (VIX, MOVE), and measures of financial instability (e.g., Z-score, non-performing loan ratios).

#### Core Explanatory Variables

- **FXTURN:** Ratio of annual FX turnover (BIS Triennial Survey) to GDP.
- **DERIV:** Ratio of OTC derivatives notional outstanding (BIS) to GDP.
- **LEV:** Financial sector leverage ratios (BIS, IMF FSI).
- **INV:** Gross fixed capital formation as % of GDP (World Development Indicators).

• **Control Variables:** Interest rates, inflation, trade openness, institutional quality indices, and dummy variables for financial crises.

#### Suggested Methodological Approaches

• **Panel Data Analysis:** Applying the models to a balanced panel of 20- 30 systemically important economies over 1995–2025.

• **Time-Series Techniques:** For global aggregates, employing Vector Error Correction Models (VECM) or ARDL bounds testing to capture short- and long-run dynamics.

• **GMM Estimation:** To address potential endogeneity between financialization and growth.

• **Threshold Regression:** To test if the negative impact of speculation intensifies beyond certain levels of DERIV/FXTURN.

#### Islamic Finance Contextualization

A promising extension would be to construct a subsample or interaction term for economies with significant Islamic

finance sectors (e.g., Malaysia, GCC countries, Pakistan). This would allow for a direct comparative test of whether higher penetration of Islamic finance moderates the negative coefficients  $\beta_1$  and  $\beta_2$  in Model (1).

### Expected Outputs

- Quantification of the marginal effect of a 10% increase in derivatives intensity on GDP growth and financial volatility.
- Scenario simulations based on estimated coefficients to model the potential growth and stability gains from reducing speculative financial activity by targeted percentages.

By pursuing this empirical pathway, future research can move from theoretical modeling to robust, policy-relevant quantification, strengthening the evidence base for financial system reform.

### Scale of Global Financial Speculation

The divergence between the financial and real economies is not merely theoretical but is starkly evident in quantitative terms. Financial globalization has led to a staggering increase in the volume of cross-border capital flows and domestic financial transactions.

- **Foreign Exchange Markets:** The Bank for International Settlements (BIS) Triennial Survey (2022) reports average daily turnover in global foreign exchange markets at \$7.5 trillion [6]. In contrast, daily global trade in goods and services is only a fraction of this amount. The BIS notes that a significant portion of this activity is driven by non-bank financial institutions (e.g., hedge funds, proprietary trading firms) engaged in speculative arbitrage and momentum trading.

- **Derivatives Markets:** The notional outstanding amount of over-the-counter (OTC) derivatives stood at \$632 trillion in 2021 [7]. While notional amounts overstate risk, they indicate the colossal scale of side-bets on underlying assets (interest rates, currencies, commodities). Only a minor fraction of these contracts are used for genuine hedging by non-financial corporations; the majority represent financial-to-financial speculation.

- **Comparison to Global GDP:** Global nominal GDP in 2023 was approximately  $\sim 105$  trillion (IMF, 2023). The annual turnover in FX markets alone (roughly 7.5 trillion/day \* 250 days) is  $\sim \$1,875$  trillion, or nearly 18 times global GDP. The derivatives notional is 6 times global GDP. This vast churn of "financial paper" detached from real output is the defining feature of financialization [8].

- **Leverage and Financialization:** The ratio of global financial assets to global GDP has risen dramatically, from about 100% in 1980 to over 350% today (IMF GFSR, 2023). This growth has been fueled by increased leverage within the non-bank financial sector and the proliferation of complex, layered financial products.

This data reveals a profound structural imbalance. The financial superstructure has grown to a size where its internal dynamics—driven by speculation, leverage, and herding—can and do overwhelm the real economic base, leading to the systemic risks analyzed next.

### Economic Risks and Harms of Speculation

#### Asset Price Bubbles and Market Crashes

Speculation is the primary engine of bubble formation. The mechanism, described by Kindleberger & Aliber (2011), follows a pattern: a displacement (new technology, low interest rates) creates profit opportunities; credit expands, fueling speculative purchases; a "mania" or euphoria takes hold, drawing in less informed investors (the "greater fool" theory); prices detach entirely from fundamentals; finally, insiders sell, panic erupts, and the bubble bursts [9].

- **Housing Bubble (2000s):** Speculation in mortgage-backed securities (MBS) and collateralized debt obligations (CDOs), coupled with lax lending standards, inflated US housing prices. The subsequent crash triggered the GFC [10].

- **Cryptocurrency Bubbles (2017, 2021):** Characterized by extreme volatility, social media-driven hype, and pure price speculation with little underlying utility as a currency, Bitcoin and other cryptocurrencies have experienced repeated boom-bust cycles [11].

- **Equity Market Bubbles:** The dot-com bubble (1999-2000) was fueled by speculation on internet stocks with no earnings, driven by narrative and momentum trading.

#### Financial Volatility and Market Instability

High-frequency trading (HFT) and algorithmic speculation can amplify volatility. These systems react to micro-signals in milliseconds, leading to events like the 2010 "Flash Crash." Speculative capital flows into and out of emerging markets ("hot money") cause severe exchange rate volatility and can precipitate currency crises, as seen in Asia (1997) and Turkey (2018). The contagion effect means instability in one market or asset class can rapidly spread globally due to interconnected, leveraged speculative positions.

## Inflationary Pressures and Currency Devaluation

Speculation can drive inflation in specific asset classes (e.g., housing, equities), creating wealth inequality. More broadly, commodity speculation—especially in oil and food futures—can translate into real-world price spikes, as seen in the 2007-2008 food and fuel crisis. Studies by Masters & White (2008) argued that financialization and index fund speculation in commodity futures exacerbated price rises, impacting global food security [12]. Persistent asset inflation can also lead to currency devaluation concerns if it prompts capital flight.

## Misallocation of Capital

This is perhaps the most pernicious long-term harm. When financial engineering and speculation offer higher short-term returns than productive investment in industry, R&D, or infrastructure, capital is “crowded out.”

- **Corporate Behavior:** Firms may prioritize stock buybacks (to boost share prices) over capital expenditure [13]. Talent is drawn toward finance (“the brain drain”) rather than engineering or manufacturing.
- **Sectoral Imbalance:** Economies become top-heavy in financial services at the expense of manufacturing and productive sectors, a phenomenon linked to lower long-term growth and productivity stagnation [14].

## Legal, Institutional, and Governance Risks

The complexity of speculative instruments like CDOs and credit default swaps (CDS) creates opacity, making it difficult for regulators, investors, and even firm management to assess true risk exposure. This lack of transparency was a key failure in the GFC. Furthermore, speculative booms erode ethical standards and foster a culture of rent-seeking, while the inevitable busts lead to protracted legal disputes, bailouts, and erosion of public trust in institutions.

## Speculation versus the Real Economy

The dominance of speculative finance has tangible, negative consequences for the real economy:

- **Employment and Productivity:** The shift from stable, long-term industrial employment to more precarious service-sector jobs is partly linked to deindustrialization accelerated by financialization [15]. Productivity growth in many advanced economies has slowed, a trend some economists link to the misallocation of resources toward unproductive financial activities.
- **Decline of Productive Investment:** As highlighted, the rate of net fixed capital formation has stagnated in many countries as corporate funds are channeled to financial markets.
- **Social and Developmental Consequences:** The inequality exacerbated by asset-price inflation (benefiting asset owners) versus wage stagnation, and the social cost of financial crises (unemployment, austerity, lost pensions), represent a major social harm. For developing countries, volatile capital flows undermine long-term development planning.

## Islamic Economic Model as an Alternative Framework

### Risk-Sharing and Real Asset-Based Finance

The Islamic model directly addresses the root causes of speculative harm. By mandating that finance be structured as partnerships (*musharakah*, *muḍārabah*) or asset-based trade transactions (*murābaḥah*, *ijārah*), it ensures a direct, transparent link to the real economy. This:

- **Aligns Incentives:** The financier becomes a partner, sharing in the venture’s success or failure, promoting more rigorous due diligence.
- **Discourages Leverage:** Since interest-based debt (*riba*) is prohibited, the excessive leverage that fuels speculative bubbles is structurally constrained. Financing is based on equity and asset ownership.
- **Promotes Stability:** Risk-sharing makes the financial system more loss-absorbent. In a crisis, losses are distributed among partners rather than cascading through a chain of debt defaults.

### Prohibition of Purely Financial Speculation

The bans on *gharar* and *maysir* act as automatic stabilizers. Prohibiting short-selling (in its naked form) removes a mechanism that can accelerate market declines.

Banning speculative derivatives prevents the buildup of unseen, systemic risk in complex, interconnected contracts. The requirement for asset-backing ensures that every financial claim corresponds to a real asset, preventing the creation of “fictitious capital.”

## Expected Outcomes of Redirecting Capital to the Real Economy

Theoretically, an economy operating on these principles would experience:

- **Higher and More Sustainable Growth:** Capital is directed to productive, job-creating enterprises.
- **Enhanced Financial Stability:** The absence of interest-based leverage and speculative bubbles reduces the frequency and severity of financial crises [16].
- **Improved Social Welfare:** More equitable risk-sharing and the avoidance of exploitative practices (riba) can lead to a fairer distribution of income and wealth, in line with the maqāsid al-Sharī‘ah (objectives of Shariah) of preserving wealth and promoting justice [17].

See Appendix C: A Case Study: The Resilience of Islamic Finance during the 2008 Global Financial Crisis and the COVID-19 Pandemic

### What If Global Capital Shifted Toward Real Economic Activity? A Scenario Analysis

This section presents a qualitative scenario analysis based on economic modeling literature. If a significant portion of the \$1.8+ quadrillion in annual financial turnover were redirected—via policy, regulation, or paradigm shift—toward equity-based, real- economy finance, the potential effects could be transformative:

- **Global Output:** Long-term potential output ( $Y^*$ ) would likely increase due to higher levels of productive investment in infrastructure, technology, green energy, and human capital. Studies on investment-led growth models support this [18].
- **Employment Levels:** A renaissance in productive sectors (manufacturing, green tech, sustainable agriculture) would create stable, higher-wage employment, reducing structural unemployment and underemployment.
- **Financial Stability:** Systemic risk would diminish. Without massive leverage and derivative pyramids, the financial sector would be smaller, less complex, and more resilient to shocks. Banking crises would become rare events.
- **Income Distribution:** The shift from rentier income (interest, speculative gains) to profit-sharing and wage income would likely reduce wealth concentration. Asset-based, participatory finance would broaden capital ownership.

**Limitations of the Scenario:** The transition would face immense political-economy hurdles from entrenched financial interests. Short-term adjustment costs, including the contraction of the financial sector, would be significant. Effective global coordination would be essential but challenging.

Previous empirical studies support the plausibility of this scenario. For instance, Cecchetti & Kharroubi (2015) found that excessive growth in the financial sector crowds out real economic growth, while UNCTAD (2017) modeled that a reallocation of 5% of global financial assets to infrastructure could raise global GDP by over 1% within five years [19,20]. Similarly, Mirakhor & Krichene (2017) demonstrated through simulation that risk-sharing financial systems—akin to the Islamic model—reduce output volatility and increase real investment shares [16]. These studies provide a quantitative foundation for the transformative potential of redirecting capital from speculative circuits to productive uses.

### Policy Implications

#### Conventional Policy Recommendations

- **Financial Transaction Taxes (FTT):** A small tax (e.g., Tobin tax) on spot currency transactions or securities trades to deter unproductive, high- frequency speculation and generate revenue for public goods.
- **Strict Regulation of Leverage and Derivatives:** Imposing higher capital requirements on speculative trading, moving standardized derivatives to transparent exchanges, and banning the most opaque OTC products.
- **Macroprudential Policies:** Using tools like countercyclical capital buffers and loan-to-value ratios to cool overheated asset markets.
- **Corporate Governance Reform:** Discouraging short-termism by taxing buybacks, reforming executive compensation, and incentivizing long-term R&D investment.

#### Policy Lessons from Islamic Economics

- **Promoting Equity-Based Finance:** Tax codes could be reformed to favor equity financing over debt financing (e.g., removing the tax-deductibility of corporate interest). Public development banks could pioneer risk-sharing investment models.
- **Strengthening Real-Sector Linkages:** Financial regulators could mandate increased transparency on the real-economy impact of financial products and encourage “impact investing” frameworks.
- **Institutionalizing Ethical Finance Principles:** Even in secular contexts, the principles of asset-backing, risk-

sharing, and the avoidance of excessive uncertainty can be incorporated into sustainability and ESG (Environmental, Social, Governance) frameworks, giving them concrete financial meaning.

• **Developing Alternative Market Structures:** Supporting the growth of peer- to-peer (P2P) financing platforms and crowd-investing that embody risk- sharing principles.

### Implementation Challenges in Contemporary Financial Systems

Translating these policy recommendations—particularly those inspired by Islamic economic principles—into practice faces significant challenges within the existing global financial architecture. The deeply entrenched dominance of interest-based debt financing, the complexity of legacy financial products, and the powerful political economy of the financial industry present formidable barriers to structural reform.

Additionally, regulatory harmonization across jurisdictions would be essential to prevent regulatory arbitrage and ensure a level playing field. The transition toward more equity-based, asset-backed finance would require substantial adjustments in accounting standards, tax systems, and financial literacy among both investors and regulators. Despite these hurdles, incremental steps—such as piloting sovereign sukuk (Islamic bonds) for green infrastructure, introducing tiered capital requirements to favor asset-linked finance, and integrating risk-sharing principles into ESG frameworks—could pave the way for a gradual paradigm shift toward a more stable and equitable financial system.

### Conclusion

This study has argued that excessive financial speculation, quantified as vastly exceeding real economic output, is a primary source of systemic risk in the global economy. It generates asset bubbles, volatility, inflationary distortions, and, most critically, a chronic misallocation of capital away from productive investment. The conventional economic paradigm, while offering post-crisis regulatory tools, remains fundamentally permissive of the speculative activities that cause instability.

In contrast, the Islamic economic model provides a coherent, alternative framework rooted in ethics, real-asset linkage, and risk-sharing. Its prohibitions on *riba*, *gharar*, and *maysir* are not merely religious injunctions but constitute sophisticated institutional mechanisms for promoting financial stability and equitable development. By tethering finance firmly to the real economy, it addresses the core pathology of financialization.

The paper's forward-looking analysis suggests that a global reorientation toward real- economy finance—inspired by these principles—holds the potential to foster higher sustainable growth, greater employment, enhanced financial stability, and a more equitable distribution of wealth. This is not a call for the wholesale adoption of Islamic law, but for the serious integration of its proven economic wisdom into a pluralistic global policy dialogue aimed at building a more resilient and just financial system.

### Limitations and Future Research

This study is primarily theoretical and qualitative. Future empirical work should focus on econometric modeling of the growth-stability trade-offs in highly financialized vs. more real-sector-focused economies. Comparative case studies of countries with large Islamic finance sectors could yield valuable insights. Further research is also needed on the practical design of hybrid financial instruments and regulatory frameworks that blend the best of conventional risk management with Islamic ethics for broader application.

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## Appendices

**Appendix A: Table 1: FX Turnover versus Global GDP**

Year	FX Daily Turnover (USD Trillion)	Annual FX Turnover (USD Trillion)	Global GDP (USD Trillion)
2015	5.3	1,325	75
2017	5.1	1,275	80
2019	6.6	1,650	87
2022	7.5	1,875	100

Note: Annual FX turnover is calculated assuming 250 trading days. The table demonstrates that FX transactions exceed global GDP by more than 15–18 times, indicating dominance of speculative currency trading over trade-related transactions.

**Appendix B: Table 2: Derivatives Notional Outstanding versus Real Output**

Year	Derivatives Notional (USD Trillion)	Global GDP (USD Trillion)	Derivatives / GDP Ratio
2015	493	75	6.6
2017	542	80	6.8
2019	558	87	6.4
2022	632	100	6.3

This table highlights the structural decoupling between derivatives markets and real economic output. From an Islamic economic viewpoint, such magnitudes reflect prohibited financial excess (maysir), as the volume of claims far exceeds real asset creation.

## Appendix C

### A Case Study: The Resilience of Islamic Finance During the 2008 Global Financial Crisis and the COVID-19 Pandemic

#### Introduction

This case study examines the performance of Islamic financial institutions (IFIs) and sukuk (Islamic bonds) during two major systemic shocks: the 2008 Global Financial Crisis (GFC) and the COVID-19 pandemic (2020–2022). It aims to

empirically assess the claim that the principles of Islamic finance—particularly the prohibition of interest (riba), excessive uncertainty (gharar), and speculative trading (maysir), coupled with asset-backing and risk-sharing—enhance financial stability and resilience.

## Performance during the 2008 Global Financial Crisis

### Islamic Banks vs. Conventional Banks

Studies indicate that Islamic banks exhibited relatively stronger resilience during the GFC. A 2010 IMF working paper found that Islamic banks had higher capital adequacy ratios, lower leverage, and were less exposed to toxic assets such as mortgage-backed securities (MBS) and collateralized debt obligations (CDOs), which were largely non-Sharia-compliant due to their speculative and interest-based nature [1].

### Key Metrics (Pre- and Post-2008):

- **Capital Buffers:** Islamic banks maintained an average capital adequacy ratio (CAR) of 18–20%, compared to 12–14% for conventional peers.
- **Asset Quality:** Non-performing loans (NPLs) for Islamic banks rose marginally from 2.5% to 3.8% (2007–2009), while conventional banks in the US and Europe saw NPLs surge to 5–10%.
- **Profitability:** While profitability declined across the board, Islamic banks remained profitable on average, supported by their fee-based and asset-backed financing structures.

### Sukuk Market Resilience

The global sukuk market, though affected by liquidity shortages, did not experience default rates comparable to the conventional high-yield bond market. Most sukuk were asset-backed or asset-based, with structures tied to real assets (e.g., infrastructure, real estate). This provided a cushion against pure speculative losses.

**Example:** The Sukuk al-Ijara (lease-based) structures prevalent in GCC and Malaysia continued to perform due to underlying real estate and infrastructure assets retaining tangible value, unlike synthetic derivatives.

## Performance during the COVID-19 Pandemic (2020–2022)

### Islamic Banks: Liquidity and Financing Support

Islamic banks, particularly in Malaysia, GCC, and Pakistan, played a countercyclical role through:

- **Profit-and-Loss Sharing (PLS) Flexibility:** Many banks offered payment deferrals and restructuring on Mudarabah and Musharakah financing without compounding interest.
- **Social Finance Instruments:** Increased use of Qard al-Hasan (benevolent loans) and Zakat funds to support SMEs and individuals.

### Sukuk Issuance Surge

The pandemic saw a notable rise in sukuk issuance, especially sustainability-linked and social sukuk, used to fund healthcare infrastructure and social welfare.

- **Example:** In 2020, Indonesia issued a \$2.5 billion “Pandemic Response Sukuk,” oversubscribed by international investors, highlighting investor confidence in asset-backed Islamic instruments during crises.

## Performance During the 2022–Present Cost-of-Living Crisis

The global cost-of-living crisis, triggered by supply chain disruptions, the war in Ukraine, and persistent inflationary pressures, has further tested the resilience of Islamic financial institutions. Preliminary evidence suggests that Islamic banks have been somewhat insulated from interest rate shocks due to their non-reliance on conventional interest-based instruments. Instead, their profit margins are largely tied to real economic activity through trade-based (e.g., murabahah) and asset-based (e.g., ijarah) financing, which may provide more stable returns during periods of monetary tightening.

Moreover, the emphasis on equitable risk-sharing and social finance instruments—such as qard al-hasan (benevolent loans) and redistribution through zakat—has enabled some Islamic financial institutions to play a stabilizing role for vulnerable households and SMEs facing inflationary pressures. However, the sector is not entirely immune to broader macroeconomic stresses, including declining asset values, reduced consumer spending, and currency depreciation in key markets.

This ongoing episode reinforces the hypothesis that Islamic finance, with its real-sector linkage and ethical constraints, may offer a degree of countercyclical resilience, though its ability to fully mitigate systemic inflationary shocks remains contingent on regulatory support and market integration.

## Empirical Studies and Reports

- **IMF (2021):** "Islamic finance has shown resilience during the pandemic, aided by its ethical principles and asset-backed nature."
- **Islamic Financial Services Board (IFSB, 2022):** "The systemic risk contribution of Islamic banks is lower than that of conventional banks, due to higher equity buffers and the absence of leverage-driven trading."

## Limitations and Challenges

- **Liquidity Management:** Shortage of Sharia-compliant liquidity instruments remains a structural issue.
- **Market Integration:** Islamic finance is still a niche segment globally, limiting its macroeconomic stabilizing impact.
- **Regulatory Asymmetry:** Many jurisdictions lack tailored regulatory frameworks for Islamic finance, affecting scalability.

## Conclusion

This case study supports the hypothesis that Islamic finance principles—particularly asset-backing, risk-sharing, and the prohibition of speculative leverage—can enhance institutional and market resilience during systemic crises. While not immune to shocks, Islamic financial instruments and institutions have demonstrated lower volatility, stronger capital positions, and a countercyclical capacity that aligns with financial stability objectives. This empirical evidence reinforces the argument presented in the main paper for integrating Islamic finance principles into broader financial stability frameworks.

## References for Case Study

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## Appendix D

### Shariah Perspective on Derivatives: Hedging Versus Speculation

#### Introduction

A common critique of Islamic finance is its perceived blanket prohibition of derivatives, which are often associated with excessive risk-taking and speculation. However, a nuanced understanding of Shariah principles reveals that hedging—when conducted under specific conditions—is not only permissible but encouraged as a means of risk management. This section clarifies the distinction between prohibited speculation and permissible hedging, particularly in the context of derivative instruments.

#### The Prohibition: Speculation (Maysir and Gharar)

In Islamic finance, two key prohibitions address speculative excess:

- **Maysir (Gambling/Speculation):** Transactions where one party gains purely at the expense of another, without productive economic activity.
- **Gharar (Excessive Uncertainty):** Contracts involving ambiguity regarding subject matter, price, delivery, or existence.

#### Examples of Prohibited Derivative Uses:

- Naked short-selling (selling an asset one does not own).
- Trading in options or futures for purely directional bets on price movements.
- Speculative currency trading without underlying trade or asset exposure.

#### The Permission: Hedging as Risk Management (Tahaffuz)

Islamic finance recognizes legitimate risk management (ظَفْحَت) as a necessary commercial practice. Hedging is permitted when:

- It is linked to a genuine underlying asset or liability.
- The primary intention is to reduce real economic risk, not to speculate.
- The contract avoids excessive gharar and does not involve riba.

## Shariah-Compliant Hedging Mechanisms: Examples Salam and Parallel Salam (Forward Contracts)

- **Purpose:** To hedge against price volatility in agricultural or commodity markets.
- **Mechanism:** A buyer pays in advance for a commodity to be delivered later. A "parallel Salam" allows the seller to hedge their own supply risk.
- **Shariah Condition:** The commodity must be precisely defined, and the delivery date fixed.

## Wa'd (Unilateral Promise) and Muwa'adah (Bilateral Promise)

- **Purpose:** To hedge currency or price risk in trade and investment.
- **Mechanism:** A party promises to buy/sell an asset at a future date at a predetermined price. Used in Islamic cross-currency swaps and profit rate swaps.
- **Shariah Condition:** The promise must be binding and non-tradable (to prevent secondary speculation).

## Islamic Options (Arbun with Conditions)

- **Purpose:** To hedge against downside risk in asset prices.
- **Mechanism:** A down payment (Arbun) secures the right to purchase an asset. If the buyer opts out, the seller keeps the Arbun.
- **Shariah Condition:** The Arbun must be part of a genuine sale contract, not a standalone bet.

## Tawarruq-based Hedging (Monetization)

- **Purpose:** Liquidity management and hedging against commodity price risk.
- **Mechanism:** A party buys a commodity on credit and sells it for cash, using proceeds to hedge a liability.
- **Shariah Controversy:** Some scholars restrict its use due to potential riba and circular transactions.

## Key Shariah Conditions for Permissible Hedging

- **Real Economic Need (Haja Haqiqiyah):** The hedge must correspond to an existing asset, liability, or operational exposure.
- **Proportionality (Tanاسب):** The hedge should not exceed the value of the underlying exposure.
- **No Sale of Debt (Bay al-Dayn):** Debt instruments cannot be traded at a discount, ruling out many conventional credit derivatives.
- **Transparency and Avoidance of Gharar:** All terms must be clear, and delivery must be certain.

## Practical Example: An Islamic FX Hedge

**Scenario:** A Malaysian exporter expects USD 1 million in 6 months. To hedge against USD/MYR depreciation:

### Shariah-Compliant Structure

- **Underlying Asset:** The exporter holds a genuine trade receivable (USD 1 million).
- **Instrument:** A Wa'd-based FX forward with an Islamic bank.
- **Mechanism:** The bank promises to buy USD 1 million at a fixed rate in 6 months. The exporter pays a fee (ujrah) for this promise.
- **Outcome:** The exporter locks in the exchange rate, eliminating currency risk without engaging in speculative forex trading.

## Contemporary Shariah Standards

- **AAOIFI Shariah Standard No. 1 (Trading in Currencies):** Permits forex hedging for genuine trade and investment needs.
- **ISDA/IIFM Tahawwut Master Agreement (2010):** Provides a standardized framework for Islamic hedging.
- **Bank Negara Malaysia (BNM) Guidelines:** Allow regulated use of FX forwards, profit rate swaps, and options for

hedging.

### **Conclusion**

Islamic finance does not reject derivatives outright. Instead, it distinguishes between:

- **Prohibited Speculation:** Where derivatives are used for leveraged betting, detached from real economic activity.
- **Permissible Hedging:** Where derivatives serve as tools for mitigating genuine commercial risks, subject to Shariah constraints.

This distinction aligns with the Maqasid al-Shariah (Objectives of Islamic Law) in preserving wealth (hifz al-mal) and promoting economic justice. By incorporating regulated hedging mechanisms, Islamic finance offers a balanced approach to risk management—one that avoids speculative excess while supporting real economic stability.

### **References for Further Reading**

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