JASIE - Journal of Aswaja and Islamic Economics *Vol. 05 No. 01 - 2026*
Website Journal : https://publikasiilmiah.unwahas.ac.id/JASIE/
DOI : 10.3194/jse.v1i1.6877
ISSN : 2962-5602 (Online) ISSN : 2963-7864 (Print)

FROM FINANCIAL FRAGILITY TO ECONOMIC STABILITY: THE ROLE OF ISLAMIC FINANCE IN CRISIS PREVENTION

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ABSTRACT

The periodic nature of global financial crises, growing sovereign debt and economic inequality, along with market instability highlights the weakness of today's financial system. This research's goal is to analyse the structural deficiencies of conventional finance and the possibility of Islamic finance as an alternative sustainable market paradigm to eliminate future economic crises. It also aims to examine how emerging technologies, such as artificial intelligence (AI), blockchain technology and Islamic financial technology (Islamic FinTech) can enhance the effectiveness and world-class status of Islamic financial systems. The research in this study is qualitative, based on doctrinal and literature analysis, where the sources are scholarly articles, reports and literature reviews on Islamic economics, financial crisis, and sustainable finance. Analysis has shown that leading causes of financial instability are excessive debt dependency, speculative ones, and the lack of connection between economic actual and financial transactions. The Islamic finance offers preventive solutions, which include the use of risk-sharing instruments, asset-backed transactions, ethical governance, and social finance instruments like Zakat and Waqf which together ensure economic justice and resilience. To conclude, Islamic finance is an alternative financial system which is comprehensive, is oriented towards the future, and can change the financial fragility into economic stability. Islamic finance can play a role in building a more inclusive, ethical, and sustainable global civilization by combining the principles of Islam with modern technological innovations.

Keywords : *Financial crisis prevention, Islamic finance, economic stability, ethical governance, risk-sharing mechanism.*

INTRODUCTION

Over the last decades, the contemporary international financial system has experienced a great transformation in the process of globalisation, innovation of technology and the development of the complex financial instruments nowadays. These changes have enabled growth and financial linkage but have not been able to stem the reclusiveness of economic crises. The Asian financial crisis in 1997, the Global financial crisis in 2008 and the economic impact of the COVID-19 pandemic have clearly demonstrated the lasting vulnerabilities of the global financial system. These crises underscore the critical weaknesses in the present model of the economy that has resulted in an extraordinary mountain of debt and speculation and significant reduction in the connections between money invested and real economic activity. This raises the question of why this prevailing economic model has become so unstable and how a critical overaccumulation of debt coupled with economic speculation and the increasing tendency of economy and finance to grow out of a relationship with real economic productivity is so non-standard and perverse.

Financial crises, their persistence and frequency, point to an important issue of the sustainability of the current financial systems. While debt-based money and profit-maximisation have been dominant since the dawn of the credit system, in times of uncertainty and instability, the economies have been undermining people's living standards and fuels inequalities. While there have been elements of regulation to mitigate financial risks, most existing practices only deal with consequences of the crisis, and not at its root levels and ethical issues. Hence, there is an immediate demand for examining financial frameworks other than the traditional ones, which can ensure stability, fairness, and sustainable development.

To meet these challenges, Islamic finance provides a holistic perspective that combines efficiency of operations with conscience in finance. Islamic finance upholds the principles of justice (Adl), social welfare (Maslahah) and mutual cooperation (Ta'awun), focuses on risk sharing, asset-backed transactions, transparency, and equitable distribution of wealth. In Islam, uncertainty in transactions and speculative transactions (Gharar and Maysir, respectively) is prohibited and Islam aimed for financial system completely linked with real economic activities and able to minimize those factors which could lead to financial fragility.

In addition, new opportunities have emerged for ways to enhance the efficiency, transparency, and accessibility of Islamic financial services due to the development of emerging technologies including artificial intelligence (AI), blockchain, and Islamic financial technology (Islamic FinTech). By incorporating such innovations within Islamic principles, Islamic finance is no longer just an alternative economic system based on persuading people of the past, but rather an economic system that is forward-thinking and really shows people how to create a sustainable civilization in the face of today's economic challenges.

To this end, this study takes a look at the root causes of the modern global financial system's structural flaws that contribute to the economic crises and takes a look at how pro-philosophical Islamic financial principles and instruments can be used to serve as prevention solutions to these challenges. In addition, the role of technological innovations in driving Islamic finance towards being a resilient and sustainable financial framework is also examined in this work. Everything is done to show that a long-term approach to sustainable economic stability will need the finance sector to become one for ethical governance, shared responsibility, and sustainable prosperity.

LITERATURE REVIEW

Islamic finance has attracted a lot of interest as an alternative financial system which can improve the financial stability of the financial system by the reduction of systemic risk and the promotion of ethical behaviour in economics. Islamic finance is often considered a system of finance that emphasizes sharing of the risk, asset-backed financing, and the elimination of over-leveraging, unlike conventional interest-based financial systems. Islamic finance takes a critical approach to risk sharing and real asset flows and may help mitigate risk of speculative bubbles and financial crises and give scope to address such risks as the Islamic laws mandate; empirical evidence on this subject, however, is mixed across the jurisdictions (Mumtaz Hussain et al., 2015).

Likewise, Belouafi et al. (2015) have conducted a broad review on Islamic finance concepts and literature and have found that theoretical arguments present in literature are generally in favour of the stability of Islamic financial system, but the empirical results are contradictory because of different implementations in Islamic countries. Islamic banking system has been found to be more resilient during financial crises due to asset-backed financing model and elimination of high-risk products, revealed further studies. Other literature, undertaken by Omar et al. 2025, indicates that Islamic finance enhances financial stability by incorporating profit-and-loss sharing models, along with restructuring banking sector capital-deficiency models, especially those of banking sectors with sound regulation. Further, strengthening Islamic financial systems is hinged on consumer protection, financial literacy, which is emphasized by Lukonga (2015). Despite being based on the Islamic principles of morality, the author say ethical principles can be compromised in practice and by the weakness of financial regulations, which can hinder its ability to achieve the purpose of financial stability. This underscores the need to comply with Islamic financial principles and for the proper enforcement of Islamic banking mandates, which calls for an effective governance and institutional integrity.

Listed in the recent literature are also studies on systemic risk in financial systems, in which emphasis is put on the need to have early warning instruments and risk monitoring tools helping to avoid financial crises. Given the findings of these studies, financial vulnerability can stem from the multifaceted risks which might be connected jointly in banking structures, thereby reinforcing the significance of staging preventive frameworks like Islamic banking interface with the real sector and risk sharing (Namaki et al., 2023). In general, it has been concluded from the literature that Islamic finance has a solid basis in theory to support the concept of financial stability. But scholars also warn it can only have an impact if it is implemented consistently if markets are regulated in a harmonious manner and if new financial governance models can be integrated with it. Overall, Islamic finance is viewed as an intriguing yet still emerging solution to preventing crises and securing long-term economic stability, as outlined in the literature.

RESEARCH METHODOLOGY

This study used qualitative research method. This method was chosen on the basis of the fact that qualitative research adopts structural and interpretive models which prioritise the generation of a meaningful and deeper understanding of a phenomenon over producing measurable and/or generalisable results (Denzin & Lincoln, 2011). Furthermore, Creswell and Poth (2018) describe the interpretive model as a way to deepen understanding as it involves examining people's experiences and interpretations. In this perspective the study aims to deepen its understanding on the subject matter by means of interpretation, not numerical analysis.

Moreover, this method is employed by analysing different sources of texts. These include academic journal articles, appropriate books and classical texts that enhance and enrich the topic studied (George, 2008). The study can present a well-supported and coherent discussion based on these materials by systematically analysing these materials. Hence, to complete this paper, the author uses thematic analysis and deductive approach to get a comprehensive analysis of the study.

RESULTS AND DISCUSSION

The debt-based economic structure and the cycle of financial instability

Over-reliance on debt financing in the present-day economic system is one of the important factors that makes financial system quite fragile in the global markets. One of the major factors for growth is the extension of credit in modern monetary systems. While debt may promote investment and consumption in the short-term it can be a cause of harm on the long-term scale, particularly in large volume. As soon as borrowers become too indebted, whether they're the home or the business or even any government, there's the potential for default and financial carelessness when it comes to a minimal economic hit.

The worst-case scenario of too much debt ruining the global economy is illustrated by the Global Financial Crisis of 2008. If what Reinhart and Rogoff (2009) found is true, then financial conflagrations tend to follow many years of increasing credit levels accompanied by high and rapid credit growth with potential to grow past borrowers' ability to repay. This debt-based arrangement for modern economies thus generates a cycle of booms and busts: a time of cheap credit, followed by a time of financial stress and severe contractions.

Speculation, financialization, and the separation from the real economy

Financial fragility is also a result of financialization of the global economy. Financialization is the increasing control of the financial markets, institutions, and motives on the real productive economy. This has resulted in financial instruments and derivatives expanding much faster than the underlying real economy.

Over-financialization leads to short-term, speculative habits that raise systemic risk and not systemic fear, as Borio (2012) of the Bank for International Settlements states. There is a greater separation of financial market from the real economy (production, trade, employment). Rather, money-making is frequently done through an array of complicated monetary devices, such as speculative trading or derivatives, which boost volatility and uncertainty.

Even higher levels of financial development after a certain point can have negative effects on economic growth through higher financial instability and excessive resource misallocation (Sahay et al., 2015), which the IMF stresses. The lack of coherence between finance and the real economy helps create asset bubbles, like the housing bubble that led to the 2008 financial crisis, where assets are priced as a matter of speculation and have little to no market value.

Economic inequality and the erosion of social stability

Structural inequality is also a possible determinant of financial fragility. An increase in the inequality of income and wealth diminishes aggregate demand, results in greater financial imbalances and lowers economic resilience. As wealth is concentrated among a smaller share of the population, lower-income groups are even more likely to leverage up in order to draw on their income, thereby boosting that systemic risk.

As Piketty (2014) pointed out, the driving characteristic of capitalism is to grow more concentrated, unless other mechanisms are put in place that reduce its concentration, typically through taxes and redistribution. The Organisation for Economic Co-operation and Development (2015) also says that higher inequality is having a detrimental impact on long-term economic growth and financial stability is more likely, as lower income groups are limited with excessive debt.

In addition, inequality can be viewed as a macroeconomic problem as it affects the economic efficiency and the possibility of crisis, as argued by Stiglitz (2012). Systemic financial fragility stems from weak demand, elevated financial leverage for vulnerable groups, and political instability, among other unexpected effects, associated with unequal economies.

Islamic Finance As A Preventive Model For Economic Stability

Financial crises have been occurring repeatedly and spotlighting the limitations of the traditional financial institutions in providing sustainable economic growth. In answer to this, Islamic finance is presently growing into an alternative finance sector that considers the underlying causes of financial fragility, which revolves around fairness, accounting, and real economic engagement. Islamic finance is characterised by reliance on risk-sharing, asset-backed transactions and ethics-based governance, leading to a stronger and stable financial system rather than ones relying on dubious debts and speculative financial transactions (Zamir & Abbas, 2011).

Risk-sharing: replacing the culture of risk transfer with shared responsibility

The basis of Islamic banking is risk sharing: the theme that the investor and the entrepreneur share any possible gains and losses of an investment opportunity. This is contrasted with traditional money-lending, which tends to pass risks to debtors in the form of set repayment terms. This could foster over-leveraging and financial fragility as observed in the 2008 Global Financial Crisis (Chapra, 2008).

Islamic financial products such as Mudarabah and Musharakah work on these principles to distribute the risks and rewards more equitably between those that have part in them. This idea will facilitate more responsible investment decisions, as financial institutions are also keenly interested in the success of the economic activity, due to their direct involvement in it, Zamir and Abbas (2011) said. Risk sharing results in less handle-dependency on potentially risky or excessive debt levels and fosters greater co-responsibility between the government and the market, which helps to create stability and resilience in the financial system.

Asset-backed financing and connection to the real economy

A significant characteristic of Islamic Finance system is also the association of financial transactions to real assets and real economic activities. The increase of financial instruments based on this type of speculative value has led to a trend toward greater decoupling of financial markets and real economy and put financial markets more at risk of bubbles and instability (Stiglitz, 2010).

Islamic finance is trying to destroy such a situation by stipulating that transactions must be backed by real assets or true business activities. Trading through financial means like Murabahah, Ijarah, and Sukuk allows for investments in trade, infrastructure, and productive areas. The asset-based approach involves transparency and cultivation of financial growth, but with real value added and not just speculation (Askari et al., 2017).

Ethical governance and the prohibition of harmful financial practices

Islamic finance is also known by its ethical and moral principles where it focuses on justice, transparency, and social welfare. These are akin to the principles of prohibit Riba, Gharar and Maysir, all three can lead towards exploitation, uncertainty, and instability for the finance (Muhammad Ayub, 2007).

Furthermore, the Sharia governance aspects help to ensure that the Islamic financial institutions act in an ethical manner and are held accountable. Based on Zulkifli Hasan (2011), a good governance of Sharia increases trust and improves the credibility of Islamic financial institutions. Thus, if Islamic finance is seen as an ethical means of control plus a financial means of control, it can help to prevent systemic risks and ensure economic stability.

Islamic finance is fundamentally about financial stability and sustainability, linking finance with risk sharing, real asset creation, and ethical oversight in the economy. Its attributes show the possibility of filling the gap in weak financial systems and can play a role in creating a more resilient and sustainable global economy.

Advancing Global Innovation: The Future Of Islamic Finance In Preventing Economic Crises

The sustainability of Islamic finance in preventing from future economic crises rely not only on the banking principles of Islamic finance but also to be open and receptive towards the integration of Islamic technology and Islamic sustainable development in the global financial landscape. The adoption of emerging technologies (e.g. artificial intelligence (AI); blockchain; Islamic financial technology (Islamic FinTech); financial inclusion, resistance) in tandem with the further development of green Islamic finance, holds great potential for further improving the transparency and efficiency of Islamic finance systems, as well as financial inclusion and resistance. The developments illustrate how Islamic finance can be inured to present-day challenges, while upholding its ethical principles and Shariah tenets.

Islamic fintech and artificial intelligence

More services in line with Sharia have become available and through the development of Islamic FinTech, the financial services have become more accessible, efficient, and inclusive. Islamic financial institutions (IFIs) have been able to use digital platforms, mobile banking solutions, and Artificial Intelligence (AI) developments to improve their customer services, speed up compliance processes and expand to previously inaccessible niches. According to Islamic Financial Services Board (2021), it is important to note that technology innovation is one of the elements under consideration to promote the resilience and competitiveness of the Islamic financial industry particularly in the wake of any abrupt economic change.

Moreover, AI can play a role in better risk management or crisis prevention, leveraging more efficient data analysis and discernment of fraudulent activities to better inform financial decisions. As underscored by the Organisation for Economic Co-operation and Development (2021), AI technologies can contribute to enhancing the strength and resilience of financial services by improving in the areas of risk assessment, operations, and procedures. In conclusion, the adoption of AI in Islamic finance has the potential to enhance transparency, efficiency, and resilience in the financial sector.

Blockchain technology and smart Islamic finance

Another significant innovation that can deal with issues of transparency and trust and governance in monetary transactions is blockchain technology. The way the blockchain technology functions is through the use of a decentralized and immutable ledger system, that removes the chance of information asymmetries and manipulation in the documents' recording of transactions. This looks very much like Islamic accounting and transparency.

Elasrag Hussein (2019) found that blockchain can have a tremendous impact on Islamic finance, particularly in the management of Sharia compliant contracts, the introduction of smart contracts, and in improving transparency of Islamic social finance instruments like Zakat and Waqf. Islamic financial solutions based on blockchain applications have the potential to enhance the efficiency of Islamic banking operations and cut down transaction costs, thereby fostering higher consumer trust in the sector and promoting a more stable and responsible Islamic financial system.

Green Islamic finance and sustainable development

The development of the digital finance system is not the only trend to thrive in Islamic finance, as green finance, another path, has grown as a solution to eco-efficiency. Beyond digital finance, green finance has also become a focus to tackle the issues and challenges of sustainability and improve economic growth. The principles of Islamic finance lean towards the concept of stewardship of resource, social responsibility, and avoidance of harm are obviously in line with the global sustainability agenda. Green sukuk is one instrument for the financing of renewable energy, sustainable infrastructure projects, and climate related projects in an ethical manner.

The World Bank (2020) pointed to the increasing use of 'green sukuk' financing for sustainable environmental projects in different jurisdictions (2020). Hence, embedding sustainability in Islamic finance not only boosts financial stability for its operators, but also shows its importance and potential in building a resilient and sustainable global economy.

In summary, the Islamic financial future is defined by its capabilities to integrate the moral values with the new innovation and creation. By implementing Islamic concepts in FinTech, AI, blockchain and green financial instruments, Islamic finance can further benefit financial transparency, risk management, sustainable investments, and future-proof the financial system.

Policy Recommendations For Global Adoption

At the institutional, technological, and educational fronts some strategies need to be adopted, with number one being offering an effective and viable mechanism for crisis prevention and some degree of stability in the medium to long term for Islamic finance.

First, governments and financial regulators should further strengthen the institutional structure of Islamic finance by establishing harmonised world Islamic financial standards and policies initial. This would entail strengthening Sharia governance, the building and strengthening of collaborative effort between border countries, and a commitment to defining Islamic financial products with the principle of risk-sharing and asset-backed financial principles and showing a commitment to Islamic principles instead of accepting debt types. The standardization would give a boost to the confidence of global stakeholders in Islamic finance and foster its ability as an alternative financial system.

Second, Islamic FinTech and digital infrastructure must also be invested to improve efficiency, transparency, and accessibility. The combination of artificial intelligence, blockchain and smart contract technologies can bring significant benefits to the risk assessment system, automate compliance, and enable a clear management of Islamic social finance tools like Waqf and Zakat. The innovations can also contribute to financial inclusion, whereby the communities which lack financial services can have access to financial services which are ethical and Sharia compliant.

Third, greater efforts must be made for education and awareness of Islamic economics and finance, both in the campus and in public forum. An interdisciplinary study of Islamic economic concepts is needed to be encouraged by universities, research institutions, and financial organisations, along with modern financial theory and technology. This will support the cultivation of new crop of professionals who will have the ability to contribute to the development of Islamic finance as a complete economic framework reaching the sustainable economic stability and global development.

CONCLUSION

What happened to the global economy throughout the various financial crises experienced over the past few years was a shock as they were found to be deeper than the limitations of the transitory market failures and shortcomings in the regulations, but a more serious structural issue of the modern financial sector. Many factors have worsened the economic situation such as high debt dependency and speculative financial operations and the divorce between financial transaction and real economic productivity, leading to a vulnerable economic environment from which repeated shocks have arisen. A fundamental rethinking is required in the operating principles of the financial system and the values of the financial system, which is based on it, so as to attain sustainable economic stability.

In this context Islamic finance is a comprehensive and preventative solution that looks into the causes of financial fragility. Islamic Finance has the ability to create a more balance relationship between the growth of finance, ethical responsibility, and social welfare through principles such as risk sharing, asset backed transactions, eliminating excessive uncertainty and speculation and through instruments like Zakat and Waqf. This, in turn, fosters more resilient economies and a more inclusive and equitable economic system. While this may be the case, however, Islamic finance cannot remain relevant in today's modern world if it does not evolve along with the economic transformation that has taken place at the global level. The convergence of innovative technologies like Artificial Intelligence, Blockchain and Islamic FinTech can improve transparency, efficiency, and access to, as well as trust in, Islamic financial institutions. Islamic finance can be an effective, competitive, and viable option to address current global challenges if it compromises neither with its principles nor with the use of digital innovation.

Indeed, the shift from financial fragility to economic stability involves much more than technological advances and growth; it involves a change to a financial system that values justice, responsibility, and sustainable prosperity. Islamic finance provides such a structure with its principles of ethics and finance and brings in social welfare. Islamic finance has some high promise for helping to create a more equitable, stable, and sustainable world.

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