1.0 Introduction

The history of Islamic economics can be traced to the 8th century and its history is identified in the Quran and the Sunna. However, the emergence of the modern Islamic finance system can be traced to the later half of the 20th century. Cox (2002) reports that the creation of Dubai Islamic Bank in 1975 was one of the first Islamic economic systems that operated within modern economic conditions. Hassan and Zaher (2001) also contend that many countries have Islamic economic and financial systems including Pakistan and Iran to fully comply with the principles of the Sharia law. Over the last four decades, there has been significant growth in the number of Islamic finance institutions around the world with locations in the Mahgreb and Persian Gulf countries. Naqvi (2013) indicates, there are over six hundred Islamic banks as of 2010 and these banks are present in over fifty countries. Furthermore, Jouini and Pastre (2008) reported that Islamic economics has emerged as a key player in the modern economic system. The authors also report that there has been a rise in shifting of the savings of Muslims to such banks and has emerged as a key player in the mortgage market in the UK.

According to Zaman(2013), the Islamic financial system is expected to be largely stable as there is limited focus on debt financing and there is a significantly higher allocation efficiency. According to the author the adoption of a ‘two-window’ approach to Islamic financial intermediaries indicates that Islamic economics identifies the need to backing demand deposits by 100% of reserves. Therefore, it can be argued that such a system has been proven to have greater stability in structure as a result of symmetry in profit sharing and lack of debt based refinancing. In light of such evidences, the purpose of this essay is to first reflect on the key principles of the Islamic economic system and then compare the traditional economic system with that of the Islamic economic system. The research ends with a discussion on if the Islamic form of economics can be considered a key alternative to the current conventional economics platform.

2.0 Unique Elements of Islamic Economics

Nienhaus (2010), argues that Islamic economics is based on the rules of Islam, especially Shariah law. Therefore, the principles of Islamic economies are based on the Quran and the views of the Prophet Mohammed. There are four key principles in Sharia law which can be linked to Islamic economics. The key principles of Islamic economics are presented in the following figure.

Firstly, the concept of interest (i.e. Riba) is considered as one which can be unfair and exploitative in nature. Islamic economics indicates that while money can be lent under the Islamic law, there is a need to ensure that there is no undue or unearned profit through the system of lending (Naqvi, 2013). In such conditions, the provider of the capital cannot fix a specific predetermined rate of interest but is allowed to gain a financial stake within the project. Therefore, in Islamic economics, money is considered as risk rather than commodity. Bjorvatn (1998) further support this argument by indicating that in Islamic economics there is sharing of profit and loss and thereby sharing of risk. The importance of Riba is highlighted in Appendix I.

The second key principles that needs to be addressed in Islamic economics is the concept of risk or uncertainty sharing (Gharar). According to Islamic economies, investments should be done only after considering a certain amount of risk and that investments cannot be made in some businesses which are considered unholy or undesirable (Haram). These include the investment in businesses like selling of pork, selling of alcohol and prostitution. The concept of Gharar identifies with the uncertainty or ambiguity that can be linked to a contractual relationship where one party has a clear and unfair advantage over another party. Therefore, when there is such an unfair advantage to one group of people over another, and when there is a contract with Gharar, then the contract will be considered as null and void (Naqvi, 2013).

Thirdly, Islamic economics prohibits speculative behaviour. Naqvi (2013) contends that within this economic system there is often the discouragement of hoarding and the prohibition of transactions linked to uncertainty, gambling and risk management.

The fourth key principle of Islamic economics is that it upholds obligations made through contracts as sacred and that disclosure of information is often considered obligatory. This is vital as it helps in the reduction of associated risks of symmetric information as well as moral hazard (Naqvi, 2013).

3.0 Similarities and Differences between Islamic and Conventional Economic Systems

There are some similarities between Islamic economics and conventional economics. As an illustrative example, a few factors are highlighted in the following table.

This section will present a detailed analysis of the similarities and differences between the two systems.

4.0 Sharing of Uncertainty

According to Honohan (2001), Islamic economics and finance can be separated from the conventional system as follows.

$P^{Int} = R - CT - I$ [Conventional finance]

Where

P^{Int} is the profit gained by the contractor within the loan system

R is the interest

CT is the total costs after deduction of interest payment

I is the actual interest costs

On the other hand,

P^{PLS} = R-CT - p [Islamic finance]

Where P^{PLS} identifies the profit gained by the contractor in the PLS system and P is the profit shared with the bank.

It is clear that in Islamic banking, the sharing of uncertainty is equal between the bank and the lender or the investor (Moisseron et al. 2014).

5.0 Comparison of Super Structures

According to Moisseron et al. (2014), the key elements of the Islamic economic system are governed by ideology which is generated through religion and logics. There are some key elements which can be considered from the perspective of Islamic economics and conventional systems including ownership, wealth distribution and monopoly as presented in the following figure.

Right to ownership

A key feature of capitalism is its promotion of right to private property ownership. The authors indicate that a capitalist economy believes in encouraging private ownership as a way to enhance production, distribution and exchange which will lead to a general development of the economy. On the other hand, Islamic concept of ownership should be considered largely unique as ownership in reality is considered to belong to Allah (Nienhaus, 2010). Visser (2013) further argues that while legal ownership is recognised in Islamic economics it can be subjected to the moral obligation that all sections of the society have a right to share. This has led to the right given to Islamic states to national things which are considered to remain under private ownership.

Competition and Monopoly

According to Visser (2013), conventional capitalist economy promotes the growth of private institutions and encourages competition. However, at the cost of competition there can be demise of small businesses due to the growth of large institutions. When such conditions of monopoly rise up, it is possible that there can be a reduction in free competition, inflation of overall prices and problems linked to unemployment. Under such conditions, Nqvi (2013), reports that Islamic economics can act as a viable alternative as monopolies are considered to be forbidden with an equal promotion of competition. An Islamic system of economics strongly acts against the monopolisation of any commodity of service by a private entity which may promote the common interest of the community.

6.0 Elements of Financial Institutions

Deposits

According to Hanif (2014), deposits which are collected through conventional and Islamic economic institutions are found to have rewards. However, in the Islamic system there is a difference in the agreement of reward. The conventional system indicates that reward is predetermined and largely fixed. However, under Islamic economics the deposits are accepted under the principles of Musharaka and Mudaraba. As per these principles, reward is not fixed but variable. Furthermore, conventional systems indicate higher interest and returns for long term deposits. A similar system is seen in Islamic economics where higher weightage for profit sharing is made available for long term deposits when compared to short term deposits. However, as Nienhaus (2010), argues, a key difference is that in Islamic economics there is equal sharing of both risk and rewards. In conventional economics, the risk is borne by the bank while only the reward is given to the depositor. Islamic financial systems indicate that there is an agreement of sharing both risks and rewards equally.

Investments

According to Nienhaus (2010) to maintain liquidity financial institutions under both Islamic economics and conventional economics look towards investments. Conventional banks invest in short notices, government securities, bonds and short term loans to raise the required investment. On the other hand, Islamic economics does not allow any investment in the above financial instrument options. Furthermore, Islamic economics does not allow interest demands on interbank loans. Therefore it can be argued that, Islamic economics prohibits investment in equity as there is a need to ensure that the system in which investment is made is Halal and that the financial operations of the firm in which investment is made should be interest free. There are some Sharia compliant securities which are maintained in which Islamic financial institutions can make investments.

Some other differences and similarities are given in Appendix II.

7.0 Islamic Economics as an Alternative to Conventional Economics

Positive Attributes

There are evidences which support the view that Islamic economics is a key alternative to conventional economics, especially during the recent economic crisis. According to Chapra (2000), during the US stock market crash of 1987 and during the dot-com bubble of 2000, there was a positive performance by the Islamic system when compared to the conventional system. This is linked to the underlying arguments of risk sharing principles. Furthermore, Boumediene and Caby (2009) also argue that Islamic banks are found to be more immune during the sub-prime crisis and do not endure risks as that of the Western banking institutions. The authors conclude that during the economic crisis, 14 Islamic institutions performed better than 14 conventional institutions as they had lower volatility. Therefore, it can be argued that when comparing conventional systems and Islamic systems, Islamic systems were found to perform better.

From the above evidences, one can argue that there are some key evidences of improvement in financial performance amongst Islamic banks. Furthermore, from prior sections, one can contend that Islamic system has a more fair and socialist form of ownership, competition and can reduce exploitation. However, this essay argues that the Islamic system is not a true contender or an alternative to traditional or conventional system. This is highlighted through the following examination.

8.0 Negative Attributes

Some researchers argue that in principle, efforts are undertaken by Islamic economic institutions to adopt principles of Islamic economics, the actual evidence of such practices is not very clear. For instance, the author argues that when compared to conventional economic institutions, Islamic institutions play similar roles in deciding on loans with limited focus on non-financial factors like health of future generations and the developmental role of Islamic banking. Similarly, Newton (2006) also argue that Islamic institutions do not provide clear evidences on prioritising on moral, social and ethical dimensions and have contributed to a rise in debt culture. It is also argued that limited efforts have been taken by the Islamic economics to reduce the profitability of Western and capitalist banks. It is argued that Western multinational banks used Islamic banking as a way to identifying the use and marketing of existing products under the Islamic banner and made huge profits which is against the key principles of the Islamic system of economics. Furthermore, El-Gamal (2007) also argues that international banks use innovative measures to develop the structure of financial products in the Islamic banking sector to meet their needs. In light of this view, a key argument which is against the Islamic economics is the lack of evidence of its true functions in many cases.

This research concludes that contemporary Islamic economics while principally has challenged the dominant capitalism and has rejected mainstream economic and banking operations, it has not in evidence achieved the same. From evidences in literature the Islamic economic system is found to flourish and is largely linked to capitalism and is found to work hand in hand with the commercial economic environment. The expansion of Islamic banking is considered to be dependent on liberalisation policies and that it has emerged as a substitute to conventional systems in some regions (Pollard and Samers, 2007).

9.0 Conclusion

The key banner of Islamic banks is the need to support a caring environment, ensure that there is social equality and support the local community. However, the contemporary actions of Islamic economic systems do not support this assertion. Therefore, it is the position of this research that Islamic economic system can be considered as a true alternative to conventional economics only when there is more evidence of both performance, profitability as well as the core principle promotion of Islamic institutions.

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Appendix I

Prohibition of Riba and Islamic Finance

Financing Aim: **Acquisition of goods/ Services** **Provision of Liquidity**

Shariah

Prohibited:

- **Riba (Interest on loans)**
- **Gharar (Avoidable Uncertainty)**
- **Maysir (Gambling)**

Permitted

- **Profits from Trade and Leasing**
- **One-Sided Declaration of will (Promise)**

Trade/Leasing Agreements (Bank as Intermediary

Profits and Loss Sharing as Part of Financial and

“Ideal World” of Islamic economics, little relevance in practice

Combination of Trade/ Leasing Agreements: commodity murabahah, tawarruq

Common practice of Islamic banks, very similar to interest

Trade Agreements plus One- Sided Promise (wa’s): Complex Synthetic Products for the Inter-Bank Market, Trading

Progressive emulation of conventional techniques Shariah qualities

Source: Nienhaus (2010)

Appendix II

Main differences between a conventional banking system and an Islamic system

	Conventional System	Islamic System
The Currency	Through trade and keeps the value	Through trade. Money is not in itself an asset.
Nature of Operations	Total separation between the depositions and the banks.	Islamic banks give depositors the possibility to know what use is made of their money; at the same time provide them with the opportunity to decide on their preferred investments.
Logic of Transactions	Transactions are based on financial assets.	Transactions are based on real assets

Remuneration	Gathering funds from applicants by paying	Partnership, sharing of profits and losses between the banks and depositors. Islamic finance does not allow a fixed remuneration by the mere lapse of time.