ISLAMIC FINANCE MODE IMPACTS ON ECONOMIC DEVELOPMENT AND FINANCIAL SUSTAINABILITY IN PAKISTAN

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Abstract

The research investigates the association between Islamic bank (IB) operations and economic development in Pakistan. Specifically, it questions whether Islamic banks are essential for economic development and how their operations contribute to financial sustainability. The study investigates the link between Islamic banking practices and financial sustainability, focusing on GDP and Z-score. It identifies the impact of Islamic financing modes on economic development. Cross-sectional data set research employing a quantitative methodology. Data was collected from five Islamic banks in Pakistan, covering 2018 to 2022. Pearson regression analysis was utilized to quantify the relationships between GDP and the Z-score while focusing on different Islamic financing structures. *Ijārah* and *Murābaḥah* (مرابحہ) modes are negatively linked with GDP, indicating a significant correlation coefficient of 0.79 between financial methods and GDP. In addition, the assessment shows and negative and significant correlation between all forms of payment except *Murābaḥah*, which has a Z-score of 0.94. But the correlation among Z-score and *Murābaḥah* and *Muḍārabah* (المضاربة) is insignificant in all cases. Regression tests provide two models. Overall, the results suggest a strong relationship between the use of all forms of payment, except for *Murābaḥah*, which is independent of Z-score. Therefore, it can be concluded that *Muḍārabah* has no significant relationship with the Z score. This research explores the link between Islamic financial structures and economic development in Pakistan. In addition to quantitative methods, Islamic banking products are used. It offers valuable information for policymakers and stakeholders.

Keywords: *Muḍārabah; Murābaḥah; Mushārakah; Ijārah; Istiṣnā‘; GDP and Z-score.*

Introduction

Islamic financing techniques can assist small and medium-sized firms in raising funds, boosting economic growth. Moreover, Islamic financing can contribute to poverty reduction and job creation and enhance financial sustainability and stability. [1,2] Islamic banks and money aim to promote equality & improve monetary outcomes. Economic development and human prosperity can be achieved through the Islamic monetary system. Focusing on risk reduction instead of support would be the best way to decrease poverty and inequality. This should be the primary focus of financial development strategy creators. Islamic banks handle crisis reserves based on Islamic banking principles. Hence, the Islamic banking system proves to be a valuable tool for economic progress and advancement. For example, the IDB, a multilateral development bank, established the IBs Fund for Economic Growth (IFEG) to offer liquidity to member countries during financial crises. Therefore, the Islamic banking system is considered valuable for fostering economic growth and development. [3,4,5] Global recognition and adoption of Islamic systems of financing has been observed. Various conventional banking organizations have established Islamic banking subsidiaries or windows to offer banking goods and services that adhere to Shari'ah principles. Improving Pakistan's financial sustainability requires building a more robust and resilient banking system.[6]

Islamic banking and finance aim to improve perceptions of value and contribute to economic development. It has the potential to promote economic development and social stability. Increasing bet sharing instead of commitment financing reduces stress and asymmetrical behavior. These are the primary objectives of financial policymakers. Islamic banks utilize Islamic banking principles to facilitate asset transfers from individual customers to business supporters. Islamic financing methods correspond with Islamic *Sharī‘ah* principles, including *Muḍārabah*, *Mushārakah (مشاركة)*, *Ijārah (إجارة)*, *Istiṣnā‘ (استصناع)* Similarly, banking services are a significant indicator of a country's advancement and transformation.[7] This study examines the relationship between Islamic finance practices and Islamic banking intermediation. It also examines its impact on Islamic institutions' sustainability. These characteristics highlight the key role Islamic finance practices play in enhancing the efficiency and stability of Islamic banking communications. Moreover, these practices are critical to Islamic financial institutions' long-term viability. By adapting to ethical principles and social responsibility. When implementing Islamic economics, it's critical to choose the most appropriate mode. A significant part of the Islamic finance sector's performance post-financial crisis depends on market risks and constraints faced by Islamic banks. [8] This is a way to prevent mistakes made by conventional financial institutions. Islamic banks aim to improve equality in society and individual well-being among Muslims through effective banking services, which can stimulate economic growth, reduce poverty, and promote national prosperity. [9] It is important to focus on the relationship between Islamic investment and economic performance when evaluating all three aspects. After that, authorities and technology makers should determine which Islamic finance strategies should be implemented in the Islamic financial system.

Islamic finance has gained significant influence around the world. Especially in a country like Pakistan, the banking industry plays a prominent role in the banking system. Despite the rapid growth, there is still a gap in understanding the short-term impact of Islamic banks on economic growth and economic performance. This research examines the relationship between Islamic banks (IBs) and economic performance in Pakistan and asks questions about the extent to which these institutions are central to the country's growth and development. The study aims to analyze how various Islamic financial terms such as *(Muḍārabah , Mushārakah, Ijāarah, Istiṣnā'* affect market trend indicators such as gross domestic product (GDP) and Z-score, which measures financial stability. This study aims to determine whether Islamic banks' operations positively or negatively affect the economy. As the existing literature presents conflicting views, this research also addresses significant gaps. It focuses on the financial impact and holding power of these financial structures. These structures are critical to the economy's health. As decision-makers and stakeholders in the banking sector strive to create a balanced and sustainable economic environment throughout the long-term economic cycle, understanding this dynamic will become increasingly significant. [10]

Research Objectives

The research objectives of the study are:

1. To analyze the relationship between Islamic banking practices and economic growth in Pakistan, focusing on GDP growth
2. To assess the impact of various Islamic financial structures on economic development through the Z-score.
3. To identify and measure the relationship between specific Islamic financial requirements *(Muḍārabah, Mushārakah),*

Ijārah, Istiṣnā‘ and their impact on economic indicators and provide insights for decision makers.

This study provides a new fundamental model for demonstrating the relationship between Islamic finance and real economic development in Pakistan. This model can be used to understand better Islamic finance's effects on Pakistan's economic development. It is critical to emphasize that the review contributes to the discussion since no previous studies have explored the correlation between the Islamic mode of finance & the sustainability of IBs in Pakistan. In sum, this research provides significant insights for policymakers and stakeholders concerned about the sustainability of the Islamic banking sector in Pakistan.

Literature Review

Literature classification can be divided into two categories. The first category focuses on the relationship between Islamic mode of finance and original economic development.[11] The second category highlights on the relationship between Islamic mode of finance and financial sustainability.

The banking framework plays a crucial role in the economic development of a nation since it facilitates the production of beneficial interests inside the country. Islamic finance plays an important role in mitigating gaps and contributing to economic development of a nation, which promotes self-sufficiency through equitable compensation. The circulation suggests that Islamic banking has a significant impact on economic results. Islamic finance contributes to advancement by focusing on two methods of finance and development relationship. Several experimental studies have been conducted to examine the effectiveness of the Islamic financial system compared to the conventional financial system. These trials have examined its impact on inflation and business rates. [12] In Islamic banking, banks' reliability and popularity are not necessarily indicative of their ability to generate revenue. In addition to boosting the economy, Islamic finance also supports the population's ability to support their own economies through equal pay distributions. [13] Financial institution has a significant effect on the economy's finances.[14] Islamic finance promotes development. Muslims make up 24% of the world's population, the second largest religious group. Islamic finance has played a crucial role in many economies' success and holds a high potential for further growth in the future.

In their view, there is a strong case for a direct correlation between banking intermediaries and market fluctuations. It was argued that the advancement of the monetary framework could potentially yield favorable outcomes for financial development. [15] That studied a similar relationship between Islamic banking and financial development in Malaysia. These studies support the hypothesis of a strong relationship, and research evidence is sometimes understated. The results highlight the significant role of Islamic banks in enhancing the country's economic landscape. The subsequent findings indicate a significant and significant correlation between Islamic bank financing and economic growth. [16] The study findings are based on research into Malaysia's economic development and Islamic banks' role in facilitating financial development. This research highlights the positive impact of Islamic banks on the country's financial development by providing efficient and interest-free banking services. The findings highlight the importance of such banks in promoting sustainable economic growth. The findings indicate that Islamic banking financing in Pakistan is strongly and significantly associated with economic growth and capital accumulation in the long term. [17] It is also said that Islamic financing, including credit types such as *Murābaḥah* and *Ijārah* exchanges, which provide credit against usufruct or substantial assets, necessitate Islamic banks to possess knowledge regarding the client's intention and utilization of the financing. [18] These modes also require the bank to assume responsibility for resource allocation, albeit for a shorter duration in the case of *Murābaḥah*. In contrast, they are longer duration in the case of *Ijārah* finance. This enhances the likelihood (or ensures) that reserves are employed for their stated objectives. Therefore, it ensures credit remains linked to authentic financial transactions throughout the agreement.

In contrast to conventional methods of financing, Islamic financing depends not only on the financial stability of the borrower, but also on the value and profitability of the endeavor being financed. Moreover, Islamic profit sharing contributes to economic development by promoting fair income distribution, leading to significant advantages for social fairness and social progress. [19] Islamic banks have shown a higher level of credit development than traditional banks in nearly all regions during the recession. It has been suggested that Islamic banks have made a greater commitment to macroeconomic and economic stability by increasing credit accessibility. Islamic finance should serve as a contrasting force in the global capital market request, as the funds in Islamic banks (which are not loans but instead open-ended investment accounts on a *Muḍārabah* basis go back to the real economy for goods and services with minimal created cash flow. [20] This paper examines the relationship between Islamic financing and Islamic banking, with a specific focus on finance and investment development. [21] We have demonstrated that Islamic banking plays a significant role in financial progress. Similarly, they proposed that future studies should investigate the impact of Islamic betting on economic growth using panel data analysis rather than time-series analysis. [22] The findings revealed that the Islamic approach to finance encompasses various principles, including *Murābaḥah, Mushārakah, Muḍārabah, Istiṣnā‘*, and *Ijārah*. The impact of financial mediation on monetary development is significant.

Thus, *Murābaḥah* and *Ijārah* financing offer an effective and secure way for businesses to manage their assets. [23]According to Islamic financing places more emphasis on the value and productivity of the project than on the client's creditworthiness. Furthermore, benefit sharing promotes financial advancement by allowing equal pay distribution. This benefits civil rights and practical advancement. Emphasizing value and project productivity, Islamic financing encourages a more just allocation of funds, benefiting both socio-economic and civil rights. [24] Islamic banks developed credit more steadily during the financial crisis than conventional banks in virtually all districts. It has been indicated that IBs showed a significant commitment to economic growth & financial sustainability by expanding recognized availability. [25]According to Islamic money should act as a settling force in the global financial market since Islamic banks' stores (which are not credit lines but evident ventures on *Muḍārabah* premises) are invested in the genuine economy for goods/services without counterfeit cash. Islamic banking can be an effective tool for macroeconomic and financial sustainability and should be encouraged. [26] Assessed the literature on the relationship between financial sustainability and sustainable development, focusing on Islamic banking as a crucial factor. They suggested using board information analysis instead of time-series analysis to investigate the impact of Islamic numbers on business progress. Islamic banking is an effective driver of economic progress, and its potential for even greater impact should be explored further. [27] Discovered Islamic financing modes like *Murābaḥah, Mushārakah, Muḍārabah, Istiṣnā‘*, and *Ijārah,* impacting economic development and financial sustainability. These modes are effective and efficient forms of business finance. Islamic finance is a crucial tool to foster economic development and financial sustainability.

Islamic institutions have demonstrated financial sustainability. Several of them examined Islamic banking security and how it compares to conventional banking, including. [28] Additionally, they examined disappointment risk (credit risk, store withdrawal risk, and functional gambling), as well as Islamic and conventional banks' responsiveness to disappointment risk. All in all, these researchers concluded that Islamic banking can be an attractive alternative to traditional banking due to financial sustainability. In their analysis, they have demonstrated that Islamic banks are highly supported, have a high liquidity level, have a lower influence, and possess an enormous functional gamble. Compared to traditional banks, Islamic banks have a significantly lower risk of disappointment. Research indicates that Islamic banks reduce bankruptcies and credit defaults. They have also demonstrated that expansion in advanced portfolios isn't associated with a higher likelihood of disappointment. [29] Believe that small Islamic banks generally have better financial foundations than small business banks, large business banks typically have stronger financial foundations than significant Islamic banks and Islamic banks typically have stronger financial foundations than significant Islamic banks, which may reflect difficulties with credit risk faced by large business bank executives. [30] This is in order to remain competitive. Based on a comparison of the Islamic Financial Framework (Uncertainties) and its foundations with the conventional premium-based framework, have provided a fundamental overview of Islamic Financial Aspects (IEs) and Money (IF). From 2010 to 2020, they examined 34 tests over a thirty-year period. For standard commercial banks, the mean Return on Equity was 8.45%, but for Islamic commercial banks, the mean Return on Equity was 10%. [31] This study points to the Islamic Financial Framework as a feasible substitute for conventional financing.

The relationship between Islamic money systems and sound finance have not been addressed in modern literature. In this study, two key principles are highlighted that may contribute to Islamic financial institutions' inherent sustainability. It is crucial that these principles are 'worked on'. [32] They support resource allocation and risk-sharing norms. This is in no way, shape, or form to be interpreted as a misrepresentation of or indifference to certain Islamic financial principles, on the one hand. In addition, the International Financial Institutions' actions continue to adhere strictly and "sincerely" to these ideal models, on the whole. In sum, these principles must be upheld and continually worked on in a way to foster the success of Global Business Organizations Islamic banks' market structure impacted total bank risk. The findings showed that Islamic banks are sustainable. [33] The Z-record findings supported the NPFs and demonstrated that Islamic banks rose in sustainability and establishment value. Additionally, they demonstrated how under-investigation Islamic banks may boost borrowing costs by using their market dominance to create credit risk Inside addition, they could ensure contract value through the risk-sharing rule and high capitalization level. In 2019, Islamic banks made up about 6% of global banking assets. Therefore, Islamic banks have significant potential to become a major player in the global banking sector. Examined the impact of credit supply on financial sustainability by focusing on Islamic banks' impact on credit supply. According to their specific findings, Islamic banks' share in the desert as a result of advances adversely affects their credit strength. This in turn results in conventional banks focusing on financial sustainability and increasing their share of credit available to their customers. Overall, this study suggests that Islamic banks' expansion into the desert has both positive and negative implications for financial sustainability.

Financial sustainability has been defined by the SBP of Pakistan (the Pakistan Islamic Meezan Bank), for example, as a condition in which "monetary intermediaries, markets, and the market framework of the financial framework facilitate the smooth flow of assets among savers and monetary backers, thus advancing the development of monetary action". [34] As such, financial sustainability is essential for an economy's proper functioning.

The Z score approach was developed to evaluate financial sustainability and demonstrate foundation reliability. During the development of this methodology, the implementation of an evaluation that simultaneously considered a number of factors to determine financial sustainability was a significant advancement over preceding approaches. As an open framework, customers benefit from the advantages without incurring the additional costs associated with the customized black box framework. Just a thorough economic investigation—no hidden enchantments. [35] Altman's strategy offers customers a cost-effective and transparent approach to financial sustainability. After some time, with additional developments specifically for privately owned organizations, the Z score has continued to grow. It received widespread acclaim from assessors, executives, accountants, judges, and database frameworks used for early evaluation. The instructions have been applied in many contexts and countries. Its credibility has been tested publicly for forty years. It is, therefore, safe to say that the Z result is a reliable instrument for risk assessment & decision-making. Influence, profitability, reinvested profits, liquidity, and productivity are all considered to calculate the score. This includes influence, profitability, reinvested profits, liquidity, and productivity. Due to the lack of external data sources, such as GDP or market prices, it is frequently used to determine past, present, or future information.

Z-Index = 6.57 (X1) + 3.27 (X2) + 6.37 (X3) + 1.06 (X4).
Where:

- Z = Calculated as a risk factor for bankruptcy.
- X1 = Operational capital/sum resources
- X2 = Reserved earnings/sum resources
- X3 = Incomes by benefit & burden / sum resources
- X4 = Calculate manuscript equity/sum equity

A higher score indicates more financial sustainability, linked with a reduced probability of default and vice versa. The methodology combines financial indicators such as liquidity, profitability, invested profit, and impact into a single composite score. It can be used with historical, present, or task data as it does not necessitate external data sources, such as GDP or market costs. Sectors of Judgments

- Z > 2.7 – "Safe Score"
- Z < 2.7 – "Grey Score"
- Z < 1.2 – "Distress Score"

Islamic finance has gained significant popularity globally and has become a significant part of the global finance landscape. [36] Islamic finance prohibits interest *Riba (الربا)*. Islamic finance considers interest exploitative and unjust, as it generates wealth without productive contribution. Instead, Islamic finance promotes profit-sharing and risk-sharing arrangements, where both parties share the risks and rewards of a business venture. This method promotes a fair sharing of wealth and helps instill a sense of responsibility and accountability among those involved. Funds are clearly of limited intrinsic significance and essential to Islamic finance. To use money effectively, we need resources like commerce and speculation to generate abundance. Islamic money is mostly used through exchange. Thus, the four main Islamic modes techniques developed by Islamic banks are *Muḍārabah*, *Mushārakah*, *Ijārah*, and *Murābaḥah*. A key component of Islamic finance is the lack of value in cash. [37] As an expression of honesty, a Muslim is prohibited from providing or receiving money from anyone for profit. He is convinced that the practice of paying a premium (referred to as Riba in Islam) is prohibited and it is unlawful to earn income through currency exchanges. Cash efficiency requires abundance through genuine trade and interest in resources. Islamic finance revolves around its exchange method. Any further elements pertaining to the exchange are allocated between the party giving the capital and the party giving the interest in it. Therefore, Islamic banks have developed four primary ways of Islamic financing, including *Muḍārabah*, *Mushārakah*, *Ijārah*, and *Murābaḥah*.

Muḍārabah is a partnership consisting of a financing and an oversight partner. Financing partners, or financiers, share their capital with oversight and performance. Partner, who in turn contributes their expertise and creative abilities to the project. The financing partner is not involved in the organization's management. [38] Trust financing has become the preferred association method for banks. Profits are distributed in a predetermined ratio. However, if a catastrophe occurs, the financing partner will face the loss, while the overseeing partner will lose their effort and time. This is unless this misfortune was caused by the monitoring partner's erratic behavior. Islamic banks are *Muḍārabah* organizations in *Islamic Fiqh (الفقه الإسلامي)*. [39] This is where the contributions are considered the financier and the bank's management (or investors) are considered the businessperson. [40] The financier is responsible for the management of the business, while the businessperson is responsible for the loss of investment. The bank is not liable for any losses incurred by the financier or the businessperson. The bank is only liable for losses caused by its own negligence or intentional misconduct.

Mushārakah indicates a cooperative effort in which profit, and loss are shared. We are not responsible for managing patches. An enterprise that is intended for commercial purposes is one that brings together the skills, resources, and efforts of at least two partners, each of whom contributes in an equal or different manner in terms of capital, managerial prowess, effort, and other key administrations. As a result of their respective contributions to capital and efforts, they also share in the risks and financial consequences. This sort of organization isn't typically used by Islamic banks since they don't want to be actively involved in project management. [41] In the end, this type of organization benefits all involved. *Mushārakah* refers to a partnership where profit and loss are shared. [42] The objective is to combine the contributions of two partners in a commercial enterprise. This is where each partner contributes capital, managerial expertise, efforts, and other essential services in equal or different amounts. In a similar way, people also bear the risks and financial consequences associated with their investments and efforts. Due to most banks' inability to get involved in project management, Islamic banks typically do not adopt this method of organization.

The term *Ijārah* refers only to a type of lease agreement that is Islamic in nature. As defined by AAOIFI, this concept is the 'return to the right to use resources as a tradeoff for thought'. A client chooses the equipment that the bank purchases and rents it back to the client for a specified rental period. Both the duration and the basis for renting are predetermined and agreed upon. [43] Sometimes the bank subleases clear resources to a client and rents them from a third party. [44] The average rental agreement lasts 12 months, but this doesn't work for everyone. As a result, the bank ensures that each client's needs and preferences are considered while developing a lease agreement. Customers who make purchases can benefit from Islamic banks' Ijarah[45], also known as *"Ijārah-wa-Iktāna (الإجارة والإكتانا)"* or " *Ijārah* with decreasing *Mushārakah*." The typical components include a rental payment and a commitment to expenditure, making Ijarah an appealing solution for clients searching for a long-term agreement. [46] Consequently, the client gains more ownership while the bank's ownership diminishes. All assets are eventually owned by the customer. As a result, *Ijārah* with diminishing *Mushārakah* is an efficient way to acquire assets. As the selling price is factored into the rental installments, the liquidity risk in both forms of *Ijarah (إجارة)* leases will be constrained by. [47] *Ijārah* leases provide an attractive option for customers interested in purchasing assets without incurring liquidity risk.

Based on *Islamic Fiqh, Murābaḥah* is defined as the offering of profits at no charge plus revenue enhancement. It is essential for the vendor to accurately disclose to the consumer the price at which the item was purchased. This is in such a type of Islamic financing. Additionally, he specifies a profit margin over the initial outlay. [48] *Murābaḥah* is, therefore, a form of exchange support. It is essentially an agreement that combines the price of particular goods or services with a predetermined rate rise (benefit). [49] Overall, *Murābaḥah* is a vital sort of Islamic financing that focuses primarily on the exact and evident presentation of the item's cost and a predetermined total revenue. The Islamic bank is the lender in this strategy, along with a middleman (the Islamic bank) and the final purchaser. In this situation, a client requests that the bank buy its selected products in line with particular conditions.

Before delving into the use of the *Istiṣnā'* contract as a supporting document for contemporary groups, it is necessary to clarify a few provisions of the contract.[50] These provisions govern the relationship between the agreement and meetings. These provisions are as follows: The parties to the agreement's rights: The *Istiṣnā'* contract is divided into two parties: the producer is the first group, and the client, or person seeking industry, is the second group. This agreement has a significant or subjective consequence in that it confirms the client's remuneration for the resource made under their responsibility. It also confirms their responsibility for the first segment ("make") of the agreed-upon (cost). However, this arrangement reduces the likelihood that the next section will be met with resistance or, conversely, dissatisfaction with the previous one. God SWT states, "O you who have accepted, keep [all] contracts," referring to this agreement's affirmation of the two parties' rights, the cost, the delivery date, and the specifics of the object produced (*Al-Mā''idah:1*). The rights of the next in line (the client) shall be confirmed upon the completion of the aforementioned material made by the first segment. To maximize benefits, the industry group can handle multiple clients simultaneously while considering delivery time. A key component of an *Istiṣnā'* contract is clearly stating the specifics of the object to be created. This includes its kind, value, quantity, delivery date, and price. The purpose of the completed and unambiguous data in the agreement mentioned above is to resolve any potential disputes between the client and the company group.

This review highlights the critical role of Islamic finance in promoting economic growth and financial stability. It focuses on specific aspects of Islamic finance strategies. Ethical foundation and its potential to drive social equity and economic sustainability. Future research should further examine the relationship between Islamic finance and financial stability. In particular, a variety of statistical methods are used to increase understanding of their relationships. Although the review provides a comprehensive overview of Islamic finance strategies, providing novel insights or specific suggestions that add value to existing writing is not groundbreaking. To expand support, the profession can explore unexplored areas or develop novel models linking Islamic finance to a wide range of economic outcomes. Additionally, integrating case studies or data can offer useful and novel insights into impacts.

Methodology and Research Design

This study uses quantitative methodology. It uses data to analyze Islamic banks' performance in economic development in Pakistan. This research approach involves collecting and analyzing data from a specific group of Islamic banks to indicate relationships between financial variables. [51] This study collected data from five reputed Islamic banks operating in Pakistan. Covers the period 2018 to 2022 based on economic indicators of financial status. The banks included in the study are Meezan Bank, Al Baraka Bank, Dubai Islamic Bank, Faysal Islamic Bank and Bank Islami Pakistan

Data collection collects secondary information from financial statements. Annual reports and publications of the State Bank of Pakistan. The study focused on several key indicators. This includes gross domestic product (GDP) and Z-score, which indicate the bank's financial stability. The main variables are GDP (economic growth indicator), Z-score (financial stability indicator), and Islamic financial conditions *(Muḍārabah, Mushārakah, Ijārah, Istiṣnā‘*. Cleaning was performed on the collected data to ensure accuracy and completeness. Missing or inconsistent data points were corrected to ensure analysis integrity. The Pearson Correlation Coefficient measures the strength and direction of the relationship between GDP and Z-score, as well as between different aspects of Islamic finance. Two regression models were created to examine the causal relationship between the independent variables. (Islamic finance terms) and relative variables (GDP). This procedure examines the impact of various Islamic banking practices. In support of economic development and financial stability. The analyzed data provides valuable insights into the relationship between Islamic banking practices and economic development in Pakistan. The findings show that Islamic banking activities in specific financial sectors are significantly related to GDP and Z-score. This supports the idea that Islamic banking contributes to financial stability and economic development in the country. A systematic and structured approach to data collection and analysis makes findings reliable and can inform policymakers and financial managers.

Result and Analysis

The review analysis the correlation among Z-score & GDP which are dependent variables & Islamic mode of finance which independent variables. From this review, it can be seen that the Islamic mode of finance has a significant effect on both Z score and GDP. The study analyses the link between Z-scores and the Islamic financial system to see if they advance in the same direction. As a result, this study gives critically significant data into the future sustainability of Islamic finance methods. Table 1 shows a significantly negative relationship to the Z Score variable. This is except for Mudarabah, which has a direct link to the Z Score variable. As a result, people with a higher Z Score profit most from Islamic finance. Although connection tests only provide the direction of the association, the researcher applies a causal connection test (regression) to assess if the Islamic method of financing influences IBs' financial sustainability. As a result, the researcher's findings imply a beneficial association between Islamic financing and Islamic banks' financial sustainability. Table 3 indicates that the Islamic form of financing constitutes 95% of the difference in Z scores, whereas other effects account for just 7%. In this significant challenge, Islamic finance research should show how Islamic banks may attain financial sustainability by utilizing Islamic modes of financing. As a result, Islamic financing plays a critical role in determining Islamic institutions' financial sustainability.

Table 1, there is no significant relationship between the Z-score and the two different financial models *Murābaḥah* and *Muḍārabah*. Thus, it can be concluded that the Z score is not a reliable indicator of financial performance. This further reinforces the importance of reliable indicators to measure financial performance.

Variables		**Z-Score**	**IJA-F**	**MUS-F**	**MUR-F**	**IST-F**	**MUD-F**
Z-Score	Correlation Pearson	1	-0.586*	-0.385*	-0.452*	-0.272*	0.279*

	(1-tailed) Sig.		0	0.001	0	0.017	0.015
IJA-F	Correlation Pearson	-0.586*	1	-00321*	-0.224*	0.138	0.207
	(1-tailed) Sig.	0		0.005	0.04	0.114	0.054
MUS-F	Correlation Pearson	-0.385	1	1	0.967*	-0.333*	-0.418*
	(1-tailed) Pearson	0.001	0.005		0	0.004	0
MUR-F	Correlation Pearson	-0.452*	--0.324*	0.967*	1	-0.232*	-0.301*
	(1-tailed) Sig.	0	0.04	0		0.036	0.009
IST-F	Correlation Pearson	-0.272	0.138	-0.333*	0.232*	1	-0.114*
	(1-tailed) Sig.	0.016	0.144	0.004	0.035		0.20
MUD-F	Correlation Pearson	0.279*	0.207	-0.418*	-0.301*	-0.114*	1
	(1-tailed) Sig.	0.014	0.054	0	0.008	0.20	

Table 1: Importance of reliable indicators to measure financial performance

**Significance level for the correlation is 0.01 (1-tailed); *Significance level for the correlation is 0.05 (1-tailed).*

Table 2: The negative relationship among Islamic modes of finance & Z-score is shown from the maximum to the minimal negative relationship. Therefore, Islamic modes of finance are adversely related to the Z score. Due to this, the researcher conducted a second linear regression test, as shown in Tables 4-6. This is to determine whether a significant mode exists. The results indicate that this significant mode is significantly affected by both the dependent and independent variables. Based on Table 6, we can determine that different variable account for just 8% of the Z score variation. On the other hand, Islamic finance (*Ijārah*, *Mushārakah*, and *Istiṣnā‘* accounts for 92% of the variation. Therefore, Islamic finance is responsible for the majority of Z score variation.

The score for Z is 3.99 - (0.0000003125) Finance for *Mushārakah* - (0.000000396) (*Ijārah* finance - *Istiṣnā‘* finance (0.0000025). This score, calculated according to the criteria, indicates a successful financial decision. Based on this model, we can conclude that the Z-score and Islamic finance have a negative correlation. Thus, it can be safely said that the Z score is negatively correlated with Islamic finance.

Have shown that an increase in the share of the market Islamic banks contribute in terms of advances has a negative impact on the sustainability of the financial system. This results in an increase in conventional banks' share of the credit market in terms of credit supply. [52] This highlights the importance of monitoring Islamic banks' market share to ensure financial system sustainability. This outcome is also in line with Z-file work, which showed that Islamic banks could use their marketability to raise financing rates, which in turn raised their credit risk, while still preserving their allowed value through risk sharing and high capitalization levels. Overall, this suggests that Islamic banks can maximize profits while mitigating credit risk through marketability.

In addition, the researcher investigates how Islamic banks' financial sustainability relates to Islamic modes of finance and economic development as well. Tables 3–5 show the results. Overall, the study suggests that Islamic banking is a significant part of the Islamic mode of finance and its sustainability is essential for economic development. We can determine from Table 9 that the Z score and Islamic mode of finance contribute to 88% of the change in gross domestic product. In contrast, other factors contribute to just 12% of the variation. Therefore, Z score and Islamic finance are significant drivers of GDP.

IMF	Correlation Level (Z-Score)	Significance level
IJA-F	-0.586	*Significance level for the link is 0.01 (1-tailed).
MUR-F	-0.452	*Significance level of the link is 0.01 (1-tailed).
MUS-F	-0.385	*Significance level of the link is 0.01 (1-tailed).
IST-F	-0.272	*Significance level of the link is 0.05 (1-tailed).
MUD-F	0.279	*Significance level of the link is 0.05 (1-tailed).

Table 2: Islamic mode of finance correlation

**Significance level for the correlation is 0.01 (1-tailed)*

Model		Square of Sum	D-f	Square Mean	F	Sig.
1	Regression	140.612	6	128.23	80.896	0.00b
	Residual	19.816	58	0.349		
	Total	160.427	63			
2	Regression	138.565	4	46.189	1.24-647	0.000-b
	Residual	21.865	60	0.372		
	Total	160.427	63			
3	Regression	558.402	7	93.068	30.474	0.000b
	Residual	171.028	57	3.055		
	Total	729.430	63			

1. Total-score factor: Dependent Variable
2. Z-score factor: Dependent Variable
3. GDP rate; Dependent Variable

a. *Total: MUR-F, IJA-F, IST-F, MUD-F, & MUS-F are (1) predictors (constants).*
b. *Z: IST-F, IJA-F, & MUS-F are (2) predictors (constants).*
c. *GDP: MUR-F, IJA-F, IST-F, MUD-F, MUS-F & Z-Score factor are (3) predictors (constants)*

Table 3: Overview of the Islamic mode of finance method

Model		Coefficients Under Standardized		Coefficients Standardized		Sig
		B	*Std. Error*	*Beta*		
1	Constant	3.689	0.175		21.228	0.000
	IST-F	-2.75E-07	0	-0.463	-7.179	0.000
	IJA-F	-4.20E-08	0	-0.83	-15.254	0.000
	MUD-F	9.07E-09	0	0.017	0.243	0.810
	MUS-F	-5.04E-08	0	-1.242	-4.130	0.000
	MUR-F	5.63E-09	0	0.465	1.737	0.089
2	Constant	12.40	1.538	1.818	8.064	0.000

	MUS-F	1.58E07	0	1.818	3.810	0.000
	IJA-F	-5.51E-08	0	-0.506	-0.990	0.003
	IST-F	6.32E-07	0	0.497	4.040	0.000
	MUR-F	-5.25E08	0	--2.032	-5.325	0.000
	MUD-F	4.55E-07	0	0.393	4.010	0.000
	Z-Score factor	-2.325	0.394	-1.091	-5.921	0.000
3	Constant	3.992	0.124		32.494	0.000
	MUS-F	-3.126E-008	0.000	-.773	-14.480	0.000
	IJA-F	-3.961 E-008	0.000	-.776	-15.262	0.000
	IST-F	-2.502 E-007	0.000	-.422	-8.264	0.000
1. *Z-score factor: Dependent Variable*						
2. *GDP Rate: Dependent Variable*						
3. *Total Islamic Mode of Finance*						

Table 4: ANOVA– Significance of the analysis
Note: The model shows that financial indicators such as MUS-F, IJA-F, IST-F, MUR-F, MUD-F, and Z-Score have a significant impact on GDP.

Model	**R**	**Square R**	**Square R Adjusted**	**Estimate Std. Error**
1	0.93 a	0.865	0.858	0.60874
2	0.876a	0.767	0.75	1.74750
a. *IST-F, IJA-F, & MUS-F are (1) predictors (constants).* b. *MUR-F, IJA-F, IST-F, MUD-F, & MUS-F are (2) predictors (constants).*				

Table 5: Z and GDP score and Islamic mode of finances are correlated by their coefficients

Linear Relationship Between Z score, GDP Rate, and Islamic Modes of Finance

The GDP rate equals 12.40 plus 0.00000157 Finance for *Mushārakah* – (0.00000056) 0.0000064 Finance for *Istiṣnā‘* –

(0.00000053) *Muḍārabah* Finance – (2.33) plus 0.0000046 *Murabahah (المضاربة)* Finance Z rating. Taking all of these into account, the GDP rate for the country is 12.40. According to Table 2, with an instance of the Z score and the constant, all variables have zero standard errors. [53] It is logical to understand the model's significance in this manner. In addition, the test results suggest that with the exception of *Ijārah* and *Murābaḥah*, all Islamic modes of finance examined have a positive causal relationship with GDP. Overall, these findings demonstrate the significance of the Islamic finance sector in stimulating economic development. [54] This study's results are similar to those who concluded that Islamic modes of finance, including *Ijārah, Istiṣnā', Muḍārabah), Mushārakah* and *Murābaḥah* are sustainable. Financial sustainability is adversely affected, but Islamic banking is positively affected in Pakistan (economic development, but this finding contrasts with those in *Murābaḥah* and *Ijārah (إجارة)*). Overall, this research provides valuable insights into Islamic banking's influence on financial sustainability in Pakistan.

Discussion

Islamic finance has emerged as a robust mechanism for promoting economic development and financial sustainability, as evidenced by both theoretical discussions and empirical studies. The literature underscores its unique focus on profit-sharing, risk-sharing, and interest-free mechanisms, distinguishing it from conventional banking. Studies, including those on Malaysia and Pakistan, highlight significant positive correlations between Islamic finance and economic growth. Regression analysis in the current study further substantiates this relationship, showing that Islamic financing modes contribute to 92% of the Z-score variation and 88% of GDP changes, underlining their critical role in financial sustainability and economic progress.

Mushārakah ($\beta = 0.00000157$) and *Istiṣnā'* ($\beta = 0.0000064$) have been particularly effective, contributing positively to GDP. This aligns with findings from previous research that emphasize the efficacy of these modes in supporting productive economic activities. However, the relatively weaker performance of *Ijārah* ($\beta = -0.00000056$) and Murabahah ($\beta = -0.0000046$) in GDP contribution suggests inefficiencies or contextual challenges, warranting strategic adjustments. These findings are corroborated by Pearson correlation results, which show a significant negative relationship between Ijarah and Z-score (-0.586), indicating potential risks in liquidity management. The Z-score analysis validates the financial stability of Islamic banks, consistently maintaining scores above the distress threshold ($Z > 1.2$). This supports the notion that Islamic banks are resilient to economic shocks, as highlighted in the literature. For instance, during global financial crises, Islamic banks demonstrated higher credit growth compared to their conventional counterparts. The current findings reinforce these observations, with Islamic banks leveraging asset-backed and risk-sharing financing to stabilize their financial structures. Interestingly, the positive correlation of *Muḍārabah* (0.279) with the Z-score reflects its alignment with long-term financial stability, echoing studies emphasizing its effectiveness in equitable wealth distribution. The ANOVA results ($F = 80.896$, $p < 0.001$) further validate the statistical significance of these findings, solidifying the argument that Islamic finance is a sustainable and impactful financial model.

Literature gaps identified in the current study suggest potential for exploring operational improvements in modes like *Muḍārabah* and *Ijārah.* Future research should employ panel data analysis to provide a nuanced understanding of the dynamics between Islamic finance and economic outcomes across diverse contexts. Integrating such insights with case studies can help policymakers and practitioners refine strategies, ultimately amplifying the role of Islamic finance in fostering inclusive and sustainable growth. This evidence-based discussion firmly positions Islamic finance as a transformative tool in global economic systems.

Conclusion

This research explores the critical relationships between Islamic modes of finance and key economic indicators, with notable findings on their implications for economic development and financial sustainability. A negative and statistically significant relationship between the Z-score and *Mushārakah* financing suggests its effectiveness as a development tool. Similarly, the Z-score and *Ijārah* financing displayed a negative and significant correlation, reinforcing its role in predicting *Ijārah*'s financial performance. Moreover, a negative relationship between the Z-score and *Istiṣnā'* financing highlights its use as a predictor of financial sustainability, where higher Z-scores imply reduced reliance on this mode. A negative correlation between the Z-score and GDP suggests that weak economic conditions drive higher Z-scores. Likewise, Ijarah financing negatively impacted GDP, suggesting a potential hindrance to economic development. In contrast, *Mushārakah*, *Istiṣnā'*, and *Muḍārabah* financing demonstrated significant positive relationships with GDP, showcasing their potential to bolster economic growth. *Murābaḥah* financing, however, presented a dual nature both negative and positive associations with GDP, emphasizing the need for careful implementation.

The study also revealed a negligible relationship between *Murābaḥah* financing and Z-scores, limiting its reliability for long-term financial sustainability. Similarly, while *Muḍārabah* financing correlated positively with Z-scores, the relationship was not statistically significant, questioning its utility as a stability indicator. Among the studied modes, *Istiṣnāʿ* emerged as the most effective for enhancing GDP and ensuring sustainability. Despite its promise, Islamic finance in Pakistan faces challenges, including limited expertise, legal hurdles, inadequate infrastructure, and regulatory gaps. It can enhance its impact by addressing these issues through improved education, legal reforms, and product diversification. Policymakers should also consider Islamic finance's unique characteristics to support its growth sustainably. Future research should delve deeper into the relationships between Islamic finance, market performance, and economic activities, offering insights for global comparisons and sustainable practices. Ultimately, the study underscores the potential of Islamic finance to drive ethical, inclusive, and sustainable economic development, contributing significantly to Pakistan's financial stability and global financial sustainability.

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