



THE ROLE OF ISLAMIC MICROFINANCE INSTRUMENTS IN POVERTY REDUCTION

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Abstract. This article examines the role of Islamic microfinance instruments in reducing poverty. Since conventional microfinance is largely based on interest (riba), it may, in some cases, contradict Sharia principles in Muslim societies. Therefore, Islamic microfinance – providing financial services in accordance with Sharia – has gained attention as a sustainable alternative for poverty alleviation. The study primarily focuses on trade-based and partnership contracts, including murabahah, istiṣna', musharakah, mudarabah, and tawarruq, and analyzes their application within microcredit models. Evidence from Bangladesh, Nigeria, and Pakistan suggests that Islamic microfinance mechanisms contribute positively to poverty reduction by increasing household income, supporting entrepreneurial activity, and strengthening financial inclusion. The article also highlights practical challenges faced by Islamic microfinance, such as regulatory limitations, insufficient financial literacy, and operational constraints. In the context of Uzbekistan, the effective implementation of Islamic microfinance requires pilot programs, enhanced financial education, improved legal and regulatory frameworks, and the introduction of innovative Sharia-compliant financial instruments.

Keywords: Islamic microfinance; poverty reduction; Sharia-compliant finance; murabahah; musharakah; mudarabah; istiṣna'; tawarruq; qard hasan; microcredit; financial inclusion; social justice.

INTRODUCTION

Poverty reduction is one of the key principles of social justice and sustainable development, and decreasing poverty is considered a strategic goal of every country. Since the conventional microfinance model operates on the basis of interest, it may, in some cases, contradict Sharia principles in the Muslim world. In this regard, Islamic microfinance implementing microfinancing in accordance with Sharia has attracted attention as an alternative and sustainable instrument for poverty alleviation. This article focuses primarily on trade-based contracts (murabahah, istiṣna', musharakah, mudarabah, and others) and analyzes their role in combating poverty within the microfinance context.



MAIN PART

Islamic Microfinance and Its Principles

Islamic microfinance refers to the Sharia-compliant activities of microfinance institutions that provide financial services to low-income individuals. It is mainly based on the rejection of interest (riba), profit-and-loss sharing, fair distribution, and the principles of social inclusion (Pupan 1.3). Such microfinance models differ from conventional credit systems in that they use trade-based, partnership (musharakah, mudarabah), and leasing/istisna' contracts instead of interest-based lending (M. Halane, M. Che Mohd. 2.4).

Trade-Based Contracts and Their Types

In Islamic finance, trade-based contracts are important instruments for financing economic activity. The main types include the following:

Murabahah (cost-plus sale) a financial institution purchases an asset or product in advance and then sells it to the client at a marked-up price, usually through installment payments.

Istisna' a trade contract aimed at manufacturing or construction/installation based on an order.

Musharakah and Mudarabah partnership-based contracts in which profit and loss are distributed according to the agreed partnership arrangement (M. Halane, M. Che Mohd. 2.4).

Tawarruq converting an asset into cash through a secondary market transaction. In this arrangement, trade is usually conducted on a deferred payment basis with the asset owner, after which the asset is sold to a third party through a secondary transaction, and the obtained cash is directed to the intended sector for financing. The main rule here is that the buyer should not remain the final owner of the asset (Muhammad Sodiq M. 3).

These contracts are directly linked to trade activities and may resemble credit-like financial products. However, unlike interest-based loans, profit is generated through genuine commercial transactions rather than through interest.

Trade-Based Contracts and the Microcredit Model

Islamic microfinance institutions apply the above-mentioned trade-based contracts as microcredit products. For example, a financial institution purchases an asset and sells it to the client on the basis of *murabahah*, allowing the client to repay the price



in installments. Through this mechanism, low-income entrepreneurs are provided with an alternative to conventional credit without encountering the usual interest-related constraints (M.Halane, M.Che Mohd. 2.4).

Practical Experience of Islamic Microfinance Institutions

Experiences in Bangladesh demonstrate that institutions utilizing *murabahah* and *qard hasan* instruments have achieved positive results in reducing poverty (Dhao, 4).

Similarly, evidence from Nigeria indicates that Islamic banking products based on *murabahah* and *musharakah* have had a positive impact on income levels and productivity (Jimoh, Bamigbade, Dayo, 5).

In Pakistan as well, Islamic microfinance strategies have played a positive role in poverty alleviation (Asif, 6). These findings suggest that microcredit mechanisms implemented through trade-based contracts can make a significant contribution to poverty reduction.

The Role of Trade-Based Mechanisms in Islamic Finance in Poverty Reduction

They create Sharia-compliant financing opportunities for low-income individuals and small entrepreneurs, thereby expanding sources of income. Profit-and-loss sharing arrangements also contribute to the distribution of financial risk.

They strengthen financial inclusion by expanding access to financial services for groups with limited or no access to conventional finance.

They promote social justice and solidarity within society by aligning financial practices with ethical and equitable principles.

CONCLUSION

Islamic microfinance and trade-based contracts (*murabahah*, *musharakah*, *istisna'*, and others) play an important role in poverty reduction. Unlike interest-based lending, these mechanisms operate through real commercial transactions and partnership arrangements. Evidence from multiple countries indicates positive outcomes, including increased household income, enhanced entrepreneurial activity, and stronger financial inclusion.

However, Islamic microfinance also faces practical challenges and limitations. These issues can be addressed through the use of modern technology, improved financial education, and more effective regulatory approaches. In the context of Uzbekistan,



an effective implementation strategy for this model should include pilot projects, the development of financial literacy programs, the improvement of the legal and regulatory framework, and the introduction of innovative Sharia-compliant financial instruments.

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