The Influence of Islamic Finance, Financial Inclusion and Governance on the Economic Growth of Islamic Countries

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Abstract

Recently, Islamic banking is considered as the suitable solution of many issues such as poverty, unemployment and inequality, and it is also considered as the possible approach of extensive economic growth. Thus, the objective of the current study is to examine the role of financial inclusion and Islamic Financial Instruments (IFIs) on the economic growth of the selected ten Islamic countries. The data were extracted from the World Bank, Islamic Finance Database & Central Banks Annual Reports from 2007 to 2018. The Generalized Method of Movement (GMM) along with Robust Standard Error techniques of panel data have been used in the present study for analysis. The findings revealed that IFIs and financial inclusion both have a positive impact on the economic growth of the selected Islamic countries. This finding is indeed an interesting one, especially for the emerging economies, which implies that substantial growth should trickle down and one of the indices to gauge it is financial inclusion.

Keywords: Islamic banking, Islamic financial instruments, Financial inclusion, Economic growth

Introduction

Recently, the operations and emergence of Islamic finance and banking in different parts around the globe, especially in Muslim nations has continued to persist one of the essential financial and economic development, particularly its concrete assistance to development and economic growth. According to Abdul-Rahman and Nor (2017), growth in the industry of Islamic finance and banking conforms with Islamic goals such as the balanced distribution of wealth and income, broad economic prosperity, optimum level of currency stability and economic growth along with socioeconomic justice. The industry of Islamic finance is vibrant, with total assets of USD150 billion in the mid- 1990s reaching USD1.0 trillion in 2009 from zero levels in 1970. Similarly, 2013 recorded a more inspiring growth in the

industry of Islamic finance, with total assets put at USD1.6 trillion (Sanusi, 2011; Tahir & Abu Bakar, 2009). In addition, Hoggarth (2016) and Ökte (2016) indicated that the growth of IBF in 2014 was over USD2trillion with a projection of 19.7% average growth rate in 2018. The total of IF assets have been projected to reach USD3.25trillion by 2020, because of its growing acceptance and viability.

Notably, Malaysia and Saudi Arabia are two primary and leading markets in the Asia Pacific and GCC, respectively (World Islamic Banking Competitiveness Report 2016). This report also shows that the core market of Islamic finance includes: Pakistan has 1.4% global share and 10.4% as a national share; Bahrain has 1.6% and 29.3%; Oman has 1.9% and 30.1%; Indonesia has 2.5% and 3.7%; Turkey has 5.1% and 5.5%; Qatar has 8.1% and 25.8%; Kuwait has 10.1% and 45.2% as global and national shares respectively. In addition, UAE with 15.4% and 21.6%; Malaysia with a global share of 15.5% and national share of 21.3%; and Saudi Arabia with global participation banking assets of 33% and national share of 51.2%.

According to the Ökte (2016), other than Islamic countries such as Vatican, France, Germany and Japan, recognize the capabilities of Islamic finance in resorting stability and credibility to the financial market after global financial crisis 2007-2008. Admittedly, strong players of the conventional market such as Deutsche Bank, Citibank, UBS and HSBC are now becoming growing vital providers of Islamic banking services via Islamic windows. Bank Negara Malaysia (2015) submits that financial inclusion, which has been broadly recognized as critical to poverty alleviation and inclusive economic growth is undoubtedly one of the main characteristics of a Sharīʿah-compliant financial system deserving extra attention. A study conducted by Naceur, Barajas, and Massara (2017) indicated the level of Islamic finance has contributed towards financial inclusion by minimizing the frequency of religious exclusion especially in Muslim countries regardless of more than double of Islamic finance assets since 2007. They contended that the level of association of Islamic banking with financial inclusion, especially in Muslim countries is emerging area for research (Naceur et al., 2017). Globally, financial exclusion due to religious reason is growing extensively in certain Muslim nations. For example, Afghanistan suffers 34% financial exclusion as compared to Tunisia and Iraq of 25-26% with 22-23% in Saudi Arabia and Djibouti; while UAE and Kuwait have 2.5-3%, Sudan has 4.5%, and Malaysia has virtually zero percent financial exclusion. Thus, Abdul-Rahman and Nor (2017) exposed that Malaysian Islamic banking is aligned to the existing economic goals regarding the broad economic prosperity.

The multiple economic contributions and benefits of Islamic banking to its congregation countries include employment generation, deepening financial development, foreign direct investment (FDI), increasing investment opportunities, poverty reduction, infrastructure development and development in the real sector (Mobolaji, 2012; Shinkafi, Yahaya, & Gusau, 2020).   Similarly, IBF is expected to contribute meaningfully to the economies of developing countries, particularly, Muslim nations by facilitating financial inclusion and economic growth through various Islamic financial instruments (IFIs) such as Murābaḥah, Baiʿ-Salam, Muḍārabah, Ijārah, Mushārakah, Qarḍul-ḥasan, Mushārakah mutanāqiṣah, Ṣukūk and Istiṣnāʿ (Abdullah, Maamor, & Mohamed Fisol, 2013; Mohieldin, Iqbal, Rostom, & Fu, 2011). Unfortunately, poverty and unemployment, along with inequality, are disheartening and pervasive in some Muslim nations. As such, these Muslim nations expose vulnerable groups to financial exclusion and economic humiliation (Kamran & Uusitalo, 2016).

Thus, Islamic banking provides instruments such as Qardul-Hasan (QH), a contract of the interest-free loan based on encashment of social welfare (Sadr, 2008). This Islamic financial

instrument can be used to provide financial support in all sorts of production, consumption, debt activities and services such as education, business working capital, agriculture activities and small industries. In addition, Abdul-Rahman and Nor (2017) exposed that the IFIs such as Muḍārabah and Mushārakah establish around 6 per cent of the total Islamic banking financing in Malaysia and result in positive development in the country. IFIs are considered as the appropriate instruments for generating entrepreneurs, especially in poverty-ridden and financially exclusive economy such as Pakistan, where many jobless youths and qualified unemployed graduates pose problems.   Greater access to financial services, which IF promotes, would help in reducing income inequality, unemployment, and poverty besides accelerating economic growth (Sadr, 2008). Admittedly, Sanusi (2011) argued that an inclusive financial system is needed in Islamic countries to attain inclusive economic growth. Thus, Islamic finance has the potential to support them financially by using the IFIs. As such, Pakistan can also become a dominant player in the industry of Islamic finance, if the necessary supports are provided and sustained.

To respond the above matters, the current study investigates the influence of Islamic finance along with the financial inclusion on the economic growth of core markets of ten Islamic countries, namely, Pakistan, Bahrain, Indonesia, Oman, Turkey, Qatar, Kuwait, UAE, Malaysia and Saudi Arabia. In this regard, the sampled countries provide us with an excellent opportunity to investigate the role and contributions of IF in simultaneously accounting for financial inclusion and economic growth in the selected Muslim countries. To this end, the remaining parts of this study are divided into four parts. Section two presents the literature review; section three discusses the methodology utilized in this study; section four discusses the results and findings; while section five provides the conclusion and recommendations.

Literature Review

Currently, Islamic banking is considered as the appropriate solution of many issues such as poverty and unemployment along with inequality and also consider as the possible measure of high economic growth and development. According to the Furqani and Mulyany (2009) who conducted their study on the connection of Islamic banking with economic growth by using the test of co-integration, Islamic banking has positively along with significantly associated with the capital accumulation and economic growth of Malaysia. This implies that Islamic banking aids the development of real sectors through increasing fixed investment. In addition, there is a "virtuous cycle" effect between the development of Islamic banking and investment, which represents bidirectional causality. Moreover, a study conducted by Johnson (2013) on the economic growth linked with Islamic banking and utilize 2SLS regressions to determine the influential power of Islamic banks on the growth of the economy and found that Muslim dominance in population is considered as the significant factor of diffusion of Islamic banking. Thus, Sharīʿah implementation supports Islamic banking and promotes economic growth, which is especially useful for Muslim economies to curb financial exclusion, poverty, unemployment, inequality and other deleterious socioeconomic phenomena (Johnson, 2013).

Islamic banking, along with its instruments, is playing a vital role in the development of the economy around the globe. Likewise, Hanieh (2020) conducted the study on gulf countries and exposed that Islamic banking is the solution to the stability of the economy in the Gulf countries. In addition, Abdullah et al. (2013) investigate the performance and impacts of Islamic Banking Scheme (IBS) of five conventional banks in Malaysia on national economic growth by focusing on four real sectors of the Malaysian economy as indicators (i.e., Agriculture, Manufacturing, Construction and Real Estate). Their study utilized a modified production function and adopted panel data of 2003-2009 with panel co-integration test. The

findings indicate that IBS of those banks has positive impacts on economic growth, especially in the manufacturing and real estate sectors. Furthermore, Yusof and Bahlous (2013) examined the Islamic banking contribution on the growth of the economy in early implementer of Islamic banking like Indonesia, Malaysia and Gulf countries. They have used panel co-integration technique, and the findings show that economic growth is positively influenced by the Islamic banking both in the long and short run. Likewise, a study incorporated by Patrick and Kpodar (2015) the influence of Islamic banking on the growth of the economy by using panel data on 52 developing countries (29 of them being OIC countries) with data spanning 1990-2010 and with an average of 3years adopted. The study revealed that countries had Islamic banking experience rapid economic growth than others. It establish positive influence of Islamic banking on growth, after controlling level of financial depth in the economy.

IFIs and financial inclusion have a considerable impact on the growth of the economy around the globe, especially in Islamic countries. In addition, studies on the influence of Islamic finance/Islamic banking on financial inclusion include a study by Razak, Muhammad, Hussin, Zainol, and Hadi (2017) on the relationship between financial inclusion and adoption of Ar-Rahn financing in promoting and enhancing customer well-being throughout Malaysia. The findings indicate a positive relationship between financial inclusion and adoption of Ar-Rahn for financing. Moreover, a study conducted by Nazar (2017) emphasizes the extent of financial inclusion among the people of Kerala in India and their awareness of Islamic banking. The results show that Islamic banking use is very high among Muslims and non-Muslims and that its promotion will ultimately lead to inclusive growth of the country. Similarly, Abdu, Jibir, Abdullahi, and Rabi'u (2018) executed their study of the influence of Islamic banking on the financial development and inclusion by using the Probit and Tobit models. The findings exposed that the establishment of Islamic banking in sub-Saharan Africa (SSA) enhanced financial development and inclusion. Likewise, a study incorporated by Nawaz (2018) investigated the influence of 18 Islamic banks of Pakistan and Bangladesh of the economic development and financial inclusion. The findings show that Islamic banks are comprehensively involved in encouraging financial inclusion to reassure economic and social fairness in society. In addition, the findings also indicate that intellectual capital resources are the main channels for stimulating financial inclusion by Islamic banks in both countries.

The growing intentions towards Islamic finance and banking and the economic-financial crisis of 2009 Hussain et al. (2012) generate the needs to explore this foremost area. The IFIs can reduce the unemployment condition and enhance the equality of wealth around the globe (Hussain, Mosa, & Omran, 2018). In addition, economic growth, along with financial development is the foremost functions of the banking sector around the globe (Khan & Nawaz, 2010). However, Islamic banking among the entire banking system is prominent to words the economic growth along with financial inclusion (Shittu, Hassan, & Nawaz, 2018). A study of Rasheed, Siddiqui, and Chaudhry (2019) conducted on the Islamic finance of the emerging economies. It concluded that current economic growth is the foremost function of Islamic finance in emerging economies. Similarly, Uddin, Abusloum, and Afroz (2020) also executed the study of Islamic financial inclusion and found that the Islamic financial system is stronger than the conventional system in terms of economic growth.

From the previous review of literature, it is clear that lack of studies simultaneously investigates the influence of Islamic finance and financial inclusion on economic growth, which is the primary concern in this study and this implies a gap exists. In addition, using the sampled countries as a research concept is new in Islamic finance discourse, as noted by the

World Islamic Banking Competitiveness Report (2016). Additionally, the lack of attention provided by the past studies on the concept as it relates to these macroeconomic phenomena under investigation in this study. In this direction, it requires an academic contribution, which the study seeks to do. Furthermore, from the methodological perspective, limited studies reviewed made use of the Robust Standard Error Approach framework to gauge the interconnectivity among Islamic finance, economic growth and financial inclusion, which are the significant variables of interest in this study. Therefore, embarking on this auspicious study is justified and necessary, since expanding the frontiers of knowledge requires exploring new concepts and discovering new horizons, which is the primary goal of this study.

Research Methods

The aim associated with the current study is to examine the role of financial inclusion and IFIs on the economic growth of ten Islamic countries named as Saudi Arabia, Bahrain, Indonesia, Oman, Turkey, Qatar, Kuwait, UAE, Malaysia and Pakistan. For this purpose, data has been extracted from well-reputed databases such as World Bank, Islamic Finance Database & Central Banks Annual Reports from 2007 to 2018. In addition, Generalized Method of Movement (GMM) along with Robust Standard Error techniques of panel data have been used by the study (Basheer et al., 2019). The adoption of GMM and Robust Standard Error techniques for this study is in line with Darwin and Hidayat (2019), Canavan, Graham, Anderson, and Barron (2018) Basheer et al.(2019) and Foldnes and Olsson (2019), who posited that the best approach for understanding the interdependencies and interconnections that exist among variables of interest (like the case in this study), which give feedback loops, is to use GMM and Robust Standard Error. The use of panel data provides for variability, less Collinearity and detailed information about the variables with more degree of freedom and estimation efficiency in contrast to time-series or cross-sectional data (Mustafa & Mobolaji). In this connection, the econometric model for the above GMM framework with natural logarithm (ln) function is hereby specified as follows.

$$EG_{it} = \alpha_0 + \beta_1 LNIFI_{it} + \beta_2 LNFI_{it} + \beta_3 LNPOP_{it} + \beta_4 LNEDU_{it} + e_{it}$$
(1)

Whereas

EG = Economic Growth

IFI = Islamic Financial Instruments

FI = Financial Inclusion

POP = Population

EDU = Education

This section presents definitions and measurements for the various variables utilized in this study and also, the sources of data for all the variables adopted. Essentially, the most important variable in this study is Islamic financial instruments (IFIs), which is proxied by the total size of assets of Islamic banks operating in a country. Table 1 presents summary information on the five variables adopted. The one endogenous variables in this study are economic growth, while Islamic financial instruments (IFIs) which represent Islamic finance proxied by the total size of Islamic banks' assets serves as the main exogenous variable along with financial inclusion proxied by ATM per 1,000 Adults. The choice of the proxy for IFIs was due to the absence of complete dataset for the known proxy for Islamic finance in the

literature as related to the sampled countries. Similarly, the choice of the proxy adopted for financial inclusion in this study was informed by the inability to get a complete dataset for the sampled countries using the popular proxy such as savings account. The choice of these proxies was thus dictated by exigency and accepting what was available for analyzing at the time. The variables, along with measurements, are given in Table 1 shown below:

Table 1: Measurement of Variables

No.	Variable	Measurement	Source of Data
1	Islamic Financial Instruments	Total Size of Assets of Islamic Banks	World Bank, Islamic Finance Database & Central Banks Annual Reports
2	Financial Inclusion	ATM per 1,000 Adults	World Bank
3	Education	Primary school enrolment	World Bank
4	Population	Population in total	World Bank
5	Economic Growth	Real GDP	World Bank

Findings

The section of the article has provided the empirical findings of the study, and firstly descriptive statistics of all the variables are mentioned. The statistics show 120 observations because data of 10 Islamic countries were extracted for 12 years from 2007 to 2018 (12x10). The minimum, maximum and mean values are also given of all the variables that are used by the study in Table 2.

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
EG	120	3.504e+11	2.952e+11	2.173e+10	1.042e+12
EDU	120	57.013	22.989	11.257	99.967
IFI	120	7.354e+09	7.964e+09	-2.186e+09	3.946e+10
POP	120	59315594	84723985	1035919	2.677e+08
FI	120	47.086	18.828	2.636	79.091

Secondly, this study tests the multicollinearity assumption that shows the variables are not severely correlated because the values of variance inflation factor (VIF) are less than five that are given in Table 3 and calculated by the following equations:

R^2_{EG} $EG_{it} = \alpha_0 + \beta_1 EDU_{it} + \beta_2 IFI_{it} + \beta_3 POP_{it} + \beta_4 FI_{it} + e_{it}$
(2)

R^2_{EDU} $EDU_{it} = \alpha_0 + \beta_1 EG_{it} + \beta_2 IFI_{it} + \beta_3 POP_{it} + \beta_4 FI_{it} + e_{it}$
(3)

R^2_{IFI} $IFI_{it} = \alpha_0 + \beta_1 EDU_{it} + \beta_2 EG_{it} + \beta_3 POP_{it} + \beta_4 FI_{it} + e_{it}$
(4)

R^2_{POP} $POP_{it} = \alpha_0 + \beta_1 EDU_{it} + \beta_2 IFI_{it} + \beta_3 EG_{it} + \beta_4 FI_{it} + e_{it}$
(5)

R^2_{FI} $FI_{it} = \alpha_0 + \beta_1 EDU_{it} + \beta_2 IFI_{it} + \beta_3 POP_{it} + \beta_4 EG_{it} + e_{it}$
(6)

$j = R^2_{EG}, R^2_{EDU}, R^2_{IFI,} R^2_{POP,} R^2_{FI}$
(7)

$Tolrance = 1 - R^2_j$ $VIF = \frac{1}{Tolerance}$
(8)

Table 3: Variance Inflation Factor (VIF)

	VIF	1/VIF
LNPOP	2.358	.424
LNIFI	1.873	.534
LNFI	1.731	.578
LNEDU	1.208	.828
Mean VIF	1.792	.

Thirdly, the present study runs the Hausman test to check the appropriate method among the fixed and random effect models (Basheer et al., 2018: Hidthiir et al., 2019). Since applying the appropriate approach of Robust Standard Error, needs to select the appropriate method between the fixed and random effect models. The figures show that the probability value is less than 0.05 that reject the null hypothesis related to the random effective is appropriate; thus, this study selects the fixed effect model. Table 4 shown below highlighted the Hausman test.

Table 4: Hausman Test

	Coef.
Chi-square test value	13.646
P-value	.009

For hypothesis testing, the first approach that has been adopted by this study is the Robust Standard Error approach. According to the statistics, all the variables have jointly 86.07 per cent (R-squared = 0.8607) impact on economic growth. In addition, IFIs, financial inclusion and population have a significant and positive impact on the economic growth because of the positive sign associated with beta along with higher than 1.64 values of t-statistics and less than 0.05 values of probabilities while education has an insignificant effect on economic growth. These figures are shown in Table 5.

Table 5: Robust Standard Error

LNEG	Beta	S.D.	t-values	P>t	L.L.	U.L.
LNEDU	-0.038	0.065	-0.580	0.575	-0.185	0.110
LNIFI	0.125	0.029	4.300	0.002	0.059	0.191
LNPOP	0.532	0.023	22.710	0.000	0.479	0.585
LNFI	0.662	0.029	22.830	0.000	0.596	0.727
_cons	5.333	0.374	14.270	0.000	4.488	6.179
R-squared	=	0.8607				

The second approach that has been used by the current study is the GMM approach. According to the figures, IFIs, financial inclusion and population have a significant and positive impact on the economic growth because of the positive sign associated with beta along with higher than 1.64 values of t-statistics and lower than 0.05 values of probabilities while education has an insignificant effect on economic growth. These figures are shown in Table 6.

Table 6: Generalized Method of Movements (GMM)

LNEG	Beta	S.D.	t-values	P>t	L.L.	U.L.	Sig
LNEDU	.036	.101	0.36	.723	-.165	.237	
LNIFI	.085	.015	5.53	.000	.054	.115	***
LNPOP	1.181	.154	7.67	.000	.876	1.487	***
LNFI	.263	.057	4.59	.000	.149	.377	***

*** p<.01, ** p<.05, * p<.1*

Discussions and Conclusion

From the previous discussions, it is evident that investigating the influence of Islamic finance along with financial inclusion on economic growth in the core markets of Islamic finance as noted by the World Islamic Banking Competitiveness Report (2016) has been accomplished in this paper. The research moves a step further to examine some of the lessons for emerging economies around the globe. The significant findings originating from the present study, expose that Islamic finance, along with financial inclusion have positive and significant impacts on economic growth in the selected Muslim countries. The findings of the present study are similar with the output of the Kim, Yu, and Hassan (2018) who also exposed that financial inclusion enhances the growth of the economy both in short and long-run. In addition, the output of the ongoing article also matched with the findings of Zulkhibri (2016), who also examined the Islamic finance impact on economic growth and found a positive association among them. Moreover, a study by Smaoui and Nechi (2017) also found that economic growth is the function of Islamic finance and a stronger impact than the conventional banking system.

This finding is indeed an interesting one, especially for emerging economies, which implies that substantial growth should trickle down and one of the indices to gauge it is financial inclusion. As rightly noted by Bank Negara Malaysia (2015), "With proper infrastructure and regulations in place, Islamic finance will eventually contribute to a more inclusive economic growth". In addition, this study recommends that governments of the selected countries should continue to promote and strengthen the growth of Islamic finance for enhanced developmental opportunities and gains. Moreover, the government of emerging economies should also learn from the sampled countries on how to diversify the economy by incorporating Islamic finance and banking in the economy. In this connection, the government of emerging economies must provide concrete supports to Islamic finance and banking operations by instituting a robust institutional framework and enduring political backing, so that emerging economies can optimize the gains of Islamic finance and banking, especially in economic growth and financial inclusion, which are pertinent to economic development as in the sampled countries. Furthermore, Islamic banks and other Islamic financial institutions should be given necessary attention and priority, to enable their smooth establishment and operations, which will allow them to contribute meaningfully to the emerging economies.

The present study has some limitations such as it takes only Islamic finance and financial Inclusion to predict economic growth, and it is recommended that future study should add more predictors in their evaluation. In addition, the current study takes only ten Islamic countries under investigation and suggested that future studies should add more countries in their analysis. Moreover, this study utilized only GMM and Robust Standard Error approaches and recommended that future studies should take other approaches for analysis. Finally, this study takes only 12 years of data under investigation due to data availability constraints and suggested that upcoming studies should include more time spans in their studies.

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