Islamic Financial Development And Economic Growth

Case of the MENA & the South-East Asia Countries

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Part 1: A Literature Survey On The Relationship Between Islamic Financial Development And Economic Growth

The importance of the financial system development-growth nexus has received recently considerable attention in the literature of development economics. From the many research works carried out in this field, some studies are trying to determine empirically the nexus between financial development and economic growth.

As comprehensively summarized in King &Levine (1993), Levine & Zarvose (1998a), Christopulos & Tsionas (2004),Aghion (2006), Papaioannou (2008). The finding suggest that the financial development and the capital markets have a positive effect on economic growth, in particular through the improvement of productivity and capital efficiency. They asserted that finance and financial intermediation, in particular, play a key role in spurring and propagating economic growth.

With regard to the role of Islamic financial development in economic growth,

Furqani &Mulyany (2009); Majid & Kassim (2010) ; Muhamad Abduh, Mohd Azmi Omar (2012) Gholamreza Tajgardoon, Mehdi Behname & Khosro Noor mohamadi (2013) are among the limited articles in this area. Their results show a significant relationship in short-run and long-run periods between Islamic financial development and economic growth.

The objective of this paper is to investigate the potential effect of Islamic banking sector on the economic growth using 15 MENA and South-East Asia countries observed over the period 2000- 2009. We chose the MENA and South-East Asia countries to carry out our study not only because no other paper so far has tested the effect of Islamic financial development on economic growth but also because this regions are the main markets where Islamic financial has a systemic importance and also the total Islamic financial assets are focused in the MENA and South-East Asia region.

The remainder of the paper is organized as follows. In the section 2, present the review of the literature on finance and economic growth also some recent literature on Islamic finance and economic growth.

Review of literature

From the 1990s, the study of the relationship between the financial system and economic growth has experienced a revival and a renewed interest in the work of King & Levine (1993, 1997). To this day, the most comprehensive work and more sophisticated on the subject have been made by these two authors.

Among the first empirical studies have addressed the relationship between the financial system and economic growth, we can mention that of King & Levine (1993 a, b, c). They assess empirically the relationship with each financial development indicators and economic growth for a sample of 77 countries over the period 1960-189. For this, the authors mobilize four financial indicators: money supply (M3/ GDP), liquid liabilities of the financial system divided by GDP, credit private sector by GDP and band credit divided by bank credit plus central bank domestic assets. They found that higher levels of financial development are positively and significantly correlated with, physical capital accumulation, economic growth and economic efficiency improvements. These results are also demonstrated by Fase (2001).

In the same vein, Raymond Atje & Boyan Jovanovic (1993). They test empirically the relationship between the growth rate and stock markets liquidity. The observed time period is from 1970 to 1988 and the sample consists of forty countries hold the OSL

regression. The result show that there a significant impact of the level of stock market development and bank development on the economic growth.

When studies focus on more homogeneous samples such as sub-Saharan Africa, the results become ambiguous. Using econometric techniques panels and using annual data covering the period 1960-1995, Savvides (1995) test the effect of financial development on growth in a sample of 28 African countries, including three Maghreb countries. The econometric model estimated results reveal that an increase in financial development indicator measured by the quasi- currency ratio as a percentage of product 10% boost up growth of 1. 8 %. This variable becomes insignificant when the " political freedom " variable is introduced in the equation.

Levine & Zervos (1998) extend their previous study to analyze empirically the relationship between development banking indicators and financial markets, economic growth, savings rate, improving productivity and accumulation capital. Using cross-sectional regression, they test this link for a sample of 42 developed and developing countries over the period 1976-1993. The Authors control the initial level of banking and other factors that influence economic growth. They find that the initial level of banking development and initial level of stock market can promote economic growth in the long-run. They also find that the stock market size is not associated with growth indicators but it is negatively related to the savings rate.

Cull & Xu (2005) focus only on the sector in china using data on 2400 firms over the period 2000- 2002, to examine the relation finance-growth nexus. Find that even in the state sector, bank financing was associated with higher productivity, profitability, and adoption of reforms compared to government transfers.

Some studies have taken a more microeconomic approach. Using a sample of 36 industries manufacturing in 46 countries over 1980-1990,Rajan & Zingales (1998), examine the effect of financial development through external financing on firm growth from a sample of 36 selected from 42 countries over the period 1980 to 1990. They examine the effect of change in financial development on growth. They find that firms that rely heavily on financing external grow faster in countries that are more development financial markets than do less dependent industries

Demirguç-Kunt & Maksimovic (1998), use firm level survey data for over 8500 firm across 30 countries, to assess the relationship between country-level financial development and firm financing constraint. They show that firms in countries with better developed financial systems grow more rapidly than these firms would have

without this access.

Jayaratne & Strahan (1996) also document an association between financial intermediation and growth. They show that when individual states of the United States relaxed intrastate branching restriction, the quality of bank loans rose and per capita GDP growth accelerated.

Hinge upon the Rajan-Zingales (1998) methodology, Beck, Demirguc -Kunt, Leaven & Levine (2004, 2005), use a cross-country cross-industry approach to examine the effect of financial intermediation efficiency on entry. They test whether financial development promotes the growth of small businesses large companies. The study focuses on a sample of 36 industries from 30 countries, covering the period 1980-1991. They define the size of the industry sector as a specific measure of production technology by integrating the economies of scale and capital- intensity. With various measures of financial development (the ratio of bank assets to deposits to GDP, the ratio of market capitalization to GDP and turnover), the authors show that the financial development of financial market is positively related with excess growth of firms. And small firms grow faster than large in an economy with a more developed financial system. They finds that higher financial development enhances growth in those industries that comprise a higher fraction of small firms.

Another approach to assess the impact of access to finance on the firm growth in the use of firm level survey data, as done by Fishman & love (2003) who use firm-level survey data for over 700 industries across 40 countries over the period 1988 - 1998. The results from the GMM and VI show that industries with greater dependence on trade credit financing exhibit faster rates of growth in countries with low level financial institutions. Furthermore, consistent with barriers to trade credit access among young firms, they show that most of the effect that they report comes from growth in the size of pre-existing firms.

Beck, Demirguc¸ Kunt & Levine (2000), based on a new methodology for their conduct, analysis on a sample of 74 countries over the period 1960-1995. They examine the dynamic relationship between financial structure and economic growth. Using GMM and instrument variables to correct for possible simultaneity biaises. They use the legal origin (Germanic, Anglo-Saxon, Scandinavian and French) as an instrument for financial development. They find that higher levels of financial development lead to higher rates of economic growth, total factor productivity and capital accumulation. Moreover, the authors also find that credit to the private

sector are associated with the quality of the legal environment (rights of creditors, the enforcement of contracts and the reliability of information) and the quality of accounting standards.

Following the work of Levine & Zervos (1998), Beck & Levine (2004) have focused on the relationship between the development of the stock market, the banking sector development and economic growth. They use a sample of 40 developed and developing countries over the period 1976 -1998. The first results show that credit ratio is not significantly correlated with economic growth, while the turnover ratio is significantly correlated with growth. The resultsof ordinary least square highlight a strong positive association between stock market and economic growth and a strong positive association between bank development and growth.

In order to correct the endogeneity problems that exist in the relationship between finance and growth across countries, Loayza & Ranciere (2004) examine empirically the relationship between financial development intermediation and economic growth. They test this relationship for a sample of 75 countries over the period 1960-2004 (annual data) using "Pooled Mean Group (PMG)" of Pesaran& al(1999). The empirical results suggest that financial intermediation as measured by private credit to GDP is positively and significantly correlated with economic growth in the longterm.

Shen & Lee (2006) showed that on a sample of 48 countries between 1976 and 2001, only the stock market has a positive effect on economic growth, however the relationship between the banking sector indicators and the economic growth rate is negative.

Kerr & Nanda (2007) have studied how the entry rate, the distribution of entry sizes, and survival rate for firm respond to changes in banking competition , that is, they investigate how changes in financial markets impact the entry and exit of nonfinancial firms in product markets. Kerr & Nanda (2007) document that branching deregulation in the United States reduce financing constraint, particularly among small startups and improved allocative efficiency across the entire firm size distribution.

The recent studies on the link between Islamic finance and economic growth are limited and are more focused on a single country. With regard to the role of Islamic financial development in economic growth, Furqani & Mulyany (2009) explore the dynamic interaction between Islamic banking and economic growth in Malaysia

employing the VECM. For this purpose they use quarterly data (1997:1-2005:4). Using total Islamic bank financing as proxy to financial development and real GDP per capita, fixed and trade activities to represent the economic growth and activity. The authors show that Islamic finance is positive and significantly correlated with economic growth and accumulation of capital in Malaysia. They find also that fixed investment cause Islamic bank to develop in the short run but in the long run hey show that economic growth cause Islamic banking institution to change and develop. In the same vein, Majid & Kassim (2010) study the relationship between Islamic finance and economic growth in Malaysia. The authors find that, in the contrast to Furqani, H. & R. Mulyany, (2009),the Islamic bank financing cause economic growth.

Recently, Muhamad Abduh, Mohd Azmi Omar (2012) examines the relationships between Islamic banking development and economic growth in Indonesia. Using data gathered from Indonesia over the period (2003:1-2010:4). Furthermore, employing the bound testing approach of cointegration and error correction models, developed within an autoregressive distributed lag (ARDL) framework , they find that Islamic banking development affect positively the economic growth in the in short-run and long-run periods. Which is obviously suggesting a bi-directional relationship?

Finally , we note in passing, recent studies on the some object, Yazdan Gudarzi Farahani, Masood Dastan, (2013), use three different methodologies (Auto Regressive Distributed lag (ARDL),Vector Autoregressive Model (VAR), cointegration, error correction models (ECMs),to assess empirically the relationship between the Islamic banks financing and economic performance. Quarterly data (2000:1-2010:4) for eight countries (Bahrain, UAE, Saudi Arabia, , Kuwait, Qatar, Yemen Malaysia, Indonesia, and Egypt). The empirical result shows that Islamic banks financing is positively and significantly associated with long term economic growth, and capital accumulation. For granger causality analysis, the author find that the relation between economic and Islamic financing development is positive and statistically significantly in the long and short term.

Pejman& al (2014), examines the relation between the Market share of Islamic banks and the development institution intermediation and economic growth in 22 Muslim countries with a dual Banking system during the period 1999-2009. Theresults show a positive relationship between the presence of Islamic banks and

economic growth in countries with a more developed financial sector and greater market share of Islamic banks.

Patrick & al (2015), investigate the dynamic interaction between Islamic banking development and economic growth in the low and middle incomes countries over the period 1990-2010. Using GMM system, the results show that the Islamic banking is positively associated with the economic growth.

Concluding remarks

Overall, past literature has shown that Islamic banking clearly functions as a key engine to economic growth. Some studies established positive statistical significant long run effect of Islamic banking on economic growth.

The results on causality direction have also been mixed. In some studies there has been bidirectional causality between Islamic financial development and economic growth in some economies. Other researchers have identified Statistical Significant Unidirectional causality from economic growth to Islamic banking institution.

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