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Does Islamic Insurance Development Promote Economic Growth? A Panel Data Analysis

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Abstract

This paper examines the impact of Islamic insurance development on economic growth. The Islamic insurance market has been experiencing tremendous growth in its activities since inception, particularly in the ASEAN and GCC markets. Using the difference GMM estimation technique for dynamic panel data model for a set of 22 countries for the period 2004 to 2012, we find a strong evidence of a positive and significant effect from the Islamic insurance activities on economic growth. We further find a robust positive and significant link between trade and economic growth, a positive but insignificant relationship between CPI and economic growth while government consumption show a negative relation. Our result provides further support for the supply-leading hypothesis in the finance growth literature.

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Keywords: Financial Development; Economic Growth; Islamic Insurance

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1. Introduction

The significance and link between financial development and economic growth have in recent years gained considerable attention in the academic setting (see Gregorio & Guidotti, 1995; Khan, 2001; Levine, 1997; Demetriades & Hussein, 1996; Zhang et al., 2012; Greenwood et al., 2013; Bittencourt, 2012; Hassan et al., 2011; Munadaca, 2009; Enisan & Olufisayo, 2009). Going by the bulk of research work conducted in this sphere, 3 main kinds of relationships can be deduced: the supply-leading; demand-following and; the bi-directional relationships.

The supply-leading relationship advocates argue that in order to achieve economic growth, a nation must strive to create financial institutions and instruments, as a result, finance induce and causality runs from financial development to economic growth. Supporters of this theory assert that by directly enhancing savings in the form of financial assets, the size and structure of financial variables bring about a rise in the capital formation and consequently real sector growth (Quartey & Prah 2008).

On the other hand, demand-following hypothesis argues that real sector growth leads to financial development rather than the argument of the supply-leading proponents. To the proponents of this hypothesis, finance does not play a major role in affecting economic growth and that it is only a consequence of growth and development in the real sector of the economy (see Quartey & Prah, 2008; Demirguc-Kunt & Levine, 2008; Ang, 2008). According to them, due to the reaction to increase in demand for financial services resulting from growth in the economy, more institutions offering financial products and services enter the market (Wolde-Rufael 2009). To give credence to their argument, the supporters of this hypothesis cited the lack of financial institutions in the third world economies as a manifestation of a shortage in the demand for the services of these institutions. Thus, as a country experiences growth in its real sector, the financial sector must evolve further with markets becoming more perfect, thereby boosting the freedom for acquiring the liquid assets for financing investment and minimizing risks (Quartey & Prah 2008). To further strengthen the support for the demand-following hypothesis, Shan (2005) maintain that the impressive growth some economies in Asia (for example Japan, China and South Korea) experienced did not in any way follow the establishment of a liberalized and well-functioning financial sector.

Contrasting the 2 hypotheses above, some researchers submit that financial development and economic growth can, and do supplement one another making real economic growth and financial deepening reciprocally causal where a bi-directional causation exists, running from financial development to economic growth (see Blackburn et al., 2005; Blackburn & Hung, 1998; Greenwood & Smith, 1997). To the advocates of this school of thought, financial development is crucial to real sector growth and naturally growth in the real sector needs an efficient and well functioning financial system. Nevertheless, researchers such as De Gregorio & Guidotti (1995) and Ram (1999) disagree that development in the financial sector results in economic growth. This position is shared by Shan & Jianhong (2006) and Shan (2005) stating that the economic crisis that engulfed the Asian market in 1997 further proofed the fact that financial development does not always influence economic growth positively.

To date, there is yet to be a consensus among researchers as regards to the direction of causality between these phenomena because the empirical evidence contained in the literature indicates a support for all the contending hypotheses (see Shan, 2005; Shan & Jianhong, 2005; Levine, 2005; Demirguc-Kunt & Levine, 2008; Ang, 2008; Aspergis et al, 2007).

Evidence from the time-series literature show that the supply-leading theory is applicable only in a small number of the economies studied, as a result, no conclusion can be drawn and generalization of the results is not an easy task (for details, see Arestis and Demetriades, 1997; Shan, 2005; Shan et al., 2001; 2002). Others have even failed to give clear evidence that a relationship even exists (for example Demirguc-Kunt & Levine, 2008; Ang, 2008). Yet other researchers have equally shown that financial development contributes economic growth significantly (see Demirguc-Kunt & Levine, 2008; Ang, 2008). Many others still maintain an absence of any positive, uni-directional causal link originating from the indicators of financial development to the growth of the real sector. Ram (1999) for instance, fail to support any view of a positive influence from financial development to economic growth while De Gregorio & Guidotti (1995) in their study also show a significant negative influence from financial development to economic growth for economies that suffer high inflation, particularly in the Latin America sub-region.

Out of the substantial research conducted in this field, there are no sufficient studies undertaken considering the insurance sector (the bulk is on banking sector and the capital market) and within the framework of Islamic finance. Chen et al. (2012) analyzed the effect of the life insurance market development on economic growth (see also Lee, 2011; Arena, 2008; Haiss & Sumegi, 2008), while Abduh & Omar (2012) considered the development in the Islamic