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Finance-growth nexus and dual-banking systems: Relative importance of Islamic banks

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ABSTRACT

This paper investigates the relative importance of Islamic banks, alongside their conventional counterparts, in relation to banking and financial development and economic welfare. Using a sample of 22 Muslim countries, with dual-banking systems, during the period 1999–2011, this paper reports some significant positive relationship between the market share of Islamic banks and the development of financial intermediation, financial deepening and economic welfare, particularly in low income or predominantly Muslim countries, and countries with a comparatively higher uncertainty avoidance index. Additionally, the results reveal that a greater market share of Islamic banks is associated with higher efficiency of conventional banks.

1. Introduction

Financial systems mitigate information and transaction costs. The core functions of financial markets and institutions are to facilitate savings mobilization, information acquisition and processing, the efficient allocation of funds and to encourage effective corporate governance (Levine, 1997). A well-functioning financial market and efficient financial intermediation can spur capital productivity and foster economic growth (Rousseau and Sylla, 1999; Beck et al., 2000; Christopoulos and Tsionas, 2004; Levine, 2005 among others).

The extant literature discusses the importance of how differently shaped financial systems can affect economic development (e.g. Levine et al., 2000; Beck and Levine, 2004; Merton and Bodie, 2004; Berger et al., 2004). Differences in banking industry structures can also differently impact the economy as a whole. For instance, Berger et al. (2004) study the role of community banks in the economic growth of 49 countries between 1993 and 2000. Their findings suggest that where small, private, domestically-owned banks have larger market shares and higher efficiency, this can boost economic growth. In this paper we study whether the coexistence of Islamic and conventional banking contributes to financial development and economic welfare.

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According to The Banker (2013), Islamic finance is growing at the rate of 15% to 20% per annum. Globally, Islamic banking assets in commercial banks are set to exceed $1.7 trillion in 2013 (Ernst and Young, 2013–2014).

The empirical work in this area has grown accordingly. The extant literature analyzes various features of Islamic banking and finance: investment financing (Aggarwal and Yousef, 2000), securitization (Jobst, 2007), mortgage loans (Ebrahim, 2009), stability (Čihák and Hesse, 2010), relationship banking (Ongena and Şendeniz-Yüncü, 2011), business models (Beck et al., 2013), risk (Abedifar et al., 2013), efficiency (Johnes et al., 2014; Saeed and Izzeldin, 2016), loan default rates (Baele et al., 2014), mutual funds (Abdelsalam et al., 2014) and valuation (Elnahass et al., 2014).[1]

However, there are few studies on the role and relative importance of Islamic banking in the transformation of the banking and finance sectors of respective countries. Using a sample of 20 Muslim countries for the 2000–2005 period, Gheeraert (2014) shows that development of Islamic banking sector boosts the whole banking system. Gheeraert and Weill (2014) claim that the development of Islamic banking improves macroeconomic efficiency. Islamic banking has changed the financial structure of many countries by introducing a dual financial system in which both Islamic and conventional institutions operate. This paper attempts to fill the void by investigating the characteristics of Islamic banking from the finance-growth perspective.

Islamic banks offer financial products and services that are compatible with Islamic doctrine, which allows Muslim individuals and firms with religious concerns to have access to finance or move from an informal to a formal financial system. In short, Islamic banks can mitigate financial exclusion and bring financial services to a wider population. This can also promote better strategies for poverty alleviation (Rajan, 2006).

Changes in market structure may affect banks' performance. In a dual-banking system, Islamic and conventional banks do not merely play a supplementary role to one another, they compete with each other for clients and investors. Whether and how conventional banks are affected by the presence of Islamic banks is an important issue from the policy-making perspective and we examine how the efficiency of conventional banks is affected when they operate alongside Islamic banks.

We focus on commercial banking industries in 22 Muslim countries with dual-banking systems during the 1999–2011 period. Overall, we find that the effect of a dual-banking system (where Islamic banks operate alongside their conventional counterparts) on financial development, economic growth and poverty alleviation depends on the institutional environment. This is examined in our study from three perspectives: religion, wealth and culture. Our results show that a higher market share of medium-size Islamic banks is associated with: greater funding mobilization and credit allocation, economic growth and poverty alleviation in countries with relatively greater proportions of Muslims in their populations; countries with a comparatively higher uncertainty avoidance index; and countries with lower GDP per capita. Our bank-level analyses reveal a positive relationship between the presence of large Islamic banks and the efficiency of conventional banks in predominantly Muslim countries. In more religiously diverse Muslim countries, the efficiency of conventional banks is positively linked to the market share of conventional banks with Islamic window/branches.

The remainder of the paper is organized as follows. Section 2 presents the research motivation and econometric specifications, Section 3 describes our sample of observations, and Section 4 discusses the results. Finally, Section 5 concludes.

2. Research motivation and econometric specifications

2.1. Financial intermediation and economic welfare

We study the relationship between the coexistence of Islamic banks and conventional banks and national financial development in terms of savings mobilization and funds allocation. We also explore the link between the presence of Islamic banks and economic growth, income inequality, and poverty alleviation.

2.1.1. Financial intermediation

Many Muslims do not use traditional financial products and services, because they believe these conflict with their religious beliefs. They may use financial services provided by the informal market.[2] A number of surveys highlight that Muslims prefer *Sharia*-compliant financial products and services. In Algeria, for instance, a study shows that around 20.7% of micro-enterprise owners do not apply for loans primarily due to religious concerns (Frankfurt School of Finance and Management, 2006). In Indonesia, around 49% of the rural population of East Java prefers Islamic finance and believes that interest is prohibited (C.G.A.P., 2008). Honohan (2008) finds that in member countries of the Islamic Development Bank (i.e. all OIC[3]-member countries except Guyana) only 28 percent of the total adult population uses formal or semi-formal financial products and services for deposit and borrowing activities.

Given the relatively low access to financial institutions and products in most Muslim countries (e.g. Honohan, 2008), there is considerable potential for Islamic finance, by moving lenders and borrowers from the informal to formal markets.[4]

[1] For a review of the literature, please refer to Abedifar et al. (2015).

[2] Often known as the curb market.

[3] Organization of Islamic Conference; please refer to http://www.oic-oci.org/oicv2/home/?lan=en.

[4] Some economists believe that curb markets are more efficient in savings and investment intermediation (van Wijnbergen, 1983; Taylor, 1983; Buffie, 1984); however, Fry (1988) argues that informal markets are not necessarily as efficient as formal markets. Chandavarkar (1992) claims that curb markets