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Islamic banking: Good for growth?☆

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ABSTRACT

While a mature body of the economic literature has shown that financial development is broadly conducive to economic growth, the question as to whether this also applies to the development of Islamic banking has not been answered so far. We contribute to the analysis of the relationship between Islamic banking development and economic growth using a sample of 52 countries with data covering the period 1990–2010. The results illustrate that, notwithstanding its relatively small size compared to the economy and the overall size of the financial system, Islamic banking is positively associated with economic growth, even after controlling for various determinants of growth. The main channels of transmission include capital accumulation and improved financial inclusion, in particular a better access to deposits. Many Islamic countries that currently suffer from low growth should develop this segment of their banking sector further, through modernizing the legislative, regulatory, and infrastructural environment for instance. Similarly, non-Islamic countries that adopt some practices from Islamic banking to their banking regulations may help spur growth as well.

1. Introduction

In Islamic countries, many of them poor and not highly developed, large segments of the Muslim population do not have access to adequate banking services—often because devout Muslims are unwilling to put their savings into a traditional financial system that runs counter to their religious principles. Islamic banks seek to provide financial services in a way that is compatible with Islamic teaching, and if Islamic banks can tap that potential Muslim clientele, that could hasten economic development in these countries.

Five decades ago, Islamic banking emerged on a modest scale in the 1960s in Egypt, to fill a gap in a banking system not attuned to the needs of the devout. The expansion of Islamic banking across the globe has been rampant since its birth, particularly over the last two decades. As illustrated by Imam and Kpodar (2013), such expansion has taken place, in particular—though not exclusively—in countries with larger Muslim populations. From an insignificant beginning, the industry has grown to over USD 1.6 trillion in assets in 2012 and is expected to reach USD 6.1 trillion by the end of this decade (Gewal, 2013). This expansion is taking place in various forms. Not only have local banks in Muslim countries adopted Islamic banking principles, but large multinational banks have established Islamic windows. Islamic finance has spread beyond commercial banks and now spans investment banks, insurance companies, and investment (e.g., asset management) and financial companies (e.g., leasing). The development of new products, such as sukuks (Islamic bonds), has also broadened the range of products available.

What are the characteristics differentiating the business operations between Islamic banking and conventional banking? Like conventional banks, they are profit-maximizing entities, acting as intermediaries between savers and investors, and they offer custodial and other services found in traditional banking systems. The constraints facing Islamic banks are, however, different (see Imam and Kpodar, 2013). They are based on prescriptions in Shariah law, which encompasses a set of duties that also apply to commercial transactions, and the hadith—the authentic traditions. The principles emphasize moral and ethical values in all dealings and stipulate that all banking transactions be based on an actual economic transaction. Concretely, there are four major differences. First, all forms of riba (interest paid on loans) are prohibited, on the grounds that interest rates are a form of exploitation, inconsistent with the notion of fairness. In practice, this means that a loan contract is not allowed to fix in advance a positive return on a loan as a reward for waiting. Second, Islamic banking prohibits maysir (games of chance) and gharar (chance). Islamic banking bans speculation, defined as increasing one's wealth by chance rather than productive effort and contracts deemed "gharar," or doubtful or uncertain contracts, such as undertaking a business venture without sufficient information or taking excessive risk. The objective is to ensure that the responsibilities of each

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party to the transaction is clearly specified and agreed upfront, thereby minimizing the possibilities of misunderstanding and conflicts between contracting parties. Concretely, this means that derivative products—a major source of crisis—are not permitted. Third, Islamic banking are subject to a code of conduct that prohibits the financing of haram (illegal) activities, activities deemed to have a negative impact on society (e.g., gambling) or forbidden by Islamic law. Finally, Islamic banks have to redistribute part of their profits to society in the form of "zakat." As justice and equality in opportunity (not outcome) are crucial for a society to function, there exists a mechanism of redistribution income to provide a minimum standard of living for the poor.

The development of Islamic banking is significant, as there is mounting evidence—at least for developing countries—that financial sector development is good for growth (see for instance the seminal paper of Levine et al., 2000; see also Levine, 1997). Although some more recent studies—especially since the global financial crisis—cast doubt on the robustness of the positive relationship between financial development and growth beyond a certain level of financial sector development (see for instance Andersen and Tarp, 2003; Arcand et al., 2015; Panizza, 2014), these results are less ambiguous for developing economies, where these studies still find a positive relationship. This is because a growing financial sector helps mobilize savings, facilitates the allocation of capital to where returns are expected to be highest, monitors the use of capital once invested, and allows for diversification of risk.

Financial development explains economic growth via its influence on resource allocation decisions that fosters productivity growth, rather than just on how it affects capital deepening.[1] Rioja and Valev (2004) find that finance boosts growth in rich countries primarily by speeding-up productivity growth, while finance encourages growth in poorer countries primarily by accelerating capital accumulation (see also Gheeraert and Weill, 2016). Moreover, there is a consensus forming among economists that it does not matter much for economic growth whether the financial system is more bank based (such as is the case with Islamic banking in most countries) or market based (Allen and Gale, 2000; Levine, 2002). The particular institutional arrangements that provide financial services to the economy are not so important; what matters is the level of overall financial development.

However, do these findings of financial sector deepening affecting growth also apply to systems where Islamic banking plays a significant role? Is the development of Islamic banking beneficial to economic growth in other words? This is an important question to answer, as Islamic banking has unique characteristics that differ from conventional banking; they appear better adapted to characteristics prevailing in poorer countries of the Middle East, sub-Saharan Africa, and Asia. In addition, with a few exceptions, countries with large Islamic populations are often Low-income countries (see Fig. 1), which is one of the causes of an underdeveloped financial system (see Nolan, 2005). This paper is not attempting to answer the question of whether the development of Islamic banking would contribute more to financial sector development than conventional banks, an altogether different question. It is simply asking the question of whether Islamic banking is good for growth.

Growth in Islamic countries, while not spectacular, has not been dismal compared to other countries with a similar level of development. The widely held perception is that Islamic countries have performed poorly in economic terms since the 1950s, but this does not hold to scrutiny. After an initial strong growth spurt following independence—in sync with other low-income countries (LICs)—growth rates fell significantly in the 1980s and 1990s. While it is true that Islamic countries and sub-national regions with large Muslim populations are characterized by low incomes and a low level of social development, with the exception of oil-producing Gulf countries, they are in fact not much

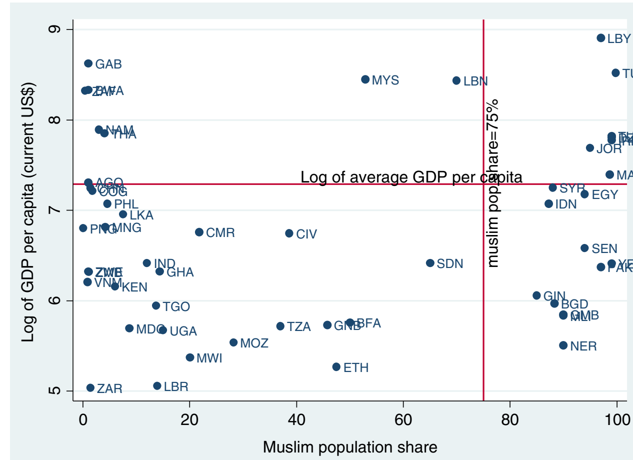

Fig. 1. GDP per capita and Muslim population share (1990–2010). Sources: IMF, Alesina et al. (2003). Note: See Appendix 4 for country names.

different from other emerging markets (EMs) and LICs (Fig. 2). Nolan (2005) stresses that once adjustments for low education levels, poor institutions, commodity prices, etc., are made, evidence is mounting that Islam *per se* is not holding back these countries (see also Pritchett, 2001).

Similarly, Islamic countries do not currently stand out in terms of private sector credit to GDP (Fig. 3). However, as Islamic banking becomes more acceptable to a large swath of the population, it could expand faster, as it would not necessarily be a substitute for conventional banking. It could provide financial products to a part of the population (the "under-banked") that otherwise would not use the financial system, potentially leading to higher financial inclusion and intermediation and an acceleration of economic growth. Currently, while many Muslims use conventional banking services, a large swath of the population—pious individuals who want to adhere to the principles of Islam—are significantly less likely than non-Muslims to own a formal account or save at a formal financial institution after controlling for other individual- and country-level characteristics (Demirguc-Kunt et al., 2014). Similarly, Kumru and Sarntisart (2016) model how in an economy populated with a certain number of religious individuals, the existence of an Islamic banking system can generate higher growth and improve welfare substantially.

Thus, the rapid diffusion of Islamic banking represents a growth opportunity for Islamic countries, as much of the empirical evidence

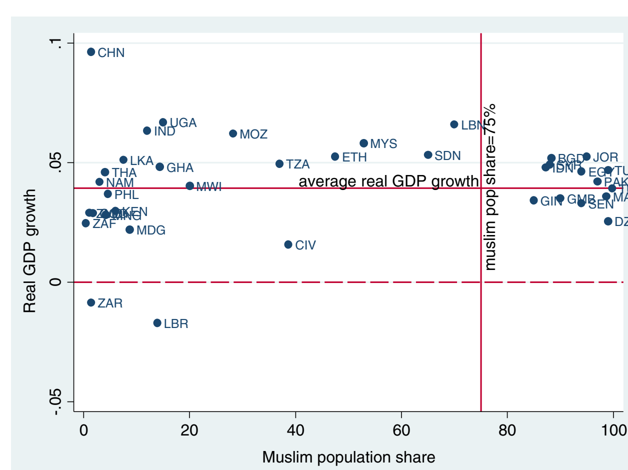

Fig. 2. Average real GDP growth and Muslim population share (1990–2010). Sources: IMF, Alesina et al. (2003). Note: See Appendix 4 for country names.

[1] The growth accounting literature suggests that physical capital accumulation per se does not account for much of long-run economic growth (Jorgenson, 1995).