ISLAMIC FINANCING TOWARDS ECONOMIC GROWTH: A STUDY ON 4 OIC COUNTRIES

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Islamic financing is a new phenomenal and one of the fastest growing component on financial system. The aim of this study is to examine the relationship between Islamic financing and economic growth of 4 OIC countries by using panel data from 1990 to 2012. This study employed panel unit root test and two stages least square (2SLS) as a method. The empirical results show that government expenditure and net export have impact to economic growth. Islamic financing is positive and significantly correlated with economic growth in 4 OIC countries which reinforces the idea that a well-functioning banking system through of financial development will promotes economic growth. This study can be used by the government to take noted in offering more Islamic financing because it's profitable to improve their income and later will increase economic growth.

Keywords: Economic growth; Islamic financing; OIC countries

INTRODUCTION

The financial development assumes the fundamental part in the global financial system. It acts as dynamic participant in channelizing assets from surplus specialist to deficiency agents. However, there are conflicting views from past literatures on concerning the impact of financial development to economic growth (Schumpeter, 1911; Robinson, 1952; Goldsmith, 1969; Mckinnon & Shaw (1973); King & Levine, 1993; De Gregoria & Guidotti, 1995).

Since Schumpeter (1911) explained that the banking sector has been shown as a tool in productive of investment financing, play the role of savings mobilization, encourages innovation and becomes driver on economic growth. Meanwhile, Robinson (1952) noted that economic growth leads on financial development. It also supported by Patrick (1966), who found the speculation of supply leading suggested that in the early phases of increase on financial development induces capital formation. In addition, some previous studies found positive sign and statistically significant the connection between financial development and economic growth (Jayaratne & Strathan, 1996; McCaig & Stengos, 2005). Meanwhile, some previous studies also found a negative effects but significant on relationship between financial development and economic growth (De Gregio & Guidotti, 1995; Akinboade, 2000; Hao, 2006).

On the other sides, the early past studies on financial development and economic growth more concentrate on analysis of cross country (Goldsmith, 1969; King & Levine, 1993; Levine & Zervos, 1998). The results suggested that finance can anticipate for economic growth, however it does not manage causality issues and utilize properties of data for time series. Furthermore, the conclusion analysis of cross country view are sensitive for chose nations, assessment on methods, frequency of data, utilitarian type of the relationship, and the measurement variable of study (Hassan & Bashir, 2003; Khan & Senhadji, 2003; Chuah & Thai, 2004; Al-Awad & Harb, 2005).

Out of the extensive research carried out in this field, there are no sufficient works conducted within the Islamic financial framework. Therefore, the objective of this paper to examine the relationship between the development of Islamic financing system and economic growth, particularly in the context balanced panel data of 4 OIC countries, using panel unit root test based on Levine *et al*., (2002) and two stages least square approach. The paper organized into four parts, first discuss on previous studies on similar issue then provide specification model followed by discussion on findings and concluding remarks.

LITERATURE REVIEW

The relationship between financial development towards economic growth has been debated issues of development economics. From previous studies carried out on this field, at least there are three type of causal relationship between financial development and economic growth:

1. Supply-leading
2. Demand-leading
3. Bi-directional causal relationships

Supply leading is financial development leads to economic growth, meanwhile demand leading is economic growth leads to financial development. Odhiambo (2008) investigated the causal relationship between finance and economic growth in Kenya for a period of 1969-2005. It employed the dynamic tri variate granger causality test and error correction model. He found that there is only one way causality from economic to finance. It indicates that finance plays a minor role in contribute to economic growth. In addition, in 2011 by using the same method to analyse, he found the same result that economic growth causes financial development in South Africa for 1960-2006 period. Therefore, he concluded that the hypothesis of finance causes economic growth does not hold in South Africa.

Gries, Kraft, and Meierrieks (2009) conducted the Hsiao Granger method, the Vector Auto-Regression (VAR), and the Vector Error Correction Model (VECM) for the purpose causal relationship between financial deepening, trade openness and economic growth in 16 Sub-Saharan African countries. The results show to support the hypothesis that finance lead to economic growth. However, it suggests that the adoption of more balanced policy approach in Sub-Saharan countries may diminish financial system. Bangake and Eggoh (2011) investigated by using panel co-integration test, dynamic OLS and panel VECM approach in 71 countries including 18 developing countries from 1960 to 2004. They also support the view of existing bi-directional causality among financial development and economic growth in developing countries.

In addition, Kar, Nazliogu, and Agir (2011), who focused on the Middle East and North Africa (MENA) for the period of 1980 to 2007. They also used a simple linear model. They employed six new indicators of financial development includes the ratio of narrow money to income, ratio of broad money to income, ratio of quasi money to income, ratio of deposit money bank liabilities to income, ratio of domestic credit to income, and ratio of private sector credit to income. Meanwhile, real incomes refer as proxy of economic growth. They also found that there is two-way directional between financial development indicator specific and economic growth.

Furthermore, Hassan, Sanchez and Yu (2011) focused on 168 countries including the low- and middle-income countries from 1980 to 2007. The countries classified by geographic region and VAR model was used as method. This study catch up two important results, there is strong relationship between financial development and economic growth in the long run and bi-directional causality exists between financial development and economic growth among the Sub-Saharan African countries, the East Asian countries, and the Pacific countries. Ghamati and Mehrara (2014) investigated the effect of indicators financial development on economic growth with using panel data in 10 countries during 1997-2007. The result showed that financial development indicator has an important effect on the level of GDP and also other explanatory variables are statistically significant in economic growth.

With regard to the relationship between Islamic financing development and economic growth, Furqani and Mulyany (2009) conducted the relationship between Islamic banking and economic growth in Malaysia from 1997 to 2005. Total Islamic financing, real GDP per capita, fixed investment and trade activities are the data that used and represent as real economic sector. This study also employed co-integration test and VECM model as method. The findings show that Islamic bank financing has positive sign and statistically significant to economic growth and capital accumulation in the long run. Their result seems to support demand hypothesis which is Islamic bank in Malaysia depends on the growth of the GDP. In contrast, the findings from Majid and Kassim (2008) are in favour of the supply-leading view. Goaied and Sassi (2011) investigated by using panel GMM procedure in 16 MENA countries over the period 1962 to 2006 to see the impact of Islamic financing on economic growth. They found that Islamic finance has a weak relation on economic growth but the connection indicates to be positive and supported by theory.

Abduh and Omar (2012) investigated by using ARDL framework for quarterly data in Indonesia from 2003 until 2010 to see the relationship of Islamic finance and economic growth. The results show that there are bidirectional relationship between Islamic finance and economic growth for both in the short run and the long run. Tajgardoon *et al.* (2013) found that there is bidirectional relationship between Islamic banking and economic growth and also bidirectional between economic growth and export in Asia countries over period 1980-2009. Yusof and Bahlous (2013) found that Islamic banking contribute to economic growth both in the long run and the short run for both GCC countries and the selected East Asia (EA) countries. In the short run however, Islamic banking contributes more to economic growth in Malaysia and Indonesia compared to the GCC countries. Tabash and Dhankar (2014) found there is a strong positive association between Islamic banks financing and economic growth in UAE from 1990 to 2010. Besides that, Islamic banks financing has contributed to increase of investment and in attracting

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foreign direct investment in the long term. Therefore, the implementation of Islamic finance with efficient method can enhance growth.

METHODOLOGY AND DATA COLLECTION

To employ the relationship between Islamic financing and economic growth, this study used balanced panel data cover from 1990-2012 in 4 OIC countries. The 4 OIC countries include Jordan, Kuwait, Malaysia and Saudi Arabia. The economic growth as dependent variable measured by the real gross domestic product (GDP) per capita (see Levine, 1997). Financial development can be defined as "improvement in quantity, quality and efficiency of financial intermediary service (Calderon and Liu, 2003)". The indicator of financial development is domestic credit to private sector to GDP, which has positive and linked to economic growth directly (King & Levine, 1993; Kemal, Qayum & Hanif, 2007; Hasan, Sanchez & Yu, 2011). Liquid liabilities measured by liquid liabilities on financial system to GDP (Favara, 2003; Ahlin & Pang, 2008). The impact of liquid liabilities has positive impact to economic growth.

Quasi money measured by broad money supply to GDP (Gilman & Harris, 2004; Noor & Abbas, 2014). It expected has positive relationship with economic growth. Islamic financing measured total financing of Islamic bank to GDP which has positive effect to economic growth (Abduh & Omar, 2012; Tabash & Dhankar, 2014). Net export measured by export minus import (Kim & Lin, 2009; Ristanovic, 2010). Increased on net export will contribute to economic growth. Investment measured by ratio of real gross domestic (public plus private) to GDP (Barro, 2003; Caporale *et al.*, 2009). Increased on investment enhances to economic growth. Government expenditure measured by total government consumption expenditure to GDP (Al-Malkawi et al., 2012; Alkhuzaim, 2014). The effects of government expenditure on economic growth could be either positive or negative. Data cover from 2000-2012 taken from World Bank, International Monetary Fund (IMF) and Islamic Banks and Financial Institutional Information (IBIS).

The panel data stationary is tested through Levine *et al.*, (2002) unit root test. To analyze the hypothesis that economic growth is affected by Islamic financing through financial development, therefore Two Stages Least Square (2SLS) is utilized on stationary data. The following equations are utilized for data analysis through 2SLS:

$$LEG_{it} = \beta_0 + \beta_1(LINV_{it}) + \beta_2(LGOV_{it}) + \beta_3(LNETEXP_{it}) + \beta_4(LFD_{it}) + \varepsilon_t$$
$$LFD_{it} = \beta_0 + \beta_1(LLIQ_{it}) + \beta_2(LQM_{it}) + \beta_3(LIF_{it})$$

Where:

LEG	= Log of economic growth
LINV	= Log of investment
LGOV	= Log of government expenditure
LNETEXP	= Log of net export
LFD	= Log of financial development
LLIQ	= Log of liquid liabilities
LQM	= Log of quasi money
LIF	= Log of Islamic financing

RESULTS AND DISCUSSION

To test the order of integration on the variables, this study utilize the methodology of Pedroni (2004), we begin with stationary test of our panel data. It was mentioned earlier that the stationary test of the panel data is needed in order to avoid the problem of spurious regression. Here, we discuss on the Levine *et al*. (2002), to determine the existence of unit root test in our panel data series can be referred in Table 4.1.

Table 4.1: Panel unit root test based on Levine *et al*. (2002)

Variables	Level	First difference
LFD	-0.72720	-3.50043[a]
LEG	-1.56605[c]	-6.22878[a]
LGOV	3.46144	-6.06561[a]
LINV	0.50143	-6.42149[a]
LLIQ	2.89001	-2.35286[d]
LNETEXP	0.36609	-9.13831[a]
LQM	-1.04115	-8.44331[a]
LIF	-6.11056[c]	25.8768[a]

Notes: [a] stationary based on all other test; [b] stationary based on individual intercept; [c] stationary based on individual intercept and trends, [d] stationary based on none

From table 4.1, it shows that all variables are integrated of order one I (d) and hence the null of unit root test is rejected. As conclusion, we could say that our panel data series are stationary at

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first difference and we can proceed with two stage least square (see Table 4.2).

Table 4.2: Economic growth use Two Stage Least Square (2SLS) in 4 OIC countries

Leg = -6.09(Cons)*** + 0.42(Lfd)*** + 0.59(Lgov)*** + 0.08(Linv) + 0.22 (Lnetexp)***

R-square	= 0.986	F-stat = 1292.18
Adjusted R^2 = 0.9860		Prob = 0.0000

Table 4.2 shows the result for economic growth using two stage least square. It can be seen that financial development as instrumented of Islamic financing, liquid liabilities and quasi money have positive signs and statistically significant at 1%. It means that increased in Islamic financing will contribute to economic growth through financial development (e.g. Abduh & Omar, 2012; Tabash & Dhankar, 2014). Government expenditure and net export have positive signs and statistically significant at 1% level. When 1% increases in government expenditure and net export will increase by coefficients 0.59 and 0.22 respectively on economic growth (e.g. Kim & Lin, 2009; Ristanovic, 2010; Alkhuzaim, 2014).

CONCLUSION

This study examines the relationship of Islamic financing to economic growth through financial development in 4 OIC countries from 1990-2012. The results found all the variables are stationary after first different based on panel unit root test Levine *et al*., (2002) approach therefore two stage least square is utilized. The main findings found that government expenditure and net export have effects of increasing economic growth. It means that two variable is source of economic growth in allocating to the more productive sectors of the economy. Besides that, it proved that Islamic financing has positive impact to economic growth indirectly through financial development. Therefore, Islamic financing can open additional channel of funding from investors to the financial system and improve real sector of economy in OIC countries.

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