Contemporary Survey on the Empirical Literature of Islamic Finance and Economic Growth Relationship

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ABSTRACT

Financial sector activities are part of the main ingredients for the growth of any economy. The financial activities that were most widely practiced are Interest-based conventional financial activities which are prohibited in Islam. Thus, non-interest Islamic financial activities were introduced and it has been accepted and practiced all around the globe. Therefore, this study surveyed, explored and analysed using library review method, the empirical studies conducted on Islamic finance and the economic growth nexus. The study revealed that the majority of the findings of the empirical studies are in support of a positive and significant contribution of Islamic finance to the growth of the real economy in short run and long run, few of the findings indicate an insignificant contribution. The causal relationship between Islamic finance and growth is mostly bi-directional as reported in many of the studies, but supply leading hypothesis also emerged in some of the few studies. It was concluded that Islamic finance is immensely contributing to the growth of the real economy.

KEYWORDS

Causal Relationship, Economic Growth, Islamic Capital Market, Islamic Finance, Islamic Financial Sector/Activities, Long-Run Relationship, Short-Run Relationship, The Islamic Banking Sector

1. INTRODUCTION

Financial activities mobilise funds for investments, which make it very important for the growth and development of an economy. The activities like giving out loans, deposits, exchange of currency and validation of coins, were typically offered in order to pay the flat fee, or when it is investments in order to get profit (Financial services review, 2009). It also serves as an intermediary activities between surplus (depositors) and deficit (borrowers) sides of the economy, with both ends benefiting in order to have an even distribution of wealth for the gain, growth and development of the whole economy. Thus, the kind of benefits or return depositors and the economy gained from borrowers is largely from interest which serves as price of the loans, it is clear rent of money and according to Islamic laws and regulations (Shari’ah) paying or receiving interest is vividly prohibited (Hasnuddeen, 2009).

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The prohibition of Interest was categorically stated in several verses of the holy Quran which include Al Baqarah (2:275-280), Al-i-’Imran (3:130), An-Nisaa (4: 160, 161), Ar-Rum (30:39). This means Muslims are not allowed in any circumstances to participate in modern financial practices. Financial activities in the modern time are necessity, as it is needed for the growth and development of an economy. Therefore, Muslims need to find an alternative, this inspires them to transform Islamic economic ideas into practice and introduced profit and loss sharing financial system tagged “Islamic finance” as an alternative for interest based conventional modern financing. With the introduction of Islamic finance in Muslims world, the expectation is that it will spur and influence the growth of the economy (Chapra, 2000). Generally, there is a need for the study of Islamic finance in the present time, because it is a new addition in the context of finance with the different perception, principles and modes. It became a new phenomenon in the field of finance which needs to be digested so that it is advantages and disadvantages can be known. Islamic finance also lacks general recognition and acceptance especially to the non-Muslim world, with quite number of studies it can be easily understood, and be accepted. Lastly it is contribution to the growth and development of nations economy need to be well spells out through studies.

Islamic finance refers to the means (which includes banks and other lending institutions), by which individuals and corporations in the Muslim and non-Muslim world sources capital and engaging into financial transactions, in accordance with Islamic Shari’ah principles or Islamic law. Even though prohibiting the receipt and payment of interest is the nucleus of the system. It is being reinforced and sustained by other principles of Islamic teachings advocating peoples’ rights and duties, property rights, equitable distribution of wealth, risk-sharing, fulfilment of obligations and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking only but also includes insurance, capital formation, capital markets, and all types of financial intermediation. It suggests that moral and ethical aspects in the regulatory framework are also necessary for addition to prudent and sound controls. It is also an exclusive system of socially responsible investment (Ross, 2018).

The main principles of Islamic finance are its devotion to interest-free financial transactions through profit and loss sharing, partaking financing, and also sharing of risk, others include prohibition of fixed return on investment, prohibition of uncertainty (gharar), gambling, lottery, betting and also speculation. Islamic finance viewed money not have any intrinsic value in itself; it’s not an asset but measure of value and medium of exchange. It strongly encouraged equity-based financing (Chapra 2000). Based on these aforementioned principles, Islamic financial contracts are designed to expedite financial contracts and financing within Islamic values and norms. Those agreements and contracts are: Murabahah (cost plus), Mudarabah (venture capital type partaking financing), Musharakah (participatory partnership financing), Ijarah (leasing), Bay-Salam (forward transaction financing), Bay-Isitsna (pre-ordered production financing), and Sukuk (asset based Islamic bonds). Islamic financial institutions are now developing and also developed other hybrid financial contracts based on these principles and modes (Gabriella, 2012). Islamic finance like that of conventional finance can spur or influence economic growth through the channel of financial intermediation using its model of profit and loss sharing as well as its instruments and contracts. The models and instruments channeled funds from surplus side to deficit side of an economy which enhances investments and hence achieve economic growth.

Islamic finance brings about a variety choice in financial contracts and mode of financing. It may increase the growth of GDP by improving finances for trades and other economic activities, and encourages more saving and lessen hoarding. This contributes to capital accumulation and saving mobilisation processes. Furthermore, Islamic finance provides employment, improves both manufacturing and agricultural sectors as well as caters for households’ basic needs (Anwar, 1991). Moreover, Islamic finance priority is investments on Shari’ah permissible productions, through the instruments of musharakah, mudarabah and murabaha. This will increase the levels of output within the economy as well as creating more jobs. (Al-Sarraf, 1993).
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