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Islamic Banking Financing Effect on Growth

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Islamic Banking Financing Effect on Growth

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Abstract

The study is an attempt to explore the transmission channel through which development in Islamic banking could lead to economic growth. In order to determinethis transmission mechanism, the estimation based Vector Error Correction model (VECM) is used. This study has tested *Murabaha*, *Ijarah* and Diminishing *Musharaka* as proposed Islamic financial products because of their majority share in Islamic financing. This study has tested two co-integrated systems in the VECM model. The first system tests the effect of an increase in financing in Islamic banking products on the net financing of Islamic banks and the second system tests the effect of net financing of Islamic banks on economic growth. The results indicate that the financing done by Islamic banking products positively affects economic growth in Pakistan. Also, the net financing of Islamic banks is significantly based on financing in Ijarah and Murabaha. Hence, this study highlights the growth potential of Islamic banking which is gaining shares in the overall banking system of Pakistan.

Keywords: Islamic banking, economic growth, Islamic banking products.

Introduction

After the revival of global financial system since the global financial crises, economies especially Islamic economies have turned their attention towards equitable and stable substitutes of the current form of financing. Since then, Islamic finance has experienced an increasing rate of acceptance in Muslim as well as non-Muslim world. This asset based Islamic finance industry has reached the size of US$ 2 trillion and spans across more than 50 economies (Islamic Banking Bulletin, 2016).

Evidently, there has been a high level of progress of Islamic banks in Pakistan during the last one and a half decade. Islamic banking sector in Pakistan holds

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about 11.4 percent share in banking assets and about 13.2 percent share in total banking deposits and this share is increasing at a rapid pace. State Bank of Pakistan (SBP) is leading the industry from the front in terms of research, development and innovation. SBP is among the few regulators in Pakistan who have strategically introduced a comprehensive legal, regulatory, and *Shariah* compliance framework for the promotion of Islamic banking industry (Islamic banking bulletin, 2016).

The increasing number of banks, investment, and financing represent the importance of Islamic banks in the respective economies (Imam & Kangni, 2010; Thomson Reuters Zawya, 2017). It has been shown by (Imam, 2010) that Islamic banking is becoming competitive and has complicated business ventures in the Middle East, North Africa, and South East Asia region. New regions are accepting the concept of Islamic banking such as Sub-Saharan Africa, Central Asia, and Western Europe. It is evident by the fact that London is hoping to be a hub of Islamic banking and finance in future (Malik, Malik & Shah, 2010). Several indexing agencies are developing Islamic market development indices (like Dow Jones) which may help in attracting investments in near future (PwC, 2013).

Islamic finance industry in Pakistan, like many other countries, has not been successful in including Small and Medium Enterprises (SMEs), poor households and businesses (Microfinance), the agriculture sector and low-cost housing. In order to increase their contribution for the welfare of society, Islamic banks must move forward and incorporate the above mentioned sectors while offering their services. Proper persuasion and facilities from different regulating stakeholders is required to push the Islamic banking industry to reach out to SMEs and agriculture. Indeed, such efforts are already in motion by SBP via second Strategic Plan for Islamic Banking Industry 2014. Furthermore, the Centers of Excellence initiative by SBP is aimed to include the academics into these efforts.

Extensive research work has been carried out in assessing the relationship between the financial sector and growth (Gurley & Shaw, 1955; McKinnon, 1973; Santomero, 1984; Levine, 1997). Still, research in the Islamic banking framework remains insufficient. The study of the impact of Islamic banking on development and growth is necessary to iterate the importance of the foundation on which Islamic banking is built. All in all, Islamic banking based on asset backed framework has what it takes for the banking sector to foster growth in the real sector. The ability to promote equity, sharing of risk and restoring justice are the reasons which merit Islamic banking to become partner in eradicating poverty and forming equality (Usmani, 2002).

There are few studies available on the role of Islamic banking on growth (Khan, 2007; Kalim, Mushtaq, & Arshed, 2016), but these studies have failed to

explain the channel through which Islamic banking influences growth. The current study is distinctive in terms of exploring the short and long run relationshipsbetweenthe development of Islamicfinance, its different products and economicgrowth, particularly in Pakistan. For analysis, we have used the vector form of Error Correction Models (ECMs) to estimate long run and short run coefficients. There are two competing models that have been developed for estimation. The first is the Auto Regressive Distributed Lag (ARDL) structure by Pesaran and Shin (1995), Pesaranet al. (1996) and Narayan (2004) which is used to explore single equilibrium models. The second is the Vector Error Correction model developed by Johansen and Juselius (1992), which is suitable when there are more than one equilibrium.

The current study aims to fill the research gapregarding the role of Islamic banking products and economic growth in Pakistan. In this study, the transmission mechanism has been devised to indicate the effects of Islamic financial instruments on the growth of the economy. The causality of economic growth and Islamic finance in Pakistan has not been analyzed. Therefore, the study examines the impact of net financing of Islamic banks, Gross Fixed Capital Formation and Islamic banking products on economic growth. The data for Gross Domestic Product (GDP) and Gross Fixed Capital Formation (GFCF) is taken from World Economic Indicators. For Islamic net financing and Islamic banking products, data is taken from the State Bank of Pakistan for the time period 2007-2015 (quarterly data). We have used the appropriate estimation model based on the unit root test results using Augmented Dickey-Fuller test. To analyze the causality we have used Vector Auto Regression (VAR) Granger causality test.

Research questions which this study intends to investigate are mentioned below.

1. Does net financing of Islamic banks cause the growth of the economy?

2. Do Islamic financial instruments cause the growth of the economy?

2. Literature Review

Economic growth is defined as the persistent enlargement of the potentials of production. Gross Domestic Product (GDP) increment is used to measure these production potentials over a prescribed period of time. When GDP of a single person grows at a faster rate than the population growth rate, the living standard of the country improves which ultimately translates into the economic growth of the nation. This growth is different in different frugalities due to increased globalization and antagonism (Riley, 2012).

Many studies have confirmed the theory that the improvement and expansion of banking industry has favourable effects on the economic growth of a country. This is because banks tend to mobilize savings, increase resource allowance

efficiency and also tend to encourage innovation in technology. Apart from these clear facts and theories, financial liberalization policies often fail to enhance the development of the financial sector and economic growth. These outcomes are the shortcomings of the studies which identify the strong relationship of financial development with that of economic growth (Goaied & Sassi, 2010).

The theory related to Islamic banking is centered on the notion of interest-free banking, which has been forbidden in Islam. Islam has given the exact guidelines related to the banking structure and functioning. The core norm of the banking system, based on Islamic teachings, follows the trade and profit stratagem while interest is forbidden (Farahani et al., 2012).

Cihák and Hesse (2008) applied z-scores analysis and demonstrated that Islamic banking structure is stronger financially and less precarious as compared to the conventional structure of banks. The conventional structure contains some imperfections, such as the equity capital gets downgraded due to the depreciation of assets caused by external shocks. Moreover, the depositors of such banks contain securities of fixed value. On the other hand, the depositors of Islamic bank accounts do not enjoy the securities of fixed value. The depositors instead share the risk factor automatically in a macroeconomic scenario or even bank-specific crunches. In the situation of asset reduction, this structure of Islamic bank allows liquid adjustment.

Goaied and Sassi (2010) worked on Middle East and North Africa (MENA) region including 16 frugalities. Their study was empirical and based on panel data that was relatively unbalanced. Generalized Method of Moments (GMM) estimation technique was used in the study of dynamic panel data. The pragmatic results identified a non-significant association between growth and Islamic system of banking, which ultimately strengthens the concept of zero contribution of banks in economic growth. Furthermore, the results also revealed a noteworthy negative relation of bank indicators with that of growth factors for some stipulations. It was also notified that Islamic banks were not exceptional in financial markets and were weakly correlated with economic growth but somehow these banks acted positively when demonstrated theoretically. Finally, the study verified a heterogeneous relationship of two specific factors across MENA countries. It elaborated a positive but non-significant relationship in oil producing MENA countries and a negative relationship in MENA countries that tend to import petroleum.

Abdullah and Omar (2012) targeted the Indonesian economy for the causality relationship between growth dynamic and development of Islamic financial sector. The approach used for the specific purpose was bound testing co-integration approach as well as ECM (Error Correlation Model). These were developed under the framework of ARDL (Auto Regressive Distributed Lag). The

outcomes of the study confirmed a noteworthy association in short as well as long run between the dynamics of growth and development of Islamic finance. However, the relationship was not unidirectional as stated by Schumpeter based on supply-leading and by Robinson based on demand-following theory. Instead, the relationship appeared to be bidirectional. In such a scenario, Indonesian Islamic banks provide domestic finance that tends to contribute in the growth of the nations' economy. At the same time, growth makes a sound contribution towards the development of Islamic system of financing in Indonesia. These results are similar to another study conducted by Abdullah and Chowdhury (2012). They focused on the Bangladeshi economy in order to test the direct association between growth dynamic and total financing as well as the deposit structure of the banking sector operating in Islamic setups. Time series data covering the time span ranging from Q1:2004 to Q2:2011 was used in this research. The outcomes of the study revealed the positive association of the two dynamics in the long run and the relationship between them also appeared to be bidirectional.

Imam and Kapodar (2015) studied low and middle income countries to investigate the link between the development of Islamic banking and economic growth over the period 1990-2010. The authors showed that even though the share of Islamic banking is small as compared to the overall banking system, still the asset based structure is able to show positive effects on economic growth while controlling for other factors such as financial depth of the economy. The authors also ensured that the results are robust across different specifications, sample composition and time periods.

Kalim et al. (2016) found a supply-side relation in Islamic banking and economic growth. The findings of the study concluded that there is a long run co-integration among the variables. The study found evidence that in the long-run, Islamic financial investment is positively and significantly correlated with economic growth and capital accumulation in Pakistan.

Moreover, there are several studies which have emphasized the role of Islamic banking in growth but these studies have failed to construct the structure which can explain the channel adopted by the Islamic banking and finance to influence the growth of the country.

3. Methodology

3.1. Research Model

The graphical representation of the research model which indicates the proposed channel of Islamic financial instruments to economic growth is shown below. In the first stage, the investment in the instruments leads to an overall increase in the net financing of the bank, its coefficient identifies the average share of the

particular instrument as compared to the total net financing. This net financing, in the second stage, tends to explain the economic growth of the country.
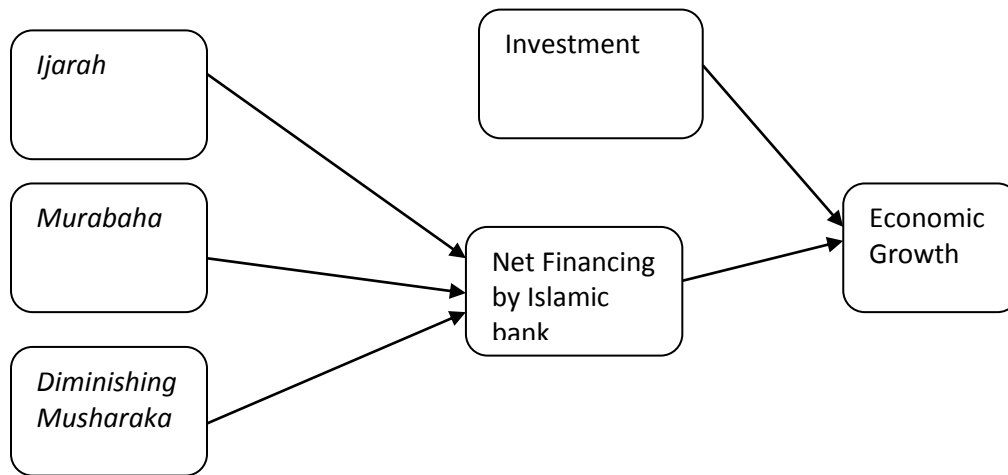

Figure 1. Theoretical Model

The functional specification form of the model is as follows,

GDP = f (Investment, Net Financing)

Net Financing = f (*Ijarah*, *Murabaha*, Diminishing *Musharaka*)

Since there are two equilibriums simultaneously existing in the economy, hence, with the confirmation that all the variables are I (1) in nature, this study will estimate this model with the help of Vector Error Correction Model (VECM).

3.2. Data Description

The data was sampled for the time period spanning from 2007Q1 to 2015Q4. SBP provided the quarterly data, while the data of GDP and investment was transformed into quarterly data using quadratic approximation in E views.

Table 1
Data and Sources

Symbol	Name	Source
GDP	Gross Domestic Product (Constant US$)	World Development Indicators
Investment	Gross Fixed Capital Formation (% of GDP)	World Development Indicators

Net Financing	Net Investment using Islamic Financing Principles	State Bank of Pakistan
Ijarah	Total financing of *Ijarah* product	State Bank of Pakistan
Murabaha	Total financing of *Murabaha* product	State Bank of Pakistan
Diminishing *Musharaka*	Total financing of Diminishing *Musharaka* product	State Bank of Pakistan

4. Estimation

4.1.Unit root tests

Table 2 presents the unit root test results on the level and at first difference. For this study, Augmented Dickey Fuller Test (ADF) proposed by (Dickey & Fuller, 1981) is used. The null hypothesis of this test is that the series is non-stationary at the level and the alternative hypothesis is that the series is stationary at the level. In table 2, the ADF test on level variables indicates the acceptance of null hypothesis while the test on first difference specification indicates acceptance of the alternative hypothesis. This means that all the proposed variables in the model are stationary at first difference.

Table 2
Unit Root Tests

Variable	Test (prob.)	Variable	Test (prob.)	Decision
GDP	-2.33 (0.16)	ΔGDP	-2.96 (0.04)*	I(1)
GFCF	-0.12 (0.94)	ΔGFCF	-4.09 (0.00)*	I(1)
Net Fin	-2.60 (0.10)	ΔNet Fin	-5.47 (0.00)*	I(1)
Murabaha	0.87 (0.99)	Δ*Murabaha*	-9.88 (0.00)*	I(1)
Ijarah	-2.57 (0.11)	Δ*Ijarah*	-8.71 (0.00)*	I(1)
Demin Mush.	-3.10 (0.12)	ΔDemin Mush.	-6.76 (0.00)*	I(1)

* Significant at 5%. Sources of data provided in Table 1, results calculated using
E views

4.2. Model Estimation

Since all the variables are integrated at the same level, hence this study will use the (Johansen & Juselius, 1992) model named as Vector Error Correction Model. In the first step, this study will find the optimal lag order specification to be used in ARDL model.

4.2.1. Lag Length Criterion. Lag length criterion estimates the VAR (Vector Auto Regressive) model using 0 lags up to 4 lags and criteria like (Akike, 1969; Schwartz, 1978) can be used for decision. Results shown in table 3indicate that the majority of the criteria are indicating upto4 lag specification of variables which is optimal.

Table 3
Lag Length Criteria

Lag	LL	LR	FPE	AIC	SIC	HQ
0	-104.98	N.A.	2.7e-06	6.52	6.80	6.62
1	111.15	343.27	7.1e-10	-4.07	-2.18*	-3.42
2	171.23	74.21*	2.1e-10	-5.48	-1.98	-4.29
3	212.28	36.22	2.9e-10	-5.78	-0.66	-4.03
4	288.86	40.54	1.3e-10	8.17*	-1.43	-5.87*

*indicates lag order selected by the criterion

LR: Sequential Modified Likelihood ratio statistic at 5%

FPE: Final Prediction Error

AIC: Akaike Information Criterion

SIC: Schwarz Information Criterion

HQ: Hannan-Quinn Information Criterion

4.2.2. Rank Co-integration Test. Since the optimal lag order has been identified, co-integration test using maximum eigenvalue and trace statistics is calculated. In VECM model, this test is called determination of the rank of co-integration matrix test. Both of these co-integration tests shown in table4below at 5% level of significance are forming two equilibriums (rank = 2). This means that all the variables are inter-related to each other and there are at the most two endogenous variables in the model while others are exogeneous variables. Hence, while constructing the VECM model, this study will try to identify two long run models similar to the model proposed in figure 1.

Table 4
Co-integration Test

Unrestricted Co integration Rank Test (Trace & Max-Eigen Value)					
Hypothesized No of CE (s)	Eigen Value	Trace statistic	Prob**	Max-Eigen Statistic	Prob**
None*	0.82	165.54	0.00	58.07	0.00
At most 1*	0.74	107.57	0.00	45.82	0.00
At most 2	0.51	62.65	0.07	24.14	0.33
At most 3	0.42	37.51	0.16	18.33	0.35
At most 4	0.31	19.17	0.27	12.73	0.35
At most 5	0.13	6.44	0.21	6.44	0.41

Trace and Max-Eigen Value test indicates 2 co-integrating eqn. (2) at 0.05 level

*denotes rejection of hypothesis at 0.06 level

**McKinnon-Haug-Michelis (1999) p-values

The sources of data are mentioned in table 1, results are calculated using E Views

4.2.3. Estimation of VECM model. VECM model is the vector form of ECM (error correction model) which allows short run endogeneity, such that in this model there is only one dependent variable in the long run if rank = 1, and there are "n" short run dependent variables which are equal to the number of variables in the model. Since we have identified rank = 2, so we will try to identify two dependent variables in long run and six dependent variables in short run.

The table of coefficients (in table 5) shows that in the first equilibrium[4] in column 2, the dependent variable is GDP and both independent variables, that is, investment (GFCF) and net financing positively affect the GDP in long run at 10% level of significance. In the second equilibrium[5], the dependent variable is the net financing of Islamic banks. Here, we can see that only *Ijarah* and *Murabaha* have a significant effect on the net financing of Islamic banks.

Since there are two equilibriums formed, so in short run, there must be two convergence coefficients showing the magnitude of convergence in equilibrium 1 (where GDP is dependent) and equilibrium 2 (where Net Fin is dependent). The convergence coefficients (i.e. error correction) provided in table 5 are negative between -1 and 0 (Chiang & Wainwright, 2005) and statistically significant indicating that both equilibriums form converging relationship. Hence, this model can be used by policy makers to apply intervention on GDP and net financing independent variables as policy instruments.

Table 5
Long run Coefficients and Convergence Coefficient

Variable	Coefficient (T value)	Coefficient (T value)
	Long Run Coefficients	
GDP	Dependent variable	
GFCF	0.40 (5.27)	
Net Fin	0.04 (1.50)	Dependent variable
Ijarah		-0.08 (-9.89)
Murabaha		0.03 (4.10)
Demin Mush.		0.002 (0.15)

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[4] GDP = f (GFCF, Net Fin)

[5] Net Fin = f (*Ijarah, Murabaha*, Demin *Mush*)

Short Run coefficients		
Error Correction	-0.03 (-2.94)	-0.20 (-1.95)
R squared	0.61	0.32

4.2.4. Autocorrelation test. Lagrange Multiplier (LM) test was used (in table 6) on the residuals of VECM model to identify the presence of serial correlation in the model. LM test was done using lag order 1 and 2, and for both cases, the probability value is greater than 0.05. This indicates that the null hypothesis is accepted and there is no evidence of autocorrelation in the model.

Table 6
VEC Residual Serial Correlation LM Test

Null Hypothesis: no serial correlation at lag order h		
Included observations: 34		
Lags	LM-Stat	Prob
1	39.54221	0.3147
2	39.96846	0.2982

4.2.5. Heteroskedasticity test. After the estimation of VECM, heteroskedasticity test was applied (in table 7) to check if the variance of the model is constant. Below, the chi-square test is applied with the null hypothesis that there is no heteroscedasticity. The prob. value is greater than 0.05, which shows that there is no evidence of the presence of heteroskedasticity in the model. So, the estimation model is efficient.

Table 7
VEC Residual Heteroskedasticity Tests: No Cross Terms

Joint test: (Included observations: 34)		
Chi-sq	Df	Prob.
340.4349	336	0.4223

4.3. Impulse Response Functions

Impulse response functions are formed to check that if there is one unit change in the independent variable, then how the dependent variable will evolve. Below chart (figure 2) shows graphs for dependent variables, that is, GDP and net financing. This chart plots a 1% policy change in the independent variable to see how this leads to change in the dependent variable. These time plots show the evolution of the dependent variable for each policy change. Here, we can see that an increase in one unit of investment, net financing, and *Ijarah* raises the economic growth of the country while an increase in *Murabaha* leads to an increase in the net financing of Islamic banks in the economy.

4.3.1. Variance Decomposition Test. Variance decomposition test decomposes the change in the dependent variable into 100 units and then identifies the number of units accounted for by the respective independent variables. In the following table 8, we can see that after 10 quarters, there have been 30 units of change in GDP in which 13.5 units are accounted for by net financing while only 9 units are accounted for by investment (GFCF). It means that net financing has a higher potency in longer term to cause change in GDP. Moreover, an increase in investment in the economy do account for change in net financing of Islamic banks since banks play their role as intermediary in investments in the economy.
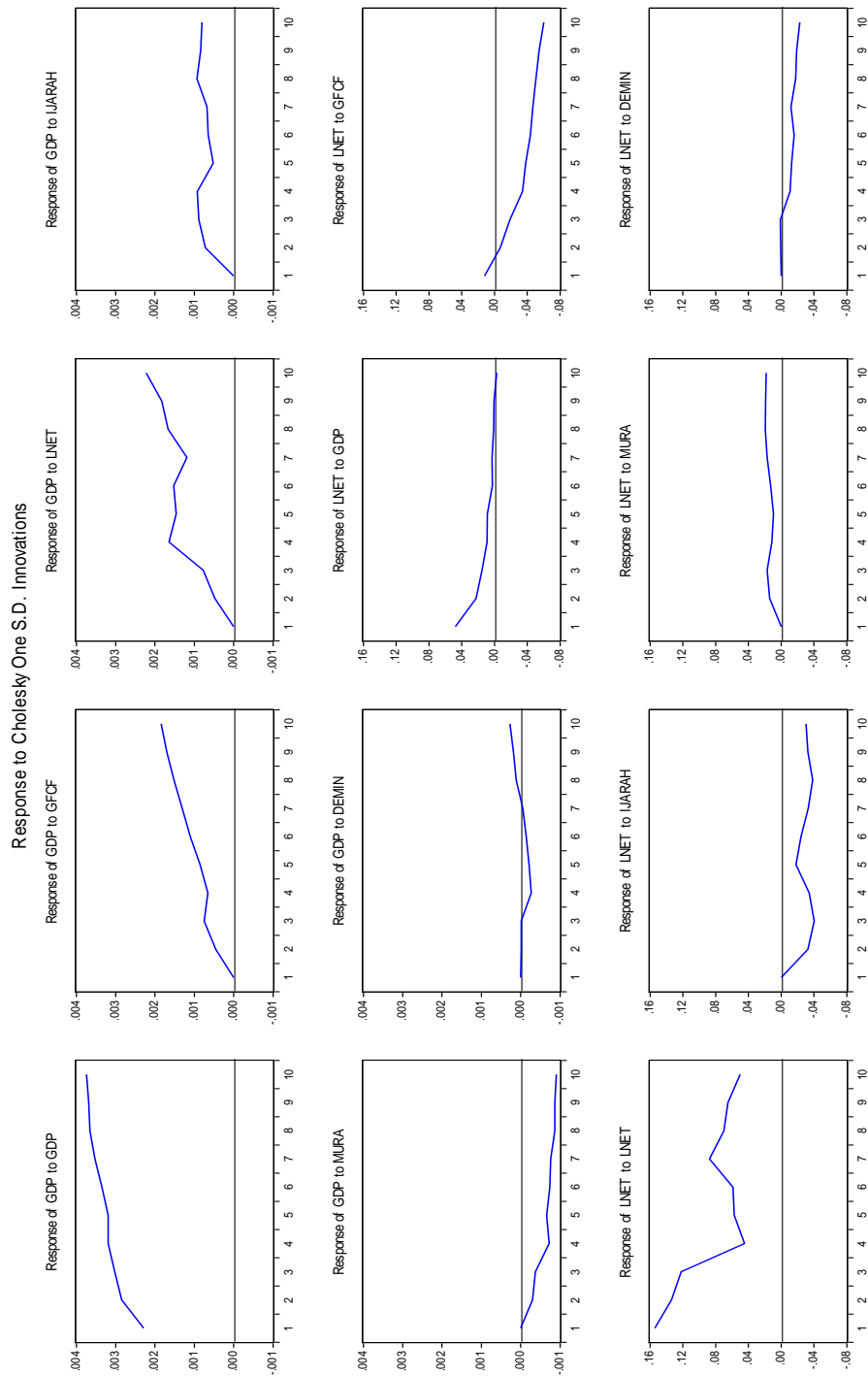
Figure 1

Table 8

Variance Decomposition of GDP

Period	S.E.	GDP	GFCF	LNET	IJARAH	MURA	DEMIN
1	0.002290	100.0000	0.000000	0.000000	0.000000	0.000000	0.000000
2	0.003795	92.73786	1.448622	1.575509	3.594891	0.641575	0.001540
3	0.005062	87.79846	3.007208	3.218659	5.068865	0.904634	0.002172
4	0.006354	80.90355	2.978789	8.723939	5.344690	1.867945	0.181091
5	0.007359	79.09990	3.566720	10.42630	4.485245	2.202543	0.219301
6	0.008360	77.33476	4.496584	11.41664	4.069261	2.484855	0.197897
7	0.009300	76.85331	5.611212	10.86792	3.817322	2.686410	0.163828
8	0.010322	74.89515	6.719540	11.44002	3.911577	2.888835	0.144885
9	0.011305	73.04652	7.851812	12.14583	3.807108	3.001489	0.147238
10	0.012317	70.76690	8.860082	13.49191	3.638820	3.070928	0.171362
			Variance Decomposition of LNET:				
Period	S.E.	GDP	GFCF	LNET	IJARAH	MURA	DEMIN
1	0.015112	8.693389	0.548384	90.75823	0.000000	0.000000	0.000000
2	0.024394	6.056561	0.424536	90.73870	2.358305	0.420884	0.001011
3	0.031868	4.749388	0.878060	89.32057	4.285349	0.764801	0.001836
4	0.038232	4.546416	2.565086	86.08319	5.730616	0.894121	0.180573
5	0.043680	4.314514	4.351842	84.22145	5.767559	0.949980	0.394652
6	0.049106	3.976205	6.425845	81.79398	6.043830	1.086173	0.673967
7	0.054521	3.488734	8.029991	79.98325	6.489248	1.263846	0.744931
8	0.059455	3.156541	9.829825	77.19154	7.327369	1.512039	0.982690
9	0.063891	2.897817	11.74659	74.69782	7.710350	1.714320	1.233102
10	0.067989	2.709344	14.03585	71.78680	7.985020	1.884629	1.598353

4.3.2. Granger Causality Test. Following table 9 shows the results of VAR Granger Causality test which checksthe overall long run and short run effect of the variables on each other. According to these test results, all the variables granger causing change in GDP and investment level in the economy.

Table 9

VAR Granger Causality/Block Exogeneity Wald Tests

Included observations: 36

Dependent variable: GDP

Excluded	Chi-sq	Df	Prob.
GFCF	7.587278	2	0.0225
LNET	1.004573	2	0.6051
IJARAH	4.033346	2	0.1331

MURA	0.128306	2	0.9379
DEMIN	10.48365	2	0.0053
All	21.42155	10	0.0183

Dependent variable: GFCF

Excluded	Chi-sq	df	Prob.
GDP	36.75995	2	0.0000
LNET	0.095804	2	0.9532
IJARAH	0.805519	2	0.6685
MURA	2.142870	2	0.3425
DEMIN	17.05105	2	0.0002
All	47.05950	10	0.0000

Dependent variable: LNET

Excluded	Chi-sq	df	Prob.
GDP	0.837214	2	0.6580
GFCF	0.329836	2	0.8480
IJARAH	1.159508	2	0.5600
MURA	2.373613	2	0.3052
DEMIN	0.717810	2	0.6984
All	7.198797	10	0.7066

Dependent variable: *IJARAH*

Excluded	Chi-sq	df	Prob.
GDP	2.021937	2	0.3639
GFCF	0.717530	2	0.6985
LNET	1.010127	2	0.6035
MURA	2.290059	2	0.3182
DEMIN	1.942423	2	0.3786
All	6.801217	10	0.7441

Dependent variable: MURA

Excluded	Chi-sq	df	Prob.

GDP	2.246295	2	0.3253
GFCF	15.49112	2	0.0004
LNET	2.893192	2	0.2354
IJARAH	3.135969	2	0.2085
DEMIN	2.991452	2	0.2241
All	38.86227	10	0.0000

Dependent variable: DEMIN

Excluded	Chi-sq	df	Prob.
GDP	1.476071	2	0.4781
GFCF	4.704377	2	0.0952
LNET	1.956543	2	0.3760
IJARAH	3.735035	2	0.1545
MURA	3.235274	2	0.1984
All	16.46488	10	0.0871

5. Conclusion and Policy Implications

The current study examined the channel through which investment in Islamic banking products influences the economic growth of the country. In the first stage, investment in the instruments leads to an overall increase in net financing of banks, its coefficient identifies the average share of the particular instrument as compared to the total net financing. This net financing in the second stage tends to explain the economic growth of the country. The variables in the model were found stationary at level 1, that is, I (1). Since all the variables were integrated at the same level, hence (Johansen & Juselius, 1992) Vector Error Correction Model was used. It was found that both independent variables, investment (GFCF) and net financing, positively affect GDP in long run at 10% level of significance. In the second equilibrium, the dependent variable was the net financing of Islamic banks. It was found that only *Ijarah* and *Murabaha* have a significant effect on the net financing of Islamic banks. The presence of co-integration and convergence specify that policymakers can use the independentvariables as a policy instrument to control the dependent variable to achieve certain targets like high growth. Variance decomposition test exhibits that net financing has a higher potency in the longer term to cause change in GDP. While an increase in investment in the economy do account for the change in net financing of Islamic banks since banks play their role as intermediary in the investments in the

economy. According to VAR Granger Causality test, all the variables granger causing change in GDP and investment level in the economy.

Despite the growth in the participatorymode of financing, Islamic banking still represents a relatively small share of the economy and of the overall size of the financial system. This is because of increasing interest in Islamic banking, conventional banking system is pitching in with Islamic windows. Since this study does not build any comparison between the conventional and Islamic banking systems, it cannot confirm if Islamic banks outperform conventional banks in proposed specification; it does, however, establish its positive impact and a channel which impacts growth. As indicated by this study and several previous studies, there are uncertainties about the magnitude of the growth effect of Islamic banking, which calls for further research from time to time as the size and complexity of Islamic banks increase. As an initial step proposed in a study by IMF, it is essential to develop proper legislation and regulation, as well as supporting infrastructure (Imam & Kapodar, 2015), in order to integrate Islamic banking with the public and private economic activities.

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