Islamic vs. Conventional Finance: Insights and Implications for Economic Growth

Abstract

Purpose – This research aims to examine the effects of both conventional and Islamic financing on economic growth in five developing economies, namely, Saudi Arabia, Bangladesh, Malaysia, Pakistan, and the United Arab Emirates.

Design/Methodology/Approach – This empirical study includes quarterly data from Q4 of 2013 through Q4 of 2020. The methodologies employed for empirical analysis are fixed-effects two-stage least squares (2SLS) and fixed-effects ordinary least squares (OLS). To address the problem of endogeneity in the model, the 2SLS method was applied in addition to OLS.

Findings – The results of the study indicate that Islamic finance surpasses traditional finance in accelerating economic growth, due to its more realistic and risk-sharing approach. Other factors that contribute to economic growth include investment, trade openness, and human capital. However, Inflation and foreign direct investment are revealed to have detrimental effects on economic growth in the sample countries.

Practical Implications - For private businesses and government institutions, this research will help better understand the role and scope of the two financial systems namely conventiaonl and Islamic. It examines the available financing options and their respectivev effects on economic growth, stability, and resource allocation.

Originality/Value – Previous studies on this subject are either single-country analyses or few with panel data to discuss the relationship between Islamic finance and economic growth. This panel data study simultaneously discusses the effect of both Islamic and conventional finance on economic growth.

Keywords: Conventional finance, economic growth, Islamic finance