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

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Abstract

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. 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. 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. 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. 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

JEL Codes: G20, G21, G24, O43

Introduction

Economic growth is a key indicator of a nation's economic well-being and is associated with increased employment opportunities and better living

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standards (Saymeh & Orabi, 2013). This encourages businesses to increase their investments and hire more employees (Khan & Chaudhry, 2019; Khan & Bhatti, 2008). A key factor in economic growth is the financial sector. Financial sector development is crucial for technology and innovation, and leads to an increase in investment funds that drive economic growth (Goldsmith, 1969). The financial sector helps businesses speed up cash flows and promotes savings through an efficient and secure payment system. Several studies, including Abduh and Omar (2012), Zarrouk et al. (2017), and Ledhem and Mekidiche (2022), have explored the role of the financial sector in the economic growth of different countries.

In the 20th century, the formal notion of Islamic banking emerged. Islamic *Shariáh*-compliant financial operations are the foundation of Islamic finance. Unlike its traditional equivalents, it is founded on Islamic *Shariáh*, the Quran, and the Sunnah, which comprises the verdicts of the Quran, and deeds of the Prophet Muhammad (PBUH). The impermissibility of *riba* (usury), *maysir* (gambling), and *gharar* (uncertainty) form the basis of Islamic banking principles and procedures. Partnership and lease agreements serve as the foundation for financing in Islamic finance (Ledhem & Mekidiche, 2022). Along with avoiding interest, participation finance also avoids contract ambiguity and forbids needless risk and wagering (Tabash & Dhankar, 2014). Both traditional and Islamic financing are active business choices in today's financial markets.

Today, the global financial industry holds Islamic banking in high demand for its practical business approach to job creation and economic growth. Since Islamic banking is based on profit and loss sharing rather than predetermined fixed interests for capital providers, it is viewed as a stable system that promotes equitable resource distribution and better capital efficiency. Operating under a profit-and-loss sharing partnership framework, it also aids in raising worker productivity (World Bank Group, 2017).

Debt financing forms the foundation of conventional finance. Conventional banks provide their customers with money in exchange for guaranteeing larger payments. The transaction at the base of all such financing is an interest-based loan, regardless of what the client may have used this facility for. Banks receive loans from depositors, extend loans, and provide credit to the private sector. Since these funds are advanced based on loans, the bank has no risk of loss. In other words, conventional finance

is based on interest, and shares no risk with investors, which seems to lead to inequality in resource distribution and decreased productivity due to a decline in capital efficiency, resulting in lower economic growth.

Islamic banks are investors and financial arbitrators. In conventional financing, the growth of the money supply in the market results in deficit financing because of the lack of real assets, which eventually creates inflation and instability. Islamic finance is a type of debt-free form of financing. The efficiency of capital in the financial sector improves as a result of Islamic finance because productivity increases (Yusof, 2013). Islamic finance enhances the likelihood of output at the country level, creates jobs, reduces inflation and poverty, and increases employment and income-generating opportunities (Arshed et al., 2020). It focuses on financing economic operations that are partnership- and equity-based to expand global assets in Muslim and non-Muslim countries (Arshed et al., 2020).

Islamic financial institutions and markets are safe and progressive, supporting the SDGs[1] because they enhance risk management and strengthen governance to address the problems of the global financial crisis (Arshed et al., 2020). Owing to the lack of interest rate risk, among many other aspects, the investor-investee relationship within depositors and Islamic banks is based on the idea of risk sharing, resulting in better investment monitoring, higher productivity, and a more stable financial system, all of which contribute to long-term economic growth. These features are found in a variety of Islamic financial instruments, including *Musharakah*, *Mudarabah*, and *Ijarah*, among many others. *Musharakah* and *Mudarabah* are equity-based business arrangements in which the saver and investor share losses and profits according to an appropriate ratio. The demand for Islamic finance compared to conventional finance has increased because of the minimum loss of assets and capital since it works under the profit-and-loss-sharing principle, which promotes economic growth (Muhammad et al., 2019).

Many researchers, such as Abduh and Omar (2012) for Indonesia, Tabash and Dhankar (2014) for Qatar, Rosman et al. (2014) for Middle Eastern and Asian countries, Gheeraert and Weill (2015) for a sample of 70 countries, Zarrouk et al. (2017) for the UAE, and Muhammad et al. (2019)

[1]Sustainable Development Goal 2 and Elements of Islamic Financial Stability

for Pakistan, among others, have investigated the relationship among Islamic finance and economic growth. Most previous studies have used time-series analyses of individual countries. This study examines the impact of both Islamic and conventional financing on economic growth in five Muslim countries using panel data analysis and compares their impacts on economic growth. We also use other control variables, such as net foreign direct investment (FDI), trade openness, inflation, investment, and human capital. This study used quarterly data. Quarterly data for variables that were not available quarterly were obtained using techniques employed by Hachicha and Amar (2015), Lebdaoui and Wild (2016), Kalim et al. (2016), Kassim (2016), and Muhammad et al. (2019).

The remainder of this paper is planned as follows; Section two analyses the relevant literature. Section 3 discusses the theoretical framework, variable selection, the empirical model, the data sources, and the estimation techniques. Section 4 presents our findings and discusses the results. Section 5 summarizes the study and provides policy recommendations.

Literature Review

Economic growth and development of the financial sector have been extensively studied, with significant attention given to how the financial industry contributes to economic growth. The financial sector plays a crucial role by facilitating foreign capital inflows, mobilizing and pooling deposits, boosting the savings rate, and optimizing capital allocation. However, the connection between economic growth and financial development is complex and varies across different regions, time periods, and types of financial institutions, including conventional and Islamic banks.

The contribution of Islamic finance to economic growth has been the subject of an expanding corpus of research, with numerous studies emphasizing the potential advantages of this sector for both economic growth and development. There is strong evidence from several studies that Islamic finance has the potential to make a difference to the economies, especially in countries where the Islamic financial system is well developed.

Goaied and Sassi (2010) studied 16 MENA countries from 1993 to 2006 and found a weak relationship between banking development and economic growth. However, after examining 15 MENA countries between 2000 and 2011, Sadraoui and Hleli (2015) found a substantial bidirectional causal

association between Islamic banking and economic growth. According to Grassa and Gazdar (2014), who studied five GCC countries from 1996 to 2011, Islamic finance increased economic growth while traditional financial development had no appreciable effect.

In their analysis of the GCC countries after 2010, Bendriouch et al. (2020) found that Islamic finance had a positive impact on economic growth, particularly after the global financial crisis. The reciprocal association between Islamic banking/finance and economic growth in Indonesia was examined by Abduh and Omar (2012) using quarterly data from 2003Q1 to 2010Q2, and they found a positive correlation. The relationship between Islamic banking and Southeast Asian economic growth between 2000Q1 and 2012Q4 was also studied by Lebdaoui and Wild (2016), who found a favorable long-term link despite no short-term correlation. Madni (2017) investigated the connection between Islamic banking and economic expansion in these countries and found that there was a positive association.

The impact of Islamic finance on Indonesia's economic growth between 2009Q1 and 2019Q4 was examined by Anwar et al. (2020). Using the Vector Error Correction Model (VECM), impulse response functions, and the ARDL approach, they found a significant relationship between Islamic finance and economic growth. This infers that Islamic financial institutes play a critical role in stimulating economic growth.

Arshed et al. (2020) examined the effects of several Islamic finance choices, such as Salam and Istisna, on economic growth in nine different countries between 2014Q1 and 2017Q4. Their findings indicated that most financing methods, except for Istisna, had a positive impact on economic growth, with Salam finance exhibiting the greatest potential. Additionally, when Ali et al. (2021) compared the performance of Islamic and conventional banks in Pakistan from 2007 to 2016, they found that Islamic banks outperformed conventional banks in terms of management, asset quality, and market risk sensitivity, while conventional banks performed exceptionally well in terms of capital sufficiency and liquidity.

Similar types of results have been confirmed by many other studies. In a noteworthy study, Gani and Bahari (2021) used the Autoregressive Distributed Lag (ARDL) model to examine the causal association between Malaysia's economic growth and Islamic financing for the period 1998 to

2017. The study determined that the development of the Islamic financial industry benefits the whole economy since it is a major factor in boosting Malaysia's economic growth. Similarly to this, Ledhem and Moussaoui (2021) used data from 2014 to 2019 to investigate the connection between Islamic financing and economic growth in Malaysia, with a particular emphasis on its effect on entrepreneurship. By encouraging entrepreneurship, which is a key factor in economic development, Islamic financing greatly boosts economic growth, according to their study, which used Granger causality and quantile regression methodologies.

Ledhem and Mekidiche (2022) focused on the Turkish economy from 2013Q4 to 2019Q4 and found that Islamic finance contributed positively to economic growth, aligning with the Turkish government's efforts to increase the proportion of Islamic finance in the economy. Similarly, Naz and Gulzar (2022) applied panel data ARDL techniques to investigate the dynamic effects of Islamic financing on real GDP growth in Muslim countries, finding a significant long-term correlation between Islamic bank assets, financing, Islamic bonds, and economic growth. Habibah et al. (2023) compared the performance of Islamic and conventional equity indices, finding no significant difference in their responses to investor sentiment, which suggested that Sharia screening criteria do not significantly impact the link between equity markets and investor sentiment.

Smolo and Nagayev (2024) looked at the relationship between financial development and economic growth, emphasizing that it depends on the quality of the institutions involved, stressing the need for Islamic finance for advancement. According to Kazak et al. (2024) assessment of the sector's sustainability based on financial performance indicators like ROA, ROE, and net profit margin, the UAE was an exception to the rule where Islamic banks in the GCC are viable. The majority of recent research has looked at new developments, like how fintech and sustainability affect Islamic banking. Fintech advances have greatly enhanced the performance, profitability, stability, and efficiency of both conventional and Islamic banking institutions in the MENA region, according to a study by Kharrat et al. (2024).

The research highlights how Islamic finance could spur economic growth, particularly in countries where the overwhelming population is Muslim. The results show that Islamic financing encourages investment, entrepreneurship, and financial stability—all of which promote economic

growth. The link between Islamic finance and economic growth varies, according to the geography, the type of financial institution, and the specific financial instruments used. Further research is needed to determine how Islamic finance affects economic growth and how it functions in various regional and economic circumstances.

This study also addresses a gap in the literature by exploring the simultaneous influence of both conventional and Islamic finance on economic growth, particularly in Muslim nations. The ongoing evolution of Islamic finance, especially its integration with modern financial technologies and its focus on sustainability, will likely continue to shape its contribution to global economic development.

Theoretical Framework and Empirical Model

The financial industry contributes to economic growth by mobilizing funds from small savers to large investors. Finance and economic growth are linked through various transmission routes. It reduces agency costs and encourages investors to increase their investments, which in turn increases a country's economic growth. Moreover, financial development boosts capital productivity, increases the savings ratio, and reduces the resource loss associated with capital allocation (Thiel, 2001). Financial factors affect financing costs and savings rates by influencing the resources available for investment. In addition to its effect on capital accumulation, financial activity boosts capital productivity through several pathways. They are concerned with (1) selecting the most profitable investment activities, (2) providing liquidity, and (3) allocating risk (Thiel, 2001). Consequently, an efficient financial system boosts capital productivity. Physical capital has a significant positive impact on long-term growth, demonstrating that long-term investment is the only way to achieve growth. Infrastructure, sophisticated services, and venture capital are examples of investments linked to long-term factors.

In Islamic finance, the debt-free financing modes of *Mudarabah* and *Musharakah* are used to finance the private sector businesses. It lowers transaction costs, encourages investors to invest more, and leads to a higher output. Higher returns resulting from more efficient money allocations are critical to a country's economic performance (Kassim, 2016). Islamic finance boosts national output and job creation, reduces inflation and poverty, and expands employment and income-generating opportunities

(Arshed et al., 2020). In summary, interest-free financing causes the least capital and asset loss, resulting in greater economic growth (Muhammad et al., 2019).

In addition to finance, investment, which represents a net increase in the overall stock of capital in an economy, also affects economic growth. When an economy's net capital increases over time, it leads to increased production, efficiency, and profitability and thus an increase in economic growth (Kassim, 2016). An improvement in the productive capacity of the economy caused by investment and capital formation leads to an increase in economic activity. Foreign direct investment (FDI), particularly in the form of creative capital input, facilitates technology transfer. Consequently, the domestic input market becomes more competitive because of FDI. The interplay between FDI and human capital (HC) has a substantial positive impact on economic growth (Habib et al., 2013). Education, an important component of a country's human capital, boosts productivity. Formal education increases individual income, lowers the probability of unemployment, and increases taxable income, thereby helping a country's economy (Sharma, 2016).

Additionally, trade openness (TO) and inflation affect economic activity. Another important paradigm that emphasizes how technological development and capital accumulation drive long-term growth is the neoclassical growth model. Trade openness can affect each of these factors by encouraging cross-border money and technology flows. To increase growth and productivity, open trade, for instance, might draw foreign direct investment (FDI), which provides access to fresh capital and technology.

Trade openness determines the rate of economic growth and has distinct effects on rich and developing countries (Kong et al., 2021). Metrics like the trade-to-GDP ratio are commonly used to evaluate it; higher ratios signify greater openness (Krugman, 1995). The most widely researched theory of trade is the Ricardian model of comparative advantage, which maintains that trade enables countries to excel in the production of goods/services in which they have a relative advantage. It implies that commerce boosts efficiency and economic growth.

Furthermore, the endogenous growth hypothesis, which highlights the importance of human capital, creativity, and knowledge spillovers, states that trade openness fosters the flow of ideas and technological

advancements, which speeds up economic growth through innovation. Increased trade openness stimulates economic growth, particularly in emerging countries, as claimed by Dollar and Kraay (2004). Their findings indicate that nations with strong institutional frameworks—such as those governing governance, legal systems, and the protection of property rights—benefit more from trade openness. The idea that trade openness may need to be paired with robust domestic institutions and policies in order to promote economic growth is supported by this research.

Another study by Rodrick (1998) suggests that the correlation between trade openness and economic growth is not always linear. It argued that the benefits of trade openness might be overstated and that premature liberalization, without adequate domestic reforms or structural adjustments, could harm the growth prospects of developing countries. In this context, some countries may experience short-term negative effects from trade openness, such as increased unemployment in industries that cannot compete with imports.

An appropriate inflation rate is a crucial determinant of macroeconomic stability. Growth and economic stability then arise from spending, saving, and investing that people, companies, and financial intermediaries do in a Shariah-compliant environment (Barro, 2013).

Based on the above discussion, our empirical model is as follows:

$$Y_{it} = f(IF_{it}, CF_{it}, HC_{it}, INS_{it}, FDI_{it}, TO_{it}, INF_{it}) \quad (1)$$

Where Y_{it}, IFit, CF_{it}, HC_{it}, INS_{it}, FDIit, TO_{it}, and INF_{it} are the per capita GDP, Islamic finance, conventional finance, human capital, investment, foreign direct investment, trade openness, and inflation, respectively, of the i^{th} country at the time "t". The stochastic form of Equation (1) is

$$lnY_{it} = \beta_{io} + \beta_1 lnIF_{it} + \beta_2 CF_{it} + \beta_3 HC_{it} + \beta_4 INS_{it} + \beta_5 FDI_{it} + \beta_6 TO_{it} + \beta_7 INF_{it} + \varepsilon_{it} \quad (2)$$

Where "*ln*" represents the natural log and ϵ_{it} represents the error term. Details of the variables along with data sources are listed in Table 1.

Table 1
Variables and their Definitions

Variables	Definitions/Constructions	Source
Growth	GDP per capita	WDI (WB)

Variables	Definitions/Constructions	Source
Islamic finance	Market value of *Shariáh*-compliant Financing	Islamic Financial Services Board (IFSB)
Conven. Finance	Domestic Credit to Private sector	IFS (IMF)
Human capital	log of Education Index	UN Human Development Report
Investment	Gross capital formation	WDI – WB
FDI	Net FDI Inflow as percentage of GDP	WDI – WB
Trade openness	Exports plus imports as percentage of GDP	WDI – WB
Inflation	Log of CPI	IFS (IMF)

Results and Discussion

The study employed quarterly panel data from five Muslim-majority countries—Saudi Arabia, Bangladesh, Malaysia, Pakistan, and the United Arab Emirates—covering the period from 2013-Q_4 to 2020-Q_4. The primary objective was to compare the effects of conventional and Islamic financing on economic growth within these nations. To determine the most appropriate econometric model for the analysis, the Hausman test was conducted to assess the suitability of fixed effects versus random effects models. A summary of the Hausman test results is presented in Table 2.

Table 2
Hausman Test

Ho: Coefficients Difference not systematic	
χ^2 (7)	$(b^{RE}- B^{FE})' [(V\_ b^{RE}-V\_B^{FE}]^{-1} (b^{RE}-B^{FE})$ 109.91
Prob >χ^2	0.0000

The results indicate that the null hypothesis can be rejected, suggesting that the fixed effects model is more appropriate for the dataset than the random effects model. In both fixed and random effects models, the assumption of cross-sectional independence among units is crucial. To evaluate the presence of cross-sectional dependence, the study employed the Pesaran CD (cross-sectional dependence) test. The outcomes of the CD test are presented in Table 3.

Table 3
Pesaran CD test

Pesaran CD	=	-0.007	Probability	= 0.995

$$CD = \sqrt{\frac{2T}{N(N-1)}}\left(\sum_{i=1}^{N-1}\sum_{j=i+1}^{N}\hat{\rho}_{ij}\right) \sim N(0,1)$$

$$\text{where}\hat{\rho}_{ij} = \hat{\rho}_{ji} = \frac{\sum_{t=1}^{T}\hat{u}_{it}\,\hat{u}_{jt}}{\left(\sum_{t=1}^{T}\hat{u}_{it}^{2}\right)^{1/2}\left(\sum_{t=1}^{T}\hat{u}_{jt}^{2}\right)^{1/2}}$$

The results of the CD test in Table 3 suggest that we can accept the null hypothesis of no cross-sectional dependence and conclude that a random shock to any country does not affect the economic growth of other countries in the sample. Thus, the sample countries were independent of each other.

To determine the impact of Islamic and conventional finance on economic growth, we estimate a fixed-effects model using both OLS and 2SLS methods.[2]. The results of this study are summarized in Table 4.

Table 4
The Results of Fixed Effects Regression (OLS and 2SLS)

Variables	FE OLS	FE 2SLS
Log of Islamic finance	0.141* (0.031)	0.157* (0.034)
Domestic Credit to Private Sector	-0.039* (0.005)	-0.037* (0.006)
Gross capital formation	0.009* (0.004)	0.013* (0.004)
Foreign Direct Investment	-0.427* (0.046)	-0.446* (0.049)
Trade Openness	0.008 (0.005)	0.006 (0.006)
Inflation	-0.051* (0.014)	-0.049* (0.017)
Human Capital	0.81* (0.036)	0.52* (0.043)
Constant	8.718* (0.301)	8.616* (0.331)
F-statistic	61.80	531.126
Prob.(*F*-statistic)	0.000	0.000

Note. Values in brackets are standard errors. * Significance at 1%, whereas no asterisk indicates that the difference was not significant.

The findings in Table 4 display the estimated coefficients for a set of variables using two distinct approaches: Fixed Effects Two-Stage Least Squares (FE 2SLS) and Fixed Effects Ordinary Least Squares (FE OLS).

[2]We use 2SLS due to the potential problem of endogeneity.

The estimated effect of each variable on the dependent variable will be explained as we methodically go over these findings. Economic growth is projected to be impacted by the majority of the underlying variables. All variables except trade openness are significant at the 1 percent level, according to Table 4's results. The log of GDP per capita served as our dependent variable. The findings demonstrated that Islamic finance and economic growth are positively correlated. A 1% rise in Islamic finance raises per capita GDP by 0.141% and 0.157%, respectively, according to the findings of the FE OLS and FE 2SLS regressions. However using the 2SLS method, the relationship might be slightly stronger, suggesting potential endogeneity issues in the OLS model that the 2SLS addresses. These results are in line with earlier studies (Bendriouch et al., 2020; Muhammad et al., 2019) that looked at the relationship between Islamic finance and economic growth.

In both the FE OLS and FE 2SLS models, conventional finance—defined as domestic credit to private sector as a percentage of GDP—has a negative effect on per capita GDP. The FE OLS and FE 2SLS models show that a 1% increase in traditional financing decreases per capita GDP by 0.039 1% and 0.037 1%, respectively. The coefficient is slightly smaller, -0.037, but still negative and significant. The effect remains quite similar even with FE 2SLS, which might indicate that the relationship between domestic credit and economic growth is robust regardless of the estimation method. This could reflect potential inefficiencies or over-indebtedness in the private sector, where excessive credit leads to lower economic performance. Ethical practices in financial liberalization and poor regulatory administration or governance damage financial markets, which has a detrimental effect on economic growth. Other researchers have observed similar findings (Sharma, 2016).

Consistent with the findings of past studies (Ugochukwu et al., 2013), investment, measured as gross capital formation, positively affected economic growth. The results also reveal that FDI negatively affects economic growth. An increase in FDI reduces the growth of selected Muslim countries. Our findings support previous empirical growth studies. According to Aizenman and Noy (2006) and Agbloyor et al. (2014), there is a negative association between FDI and economic growth because of the insufficient and inefficient infrastructure in the form of law and order, peace and security, political instability/uncertainity alongwith poor regulatory

environment. The coefficient slightly increases to -0.446, and the negative relationship persists even in FE 2SLS. The value of the coefficient increases marginally, which could indicate a more robust estimation when addressing potential endogeneity in the OLS model. This suggests that an increase in foreign direct investment leads to a decrease in economic growth. One possible interpretation of this result could be that inflows of FDI might have negative effects, possibly due to factors like crowding out of domestic investments or inefficient foreign capital allocation.

Results also reveal that trade openness have positive but insignificant impact on economic growth. Previous studies have reported mixed results on the impact of trade openness. For example, Kim (2011) finds that trade openness improves economic growth in wealthy countries but has a negative impact on poor countries.

The results also show that inflation negatively impacts economic growth in selected Muslim countries. The coefficient of FE OLS is -0.051 and is significant at the 5% level. This negative relationship suggests that higher inflation is associated with lower economic performance, which is consistent with economic theory, as inflation typically creates uncertainty and reduces investment. Also, the value of the coefficient in FE 2SLS is -0.049, and it remains statistically significant. The negative impact of inflation on economic growth is robust across both estimation methods. This may be because high inflation decreases consumers' purchasing power, which leads to less consumption and eventually decreases economic growth. Our results are in line with the findings of earlier empirical studies such as those of Bawa and Abdullahi (2012) and Mohseni-Cheraghlou (2016).

Human capital has a significantly positive impact on economic growth. The coefficient is 0.81 and is significant at the 5% level, indicating that an increase in human capital (measured by education or skill levels) is strongly associated with increased economic growth. Human capital plays a critical role in enhancing productivity and innovation. The coefficient for FE 2SLS decreases to 0.52 but is still significant. While the effect is smaller in the 2SLS model, it remains a positive and statistically significant factor, suggesting that human capital is crucial for long-term economic growth, albeit with a slightly reduced effect when endogeneity is controlled. Increasing human capital due to an increase in skills and innovation/technology causes greater productivity and therefore enhances

economic growth. Human capital development contributes to innovation and the acceptance of newer technology, which boosts economic growth. Our results align with the empirical findings of Barro (2001), Pelinescu (2015), Ali (2015), and Teixeira et al. (2016).

The *F*-statistic is 61.80, with a corresponding *p*-value of 0.000. This suggests that the model is statistically significant and that the independent variables jointly have a significant impact on the dependent variable. The *F*-statistic for FE 2 SLS is much higher at 531.126, with a *p*-value of 0.000. This indicates a very strong joint significance of the explanatory variables in the 2SLS model, suggesting that the instruments used in the two-stage estimation effectively capture the relationships between the variables.

Both models suggest a positive relationship with the objective variable economic growth, with the effect being slightly stronger in the 2SLS model, indicating that Islamic finance may have a beneficial impact on economic growth. Both models suggest a negative impact, indicating that more credit to the private sector may hinder growth, possibly due to inefficiency or over-indebtedness. Positive and significant in both models, supporting the idea that investment in physical capital boosts economic performance. Both models show a negative relationship, which could imply that foreign direct investment might have some negative effects, such as crowding out domestic investment or creating inefficiencies. No significant impact, suggesting that trade openness may not be a crucial determinant of economic growth in this context. A negative relationship, consistent with economic theory, shows that higher inflation is detrimental to economic growth. Positive and significant in both models, emphasizing the importance of education and skills in driving economic growth. The key point from the results is that the relationships between these variables and the dependent variable are fairly consistent across the FE OLS and FE 2SLS models, with minor differences due to the method of estimation. The 2SLS method addresses potential endogeneity, providing more robust estimates of the causal relationships between the variables.

Conclusion

This study uses an analytical approach to the understanding of the relationship between conventional finance, Islamic finance, and economic growth, employing a novel methodological framework through panel data analysis of five Muslim-majority countries. The findings reveal that an

increase in domestic credit to the private sector is negatively associated with GDP per capita, suggesting that over-reliance on conventional financing mechanisms—characterized by fixed-return arrangements regardless of project outcomes—may hinder investment and constrain economic growth. These traditional financing agreements for the financial sector can discourage prudent financial decision-making, which would result in inefficient capital allocation.

In contrast, Islamic finance, founded on profit-and-loss sharing principles, appears to facilitate more balanced and ethically grounded investment behavior. The empirical results, derived from both Fixed Effects Ordinary Least Squares (FE OLS) and Fixed Effects Two-Stage Least Squares (FE 2SLS) models, consistently show that Islamic finance has a positive and statistically significant impact on economic growth endorsing that Islamic financial institutions may promote macroeconomic stability, encourage inclusive investment, and serve as a viable alternative financial system.

The study also identifies several macroeconomic variables with significant implications for economic growth. Gross fixed capital formation exhibits a robust positive correlation with growth in both models, reinforcing the foundational role of capital investment—particularly in infrastructure and productive capacity—in supporting long-term economic development. Conversely, foreign direct investment (FDI) demonstrates a negative and statistically significant relationship with economic growth. This counterintuitive finding suggests that, under certain conditions, FDI may not contribute positively to domestic development—possibly due to profit repatriation, crowding out of local firms, or misaligned investment objectives—warranting further investigation.

Trade openness, while theoretically linked to growth, does not exhibit a statistically significant impact in the sample countries. This may be attributed to structural constraints within the context of the sample countries, such as limited industrial diversification or unequal trade relationships. Additionally, inflation is found to have a significantly negative effect on economic performance, underscoring its role as a destabilizing factor that diminishes investment incentives and erodes consumer purchasing power.

Finally, the study highlights the critical importance of human capital development. The positive and significant relationship between economic growth and human capital—as proxied by education or skill levels—underscores the necessity of investing in a knowledgeable and skilled workforce to enhance productivity, foster innovation, and strengthen economic competitiveness.

In summary, the empirical evidence supports the proposition that Islamic finance can play a constructive role in fostering sustainable economic growth. At the same time, the findings caution against excessive reliance on conventional debt-based financing, and emphasize the importance of policy measures that prioritize investment in physical and human capital, manage inflationary pressures, and critically assess the quality and impact of foreign investment inflows.

Policy Implications

From these conclusions, several policy recommendations can be drawn:

- Promote Islamic finance: Given the positive correlation between Islamic finance and economic growth, governments might think about promoting the growth of Islamic finance as a supplementary or alternative financial system. This could entail creating legal frameworks to facilitate Islamic financial products, increasing financial inclusion, and using Islamic finance to encourage investment in strategic areas.
- Monitor Domestic Credit Growth: It is important for policymakers to exercise caution when expanding credit too much. Credit can stimulate economic growth, but if it is used excessively, it may result in inefficiencies and financial imbalances. Prudential rules, such as limiting the rate of credit expansion or keeping an eye on dangerous lending practices, might be required to prevent unfavorable results.
- Encourage Capital Investment: Economic growth and gross given capital formation have a positive correlation, indicating that physical capital and infrastructure investments are critical to economic progress. Policies that encourage both international and domestic investment in technology and infrastructure should be given top priority by governments.
- Evaluate FDI Strategies: The detrimental impact of FDI on growth emphasizes how crucial it is to properly consider foreign investment

policies. Instead of permitting capital inflows that do not support sustainable economic growth, policymakers should think about encouraging FDI that supports local enterprises, promotes knowledge transfer, and is in line with national development goals.

- Stabilize Inflation: Maintaining economic stability and prosperity continues to depend on controlling inflation. Inflation targets that preserve price stability and encourage investment and consumer confidence should be the goal of central banks.
- Invest in Education and Skill Development: A key component of long-term economic prosperity is human capital. In terms of productivity and innovation, policies that support access to high-quality education, career training, and skill development will pay off and support long-term economic growth.

Overall, the results highlight the significance of credit management, human capital investment, and the expansion of Islamic finance as major drivers of economic development, even though trade openness does not appear to have a significant impact on economic growth in this specific analysis. Policymakers ought to concentrate on establishing an atmosphere that encourages profitable investment, guarantees monetary stability, and aids in the growth of a trained labor force. These conclusions are supported by the strong results from the FE OLS and FE 2SLS models, with the 2SLS estimates providing more trustworthy information by resolving possible endogeneity problems in the OLS model.

Conflict of Interest

The authors of the manuscript have no financial or non-financial conflict of interest in the subject matter or materials discussed in this manuscript.

Data Availability Statement

The data associated with this study will be provided by the corresponding author upon request.

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