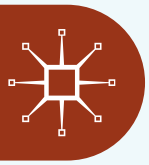

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Enhancing Financial Inclusion through Islamic Finance, Volume II

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CHAPTER 11

The Impact of the Islamic Banking Industry on Economic Growth and Poverty Reduction in Pakistan

Muhammad Abubakar Siddique, Mirajul Haq, and Memoona Rahim

11.1 Introduction

The well-known 5 higher Shariah objectives[1] include 17 social development goals set by the United Nations (UN) in its broad spectrum. Therefore, it can be said that achieving these goals is the basic purpose of Shariah injunctions. As an Islamic system, Islamic banking also is subject to achieve these goals. In the case of Pakistan, the history of Islamic banking development can be divided into two consecutive phases. The first phase ranges from 1980 to 2002 during which basic concept of interest-free economy evolved theoretically and consequently noninterest-based banking (NIB) emerged. The government of Pakistan showed its interest and made its efforts to transform the economy from interest to

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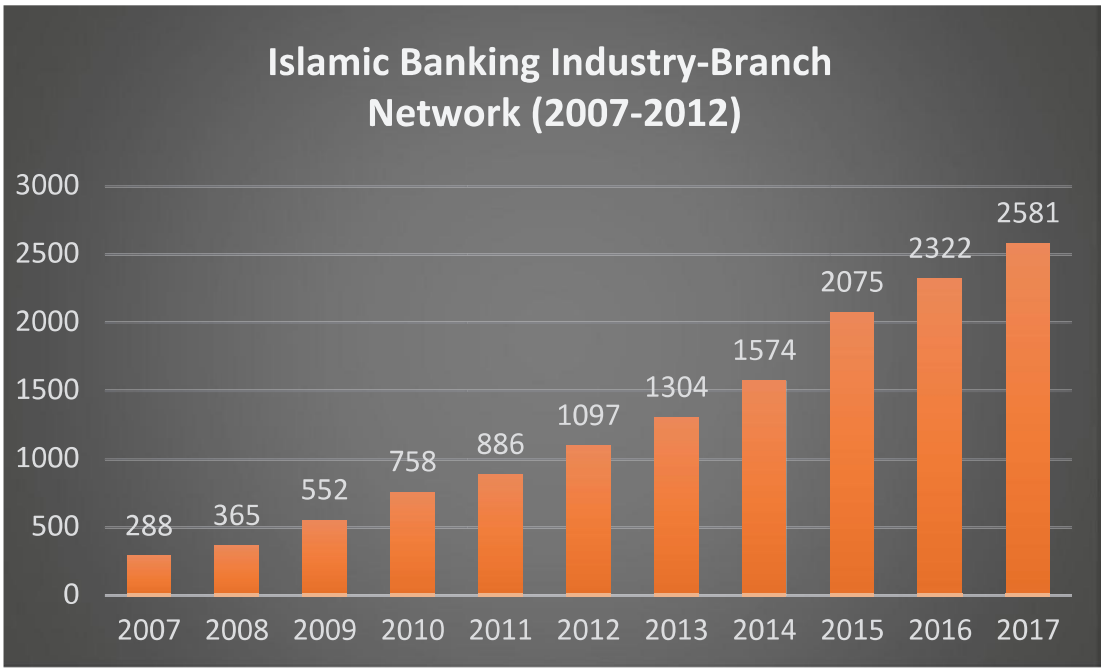


Fig. 11.1 Islamic banking industry branch network (2007–2012)

noninterest base, and it started from the banking industry. The second phase ranges from 2003 onward during which Islamic banking was practically launched and started to work in parallel with the conventional banking as per new strategy of State Bank of Pakistan (SBP) (Janjua 2004). Since then, Islamic banking has achieved 12.4% of total banking business as indicated in EY 2017 (Fig. 11.1). By the end of 2017, there were 5 full-fledged Islamic banks and 18 standalone Islamic banking branches of conventional banks and 6 sub-Islamic branches of conventional banks. IBI showed a rapid growth till 2017 (SBP Annual report 2017).

It is the time now to find out at what extent the Islamic banking industry could achieve its foundational and conceptual socioeconomic objectives of welfare like poverty elimination and economic growth in Pakistan. This study has been undertaken by using data for the period 2004–2017.

11.2 Literature Review

The banking and financial industry affects the real output growth of an economy (Goldsmith 1969), and consequently it affects the unemployment level of the economy. King and Levine (1993) explored the causality relationship between the variables of banking and financial development

and economic growth. They used the Three-stage Least Squares (3SLS) technique and found that financial industry was one of the causes of rapid economic growth of developing Asian economies. Therefore, banks were preferred over security markets in these economies for the purpose of financial intermediation (Bosworth 1998). According to Garson (1998), banking and financial industry plays its role as the main locomotives for economic growth. The reason is that the banking sector plays its role effectively in increasing the velocity of money by seeking and accepting the deposits from the individuals and lending credit from those deposits to the others. These lending are considered as growth engines, not the inputs. Employing Generalized Method of Moments (GMM) dynamic on dynamic panel data, Levine et al. (2000) also found a bidirectional relationship between the financial development of economy and its economic growth.

Furqani and Mulyany (2009) employed the vector error correction model (VECM) using quarterly time series data (1971:1-2005:4) in their study to check the long-run relationship between the Islamic financial sector and the performance of economy in Malaysia. They showed that the Islamic banking industry contributed 60.2% in the total financial industry by the end of 2005. In this way, they found that there was a positive impact of the Islamic banking industry on the economic growth of Malaysia.

Goaied and Seifallah (2010) conducted a study on Middle East and North Africa (MENA) region to find out the impact of the Islamic banking industry on the economic growth. They employed the technique of GMM estimation. They used dynamic panel data of 16 economies in MENA region. They found that there was an insignificant relationship between growth and Islamic banking system. They, ultimately, concluded that there is zero contribution of Islamic banks in economic growth of MENA region. These results were confirmed by Goaied and Sassi (2011) who studied the relationship between economic growth and Islamic financial development in MENA region. They used unbalanced dynamic panel data and employed system GMM estimation technique. They found that there was no significant impact of Islamic financial development on economic growth in MENA region. Later Echchabi and Dhekra (2015) also found same results. They conducted their research to analyze the impact of the development of the Islamic banking industry on the UAE's economic growth. Using time series quarterly data ranging from Q1: 2004 to Q4: 2011. They employed co-integration and Granger causality tests and

found that there was no significant relationship between Islamic banking and economic growth in the UAE.

Abduh and Omar (2012) studied the Indonesian economy to find out the impact of the Islamic financial development over the economic growth of Indonesia. They employed bound testing co-integration approach, and for short-run analysis, they used error correlation models (ECM). Their results showed the significant relationship between Islamic financial development and the economic growth in the long as well as short run. These results were confirmed by later research of Abduh and Chowdhury (2012). They focused on Bangladesh economy to find the relationship between growth dynamic and total financing as well as deposit structure of the banking sector operating in Islamic setups. They used quarterly time series data for the period 2004–2011. They found a significant impact of the Islamic banking industry on economic growth in the long run. These results were confirmed in another study conducted by Kaleem et al. (2016) who tried to find out the relationship between economic growth and full-fledged Islamic banking development in Pakistan. They used quarterly panel data for the period 2006–2013. They employed bound integration test and ECM developed within Autoregressive Distributed Lag (ARDL) structure. They found that there was a positive significant relationship between Islamic banking development and economic growth.

In his Bangladesh-based study, Abdin (2016) analyzed the impact of financial development over the poverty alleviation. He used time series data for the period 1974–2013 and found that poverty was directly alleviated by financial development through channeling the greater credit access along with savings opportunity for the poor. He also showed that economic growth, indirectly, reduced poverty. Same results were obtained by Rashid and Intartaglia (2016) who tried to test the influence of financial development on poverty alleviation in developing countries. They used unbalanced panel data for the period 1985–2008 and employed a two-step system GMM estimator. They showed that absolute poverty reduction was significantly positively affected by financial development. They also found that financial sector is more effective in poverty reduction when economic growth is high.

To check the impact of financial industry over poverty reduction, Rewilak (2017) divided the financial development into four categories—size, accessibility, efficiency, and stability—of financial system and used the unbalanced panel data for the period 2004–2015. He employed the ordinary least squares (OLS) method. He found that high accessibility and size

of financial system has positive significant impact on poverty reduction. The results suggest that financial instability and inefficiency have no direct detrimental effect on poverty.

11.2.1 Summary

It has become clear that no study has been done to test the impact of the Islamic banking industry as a whole on the economic growth and poverty alleviation in Pakistan. All abovementioned important studies have been done for other countries except the research done by Kaleem et al. (2016), but they used the data of just a few full-fledged Islamic banks rather than taking the complete Islamic banking industry. Moreover, they studied the impact of Islamic banking development just over the economic growth. However, this study investigates the relationship between the Islamic banking industry's development and economic growth and poverty alleviation in Pakistan. They conducted their study considering banking aggregate indicators like financing, investments, and so on, but we will consider the Islamic banking products that are being offered to the public. It is an updated version and value addition in the literature on the impact of Islamic banking offerings over poverty reduction and economic growth of Pakistan.

11.3 Data

Keeping in view the possible availability of data, we selected nine banks: four full-fledged Islamic banks and standalone Islamic branches of five conventional banks running Islamic banking operations separately from their conventional system (Table 11.1) in Pakistan.

To find out the impact of Islamic banking industry development over the economic growth and poverty eradication, we selected the Islamic financial products: Murabaha, Diminishing Musharakah (DM), Ijarah

Table 11.1 Banks

Sr.	*Standalone Islamic branches of conventional*	*Sr.2*	*Full-fledged Islamic banks*
1	Askari Bank	1	Meezan Bank
2	Bank Alfalah	2	Bank Islami
3	Bank AL Habib	3	Al Baraka Bank
4	The Bank of Khyber	4	Dubai Islamic Bank
5	Faysal Bank		

Table 11.2 List of the dependent and independent variables

Nature of variables	*Variables*	*Description of variables*
Dependent	Poverty	Poverty is measured through unemployment rate
	ECGR	Economic growth is measured through GDP growth rate
Bank-specific variables		
Independent variables	Salam	Salam financing as percentage of total financing
	Murabaha	Murabaha financing as percentage of total financing
	Ijarah	Ijarah financing as percentage of total financing
	Diminishing Musharakah (DM)	DM (house+auto) financing as percentage of total financing
	Istisna	Istisna financing as percentage of total financing
Macroeconomic control variables		
Independent variables	Foreign direct investment (FDI)	FDI as percentage of GDP
	INF	Consumer price index (Pakistan economic surveys) is taken as inflation
	EXPGR	Export growth rate

(Kaleem et al. 2016), Salam, and Istisna, offered by Islamic banks, as independent variables. The Islamic banking industry has shown tremendous growth in these areas (see Annexure). Hence, we used annual panel data ranging from 2004 to 2017, but it is an unbalanced data because different Islamic banks started their operations at different times. Data is collected from the bank's financial statements (Table 11.2).

11.4 Measurement of Economic Growth and Poverty

Economic growth is measured through collecting the data on GDP growth rate (Kaleem et al. 2016) for the period 2002–2017, while poverty is measured through an indirect measure of unemployment rate (Saunders 2002) of Pakistan for the period 2004–2017. Due to limitation of availability of data on variables, we consider unemployment as an indicator to measure poverty to find out some results and to provide the base for future

prospectus and policy structure of the Islamic banking industry of Pakistan in specific. Unemployment is a very close determinant of poverty (Karnani 2011). Though unemployment is not the best indicator to measure poverty (de Dios and Dinglasan 2014), because of limitation of availability of data on variables of the Islamic banking industry, we consider it to find out some results and to provide the base for future prospectus and policy structure of the Islamic banking industry of Pakistan in specific and of other nations in general.

11.5 Methodology

We will employ unit root and co-integration tests to avoid the occurrence of spurious regression. Banerjee et al. (2005) suggest that panel-based unit root test has higher power than univariate unit root based on univariate time series. According to Ozturk and Kalyoncu (2007), panel unit root tests have been found successful in finding evidence of stationarity that cannot be found by univariate methods. Therefore, Im, Pesaran, and Shin panel unit root test will be employed to test the stationarity of variables included in this study.

11.5.1 Model and Estimation: Islamic Banking Development and Poverty

$$\begin{aligned}\text{Poverty}_{it} &= \beta_0 + \beta_1 \text{DM}_{it} + \beta_2 \text{Salam}_{it} + \beta_3 \text{Istisna}_{it} + \beta_4 \text{Murabaha}_{it} \\ &\quad + \beta_5 \text{Ijarah}_{it} + \beta_6 \text{ME}_t + \varepsilon_{it} s \end{aligned} \tag{11.1}$$

where ME_t is the matrix of macroeconomic control variables.

$$\text{ME}_t = \left[\text{GDPGR}_t, \text{EXPGR}_t, \text{INF}_t, \text{FDI}_t \right]$$

GDPGR, EXPGR, FDI, and inflation rate also affect the level of unemployment (Rewilak 2017; Muntah et al. 2015; Dandume 2014; Suryahadi et al. 2009).

We estimated Eq. (11.1) and applied random-effect method. All other variables were found significantly related to poverty, while Ijarah was found insignificant. *R*-square value was 68% that implies that 68% of the variation in the unemployment rate is explained by the explanatory variables.

Dependent variable: POVERTY				
Method: panel EGLS (cross-section random effects)				
Variable	*Coefficient*	*Std. error*	t-*statistic*	*Prob.*
C	8.050468	0.466113	17.27150	0.0000
SALAM	−0.045212	0.009737	−1.562240	0.0004
MURABAHA	−0.023806	0.002743	−1.387273	0.0005
IJARAH	−0.031601	0.003188	−0.502274	0.0002
DM	−0.060005	0.001383	−0.061555	0.0001
ISTISNA	−0.010473	0.008185	−1.279561	0.0000
FDI	−0.571501	0.076722	−7.449000	0.0000
INF	0.015152	0.002815	5.383645	0.0000
EXPGR	0.026486	0.006017	4.402069	0.0000

Note: EGLS = Estimated generalized least square

Islamic bank-specific variables like Salam, Murabaha, DM, Ijarah, and Istisna are significant and negatively related to poverty (unemployment). These results clearly explain that the Islamic banking industry is playing its positive role in reducing the unemployment level (Matarneh and Almanaseer 2015) in Pakistan. According to the findings, a 1% increase in DM financing will cause 6% reduction in the unemployment level. Diminishing Musharakah is a multidimensional mode through which machinery, equipment of factories, and productive material are financed. Moreover, Diminishing Musharakah is also a key element in boosting up the small and medium enterprises (SMEs). In this way, Islamic financial modes play a very important role in increasing employment and in digging up new entrepreneurial horizons because it is risk sharing-based mode, not risk transferring like conventional loans (Matarneh and Almanaseer 2015; Marzban and Asutay 2014; Bendjilali & Khan 1995). These results confirm the findings of Matarneh and Almanaseer (2015), Marzban and Asutay (2014), and Bendjilali & Khan (1995) that DM may increase the job opportunities.

Though the coefficients of Salam, Istisna, and Murabaha are not high in comparison with DM, still it shows that these modes are also important in creating jobs, and these findings confirm the results of Tabash and Dhankar (2014). Textile mills, sugar, cement, other manufacturing industry, and agricultural industry are usually financed through credit sale-based modes of financing like Salam, Istisna, and Murabaha (Ali and Hussain 2017; Arsalan 2015; Ansari 2014; Tabash and Dhankar 2014). According

to Aburaida (2011) Salam affects the level of unemployment through creating the opportunities of self-employment specifically in the agricultural sector. This finding is also in line with the conclusion of Millanei et al. (2016) that Istisna increases the level of employment in the economy's internal system because banks finance the different projects which require the relevant professionals and labor. Salam, Istisna, Ijarah, and Murabaha are creating job opportunities in economies (Saleem 2007). The coefficient of Ijarah is just 0.03 but still it shows great potential for creating employment because house financing and auto financing through Ijarah mode are creating earning opportunities for the people who avail this product. Mostly, car Ijarah is being used to run a taxi business (Lateef et al. 2017; Bustami 2017).

Macroeconomic variables like FDI are significant and negatively related to unemployment having high coefficient of 57%, which means a 1% increase in FDI will reduce 57% unemployment in the economy. This finding confirms the results of Blomstrom and Kokko (2003), Klein et al. (2003); Borenzstein et al. (1998). It means poverty can be reduced by encouraging the FDI (Rutihinda 2007; Dollar and Kraay 2000; Dupasquier and Osakwe 2005). Inflation is positively related to unemployment, and it confirms the findings of Jelilov et al. (2016), Umair and Ullah (2013), Zaidi (2005), Mocan (1995), Cutler and Katz (1990). EXPGR was also found significant and positively related to unemployment rate, and it confirms the studies done by Yolanda (2017), Pierce and Schott (2013), Ebeinstein et al. (2009), James and Fujita (2000). This result shows that export growth does not absorb much labor that is why unemployment is increasing with EXPGR (Yolanda 2017).

11.5.2 Model and Estimation: Islamic Banking Development and Economic Growth

$$\begin{aligned} \mathrm{ECGR}_{it} = {} & \beta_0 + \beta_1 \mathrm{DM}_{it} + \beta_2 \mathrm{Salam}_{it} + \beta_3 \mathrm{Istisnas}_{it} + \beta_4 \mathrm{Murabaha}_{it} \\ & + \beta_5 \mathrm{Ijarah}_{it} + \beta_6 \mathrm{ME}_t + \varepsilon_{it} \end{aligned} \tag{11.2}$$

where ME_t is the matrix of macroeconomic control variables.

$$\mathrm{ME}_t = \left[\mathrm{EXPGR}_t, \mathrm{INF}_t, \mathrm{FDI}_t \right]$$

Export, FDI, inflation rate, and government spending are also important determinants of poverty reduction (Muntah et al. 2015; Abdullah et al. 2015; Dandume 2014; Ali 2014; Naseer 2013; Saqib et al. 2013; Suryahadi et al. 2009; Liang and Reichert 2006).

After repeating the same test procedure, we obtained the same results. Therefore, we estimated Eq. (11.2) and applied random-effect estimation method. All other variables are found significantly related to ECGR at the level of 5%, while Istisna is significant at 10% level. Only inflation remained highly insignificant. *R*-squared is 75% that shows that 75% of variation in ECGR is explained by explanatory variables.

Dependent variable: ECGR				
Method: panel EGLS (cross-section random effects)				
Variable	*Coefficient*	*Std. error*	t-*statistic*	*Prob.*
C	4.951455	0.217536	11.59074	0.0000
SALAM	0.012754	0.023137	4.551256	0.0001
MURABAHA	−0.017949	0.016518	−3.219435	0.0247
IJARAH	0.011346	0.027575	5.777725	0.0062
DM	0.024206	0.013285	3.671521	0.0033
ISTISNA	0.021188	0.019448	2.261070	0.0614
FDI	0.459485	0.182300	2.739912	0.0069
INF	0.093663	0.006688	3.538349	0.1445
EXPGR	0.219011	0.014296	5.329750	0.0000

Islamic bank-specific variables like Salam, DM, and Ijarah are significant and positively related to economic growth of Pakistan at the level of 5%, while Istisna is significant at 10% level. These results confirm the findings of Kalim et al. (2016), Abduh and Omar (2012). Murabaha is negatively related to economic growth as found by Kalim et al. (2016). Furqani and Mulyany (2009) and Goaied and Seifallah (2010) also concluded that the development of the Islamic banking industry is playing an important role in economic growth. All these Islamic modes of financings are real asset-based modes and boosting GDP by real productive economic activity in the economy. Out of the macroeconomic indicators, inflation remained highly insignificant, while FDI and EXPGR are found significant and positively related to economic growth (Abdullah et al. 2015; Muntah et al. 2015; Naseer 2013; Tiwari and Mutascu 2011; Chakraborty and

Nunnenkamp 2008; Omri et al. 2014; Ahmadi and Ghanbarzadeh 2011; Antwi et al. 2013; Bhandari et al. 2007; Hassen and Anis 2012) and contrary to the findings of Saqib et al. (2013) and Ali (2014), because they found a negative relationship between FDI and economic growth.

11.6 Conclusion

Islamic banking major financing modes like Salam, Murabaha, Diminishing Musharakah (DM), Ijarah, and Istisna were used as dependent variables because they play an important role in the development and growth of the Islamic banking industry. The study was focused on finding the impact of these dependent variables on poverty reduction and economic growth in Pakistan for the period 2004–2017. Random-effect estimation technique was employed. The study showed that the Islamic banking industry in Pakistan is not running just to chase the high growth rate to get a major role in the country's economic growth, but it is also prioritizing the achievements of SDGs.

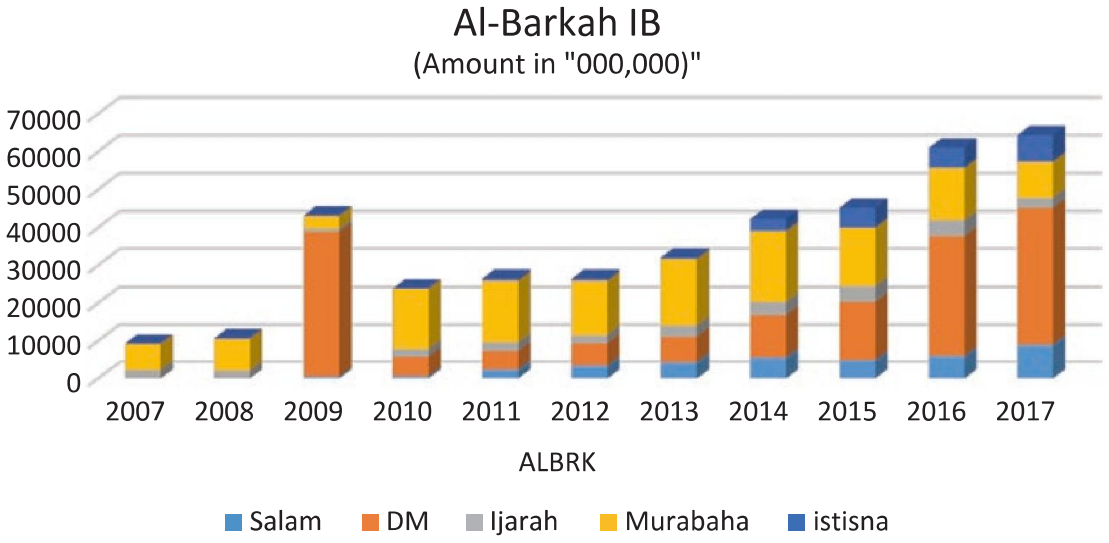
The results showed that Islamic banking products are playing a positive role in achieving social development goals like poverty eradication and economic growth in Pakistan. The negative relationship between Murabaha and economic growth shows that scholars are true in discouraging the Murabaha financing mode and considering it less ideal mode. Many scholars consider it legal device to circumvent the prohibition of riba. Nyazee (2009) added that well-known scholars of the age, for example, M. Sulyman al-Ashaqar, Bakr bin Abdullah Abu Zaid, Rafiq al-Masri, Hassan Abdullah al-Amin, and Abd al-Rahman Abd al-Khaliq, also opposed the banking Murabaha because it was not legal in view of Shariah. Such repute about Islamic banking modes is injurious for the Islamic banking industry. According to Haron et al., controversies and skepticism about Murabaha were causing risk of repute for the Islamic banking industry. Hamzah et al. (2015) and Tang (2010) found that the image of Islamic banking was positively related to the customer's satisfaction level. Regulators and other stakeholders of Islamic banking must pay their attention on the issue.

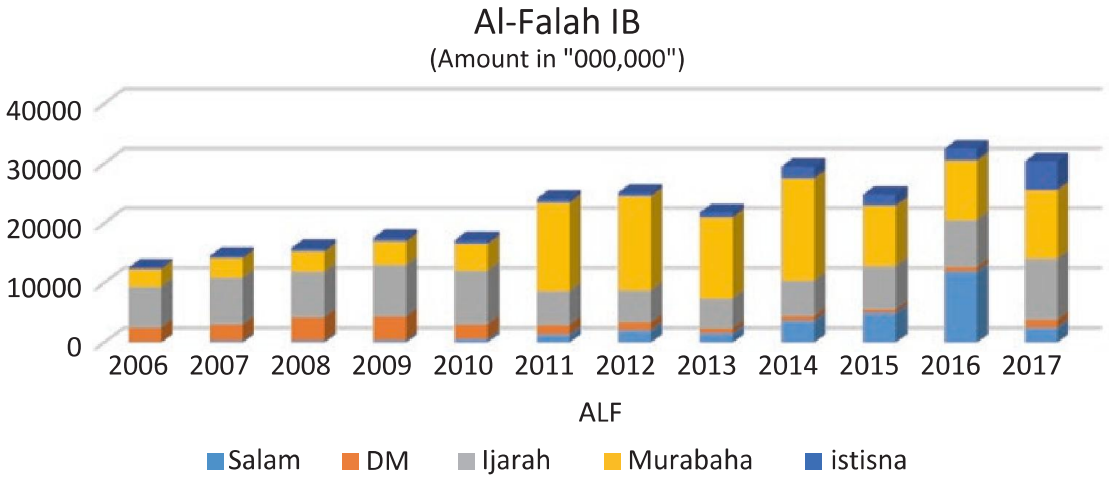
Macroeconomic variables, FDI, and export growth were also found significantly related to poverty reduction and economic growth, but inflation was insignificant with economic growth. Overall results showed that these indicators are creating opportunities in the employment area

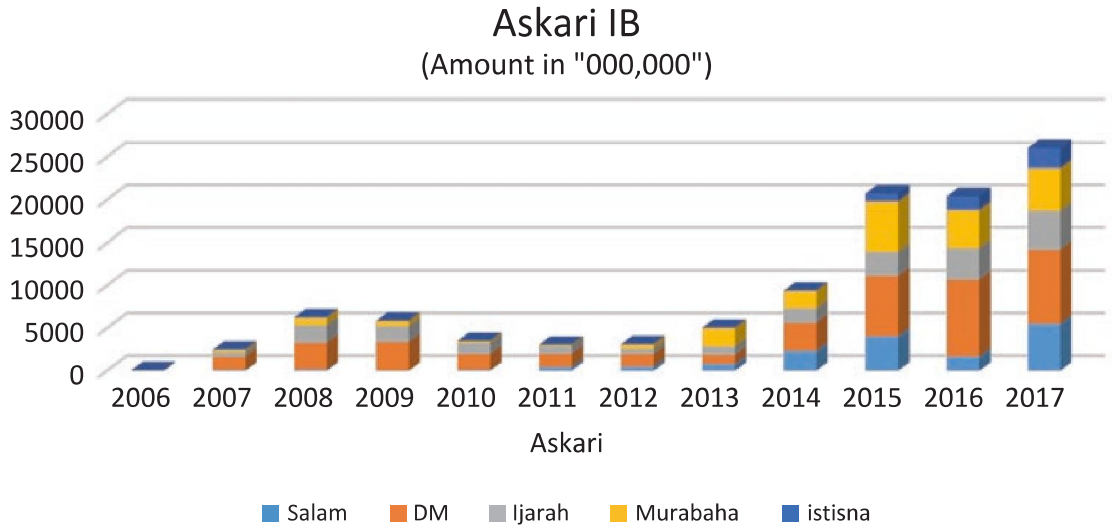
and enhancing public standard of living which obviously may bring the population above the poverty line (Abdullah et al. 2015).

The Islamic banking industry has great potential to achieve SDGs in Pakistan. The implication of the results of the study recommends that the government of Pakistan should make concrete efforts to promote Islamic banking, to cash the potential role of the Islamic banking industry at macro level, and to identify other potential economic roles of the industry in achieving SDGs. Already existent taken steps to promote Islamic banking are less enough for this great cause in many aspects.

Appendix



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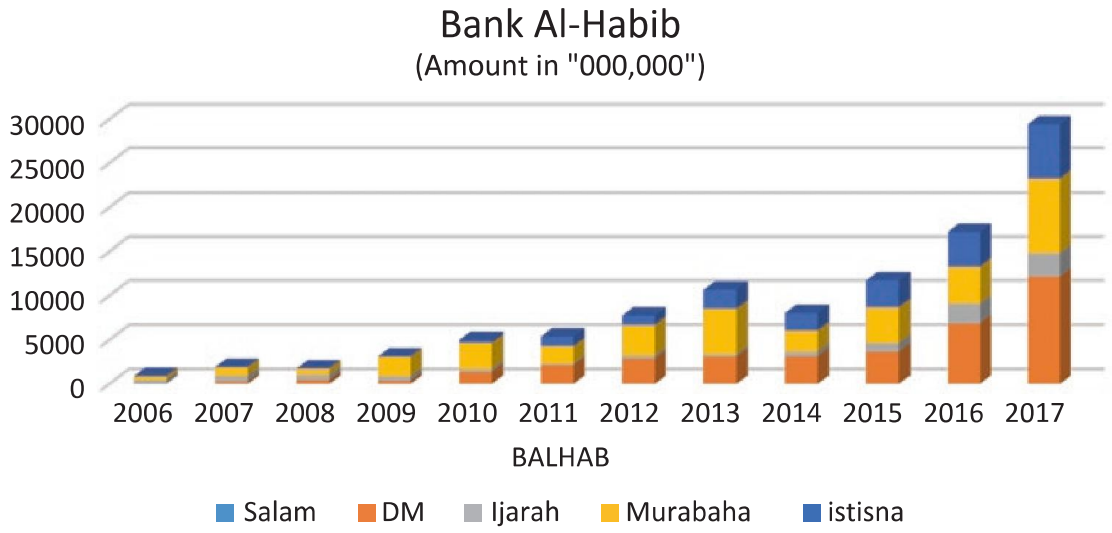
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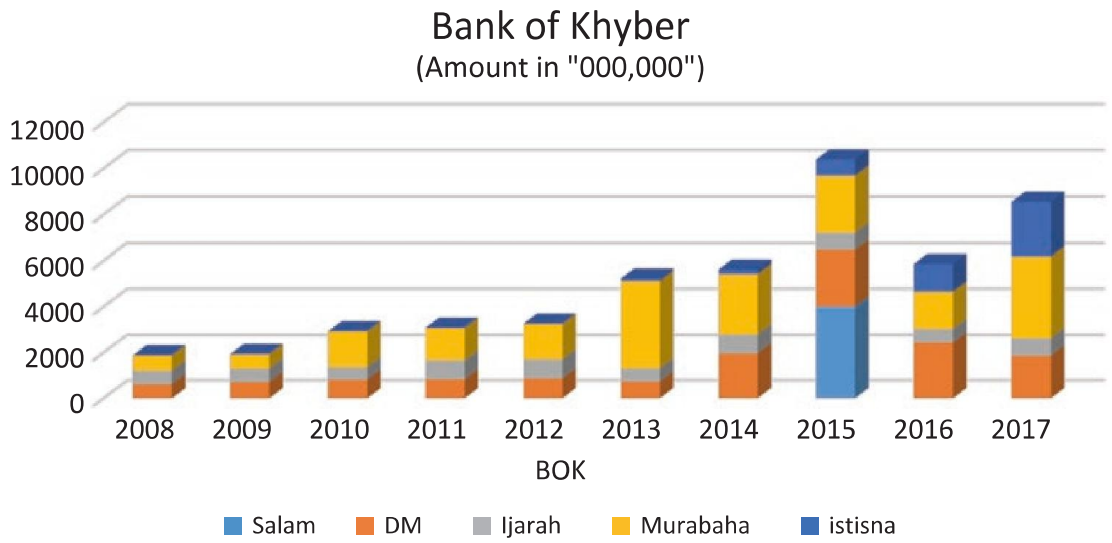
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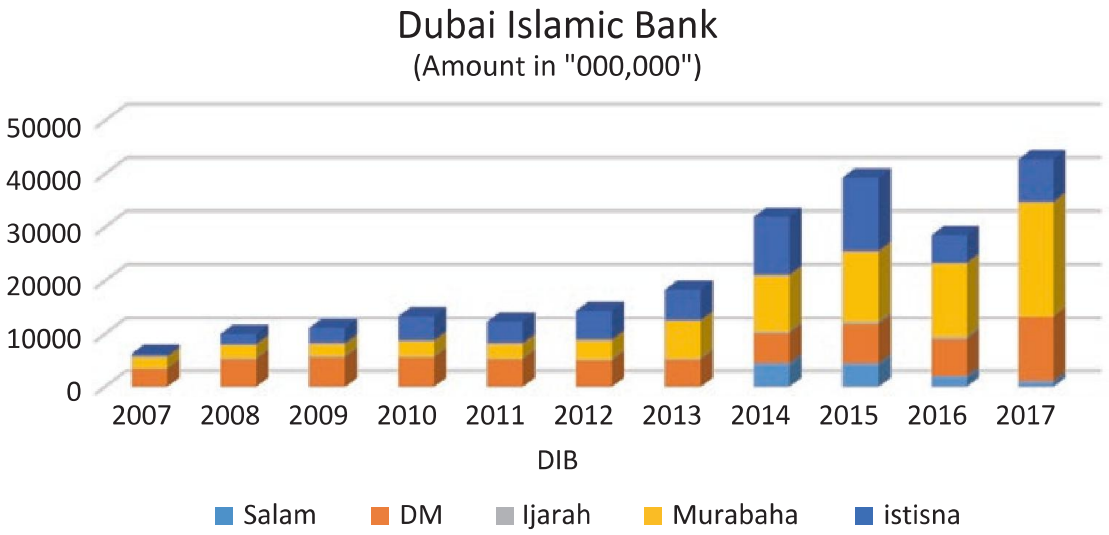
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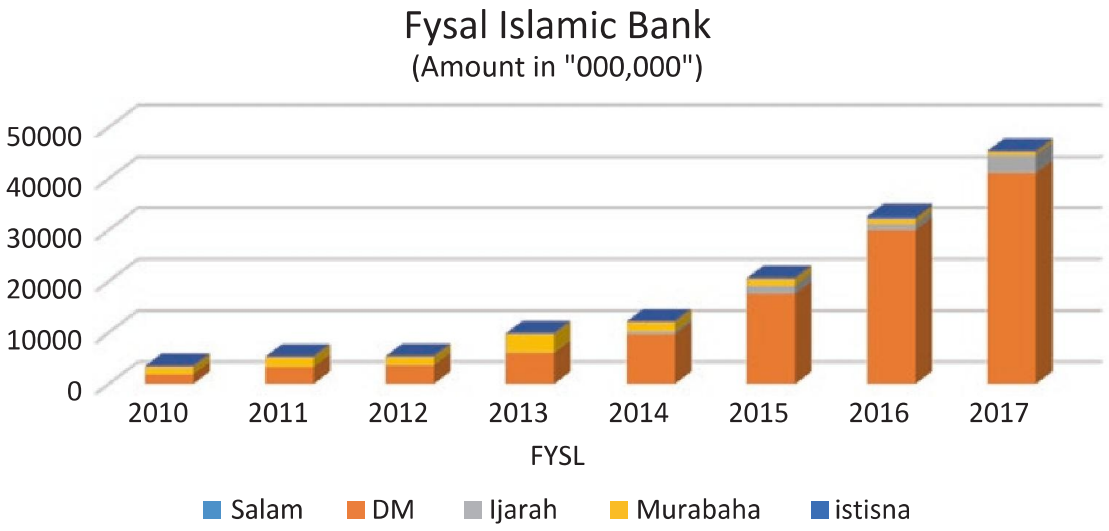
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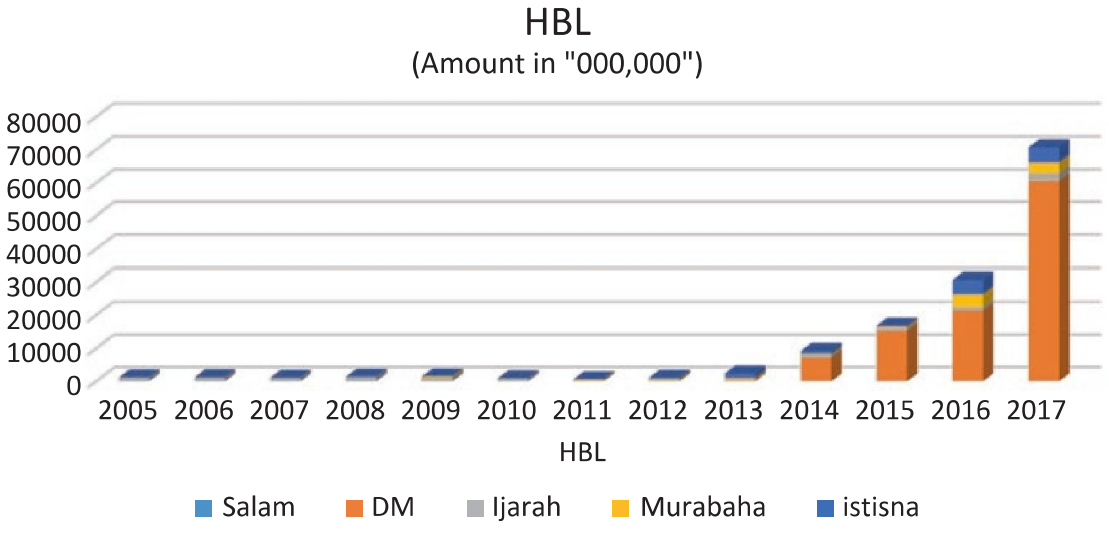
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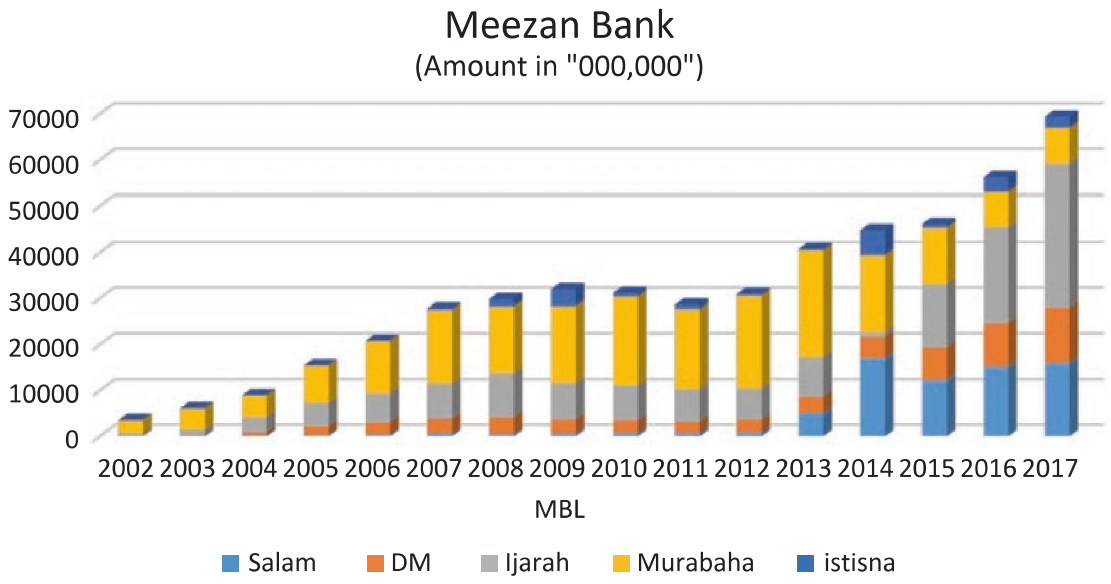
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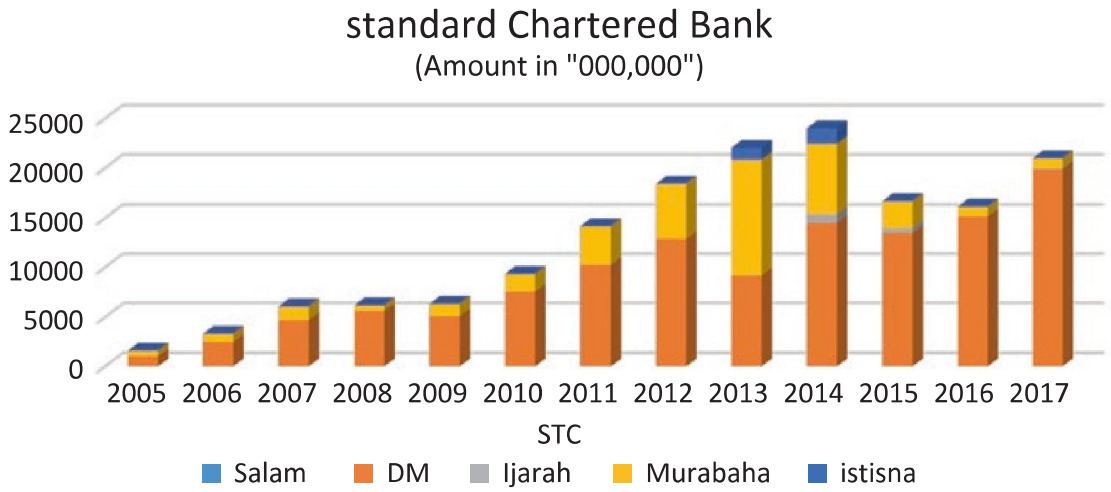
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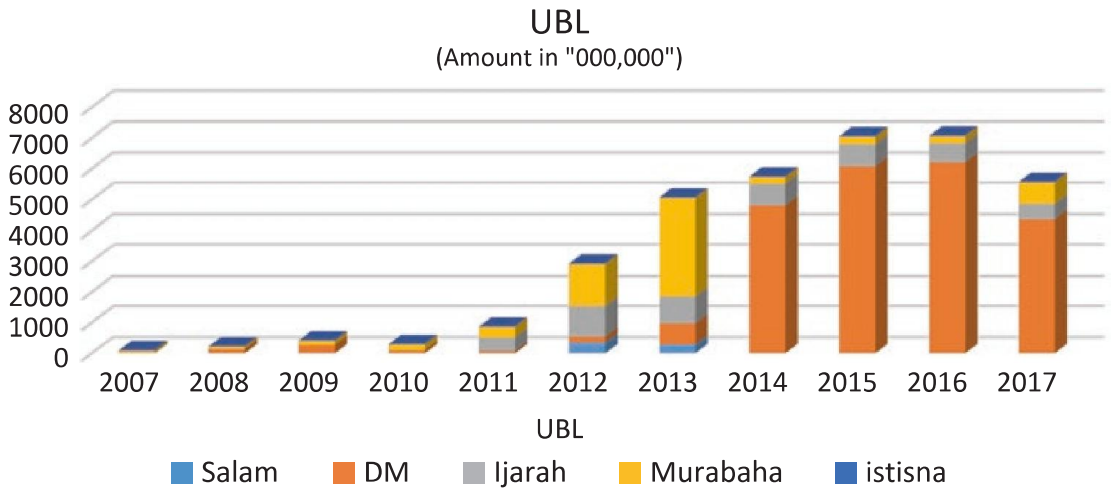
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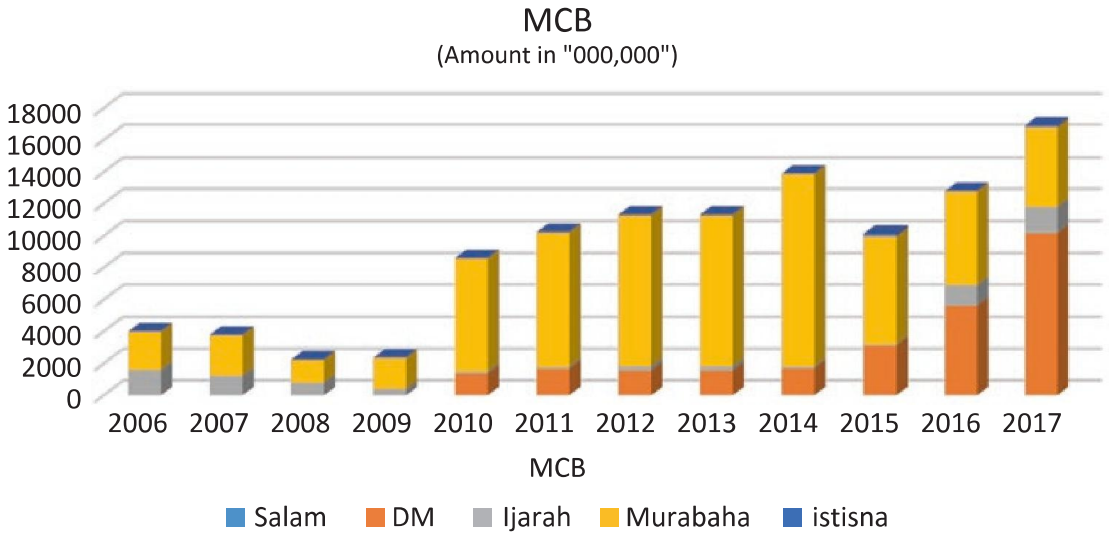

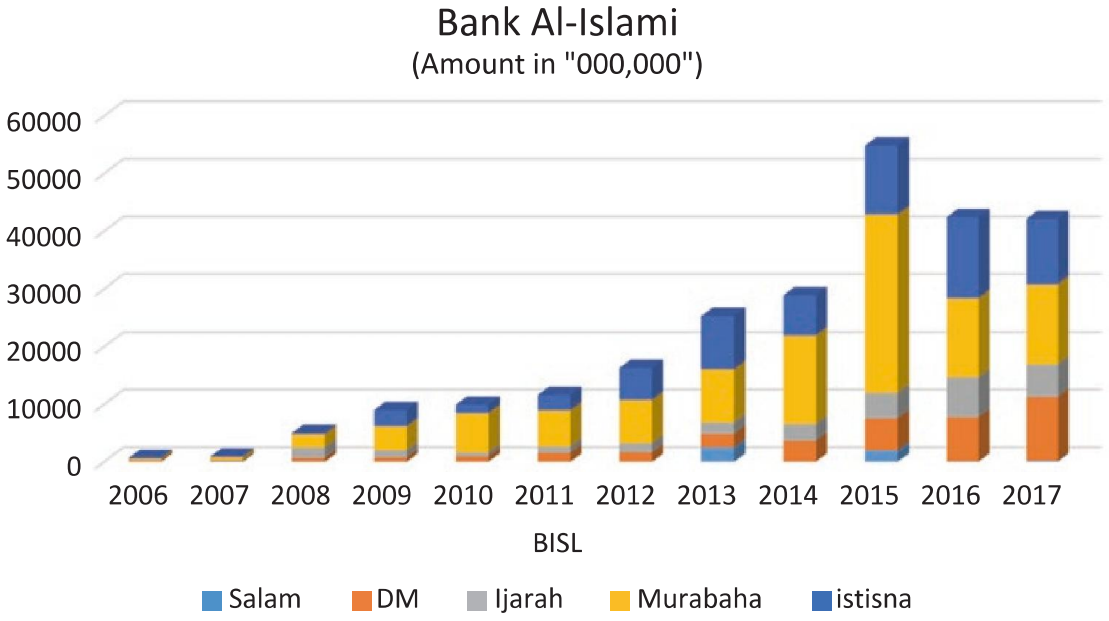

Note

1. There are five broad categories of higher Shariah objectives, for example, protection of religion, life, property, progeny, and intellect. All other objectives are covered under the umbrella of these five in different capacities.

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