

# Islamic Banking And Economic Growth: A Review

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## ABSTRACT

*Many previous studies have focused on the impact of finance on economic growth. However, few studies have examined the impact of Islamic banking on economic growth. To fill this gap in literature, this paper investigates the potential effects of Islamic banking on economic growth. The paper has two main results. The first result is that previous studies show mixed support for the hypothesis that Islamic banking is a main channel of economic growth. The second result is that previous studies on the impact of Islamic banking on growth are single-country studies and their findings are difficult to generalize. In addition, the results of this paper point to several implications for policy. One of its implications for policy is that Islamic banking positively contributes to country's macroeconomic stability.*

**Keywords:** Islamic Banking Economic Growth; Islamic Banking Economic Development

## 1. INTRODUCTION

The idea of Interest-free banking was introduced in the late of 1940s by Anwar Qureshi (1946), Naiem Siddiqi (1948) and Mahmud Ahmad (1952)<sup>1</sup>. The first modern experiment with Islamic banking was established in a small town in Egypt, called Mit Ghamr, in 1963 by Dr. Ahmed El Najjar. The bank took the form of a saving-investment bank based on profit sharing and free interest, rather than commercial bank. (Ariff, 1988; Siddiqi, 2006).

In the 1970s, the Islamic banking movement re-emerged with the establishment of the Islamic Development Bank (IDB) in 1974 by the Organization of Islamic Countries (OIC), which has been considered as the kick-start for the movement's second phase (Abdel-Haq, 1989). Many Islamic banks, both with letter and spirit, were established not only in Muslim countries, but have also gained footing in non-Muslim countries. Dubai Islamic Bank (1975), Faisal Islamic Bank of Egypt (1977), Faisal Islamic Bank of Sudan (1977), and Bahrain Islamic Bank (1979) were amongst the earliest commercial banks in the Arab countries. The Islamic Finance House in Luxembourg was established in 1978 to represent the first attempt at Islamic banking in Western world (Ariff, 1988), followed by the first Shariah-compliant insurance company (takaful) in 1983 in Luxembourg as well (Derbel et al., 2011). Many traditional Western banks have established Islamic windows / branches such the HSBC Bank, ANZ Grindlays, Standard Chartered Bank, Barclays, Citibank, ABN AMBRO, Klienwort Benson, Merrill Lynch, Midland Montagu, and Goldman Sachs (Khan, 2000; Hassan and Ahmed, 2002). Later on, during the eighteenth and nineteenth of the previous century, some Islamic countries such as Iran and Sudan have fully Islamized their banking systems (Sundararajan and Errico, 2002). Islamic financial institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, and financial service companies. The banking sector, in particular, follows different banking models, such as private institutions in a conventional economy (as in the most of Arab countries and the West), dual banking models (as in Malaysia), Islamic subsidiaries of conventional banking groups, and Islamic banking windows within conventional banks. With annual growth rates of 15-20% on average over the last five years, the Islamic finance market represents an international segment recording the fastest growth in the finance sector (Derbel et al., 2011). During the last three decades, the number of Islamic financial institutions has risen from one institution in one country in 1975 to over 300 institutions operating in more

<sup>1</sup> See Iqbal et al., (1987) for the historical development of Islamic banking.

than 75 countries worldwide (El Qorchi, 2005). These institutions are managing funds of around US\$200 billion, with total assets of more than US\$822 billion (Iqbal and Molyneux, 2005; Moin, 2008)<sup>2</sup>.

The paper is organized as follows. Section two presents the main characteristics of Islamic Banking. In turn, Section three illustrates the main advantages of the Islamic banking system over the conventional banking system. Section four presents the key instruments of Islamic banks. Section five illustrates the literature review on relationship between Islamic financing, in general, and Islamic banking, in particular, and financialization and economic development. It also reviews the comparative performance between Islamic and conventional banking, especially in the last financial crisis. Section six presents the conclusions of the paper.

## **2. THE MAIN CHARACTERISTICS OF ISLAMIC BANKING**

Previous studies identify the following nine distinctive characteristics of Islamic Finance in general and Islamic Banking in particular (see for example Riahi-Belkaoui, 2000; Mirakhor, 2000; Warde, 2000; Siddiqui, S.H., 2001; Haron and Hisham, 2003; Naqvi, 2003; Hassan and Musa, 2003; Derbel et al., 2011):

- a) The prohibition of interest “USURY”: All forms of contracts and transactions must be free from *Riba*. In general, the most obvious form of *Riba* is called “*Riba Al-Naseaa*”, which is defined as any return of money on money due to time preference alone. Guaranteed interest on a loan represents the most obvious example of *Riba* (or *Usury*) in conventional banks, which is strictly prohibited in Islamic law, whether this interest is fixed or floating, simple or compounded, and at whatever the rate.
- b) The prohibition of Unethical Investments: Islamic banking is also characterized by ethical norms and social commitments. Hence, investments in all unethical activities, such as: alcohol, gambling, tobacco, pork products, non-Islamic hotels or resorts, Sensual Entertainment...etc., are forbidden in the Islamic banking system.
- c) The freedom from Al-Gharar: All forms of contracts and transactions must be free from excessive uncertainty.
- d) The freedom from Al-Darar: Contracts should not be harmful to any party.
- e) The freedom from Impulse: Investors are prevented from making mistakes, which are harmful to their interests. For example, investors may be provided a specific period during which, they can cancel an impulsive transaction.
- f) The linking of finance to productivity: As seen above, Islamic banks cannot lend money to, or receive money from, someone and expect to benefit, because interest (usury or *Riba*) is not allowed. In Islam, money must be used in a productive way and wealth can only be generated through *legitimate trade* and *investment in assets*. New financial instruments have been developed in Islamic banks to comply with this feature. *Musharaka* and *Mudaraba* are only possible for productive companies, which contribute to real-life businesses that increase the production and improve the quality. *Murabaha* and *Ijara* must also involve a physical transaction of commodities or provision of services. Consequently, *Islamic banking system leads economic growth by promoting productive projects and supporting the trade of commodities and services*.
- g) The emphasis on equitable contracts: Investors have the right neither to be forced into a transaction, nor to be prevented from entering into a transaction. Investors have also the right to equal access to a particular set of information and to get equal power in negotiations leading to a transaction. Consequently, investors with privileged access to “Inside Information” should be prevented from using such information in their transactions.
- h) The desirability of profit sharing: Islamic banks deal with their depositors on investment basis. In that sense, Islamic banks themselves are regarded in the Islamic Fiqh as *Mudaraba* companies, where the depositors are regarded as the financier and the bank’s management (or the shareholders in general) is regarded as the entrepreneur. Consequently, Gains should be shared between the depositors and the bank.
- i) *Zakah* and *Al-Qard Al-Hassan*: Islamic banking, as one of the Islamic financial tools, aims at contributing to the fulfillment of the socio-economic objectives and the creation of a just society. Islamic banks, like any other Islamic institutions or even Islamic individuals, should pay *Zakah*, and, in some times, are required to

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<sup>2</sup> See also The Institution of Islamic Banking and Insurance: <http://www.islamic-banking.com/ibanking/statusib.php> and HSBC Amanah Finance: <http://www.amanahfinance.hsbc.com>.

provide Qard Hassan. Zakah is defined as an obligatory periodic levy on all Muslims who have wealth or income above a certain minimum, to be directed to specific categories of poor and needy people. On the other hand, Al-Qard Al-Hassan is simply defined as interest-free loan.

### **3. ADVANTAGES OF ISLAMIC BANKING**

Driven from and based upon the above characteristics, the Islamic banking system has the following advantages over the conventional banking system (Goaied and Sassi, 2009):

#### **a) More Efficient:**

Friedman (1969) has demonstrated that a zero nominal interest rate is a necessary condition for an optimal allowance of resources. Similarly, Wilson (1979) and Cole and Kocherlakota (1998) empirically demonstrated that zero interest rate is both necessary and sufficient for efficiency allocation in general equilibrium models. The reason is when fixing a zero interest rate, traders will have no reason to substitute real resources for money, so more resources will be conducted to investments. Goaied and Sassi (2009) supported this approach and explained that by excluding interest principle from its mechanism, Islamic banks exclude all speculative activities related to interest rate expectations, and, hence, change in money flow will directly reflect on real sphere by a change in demands and supplies of goods and services.

Some previous studies, using cost and/or profit functions to compare the efficiency of Islamic and conventional banks, concluded also that Islamic banks are more efficient than conventional banks (Alshammari, 2003; Al-Jarrah and Molyneux, 2005).<sup>3</sup>

Furthermore, the characteristic of “*profit sharing*”, discussed above, plays important role to boost the competition among Islamic banks to drive the profitability to its maximum in both the short and long run, which make all of them more aware and attached to the real market.

#### **b) More Stability:**

Cihák and Hesse (2008), based on “z-scores” analysis, proved that Islamic financial system is financially stronger and less risky than conventional banks. It is argued that the possessors of investment accounts in Islamic banking system don't have fixed value securities, which means that investment depositors automatically share the risk in the case of asset reduction due to macroeconomic or bank-specific crises.

#### **c) Reduction of Moral Hazard**

Islamic banks have a great advantage over conventional ones to benefit from the characteristics mentioned above, especially the productivity and the freedom from unethical investments, Al-Gharar (excessive uncertainty) and Al-Darar (harmful in contracts)...etc., to reduce the moral hazard and adverse selection problems.

In addition, the willingness to raise deposits and attract more depositors drives Islamic banks to launch “Cultural Programs” to instruct their employees on the religious dimensions of their activity. The knowledge of the Sharia combined with a high level of cultural aptitude reinforces the credibility of Islamic bank and generates a competitive advantage (Goaied and Sassi, 2010).

#### **d) More Conducive to Poverty Alleviation**

Since the most important criterion for financing projects in the conventional banking system is the ability to repay loans, collaterals and guarantees, only riches will have most access to financial market. In contrast, Islamic finance provides funds on the basis of sharing profit and loss principle, which gives importance on profitability and

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<sup>3</sup> However, Abdul-Majid et al., (2005) and Mokhtar et al., (2008) found the efficiency of Islamic banks to be similar to or less than conventional ones.

rate to return. Therefore, those who are not rich and have essential skills to success project like scientists, engineers or craftsmen would have a better chance to acquire finance. Asyraf Wajdi Dusuki (2008), based on his survey findings, recommended that Islamic financial institutions must not only focus on maximizing profit, but they should also play a vital role in addressing socio-economic issues such as poverty reduction and improvements in important aspects of human welfare (like education, research and development studies, illiteracy, reducing child mortality, youth insecurity and restlessness, etc.) by efficiently channeling financial resources towards productive opportunities, hence enhancing production, investment and trade activities.

Also it's important to notice the experience of Islamic banks in alleviating poverty through the use of Zakah funds and interest-free loans to improve the socio-economic development in the society. This is by either making the poor and needy people more productive, which in turn contribute to the economic development, financing human welfare activities, or both. Two examples are considered here (Goaied and Sassi, 2010). The first one is Jordan Islamic Bank that has established a special fund for interest-free loans to needy persons. During the period 2001 through 2003, the fund provided \$22 million to more than 40 thousand beneficiaries, an amount that is approximately 230% of the total net profits realized by the bank during these three years. The second one is the Islamic Development Bank in Jeddah, which has \$100 million in its "Waqf" account, to be spent on research, training, development studies, technical assistance programs...etc.

#### **4. KEY INSTRUMENTS IN THE ISLAMIC BANKS**

Central to Islamic finance is the fact that money itself has no intrinsic value. As a matter of faith, a Muslim cannot lend money to, or receive money from someone and expect to benefit. This means that interest (known as Riba in Islam) is not allowed and making money from money is forbidden. Money must be used in a productive way, by which wealth can only be generated through legitimate trade and investment in assets. The principal means of Islamic finance are based on trading. Any gains relating to the trading are shared between the party providing the capital and the party providing the expertise. As a result, the Islamic banks have developed four main Islamic financing techniques, which are: Mudaraba, Musharaka, Ijara and Murabaha, (see for example: chapra, 1998; Haron, 1998; Schaik, 2001; Alam 2003 and AAOIFI, 2010)<sup>4</sup>.

##### **a) Mudaraba (Trust Financing):**

Mudaraba is a partnership of a financing partner and a managing partner. The financing partner (the financier) entrusts his capital to the managing partner (entrepreneur), who in turn contributes his knowledge and entrepreneurial skills to the project. The financing partner is not involved in the actual management of the partnership. This makes trust financing the preferred form of partnership for banks. Profits are shared in a pre-determined ratio. However, in the event of a loss, the financing partner bears the loss, while the managing partner loses his effort and time, unless this loss was caused by the irresponsible behaviour of the managing partner (Chapra, 1998; Schaik, 2001; and AAOIFI, 2010).

In that sense, Islamic banks themselves are regarded in the Islamic Fiqh as Mudaraba companies, where the depositors are regarded as the financier and the bank's management (or the shareholders in general) is regarded as the entrepreneur.

##### **b) Musharaka (Joint Venture or Profit and Loss Sharing "PLS"):**

Musharaka means a profit and loss sharing joint venture. It is intended to combine the talents of two or more partners in a business enterprise, where each of them contributes capital, managerial expertise, efforts and other essential services in equal or varying degrees. Accordingly, they share in both risks and financial results on the basis of their share in capital and efforts. Since most banks do not wish to be actively involved with the management of a venture, this form of partnership is not commonly applied in Islamic banks (Schaik, 2001; Alam, 2003; and AAOIFI, 2010).

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<sup>4</sup> See also: Dubai Islamic Bank "<http://www.dib.co.ae/>" and Abu-Dhabi Islamic bank "[http://www.adib.co.ae/Main\\_E/index.asp](http://www.adib.co.ae/Main_E/index.asp)".

c) **Ijara (Leasing):**

Ijara is simply an Islamic lease agreement. It is defined by AAOIFI (2010) as: “*Ownership of the right to the benefit of using an asset in return for consideration*” (AAOIFI, 2010, p. 258). In this type of financing, the bank purchases a piece of equipment selected by a client, and then leases it back to him/her for a specified rental over a specific period. The duration of the lease, as well as the basis for rental, are set and agreed in advance (Pomeranz, 1997). In some cases, the bank may lease a tangible asset from a third party and subleases it to its client (Ali, 2004). The Islamic banks are currently practicing this technique in circumstances, under which clients opt to buy the item(s) eventually. In such circumstances, Ijara is practiced either in the form of “*Ijara-wa-Iktana*” or “*Ijara with diminishing Musharaka*”. The contract of “*Ijara-wa-Iktana*” extends the concept of Ijara to a hire and purchase agreement. It includes a promise from the client to buy the equipment at the end of the lease period, at a pre-agreed price. Rentals paid during the period of the lease constitute part of the purchase price. In other words, the monthly payment will consist of two components, i.e., rental for the use of the equipment and instalment towards the purchase price. Often, as a result, the final sale will be for a token sum. However, the contract of “*Ijara with diminishing Musharaka*” is widely used for home-buying services. Diminishing Musharaka means that the bank reduces its equity in an asset with any additional capital payment the client makes, over and above his/her rental payments. The client’s ownership in the asset increases and the bank’s ownership decreases by a similar amount each time the client makes an additional capital payment. Ultimately, the bank transfers ownership of the asset entirely over to the client.<sup>5</sup> The liquidity risk in both types of Ijara contract will therefore be limited as the sale price is built into the rental instalments (Suleiman, 2000).<sup>6</sup>

d) **Murabaha (Mark-up financing or Cost-plus financing):**

Murabaha is defined in the Islamic Fiqh as the sale of goods at cost plus an agreed profit mark-up (Al-Mawseli, 1963; Al-Gzaairi, 1979; Al-Jinde, 1986 and AAOIFI, 2010). It is very important in this type of Islamic financing that the seller truthfully informs the purchaser of the price at which he purchased the product and stipulates an amount of profit in addition to the original cost (see for instance: Al-Shirazi, Vol. 1; Ibn Rushd, Vol. 2; Ibn Aanas, Vol. 4; Al-Kasani, Vol. 5; and Ibn-Qudama, Vol. 4). Thus, Murabaha is, in theory, a form of trade financing. It is simply a sales contract that fixes the price of certain goods or items, plus a specified percentage mark-up (profit). However, it is currently practiced as an agreement between a final buyer (the customer) and a middleman (the Islamic bank), by which the Islamic bank plays the role of financier. In this case, a client requests the bank to purchase the selected goods according to certain specifications. Once the bank purchases the goods, it resells them to that client at the cost plus a certain profit. The Murabaha contract in such a case is called “*Murabaha to the Purchase Orderer*” (Al-Qaradawi, 1987; Shehatah, 1987; El-Galfy, 1991 and Suleiman, 2000).

## 5. EMPIRICAL STUDIES ON THE ISLAMIC BANKING-GROWTH NEXUS

Even though economists disagree sharply about the role of financial sector like banking in economic growth, they do agree that finance follows enterprise i.e. finance responds to the changing demand of the real sector. For some economists like Raveendra Nath Batra (1985), financial capitalism breeds excessive inequality and political corruption, which may lead to financial crises and economic depression. According to Marxian political economics, the term “financial capitalism” is defined as a subordination of processes of production to the accumulation of money profits in a financial system. It is characterized by the pursuit of profit from the purchase and sales of financial instruments like currencies, bonds, stocks, futures and their derivatives. Marxists see financial capitalism as exploitative because it supplies income to non-laborers. Islam shares this idea to some extent and for this reason it prohibits the giving and charging of interests in a loan or sale transaction. Financial capitalism, or financialization as some writers call it, is one of the main reasons for financial crises that may lead to an economic depression.

<sup>5</sup> For more details, see the Islamic Bank of Britain: <http://www.islamic-bank.com>

<sup>6</sup> See: <http://www.al-bab.com/arab/econ/nsbanks.htm>.

## **5.1 Financialization and Islamic finance**

Financialization refers to a pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production. Gerald Epstein (2001) defined financialization as the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international levels.

Financialization becomes a reality when the vastly expanded role of financial motives, financial markets, financial elites and financial institutions in the operation of domestic and international economies gain greater influence over economic policy and economic outcomes. Financialization transforms the functioning of the economic system at both the macro and micro levels. This may include elevating the significance of financial sector relative to the real sector, transferring income from the real sector to the financial sector and increasing income inequality.

Financial services in developed economies represent a sizable share of the GDP and source of employment. For this, in the wake of recent financial crisis some economists argue that the increasing size of financial services in an economy may lead to the Financialization of the economy. Some, such as former International Monetary Fund chief economist, Simon Johnson (2009) even went so far to argue the increased power and influence of the financial services sector had fundamentally transformed the American polity, endangering representative democracy itself.

Mirakhor and Krichene (2009) are of the opinion that Financialization has drastically weakened the link between the financial and real sectors, allowing for the inverted credit pyramid to reach a leverage ratio in relation to real GDP that might have exceeded a multiple of 50. It has been noted the alarming growth of the inverted credit pyramid in relation to real GDP and determined that financialization had nearly severed the relationship between finance and production. For each dollar worth of production there are thousands of dollars of debt claims, and predicted the imminent collapse of such a credit pyramid. The housing and commodity bubbles were fuelled by the securitization of assets and credit derivatives which pushed floods of liquidity to the sub-prime markets. The ratio of credit has risen to an unprecedented level in relation to GDP, which led to difficulties in servicing such credit. Households were not able to pay the speculative prices and speculative gains as well as the high salaries of debt merchants. These become a burden on households. Foreclosures have transferred the entire burden to banks that suffered large losses and had to be bailed out with trillions of dollars by governments during the last financial crisis.

William K. Black (2009) listed the ways in which the financial sector harms the real economy. For him, the financial sector functions as the sharp canines that the predator state uses to rend the nation. The financial sector misallocated the remaining capital after siphoning off capital for its own benefit. This was done in a way that harms the real economy in order to reward the already-rich financial elites at the expense of the financial wellbeing of the nation.

In a speech before the Reserve Bank of India (Central Bank of India), the head of Britain's Financial Services Authority (Adair Turner, 2010) directly blamed Financialization of the economies as a primary cause of the 2007-2010 world financial crisis and 1997-98 Asian financial crises. He said both were rooted in, or at least followed after, sustained increases in the relative importance of financial activity relative to real non-financial economic activity, an increasing "Financialization" of the economy.

Unlike to financial capitalism or financialization, Islamic financing is purely a real-life, real goods financing. No financing can find its way to the Islamic system without passing through the production and/or exchange of real goods and services.

According to Kahf, Ahmed and Homud (1998), Islamic financing is intrinsically integrated with the goods and commodities market and it is limited by the volume of finance required by actual transactions that take place in this market. Islamic financing is limited by the size of the transaction in the goods and services market whether it is done by means of sharing, sale or lease contracts. This makes Islamic modes of financing direct and strongly linked to real and physical transactions. Like sharing modes are only possible for productive enterprises that involve real-

life business that increase quantity or improve quality or enhance usability of real goods and services; and by doing that, such business generate a return that can be distributed between the entrepreneur and the financier. Even the sale-based modes are those that involve actual and physical exchange of commodities from one hand to another whereby financing is measured only by real sale of commodities and only can be provided to the extent of the real value of goods exchanged. The same thing also applies to leasing where leased assets are the pivotal thing around which financing is built.

## **5.2 Modes of Financing and Economic Development**

The Islamic mode of financing, by virtue of their very nature, are incompatible and inapplicable to the purely monetary activities of conventional banking like debt rescheduling, debt swaps, financing speculative cash balances, interbank liquidity speculative transfers, currency speculation, short selling, hedge funds, collateralized debt obligations (CDOs) which rarely add value to the real economy.

It is no exaggeration to say that without the evolution of banking system industrial revolution would not have taken place in Western countries. It is also true to say that without the sound banking under developed countries would not have joined the ranks of advanced countries.

No doubt, if a country's banking system is efficient, effective and well-disciplined it brings about rapid growth in the various sectors of the economy through promoting capital formation, providing credit facilities, investment in new enterprises; promotion of trade, industry and agriculture; promoting export and implementation of monetary policy. This suggests that banks' role in economic development rests chiefly on their role as financial intermediaries. In this capacity, banks help drive the flow of investment capital throughout the marketplace. The chief mechanism of this capital allocation in the economy is through the lending process.

But can western banks address the issue of economic development with this lending process in their hand? Previous studies (World Bank Research Observer, 1996) showed that most commercial banks avoid financing high risk projects even if they have high return and prefer lending to low-risk activities even if the returns from such activities is very low. These banks don't look for better investment opportunities with reasonable risk and return profile but they are looking for firms with sufficient collateral to give credit and charge interest. This makes them less willing to finance small firms that don't have adequate collateral. Also the Bank of International Settlement (BIS, 1982) has acknowledged that conventional banks contributed in the credit expansion through excessive and imprudent lending practices.

According to Umer Chapra (2009), three factors make it possible for banks to resort to such unhealthy practices: inadequate market discipline, the mind boggling expansion in the size of derivatives like credit default swaps (CDSs) and the "too big to fail" concept which provided banks with a false sense of immunity from losses. This false sense of immunity led to unhealthy expansion of credit, excessive leverage, unsustainable rise of asset prices, living beyond means and speculative investment. On the other hand, he argues, Islamic financial system does not allow the creation of debt through direct lending and borrowing because it can only be done through lease or sale-based financing. Of course the asset sold or leased should be real asset and the seller or the lessor should own the asset before the transaction. The debt created from such transaction cannot be sold out to a third party to avoid the risk associated with it. This makes the lender take full risk of his actions, as no risk no gain. This will help us prevent the rising of debt far above the size of the real economy, which resulted, into global financial crisis. There is a public good in curbing excessive credit expansion.

Salman Sayed Ali (2011) also argues that even the credit types of Islamic financing, like Murabaha and Ijara transactions, which provide credit against usufruct or tangible asset, require Islamic banks to know the client's purpose and use of finance. These modes also require ownership of the asset by the bank, albeit for shorter duration in case of Murabaha and longer duration in case of Ijara finance. This increases the likelihood (or ensures) that the funds are used for their stated purposes. Thus, it keeps credit tied to real economic activity for each transaction and throughout the tenor of contract. In conventional bank financing the client is not required to disclose the use of funds as long as the client is believed creditworthy or can post suitable collateral. This ownership of the financed asset by banks can help them in credit risk mitigation. In addition to that it curbs the roll-over of the credit which may lead to the ballooning of debt and credit which may delink the financial sector from the real sectors.

It has also been observed that small manufacturers and farmers, as compared with larger production units, face much greater difficulties in obtaining short, medium and long-term credit through institutional channels. The major constraint to access to finance was the lack of tangible collaterals.

Abdel Hamid Abdouli (1991) argues that Islamic banking breaks this discriminative barrier and offers an equal opportunity to all potential producers by taking intangible assets, such as education, skills, and experience as collateral as tangible assets. Islamic banking would contribute to the emergence of a just and growing economy by enabling small enterprises to obtain finance on participatory basis in which collateral is not necessary. He argues that the common practice of western banking institutions of granting credit facilities only to those who are able to offer sufficient tangible collateral security, would rather deteriorate the already uneven income distribution between upper and lower classes. Because of the nature of its operations, Islamic banking does offer a new dimension in lending. Since it is a system based on participatory financing, Islamic banking would not depend on tangible collaterals as much as western/conventional banks. Such access of finance not totally dependent on wealth endowment, would eventually lead to a better distribution of income and a larger improvement in the well-being of those who for none of their fault were endowed with niggardly resources.

Nidal El-Ghattis (2011) also argues that in contrast to conventional methods of financing, Islamic financing is not centered only around creditworthiness of the client but rather on the worthiness and profitability of the project to be financed. Therefore recovering the principal becomes a result of profitability and worthiness of the actual project. The Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution, which results into greater benefits for social justice and sustainable growth. The profit and loss sharing (PLS) scheme improves capital allocation efficiency as a return on capital depends on productivity and profitability of the financed project.

The profit and loss sharing based financing encourages entrepreneurial activities by removing the injustice caused by interest-based financing which makes the entrepreneur responsible for every loss that happens to his project. PLS distributes risk in a fair manner that encourages venturesome entrepreneur to take more projects with the same level of risk-taking attitude he/she already has. For Kahf (1999) entrepreneurship and risk sharing are therefore promoted by Islamic finance and its expansion to the unwealthy members of the society is an effective development tool. The social benefits are clear, as currently the poor are often exploited by financial institutions charging usurious rates. This sharing principle is very different to traditional banking practices. It introduces the concept of sharing to financing and creates a performance incentive within the mind of the banker that relates deposits to their performance in the use of fund. This increases the deposit market and gives it more stability.

For Iqbal (1997), the economic development of Islamic countries can be greatly enhanced by the Islamic financial system due to the mobilization of savings that are being kept away from interest-based banks and the development of Islamic capital markets. This motivation to invest in Islamic banks may also stem from the fact that research shows that the share in the banks' profit may at time be higher than the fixed rate of interest given by conventional banks.

Even Iqbal and Molyneux (2005) are of the opinion that Islamic banking promotes innovation by financing anyone who has a good idea. If a small and medium entrepreneur has a better project he has the possibility of getting financed and he will not be held back by the fear of tremendous risk since innovation involves a huge risk. Islamic banking system results in a better risk distribution since the risk is distributed between the financier and the entrepreneur.

Of course economic development requires effective and efficient mobilization of financial resources both internally and externally and any resource left hoarded indicates unrealized potential for economic development. For Kahf (1999), the focus of Islamic finance on profitability and rate of return of investment due to equity and profit sharing has the potential of directing financial resources to the most productive investment and hence increases the efficiency of resources allocation.

Dridi and Hasan (2010) also asserted that there was a difference in terms of financial intermediation between Islamic and conventional banking. The central concept in Islamic banking and finance is justice, which is

achieved mainly through the sharing of risk. Stakeholders are supposed to share profits and losses because of the prohibition of interest in Islam. While conventional intermediation is largely debt based, and allows for risk transfer, Islamic intermediation, by contrast, is asset based, and centers on risk sharing. One key difference between conventional banks and Islamic banks is that the latter's model does not allow investing in or financing the kind of instruments like bonds, derivatives and toxic assets which have adversely affected their conventional competitors and triggered the global financial crisis.

Umer Chapra (2009) is of the opinion that since the current architecture of the conventional financial system has existed for a long time, it may perhaps be too much to expect the international community to undertake a radical structural reform of the kind that the Islamic financial system envisages. However, the adoption of some of the elements of the Islamic financial system, which are also part of the western heritage, is indispensable for ensuring the health and stability of the global financial system.

### **5.3 Comparative Performance Between Conventional and Islamic Banks Using Financial Ratios:**

Olson and Zoubi (2007) investigated whether financial ratios will differ significantly between the two categories of banks; Islamic banks via conventional banks. They examined 16 financial ratios commonly used in the banking industry and used logit, neural networks, and k-means nearest neighbors to determine whether researchers or regulators could use these ratios to distinguish between types of banks. Although the two categories of banks have similar financial ratios, the best nonlinear classification technique (k-means nearest neighbors) is able to correctly distinguish Islamic from conventional banks in out-of-sample tests at about an 87% success rate. The results indicated that characteristics such as profitability ratios, efficiency ratios, assets quality indicators, and cash/liability ratios are good discriminators between Islamic and conventional banks in the GCC region. Such findings are consistent with the literature on corporate failure, credit rating, and assessment of risk that also show that accounting numbers are useful for classifying firms within the same industry into two or more categories based on financial characteristics.

Consistently, Moin (2008) examined the performance of the first Islamic bank in Pakistan, i.e. Meezan Bank Limited (MBL) in comparison with that of a group of 5 Pakistani conventional banks, with respect to profitability, liquidity, risk, and efficiency for the period of 2003-2007. He used 12 Financial ratios, such as Return on Asset (ROA), Return on Equity (ROE), Loan to Deposit ratio (LDR), Loan to Assets ratio (LAR), Debt to Equity ratio (DER), Asset Utilization (AU), and Income to Expense ratio (IER), to assess banking performances. T-test and F-test were used in determining the significance of the differential performance of the two groups of banks. The study found that MBL is less profitable, more solvent (less risky), and less efficient comparing to the average of the five conventional banks. However, MBL is improving considerably over time indicating convergence with the performance of the conventional banks. In terms of liquidity, the results indicated that there was no significant difference between the two sets of banks.

Janbota & Anju Kishore (2006) got different results when they examined the performance of Islamic banks in the UAE, where the Islamic funds are highly concentrated, during the period 2000-2004. They found that the UAE Islamic banks are relatively more profitability, less liquid, less risky, and more efficient compared to the UAE conventional banks. Authors associated this performance to productive characteristic of Islamic products on the basis of profit-loss sharing principle.

Karim and Ali (1989) investigated the effect of the interaction between environment (competition) and financial strategies adopted by banks on the capital structure of two Islamic banks, Faisal Islamic bank and Kuwait Finance House, for the period 1979-1985. The results indicated that the composition of the capital structure of the two banks examined is dependent upon the management strategic choice. It suggested that Islamic banks may prefer to obtain funds from depositors rather than from shareholders during expansionary periods in an economy. When combined with the requirement for risk sharing, return on equity should be higher for Islamic than for conventional banks.

Rosly and Abu Baker (2003) examined six financial ratios for Islamic and mainstream banks in Malaysia for the years 1996-1999. They showed that Islamic banks' return on assets, profit margin, and net operating margin are statistically larger than for mainstream banks, while operating efficiency and asset utilization ratios are

statistically smaller than for conventional banks. Nevertheless, they suggested that Islamic banks have chosen to behave more like mainstream banks than required by Shariah principles. Their research leaves unresolved the question of whether both types of banks behave similarly in other countries and whether financial ratios can be used to meaningfully distinguish between Islamic and conventional banks.

Another line of research has focused on the profitability of the banking sector in general, without comparison between Islamic and conventional, in one or more countries in Islamic world. Islam (2003) investigated the development and performance of commercial banks in Bahrain, Oman, Dubai and Abu Dhabi in United Arab Emirates for the period 1998-2000. He used several financial ratios to measure bank performance and show that GCC banks perform well relative to western banks. He also indicated that competition among GCC banks increased over the period examined. Ahmed and Khababa (1999) studied the effect of business risk, market concentration, and size on profitability of eleven commercial banks in Saudi Arabia for the period 1992-1997. They employed a regression model using three measures of profitability: return on assets, return on equity, and earnings per share. Their results showed that business risk and size explain bank profitability in Saudi Arabia. Murjan and Ruza (2002) examined the competitiveness of the commercial banks in nine Arab countries (Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar, Saudi Arabia, Tunisia, and United Arab Emirates). Using a Ross-Ponzar test for the period 1993-1999, their study suggested that the banking industry in those countries operates under conditions of monopolistic competition. Essayad and Madani (2003) examined the concentration, efficiency, and profitability of 10 commercial banks in Saudi Arabia for the period 1989-2001. Their results indicated that the Saudi Arabian banking industry is highly concentrated and has a four-firm concentration ratio ranging between 69% and 87%. They also showed that profitability rises with increases in bank efficiency and that bank profits are positively related to oil revenues. Finally, Al-Tamimi and Al-Amiri (2003) examined the service quality of two Islamic banks in UAE (Abu Dhabi Islamic Bank and Dubai Islamic Bank) by distributing questionnaires to 700 customers. About 350 responses were received and they revealed that customers were very satisfied with the quality of services received from these banks.

#### **5.4 The Performance of Islamic and conventional Banks During the Financial Crisis**

Islamic banks showed stronger credit growth than conventional banks during the financial crises in almost all counties according to the work of (Dridi and Hasan, 2010). This suggests that Islamic banks made a greater contribution to macroeconomic and financial stability by making more credit available. Most studies showed that the inherent resilience of Islamic finance have seen the total asset in the industry to grow to an estimation of USD 1.2 trillion by the end of 2011.

Oliver Agha (2012) stresses that Islamic finance should serve as a stabilizing force in the global economic order, because deposits in Islamic banks (which are not loans but true investment deposits on a Mudaraba basis) are reinvested in the real economy for goods/services without any artificial money expansion. In the conventional system, banks increase credit in good times on the fractional reserve banking system principle -- for each dollar deposited (loaned) to a bank, the bank may loan out many more. The "choking" of such credit, in a downturn, can wreak havoc as evidenced by the financial crises, and therefore the equity-based constructs inherent in the Islamic system are likely to serve as a stable pillar of the economic system particularly in these times.

The goal of Islamic banking and finance is to bring greater justice and strive to achieve socio-economic development. Islamic financial system can serve as a tool to foster economic growth and human well-being. Promoting risk-sharing instead of debt-financing, reduces poverty and inequalities which are the necessary objectives of that need to be addressed by economic development policy makers.

## **6. CONCLUSION**

This study is a precursor to a major empirical study into the impact of Islamic banking experiment on economic growth. It contributes to the literature by reviewing the main characteristics, advantages and key instruments of Islamic banks. The main characteristics of Islamic banking include the prohibition of interest "USURY", unethical investment, Al-Gharar, Al-Darar, and impulse. Islamic banks are also characterized by the emphasis of productivity, equitable contracts, profit sharing. Islamic banks have developed many financial

techniques that adopt the above characteristics and comply with Islamic sharia principles. This led to some unique advantages of Islamic banking over conventional banking, which include superior efficiency and stability, reduction of moral hazard and conducive to poverty alleviation.

The main focus of this paper is to review the literature related to the relationship between Islamic financing, in general, and Islamic banking, in particular, and financialization and economic growth. It also concentrated on the literature that discussed the comparative performance between Islamic and conventional banking.

One of its implications for policy is that Islamic banking positively contributes to macroeconomic stability for both developing and developed countries. In summary, the paper has two main results. The first result is that previous studies show mixed support for the hypothesis that Islamic banking is a main channel of economic growth. The second result is that previous studies are single-country studies and their findings are difficult to generalize. To obtain more general results, future research should investigate the impact of Islamic banking on economic growth using panel data analysis rather than time-series analysis.

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**NOTES**