THE ISLAMIC BANKING FINANCE AND ECONOMIC GROWTH NEXUS

by

Muhammad Irfan Saleem

Pide2018FMPHILEAF05

Supervisors

Dr. Farhat Mahmood

Dr. Ahsan ul Haq Satti

PIDE School of Economics

Pakistan Institute of Development Economics

Islamabad, Pakistan

2022

Pakistan Institute of Development Economics, Islamabad

CERTIFICATE

This is to certify that this thesis entitled **"The Islamic Banking Finance and Economic Growth Nexus".** Submitted by **Muhammad Irfan Saleem** is accepted in its present form by the PIDE School of Economics, Pakistan Institute of Development Economics (PIDE) Islamabad as satisfying the requirements for partial fulfillment of the Degree of Master of Philosophy in Economics and Finance.

Supervisor: ______________________
Dr. Farhat Mahmood
Lecturer,
PIDE, Islamabad

Co-Supervisor: ______________________
Dr. Ahsan ul Haq
Assistant Professor,
PIDE, Islamabad

Internal Reviewer: ______________________
Dr. Hafsa Hina
Assistant Professor
PIDE, Islamabad

External Examiner: ______________________
Dr. Anwar Shah
Associate Professor, School of Economics,
Qaid-I-Azam University, Islamabad.

Head, PIDE School of Economics: ______________________
Dr. Shujaat Farooq
Assistant Professor,
PIDE, Islamabad.

Date of Examination: 06-01-2022

Author's Declaration

I, **Muhammad Irfan Saleem,** hereby state that my MPhil thesis titled **"The Islamic Banking Finance and Economic Growth Nexus"** is my work and has not been submitted previously by me taking any degree from Pakistan Institute of Development Economics or anywhere else in the country.

At any time if my statement is found to be incorrect even after the completion of my degree the university has a right to withdraw my MPhil degree.

Date: 17-03-2022

Muhammad Irfan Saleem

Dedication

*To my **"beloved family"** who gave me lessons in many things. To the men and women surrounded me, who are in the community in quest to have a healthy living. To the **"Mentor and velvety personality"** my supervisor in particular with bright-eyed and bushy-tailed, to the lady who I loved the most, **"My mother",** to my friend **Muhammad Hassan** for his unlimited support, to my elder sister **Dr. Madiha Gohar** for her guidance and most especially to **"Al-Mighty Allah",** this Research is dedicated to you.*

ACKNOWLEDGMENT

I am thankful to Al-Mighty Allah who bestowed blessing and power to me for completing this provocative Research. I am thankful to my parents especially to my mother whose prayers, courage and help made my research efficaciously completed. I also want to pay a special thanks to my friends who encouraged me and helped me in pursuing this tremendous achievement. Finally, I am grateful to all those who helped me in completing my thesis.

I feel pride in expressing my genuine sense of gratitude to my mentor and dedicated personality honorable supervisor "**Dr. Farhat Mahmood"** and co supervisor **"Dr. Ahsan ul Haq Satti"** Senior Research Economist at **"Pakistan Institute of Development Economics (PIDE), Islamabad"** who is the source of initiation for this research.

Most importantly, I present my obligations and heartfelt admirations to my loving parents, sisters, and brothers because; my success is the fruit of their support and devoted prayers. Their wishes and prayers made me to complete my thesis.

ABSTRACT

Islamic Banking is form of banking in which the transactions are based on Shariah (Islamic Laws) and all the financial transactions/activities are carried through or with according to the Islamic rules and regulations. This research targeted to determine the Islamic Banking financing effect on economic growth of Muslim populated Asian countries including Bangladesh, Brunei, Indonesia, Malaysia, and Pakistan. This research employs the multiplying mediating approach by utilizing the yearly panel data (2005-2019) along with interviews from relevant industry experts and review of policies/guidelines issued by State Bank of Pakistan from time to time on Islamic Banking. Overall, the finding suggests that there is no direct significant effect of Islamic banking financing on economic growth. Nevertheless, it concludes that Islamic banking financing possesses significant indirect effect on economic growth via mediating variables like investment and consumption. In conclusion, our research recommends that future economic analysis and policies should focus on the Islamic finance-growth nexus via Islamic banking development in order to stimulate sustainable economic development in nations. Further, it tends the authorities to work on the solutions of possible challenges and issues faced by the Islamic banking industry and mull over its regulatory, institutional, governmental, and political factors and it influence. It further puts emphasis on promoting sharia research for an innovative and efficient banking system.

Keywords: Islamic Banking financing, Consumption, Investment, Economic Growth and Mediating Analysis**.**

TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

LIST OF ABBREVIATIONS

Acronym	Prolongation
ADB	Asian Development Bank
CBF	Commercial Bank Financing
CPI	Consumer Price Index
FDI	Foreign Direct Investment
FIs	Financial intermediators
GCC	Gulf Corporation Council
GDP	Gross Domestic Product
HBFC	Housing building finance company limited, Pakistan
ICP	Investment corporation of Pakistan
IBF	Islamic Banking Financing
IFSB	Islamic Financial Service Board
IMFN	Islamic Microfinance News
MENA	Middle East and North Africa
NIT	National investment trust, Pakistan
QISMUT	Qatar, Indonesia, Saudi Arabia, Malaysia, the United Arab Emirates and Turkey

CHAPTER 1

INTRODUCTION

1.1 Introduction

There is no denying the fact that the financial system including financial intermediaries (FIs) and economic development of a country are interlinked. The financial system of any nation performs a critical function in the country's economic development (Bist, 2018). Some avenues through which the financial system affects economic growth is through consumption and investment channel in the economy. The financial intermediaries like banks have a pertinent role to play here. They are able to channel funds from those who wish to save to those who want to invest but do not have the sufficient funds to do so. The middleman or the intermediary role of the banks is a win-win situation for both the parties as banks pay interest on saving deposits and investors receive funds at a competitive rate for them to invest in productive activities.

1.1.1 The Role of Financial Intermediaries (Fls)

Financial intermediaries (FIs) support purchasers and suppliers of financial capital resources. (Samuelson & Nordhaus, 1989) describes financial intermediaries (FIs) as a financial institution which promote savings and loan associated assessment to that, take credits or funds from one individual or group of individuals to distribute them to another individual or group of individuals, like banks, insurance companies etc. The function of financial intermediaries can be finely enlightened by the absence of these institutions in an imaginary assumption. What can a financial intermediator do that could not be done in absence of them?

Financial intermediaries like banks provide feasible indication to capital markets through their loan process. The steady supervision of their clients' financial position alleviates lop-sided information (James, 1987); Banks improve and advance the worth of total aggregate investments (Bhattacharya & Thakor, 1993).

After all, there is always an option available to people who intend to avail financing at a specified interest rate without involving any financial intermediary in between. The reason for why we abstain to do so is because individuals are faced with adverse selection and moral hazard problem. In this world of skewed and imperfect information, it is arduous to accurately weigh the numerous quantifiable features of the lending and borrowing processes for an individual, assuming the time constraint. People would rather believe the financial intermediary than any other stranger, given its specialty in the business. (Thakor, 1995) categorize financial intermediators as executing two (02) main roles: The brokering Function and The Qualitative Asset Transformation (QAT) Function. In the brokerage function, the brokerage function is devoted to the information/data, timeliness, and costs minimizing that FIs offer in the conversion of assets. (Rajan, 1992) proposes that financial intermediaries control information-related rents which cannot be substituted in direct borrowing.

Apart from the above mentioned primary purposes of banks, banks also provide other services for which they charge fees as a compensation. These may include providing instant and convenient access to own cash through Automated Teller Machines (ATMs), financial advisory services, platform for making online national and international payments, offering third-party services like bank assurance, vouchers and discounts, and bank lockers for safe keeping of important documents.

1.1.2 What is Islamic banking?

Similarly, a number of research scholars have also identified financial sector's role of financial intermediation to promote economic growth. Like (Schumpeter & Nichol, 1934) discussed that financial intermediaries play a vital part in economic development because it utilizes the saving to finance the growth of the businesses. Having measured the importance of the role of financial intermediaries, research also analyzes how different financial systems/institutions aid economic growth. In this regard, studies have been undertaken to highlight the role of Islamic Banks' in promoting economic growth. However, (Levine, 2003) mentioned credit as the indicator of the financial intermediary's development.

In this backdrop and subsequent to financial crises during 1950s to 2000s, people have sort for alternative financial systems. Although the conventional financial system is used in most of the world, episodes of financial crises have brought forward its vulnerabilities. Islamic banking is now more than a few decades old. Most of the literature approves that Islamic banking took place in Egypt in 1963 but most of the countries in the world acknowledged and developed Islamic banking in their countries during seventies (70s) and eighties (80s). Islam considers that income or wealth should be equally distributed among all the classes of the society or community and wealth should not stay with the rich or in few hands only. Islam also provides a very active system of banking and finance based on real economic activities.

According to Investopedia, Islamic Banking refers to financing or banking activities carried out in adherence to the principles laid down in sharia laws. In this regard, two (02) essential principles of Islamic Banking are put forward which differentiates it from conventional form of banking.

They are sharing of profit and loss sharing and the prohibition of collection and charge of interest on the money lent by creditors.

Islamic Banking and financing refers to actions that are based on Sharia laws (Islamic Laws) and the entirety of the financial activities are performed through or in accordance to the Islamic rules and regulations. Accumulating interest or 'Riba' is not permitted under Islamic Law. According to the Institute of Islamic Banking and Insurance, Islamic banking denotes to a system that works in accordance with the Islamic Principles and these principles have widespread universal assurance due to its moral and ethical concepts about all activities. Sharia law forbids the payment or receiving of interest charges (riba) for the lending and receiving of money, as well as functioning trade and other activities that deliver goods or services considered conflicting to principles laid down in sharia law. While these values of Islamic banking were used as the foundation for a booming economy in earlier times, it is only in the late twentieth 20th century that several Islamic banks were founded to cater to the demands of faith sensitive Muslims. Having said that, the system of Islamic banking is not limited to Muslims. Many countries in the West have also begun conducting financial transactions on the basis of Sharia. The aim of Islamic Banks is similar to that of its conventional counterparts and the values used in this Islamic banking system are not new because they have been usually recognized all over the world for centuries rather than decades but possibly their original state has been transformed over centuries.

According to sharia law, Islamic banking prohibits the interest (riba). All instruments in Islamic banking work according to the Sharia law which focus on interest free instruments. Islamic banking usually operates in an Islamic country which predominantly includes Asian and Middle Eastern region. However, we are also witnessing the growth of Islamic banks in Non-Muslim parts of the world and this has brought serious implications for the financial instruments indicating change of pattern in businesses (Aggarwal & Yousef, 2000). It is stated that investment and consumption in the country through Islamic banking has a huge impact on the economic activities.

Under the umbrella of financial development, we are witnessing increase in number and share of Islamic Banking assets in the world particularly in Muslim majority countries. **Figure 1.1** indicates the increasing trend of total Islamic banking assets in the world with the passage of time.

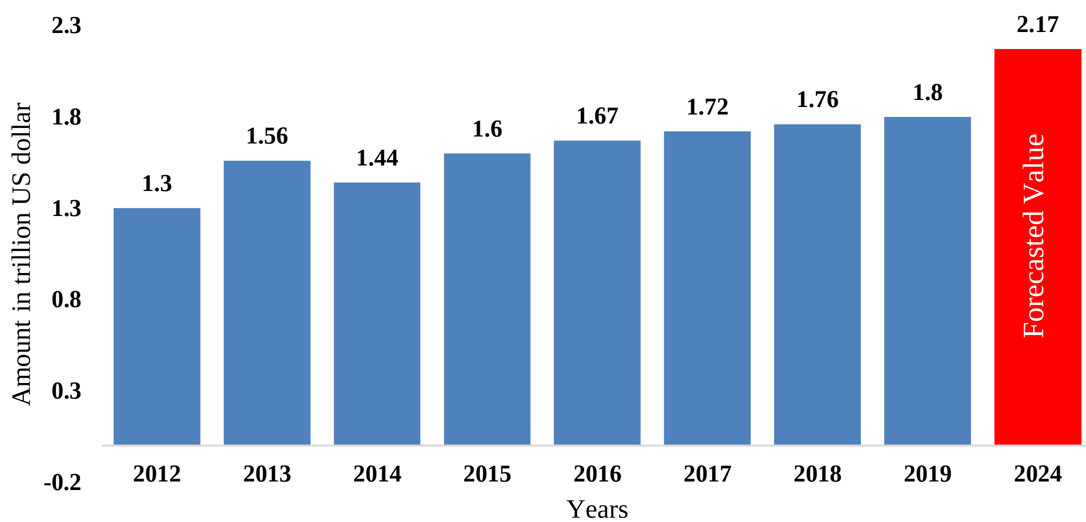

Figure 1.1: The Total Assets of Islamic banking in World

Source: The Islamic Microfinance News (IMFN, 2020)

Figure no 1.1 shows that the total Islamic banking assets were USD 1.76 trillion dollars in 2018 and USD 1.8 trillion dollars in 2019. The right most, red bar, shows the forecasted value of total Islamic assets in 2024 which is forecasted to be USD 2.17 trillion dollars. It means that there is increasing trend throughout this time period. In 2019, the share of Islamic banking assets in total global financial assets was more than 6 percent. It shows that with the passage of time the Islamic banking assets are going to increase which also means that the volume of Islamic banking sector is increasing.

One (01) justification for this gradual increase can be found in the underlying framework on which Islamic Banking is based. The principles of Islam for financial system are summarized into five points which are the basis of Islamic financing; the money is a tool to exchange goods and services but has no intrinsic value, it should be dependent on real economy. There is no concept of the time value of money which is present in conventional banks. Furthermore, there must be profit and loss sharing. Moreover, all the good and services which directly and indirectly deteriorates the society are prohibited. In addition to this, excessive charges in the form of interest rate in all shapes on transactions is banned. Finally, "Qimar" and totally risky transactions are not allowed in Islam (Moosavian, 2007)

The Islamic banking sector has emerged as an essential section of the global banking industry. The Islamic banking industry shows an encouraging upward trend in the Asian region. The following figure shows the domestic market share of Islamic Finance provided by Islamic banks in Asian countries.

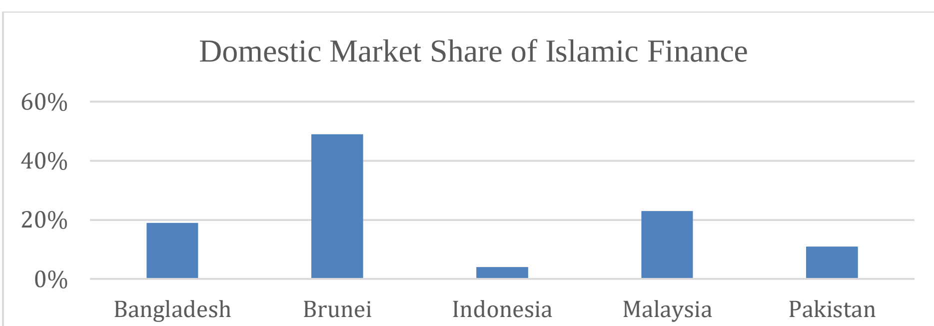

Figure 1.2: Share of Islamic Banking Assets in Total Banking Assets
Source: Islamic Financial Services Industry Stability Report (2016).

The above graph shows that Brunei has the highest domestic market share of Islamic Finance compared to other countries. Malaysia lies in the second slot where its share comprises of 23 percent. Bangladesh lies at third with 19 percent and Pakistan and Bangladesh has 11 percent share respectively.

1.1.3 The concept of Riba in Islamic Banking

In Islamic banking, Riba is thought of charging excess as interest rate. Depending on the different schools of thought, Riba may only refer to extreme or excessive interest rate charged. Conversely, some view the whole concept of interest is Riba and thus is unlawful in accordance to the values and principle of Islamic sharia. Regardless of the fact that interest holds a vital place in modern economic systems and that it turns out to be the blood life in the present financial institutions, Islam ponders that the principle of indicting interest is quite contrary to the essence of sharing and cooperation in business and that interest charged on funds lent is not business in actual sense. This argument is based on the premise that Interest may lead to exploitation. Islam reflects even interest-based loans occupied or taken for investment in an economic activity as not reasonable because the profits are not always mandatory and if losses are incurred in the business activity, the entrepreneur has to suffer the whole loss regardless of all the risk he took, while the money lender, who did sacrifice less than the entrepreneur, acquire an easy profit governed by a positive rate. In Islam, both risks and returns should be divided among various groups on equal basis.

Moreover, the interest rate volatility above average point prevails in the modern economic systems, it places great uncertainty hooked on to the investment markets. Thus, creating difficulty for entrepreneurs to invest in a long-term investment plan, and also refrains them to take their decisions with confidence.

Therefore, Islamic banking systems avoids riba and purely works on the sharing loss and profit model. This is giving the investor opportunity to make investment with confidence. Thus, the trend towards Islamic banking is increasing day by day (M. F. Khan, 2013). The investment and consumption concepts under the Islamic banking system has significant implications for both the lender and investor which in turns aids the economic activities in the economy.

1.1.4 The consumption and investment financing in Islamic Banks

Besides, Islamic banking financing effect on economic development, it is the important to explain the question of how does Islamic banking affect economic growth? Keynesian economics have identified investment, consumption, and government expenditure as the primary sources of growth. It is essential to examine the role of Islamic banking financing through two aspects i.e. investment and consumption. Limited research used these mediators' variables to grasp the comprehensive understanding of the impact of Islamic banking. Most studies have regressed effect of Islamic banking on GDP directly. However, mediating variables like consumption and investment are essential while examining the role of Islamic banking financing for growth (Abduh & Omar, 2012). (Archer & Karim, 2012) found that consumption and investment in short run indeed led to economic growth. However, some researchers are hesitant on the role of consumption (Radulescu, Serbanescu, & Sinisi, 2019). Moreover, the investment mode of Islamic banking financing concentrates on increase in real economic activities in the country.

(Mishkin, 1995) stated in his study that the most prominent channel through which financial system affects economic growth is through the consumption and investment channel. This channel becomes prominent in countries where market capitalization of Islamic Banks is small compared to commercial banks. The mechanism through which Islamic Banks work is by impacting the real economic variables like those mentioned above. This is done through equity-based financing contracts like Mudarabah financing and Musharakah financing. Furthermore, a Shariah compliant alternative for debt financing is also widely used by Islamic Banks, Murabaha financing, in order to satisfy the needs of its customers. Furthermore, Islamic banks conduct their business in an interest free environment by providing profit-loss sharing mechanism between the bank and its customers.

International Financial Services Board (IFSB) (2018) [1]defines Mudaraba financing as a partnership agreement in which the bank is called Rab-ul-Maal as it provides funds to the customer (known as Mudarib) for conducting business activities. Musharaka is similar to a partnership in a joint enterprise where the profits and losses are shared according to a pre-determined profit and loss sharing agreement like Mudarba. Another type of financing that Islamic Banks provide is called Murabaha financing that is similar to a buy sell contract. In a Murabaha contract, the customer shows his desire to purchase a commodity. The bank then purchases the commodity and sells it to the customer with a profit. The customer then has an option to either pay the price in full or pay it in instalments.

Therefore, one can safely assume that under these modes of financing, Consumption and Investment are affected which in turn affects the economic growth. In other words, the partnership-based contracts or agreements impact the investment rate and the Buy/Sell contracts impact consumption spending by increasing populations' marginal propensity to consume.

[1] https://www.ifsb.org › download

Hence, two (02) aspects of consumption and investment are the most essential part of the study while looking into the role of Islamic banking financing. Additionally, comparing the results of direct effect of Islamic banking and its indirect effects need a profound study which will extend the scope of the Islamic banking financing for economic growth.

1.2 Research Problem

Islamic Banking is gaining traction around the world. Although, Islamic Banking dates back to centuries, the recent episodes of financial crises have brought new focus onto this subject. Islamic Banking presents itself as a viable alternative to conventional banking. It performs all the functions that a conventional bank performs but the motive behind an Islamic Banks operations is not just profit making. However, Islamic Banks have to abide by certain rules and regulation prescribed in Sharia laws. By prohibiting the charging of excess money in the form of interest from its customers, Islamic banking transactions are always backed by real economic activity. In other words, the transactions of an Islamic Bank are asset backed. In this way, it is suggested that Islamic Banks are in a better position to help in sustainable development of an economy. Several researches are conducted around the world to test the hypothesis of Islamic Banking financings' impact on economic growth. Some of the studies found insignificant impact of Islamic banking financing on economic growth. But those researches were conducted in countries where the share of Islamic Banking as compared to conventional banking is low. In this scenario, it is possible that there might be some other mechanisms or channels through which we can capture the true effect of Islamic Banking on economic growth. It is suggested that economic growth may be effected by Islamic Banking Financing through indirect channels of investment and consumption. Very few studies have been undertaken to explore the dynamics of Islamic finance-growth nexus in depth.

1.3 Research Questions

- What is the direct impact of Islamic Banking Financing on economic growth?
- What is the indirect impact of Islamic Banking Financing on economic growth mediated through consumption channel and through investment channel?

1.4 Research Objective

The key purpose of the current research is to explore the direct and indirect relationship among Islamic banking financing and economic growth. To meet core purpose, we have the following objective of this research:

Revisiting the Islamic Banking financing and Economic Growth nexus by considering indirect channels through Consumption and Investment by using mediation analysis. The research has used annual panel data from nations like Pakistan, Bangladesh, Malaysia, Brunei, and Indonesia. The research has also taken necessary inputs from relevant policy documents of the State Bank of Pakistan and conducted interviews from industry experts in the field of Islamic Banking to gain a holistic view of the phenomenon.

1.5 Research Hypothesis

The hypothesis for the research which would be tested using mediation analysis are:

H1: there is a significant impact of Islamic banking financing on investment

H2: there is a significant impact of Islamic banking financing on consumption

H3: there is a significant indirect impact of Islamic banking financing on the economic growth mediated by investment and consumption

H4: there is significant direct impact of Islamic banking financing on economic growth

1.6 Significance of the study

To begin with, the future outlook of Islamic Finance appears to be bright in Asia and given that the region comprises of dominant Muslim community, it becomes important to explore the Islamic banking finance and economic growth nexus deeply so that countries are in a better position to capitalize on this opportunity. The above premise is based on a number of facts. These facts are given below:

(i) Muslim population is increasing, especially in Asia. Together with improving standards of people in this region, it may improve the acceptance of Islamic finance as a strong substitute to the conventional form of banking. According to a survey conducted by (House, 2013), one-half of the Muslim population would opt for an Islamic version of financing if provided a viable alternative to the conventional system. This would enhance financial inclusion and lead to formalization of informal economy.

(ii) The governments and financial regulatory agencies are providing an enabling environment for these sharia compliant institutions to perform their activities in line with their objectives to increase investments and economic growth.

(iii) The financial stability and ethical standards of Islamic financial products may increase their desirability.

(iv) Given that the transactions under the Islamic system have a real asset at its back, it is likely to use the asset-backed nature and risk sharing facets of Islamic Finance for enhanced consolidation with the real economy and to expand the overall economic equilibrium within the real and financial sector. Thus, this would imply that the chances of a financial bubble leading to recession are minimal as all transactions are backed by real economic assets.

(v) History has shown that Islamic Banks were in a better position to absorb financial shocks and the time for recovery for Islamic Banks was shorter as compared to conventional commercial banks which has increased its demand.

(vi) As Islamic Banking is based on principles of equity and justice, this form of banking has caught traction among the Environmental, Social, and Governance (ESG) investors. ESG investors are class of investors who while making investment decisions, screen options not only on the basis of financial return but also on the basis of environmental and social returns.

This study is important because it explores the direct and indirect linkages between Islamic banking financing and economic growth in countries of Asian region. These countries have larger portion of Muslim population as compared to other countries in these regions. According to the study of (Jeanneney & Kpodar, 2011) and (Eggoh, 2010), the religious beliefs of population play a significant role in emergence of Islamic banking. People invest in Islamic finance due to religious moralities. The larger portion of these countries' population consists of Muslim population that is why there is dire need to explore the relationships between Islamic banking and economic growth. Moreover, with the national financial inclusion strategy of Pakistan in full swing, a number of efforts are being made to increase financial inclusion in the country – one of them being the development of a parallel Islamic Banking system. Also, no study has been conducted to specifically to study the in-depth relationship in the Asian region. This study will explore the relationship through direct and indirect channels of consumption and investment.

In addition to this, even if we find insignificant direct relationship between Islamic bank financing and economic growth, it does not rule out the possibility of Islamic bank financing indirectly impacting economic growth through Consumption and Investment. Following Keynesian school of thought, the primary sources of economic development are investment, consumption and government spending. Therefore, if Islamic financing through it various modes of financing affects any one of the above variables, it may be safe to conclude the presence of indirect relationship amongst economic growth and Islamic bank financing.

This study may also help Islamic banking practioners to develop products that are increasingly using Islamic mode of financing and thus increase profitability.

In addition, this study will also provide insights into the development of Islamic banking framework for increasing financial inclusion in the country.

1.7 Organization of the study

The organization of this research is as follows. Chapter one (01) discusses the introduction of Islamic Banking financing and how Islamic banks affect consumption and investment in a country. Chapter two (02) presents the literature review of the Islamic banking financing and economic growth. It also represents the impact of Islamic banking both direct and indirect impact on growth of economy. Further, it signifies the impact of consumption and investment, the mediating variables and the prior study of other control variables. Chapter three (03) illustrates the research methodology with the description of data and variables. Chapter four (04) shows the summary of important estimation results and discussion on the analysis of interviews that were conducted from relevant experts on the subject. To conclude, chapter five (05) includes conclusion and policy recommendations for further necessary action.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter provides an overview of the existing literature that mainly focus on the Islamic banking and its impact on the economic growth. This chapter starts with previous studies on the effect of financial development. Then, we dive deeper into finding the impact of Islamic banking on Economic development. Further, there also includes literature on the mediator (consumption and investment) which are very significant and important factors in the economic growth. It covers both theoretical literature (discussed in the first section) and empirical literature. The last section of this chapter defines the literature or research gap.

2.2 Asian countries and the history of Islamic banking

Pakistan came into being on 14th August 1947 as an independent state. It was created in the name of Islam and it was described that this state will make its identity as a Muslim State essentially based on the principles and values of Islamic principles and teaching. Now, if we look at the history of Islamic banking in Pakistan, it was started during 1970s. Pakistan named as the third country that adopted the Islamic banking system after this system was introduced in the world financial market. Investment Corporation of Pakistan (ICP) and National Investment Trust (NIT) were the first institutions in Pakistan that initiated the operations of eliminating and removing interest from their inclusive financial operations. However, Investment Corporation of Pakistan (ICP) initiated the new investor scheme in October 1980 grounded on profit and Loss sharing mechanism. The House Building Finance Company Limited (HBFCL) also eradicated interest from their operation of services completely in July 1, 1979. Major amendments, ranges from seven were adopted in the

Law in the title of banking and financial services ordinance of 1984. Since 1985, all commercial banking in local currency was made interest free. In 2001, the State Bank of Pakistan (SBP) circulated its first ever Islamic Banking Policy. This policy was introduced to operate the Islamic system of banking in parallel with the conventional banking. Meezan Bank Limited was the first Islamic Bank to get licensed from the State Bank of Pakistan in 2002. The bank was licensed to offer broad range of Islamic instruments to public strictly in compliance with Sharia law.

(M. S. Khan & Mirakhor, 1989) studied about the development of Islamic system of banking in Iran and Pakistan. According to the research, Pakistan and Iran are identical as the countries which started the more efficient and affective test of Islamic banking system. The activity of implementation of Islamic system of banking in Pakistan was very slow in the starting years (1979). Further, the authorities appointed the council of Islamic Ideology to accelerate the process of Islamization in Pakistan in which Islamic banking was on the top priority.

Iran has started the Islamic banking financing rapidly which was divided in two three phases (M. S. Khan & Mirakhor, 1989). In the first phase the financial system was nationalized by the Iran authority as contrary to Pakistan (a gradual transfer from conventional to Islamic banking). The second phase was to legislate for the new system by setting an administrative basis for the development of and implementation model of Islamic banking system. In this manner, in 1983 the interest free banking law was passed. The third phase indulged the short term and long-term profit-sharing modes of financing.

In Bangladesh, at the research and development bank of Bangladesh a new Islamic economic cell was established in 1990. It was considered as major step towards to initiate the preliminary analytical research work on Islamic economic system and financing and banking. International and national series of conferences and workshops were arranged in this manner to raise awareness and capacity building of relevant stakeholders. It was with the joint collaboration of Islamic Development Bank. This process explored the dynamics of the Islamic system of banking, and totally a new verse of banking surfaced in the country. The trainings and programs on Islamic banking and financing was also arranged in the banks learning resources centers in Bangladesh.

The Research Department at Bangladesh Bank, in 1990, set up an Islamic economics cell. This was a major step and the cell was responsible to handle analytical research work on Islamic economics, banking and finance. A number of local and foreign conferences and workshops were set to in joint to collaborate with the Islamic Development Bank to realize and explore the current dynamics of this new model of banking. Bangladesh Bank Training Academy & BIBM have also been conducting numerous training sessions on Islamic banking and finance.

Now, globally the share of Islamic banking financing has shown an upward trend. According to Ernst and Young (2014), total Islamic finance assets of commercial banks rose to 17 percent between the period of 2009 to 2013. However, the global Islamic finance assets rose to USD 2.88 trillion in 2019 and USD 3.69 trillion in 2020 respectively (IFSB, 2020). [2]

The table below compares the breakdown of Islamic Financial systems influence between different regions.

[2] https://www.ifsb.org › download › sec03

Table 2-1 Breakdown of the Global IFSI by Sector and Region (USD billion, 2018)

Region	Banking Assets	Sukuk Outstanding	Islamic Funds Assets	Takaful Contributions	Total	Share%
Asia	266.1	323.2	24.2	4.1	617.6	28.20%
GCC	704.8	187.9	22.7	11.7	927.1	42.30%
MENA (ex GCC	540.2	0.3	0.1	10.3	550.9	25.10%
Africa (exNorth)	13.2	2.5	1.5	0.01	17.2	0.80%
Others	47.1	16.5	13.1		76.7	3.50%
Total	1571.4	530.4	61.6	26.11	2189.5	100.00%

Sources: Islamic Financial Services Board (IFSB, 2019)

Asian region plays a significant role in world economy through, trading and finance. Also, Asia represents majority portion of Muslim community including 96.4% in Pakistan, 86.3% in Bangladesh, 87.2% in Indonesia, and 61.4% in Malaysia (Komijani & Taghizadeh-Hesary, 2018). Particularly, Asian region is poised to play a very important role given its steady economic reform process (IMF Country Focus). Subsequently, Islamic banking has also flourished in Asia since the last two (02) decades. Islamic banking financing's total share in total finance in Asia is going to increase with the passage of time. In Asia for 2014, the aggregate of Islamic finance sector was worth more than USD 617 billion of the 28.2% of the global financial Islamic assets (IFSB, 2019)[3].

The public and financial authorities of Asian countries perform a significant role in the promotion of Islamic banking to enhance economic growth (Komijani & Taghizadeh-Hesary, 2018). For instance, the State Bank of Pakistan (SBP) is devoted towards encouraging Islamic Banking in a phased way. Whereby, Islamic banking was allowed to flourish alongside their conventional counterparts and conventional banks were given permission to open Islamic Banking Subsidiaries and Islamic Banking Windows in 2001. Similarly, the financial system in Iran is completely molded according to the principles laid down in Shariah. In 1983, the government of Ayatollah Khomeini passed an act called the Riba free banking Act, thereby mandating the local banks to conduct their business in a Shariah Compliant manner. Iran being one of the largest Muslim countries by population becomes an ideal platform for practicing Islamic Banking as majority of the Muslims are devoted to living their economic lives adhering to Islamic principles. With opening of the first commercial Islamic bank in 1983, Islamic Banking has recorded a strong performance with its market share growing by more than 20% (SBP Bulletin, 2018). Fast forward to the 21st century, the drive towards banking activities grounded in Sharia laws has gained pace. Today, Islamic banks are established in about forty-five (45) countries, some of the countries like Iran and Sudan have converted their entire banking operations to follow to Islamic Laws and others such as Pakistan have a parallel system whereby both conventional and Islamic commercial financial institutions operate in the financial system (Ashraf & Giashi, 2011).

[3] ADB-IFSB. 2019. Islamic Financial Services Industry Stability Report: Asian Development Bank.

2.3 A Global Perspective of Islamic Banking and Economic Growth nexus

Prior to this study, several studies have been carried to estimate the impact Islamic Banking has on Economic Growth. According to these studies there is affiliation between Islamic banking and economic growth. The development of Islamic Financial system significantly contributes to economic growth. As the financial system develops, it positively impacts the economic growth (Boukhatem & Moussa, 2018). There is significant positive connection between economic growth and Islamic banking in short run and long run periods (Tabash & Dhankar, 2014). After controlling for some minor factors, the Islamic banking ultimately affects economic growth (Imam & Kpodar, 2016). The use of technology in Islamic finance and pooling of fund plays a positive role in enhancing economic growth (Nalan, 2018). The investment in Islamic financing and economic growth has positive relationship and its direction is supply leading (Tabash & Anagreh, 2017). The industrial production and Islamic financing have positive affiliation both short run and long run periods (Bougatef, Nakhli, & Mnari, 2020). There is positive short run and long run causal linkages between economic growth and Islamic finance (Jobarteh & Ergec, 2017).

(Darrat, 1988) empirically investigated the effects of an interest free banking system on the economy on Tunisia for the period of 1960-1984. By historically examining the interest-bearing assets (time and saving deposits) and non-interest bearing assets (currency and demand deposits) along with simple regression analysis and formal stability techniques, the author found that Islamic interest free financial system is relatively more resourceful than interest based financial system. In addition to this, Interest free financial system is found to display well-behaving and plain velocity of money. Moreover, for a structurally steady demand for financial assets, interest free monetary systems are important. Finally, monetary assets with no interest can be effectively controlled by policy maker so can be used as an intermediate target.

(M. S. Khan & Mirakhor, 1989) studied about the development of Islamic banking in Iran and Pakistan. According to the research, Pakistan and Iran are identified as the countries which started the more efficient and affective test case of Islamic banking system in the Asian region.

To study the specifics of Islamic banking and growth nexus, limited studies were found. (Ang, 2008) examined the capital accumulation and total productivity channel for Malaysia. (Mifrahi & Tohirin, 2020) examined the consumption and investment channel for QISMUT which includes Qatar, Iran, Sudan, Malaysia, UAE and Turkey. Overall, the results have extended support for the presence of these straits through which economics growth is affected by financial development in Malaysia and QISMUT nations respectively.

To gauge the impact of Islamic banking on economic growth in the Gulf Cooperation Council (GCC) and East Asian Countries (EAC), (Yusof & Bahlous, 2013), employed Panel Co-Integration Analysis along with variance decomposition and impulse response functions. The author looked at various variables including GDP, Gross Fixed Capital Formation (GFCF), total value of stock traded, Islamic financing, volume of trade, and Islamic banking development between 2000-2009. The results indicated that Islamic banking was the driver of growth in both short and long run. In the short run, the effect on economic growth was more evident in East Asian countries than in GCC countries. The rationale behind these conclusions was that Islamic banking enhanced the entrepreneurial skills of the managers and led to lower agency cost arising from information asymmetry. Similar results were obtained by (Kchouri & Lehnert, 2018) for Turkey for the period 2002-2014. The author then employed Granger causality test to check whether the direction of this connection in uni-directional or bi-directional. The results, in support of previous studies done in

Turkey in a similar domain, showed that there exists a bi-directional association between economic growth and Islamic banking deposits.

(Abduh & Chowdhury, 2012) uses quarterly data for the years 2002 to 2011 for Bangladesh to test the presence of relationship between economic growth and Islamic banking. Bangladesh is the first country in Asian region to start an Islamic banking system to provide Shariah Compliant financial services to the majority Muslim faith sensitive population of the country. As a proxy for the presence of Islamic Banking, total deposits and total financing provided by the Islamic banking sector is regressed with real GDP growth of Bangladesh. By employing Johanson co-integration test and granger causality approach, the author discovers that there exists a bi-directional relationship between economic development and Islamic Banking Development.

(Boukhatem & Moussa, 2018) presents an elaborate case for the presence of positive and significant affiliation between economic growth and Islamic Financial development for the 13 MENA countries. Moreover, the authors state that previous work on Islamic banking and growth nexus have either focused on a single country sample or have only considered cross-sectional data. As per the authors, it is not considered a good practice to generalize the results of such studies for a set of countries over a time period due to the neglect of temporal dimension. They used GMM method on panel data to find the relationship between Islamic banking development and economic growth. Since economic growth is a multi-faceted phenomenon, a number of control variables are used in order to get better estimates of the variables. Control variables used in this equation are banking system activity, initial real GDP per capita, inflation, education, government consumption expenditure, trade openness, and quality of institutions. Islamic system activity which is main dependent variable is represented by loans advanced by Islamic banks. The Pedroni panel co-integration test and the Westerlund panel co-integration test are applied to check for the existence of co-integration among the variables. FMOLS techniques for heterogeneous co-integrated panels and DOLS technique is applied to obtain efficient estimators. These techniques carry precedence over a simple OLS technique because they offer a check for the robustness of results and can also provide consistent estimates in small sample sizes. The results of this study show that deepening of Islamic financial system is positively associated with economic growth provided there is a sound institutional framework in place such as adequate regulation, legislation, supporting and enabling infrastructure. Robustness results reveal that net oil exporting countries in the Middle East and North Africa (MENA) region have no advantage over non-net oil exporting countries in terms of benefiting from Islamic banking activity. The authors undertook a study to explore the correlation between Islamic banking and gross domestic product (GDP) growth for selected MENA countries. They selected 13 MENA counties and used data from 2000 to 2014. They employed Pedroni cointegration procedure to explore short and long run relationships. They found that positive correlation in short and long period between Islamic banking and GDP growth.

(Tabash & Anagreh, 2017) found the relation between Islamic financing and economic growth. They employed cointegration & error correction procedures to explore the linkages between them. They found that the investment in Islamic finance attracting investment in country and bringing more foreign direct investment in country which finally effect economic growth. They also concluded that Islamic financing and FDI affecting each other.

(Kassim, 2016) examined the effect of Islamic financing on economic growth of Malaysia. He used Pesaran Bound testing procedure to estimate the long and short run parameters. Also, concluded that the Islamic finance is the now an emerging trend and has contributed to advancement of real economy activity in country which shows that he found positive linkages between Islamic finance and real economy.

(Abduh & Omar, 2012) studied the relation between Islamic banking and economic growth. They used three-monthly time series data from 2003 to 2010 and employed co-integration analysis. They found co-integration between the variables with positive signs. And the association in long run are bidirectional.

(Caporale & Helmi, 2018) investigated the association between Islamic financing and economic growth. They made a comparison between countries who have Islamic banking and those who have conventional banking. They used panel data 2001 to 2016 and employed Granger causality, Johnson co-integration and error correction procedures. They found Islamic banking significantly contributed to economic growth.

(Furqani & Mulyany, 2009a) explored the nature of link between Islamic banking and growth of economy in Malaysia. They used time series data from 1997 to 2005. They employed VECM and co-integration tools to find out the affiliation in long run and short run. They found that in long run period the fixed investment and Islamic banking are interlinked. While the gross domestic product is improved because of Islamic banking but the reverse connection is not possible.

(Ali & Azmi, 2017) examined the influence of Islamic financing on volatility and economic growth. They used panel data of 21 Organization of Islamic Countries (OIC) countries from 2007 to 2013. They found that the growth of economy is impacted by Islamic banking but the volatility of economy did not. Also, the influence of Islamic banking on economic growth is positive.

Furthermore, the capability of a financial intermediary which may be Islamic or conventional to connect to the capital was described in many previous researches and can be attributed to the opening of several Islamic and conventional branches (financial intermediation of Islamic and conventional) (Lentner, Vasa, Kolozsi, & Zoltan, 2019). More branches can have improved projections for directing the funds and hence a high degree of financial intermediation, on condition to that the internal regulations and controls ensure the quality of bank exposures.

In countries having a dual banking system like Islamic, and conventional, it is greatly applicable to study the Islamic finance-growth nexus by taking in consideration the conventional banking parallel with Islamic financial depth.

(Anwar, Junaidi, Salju, Wicaksono, & Mispiyanti, 2020) used total Islamic development, whereas the comparison of the both Islamic and Conventional banking financing should be studied by utilizing the concept of Islamic financial depth. (Elmawazini, Khiyar, & Aydilek, 2020) pointed the same concept of utilizing the concept of Islamic financial depth.

(Mustafa, 2018) explored the effects of financing based on Islamic rules and development of Kenya’s economy. He used descriptive statistics to explain the relationship between these variables. The t-stat and F-stat are used to test individual and joint significance. The results indicated that there is a positive linkage between GDP growth and Mudarabah based financing offered by Kenyan financial institutions. Also, the Mudaraba has positive association with economic growth.

(Wardhani & Arshad, 2015) argued that there is positive and statistically significant linkage between Islamic financing and Indonesia’s economy. They used quarterly data and employed

Granger cointegration and Johnson cointegration. They concluded that there are positive and significant causal linkages between Islamic banking and economic growth.

(Kchouri & Lehnert, 2018) found the associations between Islamic finance and the development of an economy. They used panel data from 2000 to 2016 for thirty-two (32) countries and used difference GMM and system GMM to explain these connections. They found that although the Islamic banking has very little portion in financial system, but it has significant impact on growth.

On the other hand, there are some previous studies on the contribution of Islamic Banks to economic growth that have concluded that there is no significant impact of Islamic banking on growth of an economy. A study was conducted for Turkey by (Yüksel, Canöz, & Özsarı, 2017) and they found no significant impact of Islamic or Shariah complaint loans on economic growth and Turkey`s industrial development. The authors regressed quarterly data for the period 2015-2016 using VAR granger causality tests to come to this conclusion. One of the reasons for absence was due to low penetration of Islamic banks as compared to conventional banks in Turkey. Furthermore, a study conducted for Pakistan by (Ahmad & Ihsan, 2018) also found no significant connection between Islamic banking and economic growth in the short run. The authors came to this conclusion by utilizing quarterly time series data. (Lebdaoui & Wild, 2016) also came to the same conclusion about there being no relationship between Islamic banking and financial development. As the link between Islamic Banking and financial development was absent, it may be concluded that Islamic Banking does not affect economic growth of a country (Wahab, Mufti, Murad, & Khattak, 2016) by studying the co-integration and causal link between Islamic Bank Financing and growth of an economy also found that there is no significant relationship between economic growth and Islamic Banking Financing in Pakistan. However, it is pertinent to mention that the above study was conducted in 2016 with the author highlighting that the cause for negative relationship in Pakistan is limited data and recent introduction of Islamic Banks in Pakistan. Similar conclusion is also reached by (Hachicha & Amar, 2015)

Analysis of previous literature shows that the results are varied with regard to that of the Islamic finance–growth nexus. A common conclusion could not be established due to the variance in the political settlement and conditions, economic situation, features of financial sector, asset value, services contributed by central banks, acceptance of consumers to choose the service of Islamic banks and many other socioeconomic dynamics. Furthermore, some limitations are also present in prior studies, as utmost of the working and researches measured only the total Islamic financing as a proxy of Islamic system of financing development. Conversely, countries indulge in a larger share in international Islamic finance market including Turkey, Bangladesh, Malaysia, Indonesia, Saudi Arabia, Qatar, and Pakistan do opt a similar interest-based banking system. In the existence of a dual banking system like Islamic system, and conventional system, it is greatly applicable to the study the Islamic finance-growth nexus by taking in consideration the conventional banking parallel with Islamic financial depth. Secondly, research carried in Pakistan, (Zeeshan et al., 2020), only used aggregate Islamic financing, whereas a comparative development of Islamic finance associated to conventional banking should be considering by the concept of Islamic financial depth (as acclaimed by (Anwar et al., 2020). Moreover, the capability of a financial sector (Islamic or conventional) to connect the funds was explained in previous studies and can be taken by the several of Islamic and conventional branches (financial intermediation of Islamic and conventional). More branches can have better outlooks for directing the funds and hence a large degree of financial intermediation, on condition to that of the internal regulations and controls ensure the quality of bank experiences (Lentner et al., 2019).

2.4 Pakistani Perspective on Islamic Banking and Economic Growth nexus

Similarly, there are some studies which were conducted for Pakistan. The increment in Islamic banking leads to increase the economic growth. The increasing trend in Islamic banking increase the financial development which ultimately effect economic growth (Saleem, 2007). The Islamic banking has positive and significant relation between economic growth. The net financing is also expressively consisting on financing in Murabaha financing and the Ijarah financing in case of Pakistan (Mushtaq, Arshed, & Kalim, 2018). There is bi-directional short run and dynamic long run correlation between real economy activity and Islamic banking. Because of that, both variables have bi-directional causal linkages (Rafay & Farid, 2017).

(Sarwer, Ramzan, & Ahmad, 2013) explored the impact of Islamic banking on economic development in case of Pakistan economy. They interviewed different experts and asked them about the benefits of Islamic banking in Pakistan economy and the impact of Shariah compliant banking on development of Pakistan economy. They concluded that most of the people argued that Islamic banking is playing significant role in Pakistan economic development through financial sector. In other words, Islamic banking can be used as a tool to formalize the informal sector in Pakistan.

(Ahmad & Ihsan, 2018) explored the linkages Islamic financing and growth of economic activities in case of Pakistan. They used time series data from 2006 to 2015 and run causality test and co-integration test. They explored that the Islamic banking is having statistically significant relationship with growth of Pakistan economy in long run. They have suggested to promote the Islamic banking in Pakistan to increase the pace of growth rate. They also did not find any linkages between the series in short run.

(Kalim, Mushtaq, & Arshed, 2016) also conducted research on the affinity between Islamic Banking and Economic Growth for Pakistan using quarterly data for the time period 2006-2013. The variables used in his study were Gross Domestic Product (GDP), Gross Fixed Capital Formation (GFCF), Net Financing and Investment of Islamic Banks, Murabaha financing, Diminishing Musharaka and Ijarah financing as a percentage share of total investments by Islamic banking institutions respectively. By applying a distributed lag ARDL model, the author came to the conclusion that there is a supply side relationship between economic growth and Islamic Banking. i.e. Islamic Banking Net Financing, GFCF, Diminishing Musharaka, and Ijarah financing causes economic growth in Pakistan.

2.5 Research Gap

In this section, we present the research gap that provides the basis for our current study. After having reviewed most relevant foreign studies and some domestic studies, it was found that very limited research has been undertaken which deeply investigated the link between Islamic banking and economic growth in Muslim populated countries of the Asian region. Particularly, the indirect channels of consumption and investment through which Islamic Banking Financing may affect economic growth due to nature of transactions occurring in Islamic Banks. In addition to this, previous literature around this topic is also scarce regarding the bond of Islamic financing and economic growth to show the channel through which Islamic Banking effects economic growth i.e. Consumption and Investment. So that’s why there is need to study Islamic finance-growth nexus in the Asian region by choosing most Muslim population countries. Further, as highlighted in the literature review, the researchers also pointed out low penetration of Islamic banks as the main cause of insignificant relationship between Islamic banking and economic growth. Therefore, through this research study, it is proposed that we might substitute for low penetration by incorporating mediating variables which are affected by Islamic Banks financing. These mediating variables in turn effect the growth of the economy. Thus, there is a possibility that despite there being low share of Islamic Banks, we might still find presence of a significant relationship between Islamic Banking and economic growth.

At the end, the asset attributes and financial stability are found to be significant functions in developing the financial sector. To signify the quality of assets, and with this research as the first case to the best of the knowledge, can represent non-performing assets (NPAs) to impede its deserted impact on economic growth. The non-performing assets (NPA) is likely to put off the valued financial performance of a financial sector. Importantly, previous researches are conducted on an yearly time-series data from Pakistan, one of this study's significant contributions is to use a panel time series data using the meditation analysis and taking other Muslim populated Asian nations along with Pakistan along with expert interviews in the field of Islamic Banking in Pakistan to see how Islamic Banking is performed in the financial sector of Pakistan.

CHAPTER 3

MODEL SPECIFICATION, DATA AND METHODOLOGY

3.1 Introduction

This section provides the research methodology i.e. the way in which this research is conducted. The important countries of Asia which have significant traces of the Islamic banking financing. These nations are Bangladesh, Brunei, Indonesia, Malaysia, and Pakistan. Annual panel data is used to find the direct and indirect impact of Islamic banking financing on the economic growth. Further, to check the significance of this relation, mediation analysis using SEM Modelling technique is employed to find the implications of direct and indirect impact of Islamic system of bank financing and economic growth. The main variables are consumption, investment, GDP, and Islamic banking financing. Other control variables are real interest rate, real effective exchange rate and consumer price index.

Apart from the above quantitative analysis, we have also used qualitative analysis in order to substantiate the results obtained from the quantitative analysis. In this context, relevant policy documents for Pakistan were reviewed to analyze the relationship between Islamic Banking & economic growth in the context of Pakistan. Furthermore, interviews were also conducted from experts in the Islamic Banking industry to help explain the phenomenon in depth.

3.2 Islamic banking in the context of countries in the Asian region

Islamic banking financing has a critical role to play in the modern-day financial settings (Hassan, Rabbani, & Ali, 2020). The growth of Islamic system of banking and financing from 1970 was almost null. However, it has reached to approximately $4 trillion by 2020. It supported its transformation from a marginal fraction to the core or an extreme segment of the international financial system (Hoggarth, 2016). The range and market capitalization were never been broader for Islamic financial institutions relatively to the former periods (Chowdhury, Haque, & Masih, 2017). Given the intense arrival of COVID-19 has apparently censored the growth of the modern economies, but still, the means to Islamic financial institutions have sheltered the stakeholders from a definitive recession (Alam, Ali, Bhuiyan, Solaiman, & Rahman, 2020; Carlsson-Szlezak, Reeves, & Swartz, 2020). Thus, in dealing the afterward world of covid-19, Islamic financial institutions are believed to indicate its significant play, following the incredible success in its operations during the COVID-19 pandemic. A substantial research gap is open for the successful management of the Islamic banking finance institutions and what potential stakeholder can discover or absorb for the future prospect. In this regard, numerous studies have been established on different aspects and dynamics of Islamic finance in Asia because of its occupancy of Muslims majority population. In present time, many international and multinational organizations in Asia are engaging Islamic finance as a developing strategic intermediation to inspire the fusion of individuals into financial markets by using the Islamic saving and lending instruments (Hanieh, 2020). Moreover, Islamic finance has now been recognized as a reliable alternative arena for public-private partnership financing which can be very operative and efficient to highlight the concerns of developing countries and their societies (Kociemska, 2020). The projection of Islamic finance in Asian countries seems even encouraging as most of the market is still at a nascent stage. Currently, access to formal financing to businesses in Asia is only thirty-three (33) percent. Eighteen (18) percent of adults use a bank account, only eleven (11) percent of adults borrow formally from banks and twenty-seven (27) percent of adults save formally through banks (Asian Development Bank, 2020).

Due to the high potential of Islamic banking and its enormous opportunities, this study intends to develop a model of Islamic banking and find its impact on the economic activities in the Asian countries. Because of the fact of certainty and profit and loss sharing model the Islamic banking, investment and consumption lending are leading the major businesses. Thus, this research intends to identify the Islamic banking investment and consumption financing impact on the overall economic activities through the indirect path.

3.3 Methodology and Theoretical considerations

This study specifically is about to detect the presence of direct and indirect affiliation between the Islamic system of banking and financing and growth of economy through indirect channels of consumption and investment. In this study at first, we will explore the connection between Islamic system of banking and financing and economic growth for Muslim majority countries in the Asian region. Secondly, we will try to see the role of mediating variables namely consumption and investment in this connection through quantitative and qualitative analysis.

3.4 Model Description

Multiple mediating analysis using SEM models are models that are employed to scrutinize the link between an independent and dependent variable by examining the underlying mechanisms and processes that acts as a sort of bridge between the independent and dependent variable. These underlying processes or mechanisms are referred to as mediating variables.

(Baron & Kenny, 1986) is said to have introduced multiple mediating analysis into statistical research. According to him, this type of a model involves several regressions. Firstly, regressing the mediator on the explanatory variables. Secondly, regressing the dependent variable on the explanatory variables. Thirdly, regressing the endogenous variable on both the explanatory variable and the mediator. To establish a mediating connection, there must be a nexus between the independent variable and the mediator. Further, the independent variable should have an impact on the dependent variable and finally the mediator must affect the endogenous variable. If all these conditions prevail then the effect of exogenous variable on the endogenous variable must be small in third equation than second equation. However, some economists have also argued that a significant direct effect of independent variable on dependent variable is not necessary for mediation to occur (Collins, Graham, & Flaherty, 1998) (Judd & Kenny, 1981), (MacKinnon, Krull, & Lockwood, 2000), (Shrout & Bolger, 2002)

3.5 Hypothesized Framework

A graphical presentation of the hypothesized framework that underlines the mediating analysis models has been presented below:

Islamic Banking Financing and Economic growth are our independent and dependent variables respectively whereas Investment and Consumption play the mediator role in the below model. The

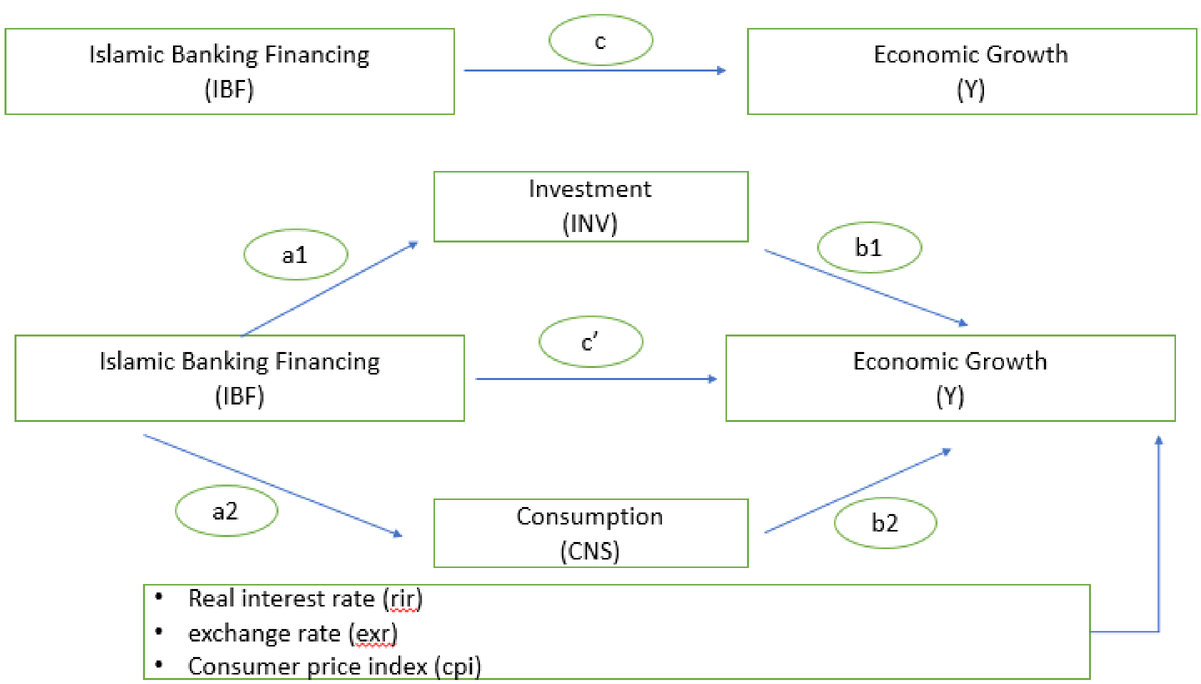

Figure 3.1 Hypothesized Framework for the Study

Remaining variables are incorporated as control variables in the study. The aim of control variables is to keep all conditions as alike as possible between two subjects except for the explanatory variable. The stages for mediation analysis suggested by (Baron & Kenny, 1986) include three sets of regression: X (IV) → Y(DV), X(IV) → M(MEDIATOR), and X + M → Y.

The above model can be elaborated through the following three stages. To begin with, in order to separate the effect of Islamic banking financing on economic growth, the impact of Islamic banking financing variable is divided into 2 parts. The first part shows the direct effect of Islamic bank financing on economic growth. And the second part shows the indirect impact of Islamic bank financing on economic growth through consumption and investment. Finally, the direct and indirect effect of Islamic bank financing is combined as total effect.

In other words, the direct effect is the effect of Islamic banking financing when the mediators are included the model (shown by c'). Similarly, the indirect effect is a measure of how much of the effect of Islamic banking on economic growth is mediated by consumption and investment. This is also known as mediation effect. The indirect effect is estimated by multiplying "a" with "b" in diagram above.

3.6 Econometric model

We can describe the equation for mediation analyses from figure 3.1 to be the following.

Direct Effect:

$$lnGDP_t = i_1 + clnIBF_{it} + \Upsilon_1 rir_{it} + \Upsilon_2 exr_{it} + \Upsilon_3 inf_{it} + e_1 \qquad (3.1)$$

Mediation effect:

$$lninvt = i_3 + \alpha lnIBF_{it} + \Upsilon_1 rir_{it} + \Upsilon_2 exr_{it} + \Upsilon_3 inf_{it} + e_2 \quad (3.2)$$

$$lnCnst = i_4 + \alpha_2 lnIBF_{it} + \Upsilon_1 rir_{it} + \Upsilon_2 exr_{it} + \Upsilon_3 inf_{it} + e_3 \quad (3.3)$$

Indirect effect:

$$lnGDP_t = i_2 + c' lnIBF_{it} + \beta_1 lninvst + \beta_2 lnCnst + \Upsilon_1 rir_{it} + \Upsilon_2 exr_{it} + \Upsilon_3 inf_{it} + e_4 \quad (3.4)$$

Where,

GDP = Gross Domestic Product

Invest = Investment

Cnst = Consumption

IBF = Total Shariah Complaint Financing (excluding Interbank Financing)

rir = real interest rate

inf = inflation

exr = exchange rate

One advantage of Mediation analysis is that it is not constrained to linear regression only we can use logistic regression or polynomial regression and others. Also, we can put more variables and relationships, for instance, moderated mediation or mediated moderation. However, if our model is very complicated and cannot be stated as a small set of regressions, we might want to ponder structural equation modeling (SEM) instead.

3.7 Data and Variable Description

By means of annual panel data (2005-2019), research exploits a method to multiple mediating analysis models. Data is collected according to the availability of data on different variables. Important variables include Islamic banking financing (IBF), GDP growth, consumption, and investment. Islamic banking financing and economic growth are our independent and dependent variables respectively whereas Investment and Consumption play the mediator role in the described model. Other control variables are real interest rate, inflation rate and exchange rate. The aim of a controlled variable is to keep all conditions as similar as possible between two subjects except for the explanatory variables.

3.7.1 Islamic Banking Financing (IBF)

IBF is presented as a log form of Islamic Banking Financing and refers to the amount of Shariah compliant loans and advances provided by banks using different modes of Islamic Financing in a given year. It represents the share of total financing that is provided as per Shariah laws and implies the depth of Islamic finance in the country (Nursyamsiah, 2017), (Adebola et al. 2011). IBF has a vital role to play in economic growth of a country (Hassan, Rabbani, & Ali, 2020).

3.7.2 Gross Domestic Product (GDP)

GDP is presented as a log form of GDP. It represents the income and development level of a country. High GDP countries have a high demand for banking services (Maudos 2002) and have more savings rates and more funds to keep in banks as deposits (Neely & Wheelock, 1997).

3.7.3 Consumption

Consumption is presented as the log form of total final consumption expenditure. It represents expenditure on goods and services that are used for direct satisfaction of individual needs or collective needs of members of a community. It is stated that the Islamic Banking finance through its asset-backed nature of transactions can lead to increase in consumption spending in the country.

3.7.4 Investment

Investment is presented as the log form of gross fixed capital formation. Investment consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Numerous scholars used investment as a mediator variable to give a more in-depth explanation of the underlying phenomenon. For instance, (Justesen, 2008) used the Investment variable as an intervening variable to study the impact of economic freedom on growth of economy. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." (World Development Indicator)

3.7.5 Inflation Rate

It represents the inflation rate that has a negative impact on the banking sector. High inflation reduces savings and thus funds to place deposits in banks. An increase in the inflation rate increase the cost of funds thus reduces bank efficiency (Sufian & Habibullah, 2012). It is stated that only high inflation rate significantly affects economic growth (Barro, 2013).

3.7.6 Real Effective Exchange Rate

Real effective exchange rate is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs.

3.7.7 Real Interest Rate

Real interest rate is the lending interest rate adjusted for inflation as measured by the GDP deflator. (Nursyamsiah 2017), (Mushtaq & Siddiqui 2017), (Tariq & Masih 2016) have used this variable found negative realtionship with economic growth.

3.8 Sources of Data

The data for this research is collected from various sources in which International Financial Statistics (IFS) of International Monetary Fund (IMF) and annual bank financial reports of respective countries are the major sources for data collection. Furthermore, World Development Indicator database of World Bank has also been used to collect data for other variables used in the model. A sample of fourteen (14) year's annual data from 2005 to 2019 is employed to analyze the relation of dependent and independent variables, respectively.

3.9 Qualitative Analysis

Qualitative approach is another lens that helps exploring a phenomenon in depth. If quantitative is about breath, qualitative is about the depth. After analyzing results obtained from the secondary data it was deemed important to authenticate these results in the context of the study. Qualitative research helps in exploring and explaining the contextual factors at play. It provides an in-depth understanding of the way people make sense of some of their day to day situations in particular settings. It aims of explicating the phenomenon by asking 'why' and 'how' something is happening.

A qualitative approach also tolerates the generation of inclusive insights, and for the purpose of this study, the experts' perception and experiences on Islamic banks were assembled (An Idyllic Vista of Islamic Banking Enhancement Knowledge Towards Triumph of Knowledge Delivery Process, 2019). Various approaches exist for collecting data in qualitative research, however, interview is among the most widely used methods. For this research, expert interviews were conducted with officials from State Bank of Pakistan. Expert interview as a method of qualitative data collection has been greatly discussed in political and social research since early 1990s. The main objective of expert interview is to get an understating about a particular field of interest, focusing on the knowledge in a particular field of action (Meuser and Nagel, 2009). Experts are thought to be knowledgeable individuals identified by virtue of their specific knowledge, their community position, or their status (Kaiser, 2014) as seen in The problem-centered expert interview' which combines qualitative interviewing approaches for investigating implicit expert knowledge.

Expert interviews are methodologically situated in subjective paradigm "in practice, individual relevancies of experts tend to be overshadowed by the researchers' interest in collecting information about a particular social field" (The problem centered expert interview'. Combining qualitative interviewing approaches for investigating implicit expert knowledge; 2020: 266). It can be used as a part of a more complicated set of methods used in a study or a stand-alone method in its own right. For the current study it has been used in a combination with document analysis, however, it remained dominant.

3.9.1 Recruitment of Participants

Creswell states that in qualitative research, "the intent is not to generalize to a population, but to develop an in-depth exploration of a central phenomenon", which is best achieved by using purposeful sampling strategies. A purposive sampling strategy with snow balling was used to select experts for this research. Snowballing "typically proceeds after a study begins and occurs when the researcher asks participants to recommend other individuals to study" (Creswell, 2005).

They were recruited according to their work experience and diversity of expertise and knowledge in the fields of banking and Islamic banking. The researcher opted for a maximum variation to obtain diverse experiences that will help understanding the complexity of the phenomenon. The experts were contacted personally by research via phone and/or email. The invitation contained purpose of the study and a proposed time and date of appointment. Afterword few other experts were contacted through snow ball sampling. A total of five (05) experts were interviewed.

"An Expert Knows All the Answers – If You Ask the Right Questions." Interviews are considered to be the most appropriate method for collecting data. Qualitative interviewing highlights the significance of looking into experiences and viewpoint of the interviewees to develop a better understanding of the reality (Edwards & Holland, 2013; Flick, 2018). Kumar speaks of the interviews as "[o]n one hand, interviewing can be very flexible, when the interviewer has the freedom to formulate questions as they come to mind around the issue being investigated; on the other hand, it can be inflexible, when the investigator has to keep strictly to the questions decided beforehand" (2005:123). For the present study a semi-structured anonymous interview design with open-ended questions was considered to be significant for the following reasons mentioned by Nohl, 2009.

It gives participants enough time and scope to elaborate on their views related to a particular phenomenon and also researcher can react and follow up the emerging ideas unfolding during the process of data collection.

Findings arrived through the semi structured interviews gives the opportunity to be compared for all the participants as they express their views about the general theme.

This type of data collection not only gives a chance to assess participants' opinion and allow them but it also allows eliciting narrative about the personal experiences.

Open ended questions allow the participants to express freely their experiences and reduce the influence of researcher's attitude and existing research about the same phenomenon (Creswell, 2005).

3.9.2 Interview Analysis

The interviews lasted for 30-60 minutes and various probing questions were asked after the opening open ended questions. The interviews were recorded with the consent of the experts however a few experts opted to be anonymous. The recorded interviews were then sorted out and heard couple of time before starting off with verbatim transcription. Transcription is the conversion of talk into text, which is first step in qualitative data analysis process. For the current study intelligent verbatim transcription was performed. "The transcriber therefore has to make subjective decisions throughout about what to include (or not), whether to correct mistakes and edit grammar and repetitions. This has been described as a spectrum between ''naturalized'' transcription (or ''intelligent verbatim'') which adapts the oral to written norms, and ''denaturalized'' transcription (''full verbatim''), where everything is left in, including utterances, mistakes, repetitions and all grammatical errors (Bucholtz, 2000). Once the transcription was done, it was sent back to the experts for a review.

3.9.3 Documentary Analysis

Organizational and institutional documents have been a staple in qualitative research for many years. Along with expert interviews, the other source of qualitative data consulted was policy document(s) available on Islamic banking for Pakistan. Documentary analysis is a form of qualitative research in which documents are interpreted by the researcher to give voice and meaning around an assessment topic (Bowen, 2009). "Documentary analysis is a systematic procedure for reviewing or evaluating documents both printed and electronic (computer-based and Internet-transmitted) material…document analysis requires that data be examined and interpreted in order to elicit meaning, gain understanding, and develop empirical knowledge." (Bowen, 2009). Through documentary analysis, the researcher gets an opportunity to look at the messages the policy conveys or policy goals and the practices taking place in the local context. For the current research, the Islamic banking policy documents and guidelines of the Islamic Banking Department of State Bank of Pakistan were consulted to understand the initiatives taken by the State Bank to promote and grow Islamic banking in the country. To carry on the documentary analysis for the present research, step wise process was followed. In documentary analysis the first step is finding and getting access to the document, this was not difficult, being a part of the setup, the researcher was able to find the relevant documents and get a chance to read through it. The next step is to get the relevant data from the document and organize it. While, reading through the policy documents on Islamic Banking in Pakistan, the researcher took note of the relevant information or sections adding to the knowledge about role of Islamic banking on economic growth. The data was latter-on compared with the findings from the expert interviews. Some excerpts of the policy document are presented within the Results and Discussion chapter of this research.

CHAPTER 4

RESULTS AND DISCUSSIONS FROM QUANTITATIVE AND QUALITATIVE ANALYSIS

4.1 Descriptive statistics of variables

Analysis of descriptive statistics of the data set is an important pre-requisite for any study. These statistics summarizes and elaborates the data in a meaningful way so that it is convenient to comprehend the underlying natures of the variables used in the study. "N" shows the sample size of the data used in the study. Commonly used statistics are central tendency (mean), minimum, maximum, and Standard deviation. Mean represents average value of the variable. Furthermore, closer values of mean represent symmetric distribution. Moreover, minimum and maximum statistics reveal the range of the data. Finally, the standard deviation illustrates the estimated value of dispersion. The following tables demonstrate the descriptive statistic of the variables. Table 4.2 illustrate the number of observations (N=490), the maximum, mean and minimum points of the data set. The last column of table 4.1 illustrate the standard deviation of the date set.

Table 4-1 Descriptive Statistics

Variables	N	Minimum	Maximum	Mean	Std. Dev
LnGDP	490	23.311	27.817	26.458	0.779
LnISF	490	2.001	23.083	7.366	5.574
REER	490	93.335	167.058	110.932	15.307
RIR	490	-12.215	28.054	4.182	3.467
CPI	490	98.406	182.321	127.768	22.625
LnINV	490	21.901	26.739	24.978	0.975
LnCON	490	22.343	27.359	26.155	0.763

Note: Descriptive statistics are calculated for five (05) countries from 2005 to 2019. All values are in percentage form except LnGDP, LnISF, LnINV, and LnCON.

On the other hand, table 4.2 shows the correlation matrix, which indicates the correlation between variables. It is necessary to identify the correlation matrix to avoid the collinearity issues in estimation. Other, it is also important to mentioned because to minimize the risk of any specification bias in the model.

4.2 Correlation Matrix

Table 4-2 Correlation Matrix

Variable	LnGDP	LnISF	REER	RIR	CPI	LnINV	LnCon
LnGDP	1						
LnISF	-.458**	1					
REER	-.232**	.443**	1				
RIR	.220**	-.037	.173**	1			
CPI	.062	.045	.536**	.359**	1		
LnINV	.551**	-.274**	-.208**	.237**	-.046	1	
LnCon	.570**	-.512**	-.163**	.233**	.191**	.658**	1

**. Correlation is significant at the 0.01 level (2-tailed).

There is no problem of multicollienairty in Panel data however correlation matrix is used in this research study to check correlation between panel variables. It is used to check whether the variable used in the research have extreme correlation or not which can violate our model estimation.

4.3 Model fit tests

To determine the fitness of the model several tests are used to check the reliability of the model. For instance, these tests include i) Goodness of fit index (GFI), ii) comparative fit index (CFI), iii) Tucker Lewis Index (TLF), and Normed Fit Index (NFI). Further, the results are also tested against chi-square and p-value to determine fitness of the model. The chi-square value is 107.773 and Degree of Freedom is seven (07) as shown in table 4.3. It is apprised that there is no huge difference in degree of freedom and chi-square value. At the same time, the p-Value is less than 0.05 which is another measure showing that our model is Good-fit.

4.4 Tests for Robustness

In the discipline of statistics, the term robust or robustness denotes to the strength of the statistical model. The tests and procedures with accordance to the specific conditions of the statistical analysis which a study want to accomplish. In simple terms, the robustness is the resistance to error in the estimation.

To ensure reliability of the model, the above-mentioned criteria namely GFI, CFI, TLI, and NFI should be close to 1. In the model above, values corresponding to the mentioned tests are greater than 0.900. Hence, this provides us the ample evidence that the model is robust.

Table 4-3 Test for Robustness

Tests	Chi-Square	DF	p-Value	GFI	CFI	TLI	NFI
Values	107.773	7	0.000	0.943	0.977	0.932	0.976

4.5 Structural Equation Modelling (SEM)

Previous researches have used at least a dozen models to test hypothesis about mediation. However, the most commonly used approach is the causal step approach popularized by (Baron & Kenny, 1986) in which the researchers use SEM models to estimate the coefficients of the paths of the model. There are multiple benefits to using SEM modeling in the context of mediation analysis. For instance, SEM can be used when extending a mediation process to multiple independent variables, mediators or outcomes. Thus, the causal relationships in a hypothesized mediation process, the simultaneous nature of the indirect and direct effects, and the dual role the mediator plays as both a cause for the outcome and an effect of the intervention are more appropriately expressed using structural equations than using regression analysis.

4.6 Direct and Indirect Effects of Mediation Analysis

Table 4-4 Meditation analysis, direct and indirect effect

Meditation analysis, direct and indirect effect						
Variable Impact		**Estimate**	**Thru, Inv**	**Thru, Cns**	**Total**	**p-Value**
LnIBF >	LnCon	0.072			0.072	0.00*
LnIBF->	LnINV	0.048			0.048	0.00*
LnINV>	LnGDP	0.375			0.375	0.00*
LnCon>	LnGDP	0.559			0.559	0.00*
lnIBF to lnGDP			0.048*0.375= (0.018)	0.072*0.559= (0.040)	0.058	0.011*

Notes: entries in * are significant at 5% significance level respectively.

The direct effect of Islamic banking financing on economic growth through direct path 'c' illustrated in table 4.5 (given below) according to estimate shows that there is an insignificant relation between Islamic banking financing and GDP growth directly. The p-value for direct effect is 0.07 which is greater than 0.05 (p-value<5%). It implies the economic growth is not directly influenced by the Islamic banking financing. (Mifrahi & Tohirin, 2020) also indicated in their study that the direct effect of Islamic Banking financing in QISMUT countries is statistically insignificant.

However, (Mishkin, 2007) proved the monetary transmission theory, the bank's deposits and afterward loans by bank accelerate the economic activities which tends to impact the economic growth. Secondly, the asset-based financing of Islamic banks serves as an enhanced channel for transferring finance to the real economic activities (Tohirin & Ismail, 2011). On the other hand, the finding of mediation analysis is shown in table 4.4 (above) which assert that the value of indirect effect through investment and consumption. The total value of indirect effect 0.058 with the p-value of 0.011 means that the total indirect effect is statistically significant. It confirms that Islamic banking financing (IBF) significantly impact the economic growth indirectly through mediation variables investment and consumption. An upward change in investment spending and consumption spending tends to increase the economic growth as shown in table 4.4. A change in investment spending by one percent cause to change the GDP growth by 37 percent. At the same time, a percent change in consumption spending tends to elevate GDP growth by 55 percent. Meanwhile, the indirect effect of consumption spending through Islamic banking is 4 percent and that of investment is 1.8 percent. Hence, this proves that the indirect effect of consumption spending on economic growth is greater than indirect effect of investment spending. These findings have a similar result as the study of (Furqani & Mulyany, 2009a). (Daly & Frikha, 2016) also provided the evidence of Islamic banking significantly affects the investment spending. Thus, the estimated results show that the increase in investment and consumption through Islamic banking tends to accelerate the economic growth.

The following table 4.5 summaries direct effect, indirect effect, and total effect.

Table 4-5 Summary: Direct, Indirect, and Total Effect

Table 4.5: Summary: Direct, Indirect, and Total Effect

Effects	**Estimates**	**p-Value**
Direct Effect	0.005	0.07
Indirect Effect – Consumption	0.040	
Indirect Effect – Inv	0.018	
Total Indirect Effect	0.058	0.011*
Total Effect (Direct+Indirect)	0.063	0.010*

Notes: entries in * are significant at 5% significance level respectively

Table 4.5 states that the direct effect is insignificant with the p-value greater than 5 percent. However, the total indirect effect through investment and consumption is statistically significant. Further, the total effect of Islamic banking financing is also significant with the p-value of 0.010 (P-value<5%).

4.7 Model estimation summary

Table 4-6 Model Estimation Summary

Effects	**Estimates**	**p-Value**
Equation 3.1 (Direct)	0.005	0.07*
Equation 3.2 (inv)	0.048	0.00*
Equation 3.3 (cons)	0.072	0.00*
Equation 3.4 (indirect)	0.058	0.011*
Notes: entries in * are significant at 5% significance level respectively		

The same results are shown in table 4.6, which indicates that Islamic banking financing has a significant impact on investment (Equation 3.2). The impact is statistically significant at 5 percent significance level (p-value<0.05) (table 4.5). The effect demonstrates a positive relation among the dependent and independent variable. However, it implies that a percent change in Islamic banking financing effect investment spending by 4.8 percent (equation 3.2). Similarly, the consumption spending is also positively related to Islamic banking financing showing a significance at 5 percent respectively. Hence, a change of a percent in Islamic banking financing effect consumption by 7.2 percent (equation 3.3). From the above results, the impact of Islamic banking financing on consumption (7.2%) is greater than the impact of Islamic banking financing on investment (4.8%).

Equation 3.4 refers to the meditation analysis of Islamic banking taken together with consumption and investment variables and the other control variables impact on the economic growth. The said analysis identified that Islamic banking affects indirectly and significantly the economic growth mediated by consumption and investment. (Zhao et al., 2010) identified that the Islamic banking impacts the economic growth indirectly through meditation. The above finding in equation 3.4 assert that a percent change in the Islamic banking financing is likely to change the economic growth positively by 5.8 percent.

To conclude, according to (Hayes, 2008), it is possible to have insignificant direct effect while obtain significant indirect effect. Our results also show that there is presence of indirect only significant relationship which is mediated through investment and consumption.

4.8 Dependent variables and control variables

Result of the control variables shown in table 4.7 reveal that the real interest rate has negative and significant impact on the economic growth. This implies that an interest-free system owned by the Islamic banking will positively impact on the economic growth. This result is parallel to the finding of (Shaukat, Zhu, & Khan, 2019) that a high interest rate obstructs the country economy to gain higher economic growth. As, (Hamza & Saadaoui, 2018) suggested that utilizing profit sharing instrument like *Mudaraba and Musharaka can* overcome the negative impact of the interest rate. Similarly, (Bacha, 2008) proved the same finding that Islamic banking is subjected to a negative impact of interest rate. Some impact that of interest rate to the economy is because of the country dual banking system. Thus, some Islamic banks relay on the conventional financing system of interest rate (Bacha, 2008).

Table 4-7 Effect of control variables on dependent variables

Variable Impact		**Estimate**	**S.E.**	**t-stat**	**p-Value**
RIR--->	LnGDP	-0.004	0.001	-6.887	0.00*
REER--->	LnGDP	-0.001	0.0009	-9.292	0.00*
CPI--->	LnGDP	-0.045	0.190	0.24	0.814

Notes: entries in * are significant at 5% significance level respectively

Table 4.7 indicates that interest rate has a significant and negative impact on the economic growth. Meaning, a positive change in interest rate leads to a negative impact on the economic growth and vis versa.

Subsequently, the finding on exchange rate suggests that exchange rate does significantly affect the economic growth. One reason for this likely impact is the use of floating exchange rate by the Asian countries. (Razmi, Rapetti, & Skott, 2012) indicates that countries with the fixed exchange rate defeats the impact of exchange rate on the economic growth. Moreover, the finding will be different if it further uses the changing exchange rate. The above result indicates that any positive change in exchange rate leads to a negative 0.1 change in economic growth.

On the Consumer price index (CPI) variable testing, consumer price index does not have a significant impact on the economic growth. According to (Barro, 2013), only a high price index deters the economic growth. Looking in the data of 14 years form 2005-2019 consumer price index has no significant effect on the economic growth. The consumer index in Asian countries relatively remain stable due to which the consumer price index indicates no significant effect on the economic growth.

The overall finding generally affirms that financial sector matters to economic growth. Thus, it has confirmed the previous studies that financial sector impacts the economic growth. (Levine, Loayza, & Beck, 2000) and (Rioja & Valev, 2004) provided that the financial sector has a gross significant implication for the economic growth. However, (Mishkin, 2007), stated that in terms of monetary transmission system, bank loans cause investment and spending to rise. This channel is also applied in Islamic banking financing thus impacts the economic growth. According to

(Tohirin & Ismail, 2011), Islamic banking mode of financing like *Musharaka, Mudaraba and Murabaha* can increase the bank-based view of economic expansion. Hence, Islamic banking is the source of growth and play essential role in promoting economic growth through mediation of investment and consumption. Also, (Tohirin & Ismail, 2011), economic policies should utilize the Islamic banking financing for the financing-growth relation to maintain the development of the economy.

4.9 Hypothesis Results

This research aimed to analyze the direct and indirect channels of the effect of Islamic banking financing on economic growth in Muslim populated Asian countries. The results of our estimation fully support our hypothesis (H1, H2, and H3). Based on the results of mediation analysis conducted using Structural Equation Modelling approach, the results support Hypothesis 1 (H1), indicating there is significant impact of Islamic Banking Financing on investment (Est 0.048, p-value <5%). Furthermore, the presence of positive significant relationship between Islamic banking financing on consumption also supports Hypothesis 2 (H2) of our study (Est 0.072, p-value <5%). Similarly, their combined effect which is referred to as Indirect Effect is also found significant in our research which lends credence to our Hypothesis 3 (H3), indicating significant indirect impact of Islamic Banking Financing on economic growth (Est 0.058, p-value 0.011). However, the direct effect of Islamic banking financing on economic growth is insignificant (Est 0.005 p-value 0.07). Thus, we may reject our Hypothesis (H4) that is Islamic banking financing has significant direct impact on economic growth.

4.10 Review of Documentary Analysis

Islam was the basis of creation of an independent state within the undivided Indo-Pak Sub-Continent. Since its creation, the people of Pakistan have held the demand for elimination of Riba from the financial system of Pakistan on the basis of Islamic precepts. All Constitutions of Pakistan have incorporated, within the principles of policy, the elimination of Riba as an important objective of the State policy. Quaid-e-Azam, the father of the nation, in his speech at the occasion of the inauguration of State Bank of Pakistan, had expressed the desire for evolving an Islamic system of banking. He said:

"I shall watch with keenness the work of your Research Organization in evolving banking practices compatible with Islamic ideas of social and economic life…. The adoption of Western economic theory and practice will not help us in achieving our goal of creating a happy and contented people. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save and secure the welfare, happiness and prosperity of mankind."

Moreover, Article 38(f) of the Constitution of the Islamic Republic of Pakistan provides: "The State shall …. Eliminate riba as early as possible." The Objectives Resolution, 1947, now a part of the Constitution, as well as principles of policy enunciated in the Constitution also require to establish an order in Pakistan "[w]herein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah".

The lesson that was learnt with the Islamization process that was initiated in 1980s was that the process of Islamization of an economy should be evolutionary and not revolutionary. Hence, in September 04, 2001, the Government of Pakistan along with other relevant stakeholders decided that the shift towards Islamic Banking would be made in a gradual manner and the SBP would offer three institutional choices. In this connection, banks in Pakistan were allowed to start Islamic banking operations through opening of Islamic Banking subsidiaries of conventional banks to conduct operations in a Shariah compliant manner, or Islamic Banking windows of conventional banks by specifying its branches dealing with Islamic products, and setting up full-fledged Islamic commercial banks to perform exclusive banking business based on Shariah principles.

As part of this initiative, various other decisions were taken to kick start the Islamic Banking sector in the country. These include:

- Rules for establishment of Islamic Banks in December 2001
- Amendment in Banking Companies Ordinance to allow banks to open Islamic Banking Subsidiaries in September 2002
- State Bank issued a detailed policy in January 2003 defining criteria for establishment of Islamic Banks in private sector, Islamic Banking subsidiaries, and stand-alone branches by conventional banks
- Creation of a separate Department at SBP to cater to regulate and supervise the Islamic Banking industry

The Central Bank of Pakistan, State Bank of Pakistan (SBP), has laid special emphasis on the development of Islamic Banking industry in Pakistan. This can be seen from the fact that ever since the re-launch of Islamic Banking in Pakistan in 2001, SBP has focused on the development of Islamic Banking by producing five (05) year strategic plans for achievement of headline Islamic banking growth targets. Two (02) strategic plans for the Islamic Banking Industry have been made with headline targets for increasing the outreach of Islamic financial services to the masses in the country. In its third Strategic Plan for Islamic Banking Industry (2021-25), SBP has stressed upon the importance of Islamic Banking to broad based economic growth:

"Given its potential towards ensuring broad based economic growth and development, Islamic banking throughout has remained among priority areas of the State Bank of Pakistan (SBP). This is reflected in SBP's dedication and commitment for laying sound foundations for sustainable growth of Islamic banking industry in the country."

Strategic Plan for Islamic Banking Industry (2021-25)

The document further guides the focus of Islamic Banking industry towards six (06) strategic pillars that will require work so that the headline targets can be met by 2025. These include

- Strengthening Legal Landscape
- Enhancing Conducive of Regulatory Framework
- Reinforcing Comprehensive Shariah Governance Framework
- Improving Liquidity Management Framework
- Expanding Outreach & Market Development
- Bolstering Human Capital & Raising Awareness

Moreover, SBP has also stressed the importance of Islamic Banking as a way to promote the development of an inclusive financial system required for overall economic development:

SBP's drive to promote Islamic banking as a parallel system, operating at a level playing field with commercial banking, is aimed at building a broad based financial system in the country to enable all segments of the population to access financial services and play their due role in the overall economic development. *Foreword, Islamic Banking Review, 2003-07*

4.11 Interview Analysis

This part of the chapter presents the findings of the expert interviews which were conducted to have an in-depth understanding and localized perspective. As mentioned in the Chapter 3, that qualitative data was collected in the form of policy guidelines and documents from the State Bank of Pakistan (SBP) and in-depth interviews with industry experts/players were also conducted. From the interview analysis, some very interesting facts were revealed.

Theses interviews were conducted from five (05) industry experts who have acquired years of experience working in the Islamic Banking industry. Two Senior Joint Directors are working in the Market Research and Analysis Division at Islamic Banking Department at SBP while the other Senior Joint Director and Joint Director are working at Shariah Division of Islamic Banking Department, SBP. From the expert interviews it was revealed that all experts interviewed for this research have strong faith in Islamic banking and they foresee future growth of the Islamic banking As per the experts:

"The future of Islamic Bank is bright, it is a line of business for rest of the world, you can see it is taking market share in non-Muslim countries. The market share of Islamic Banking is around 18% of the total banking assets in Pakistan. Though Islamic Banking has relatively less number of products as compared to conventional banks but still there is going to be much growth of it."

One of the expert not only mentioned about the growth of Islamic banking in Pakistan but he also proposed a strategy for its growth by suggesting that Islamic banks have to first reduce the growth of conventional banks in the market by not only opening more branches or converting the existing conventional branches into Islamic banking. He mentioned that:

"The footprints of Islamic Banking are enlarging in Pakistan, the pace might be slow but the if you look at the branch network you will see a lot growth, yes from the share of Islamic Banking in the overall banking system, the share in increasing but the pace is slow as its pace is eaten by the conventional banking. For any number to register, the Islamic Banking will first nullify the growth of the conventional banking and then adding its numbers."

In order to understand the dynamics of Islamic banking in terms its impact on consumption and investments, there was a consensus among the experts that Islamic banking is about real growth, it neither creates artificial growth nor a financial bubble which was cause of the Global Financial Crises in 2007-08. The expert were of the view that:

"We need to understand the difference of Islamic and conventional banking, conventional banking lends money, money is a commodity, while Islamic Banking believes there should be exchange of the real commodities, money is not a commodity but only a medium of exchange so when conventional banks lend money … they make it a commodity and trade it. This comes under the concept of the RIBA."

It is pertinent to mention that the aim of this research was to understand the impact of Islamic banking on consumption and investment separately; hence all the experts were asked the questions specifically about these two dimensions of the Islamic banking. The experts mentioned that Islamic banking has its own way and various modes of financing which are different in terms its modalities and these modes of transactions have a more significant impact on both consumption and investment.

"Modes of financing in Islamic Banking are 8-10 but we always encourage banks to go over and above, be innovate and develop your own, banks use these modes to offer their products. They positively affect economic growth as it is trade, trade of commodity so overall economic growth gets better, unlike a conventional side, where there is a trade of money taking place. Islamic side trades real good. Like Murabha and salum etc."

Some of the experts opined that:

"Islamic banks can help in resource mobilization and efficient allocation using either profit sharing (Musharakah and Mudarabah) or trading & Ijarah based categories of Islamic modes of financing. Profit sharing modes can be used for short, medium and long-term project financing, import financing, pre-shipment export financing and working capital financing transactions."

As per the experts, Islamic banking is dealing in terms of commodity financing than dealing in money. This is seen as prudent and more socially responsible in comparison to conventional banking. As per the experts:

"Islamic Banking is very cautious and conservative approach, rather it is very prudent. Because it does not deal in speculative matter activities like in conventional banking arena a lot of activities are speculated like you talk about derivatives a huge amount of volumes in derivatives globally. I mean derivative are not the subject matter of Islamic finance. And further IB is more socially responsible, because it is not indulging in any kind of activity which is against and good at large. So I mean it is more reasonable to the society and it adds value to the society"

It is also important to mention that the Islamic banking experts are well aware of the fact that the current modes of financing are not sufficient but the Central bank is always encouraging the banks to come up with new and innovative modes to meet the increasing needs of their borrowers.

There are avenues like Qard e Asna that can be provided for Education purposes or "Tawarruq" to satisfy the consumption needs of their borrowers. Although the avenues of Shariah compliant personal loans in Islamic Banking are limited but the banks are innovating while remaining within keeping in mind sharia rules.

The experts explained that the impact of Islamic banks can be seen on investment through:

"Trade-based techniques like Murabaha with lesser risk and better liquidity options have several advantages vis-à-vis other techniques but may not be as fruitful in reducing income inequalities and generation of capital goods as participatory techniques would do. Ijarah related financing requires the banks to engage in activities beyond financial intermediation."

"Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole. It provides incentive to enhance production as the seller would spare no effort in producing, at least the quantity needed for settlement of the loan taken by him as advance price of the goods."

From interviews with experts we also understood that Islamic banking is more holistic, socially and economically responsible. It is not only a way of financial inclusion for the faith driven people who have created the demand for these institutions, but also they provide an avenue for banks:

"to be environmentally conscious, so those investors who are conscious about their impact on the society, an avenue is provided to them as well. Islamic Banking is more ethical and based on moral grounds so when you talk about Environmental, Social, Governance (ESG) it is more

inclined towards Islamic finance promotions and developments compared to conventional banking."

All experts were in agreement that although the foot print of Islamic banking is getting stronger and deeper in the economy, however, there are still some untapped avenues that Islamic bank has to tap.

"They still have to tap the untapped market in the agri sector, SME sector, micro finance sector obviously there are some challenges in these sectors as well so at the same time IB should not let go any kind of opportunity. And these sectors have a great potential to stimulate economic growth"

CHAPTER 5

CONCLUSION AND POLICY RECOMMENDATIONS

5.1 Conclusion

The research about Islamic system of banking and financing and economic growth nexus is important as this financial system provides vivid opportunities for investment and consumption with strong assurance of funds as it is backed by real economic activities. Investment and consumptions are key factors in the economic development. It can be implied that neglecting the role of the Islamic banking plays in the financial system is synonymous to ignoring an important aspect or determinant of economic development. It is a necessary to explore the Islamic banking system role in the economy.

This research consists of four (04) hypothesis, i) Islamic system of banking and financing has a significant impact on investment, ii) Islamic system of banking has a significant impact on consumption, iii) Islamic system of banking has a significant impact indirectly on the economic growth mediated by investment and consumption, iv) Islamic banking financing has significant direct relationship with economic growth.

Firstly, the Islamic system of banking has a significant impact on the investment spending. Secondly, it too has a significant impact on the consumption spending. Further, the impact of consumption spending is greater than the impact of investment spending. However, directly analyzing the impact of Islamic system of banking, the statistical evaluation indicated no significance. The Islamic system of banking has no direct impact on the economic growth. On the other hand, indirect method through meditation variables (consumption and investment), the estimates show a significant impact of Islamic system of banking on Economic growth. One important aspect of this impact of Islamic system of banking on economic growth is the assurance of funds and profit and loss sharing schemes. These schemes afloat confident investment and consumption spending through Islamic banking. Hence, this phenomenon also upholds Keynesian theory which assert that investment and consumption provide the most tremendous support to economic growth of the country.

From the estimation of control variables, the finding on exchange rate suggests that exchange rate does significantly affect the economic growth. One reason for this likely impact is the use of floating exchange rate by the Asian countries. Moreover, the finding will be different if it further uses the changing exchange rate. The above result indicates that a positive change in exchange rate leads to a negative 0.001 change in economic growth. Secondly, the real interest rate has negative and significant impact on the economic growth. This implies that an interest-free system owned by the Islamic banking will positively impact on the economic growth. On the Consumer price index (CPI) variable testing, consumer price index does not have a significant impact on the economic growth. The consumer index in Asian countries relatively remain stable due to which the consumer price index indicates no significant effect on the economic growth.

The findings of our estimation analysis using SEM modelling are confirmed after reviewing relevant policy documents/guidelines issued by State Bank from time to time and conducting interviews from relevant industry experts in the field of Islamic Banking. In view of the above analysis, it can be safely assumed that Islamic Banking has a role to play in the economic growth of the country through investment and consumption channel.

5.2 Policy Recommendations

The Islamic banking financing have some significant implication for economic growth but due to the less assets share of Islamic banking it has no direct impact on economic growth. To boost the role of the Islamic banking and its subsequent implication for the economic growth the economic policies should spot the finance-growth nexus through Islamic banking development to preserve sustainable development in the economy.

Islamic banking financing has a great potential; it can bring positive implication for the economic growth of the country. However, Islamic banking is still at a nascent stage of development as indicated by the share of Islamic banking in the international market is still at a low. It is important to reveal the role of Islamic banking in an economy. One of the most immersing features of the Islamic banking is that it provides tremendous opportunities for the trade. Therefore, it is imperative that Islamic alternatives to conventional trade finance be promoted to enhance trade in the country.

The results of this research suggests that the policy makers and regulators should create an enabling regulatory and business friendly environment for Islamic banks to increase consumption and investment spending that leads to economic growth. This will also help with increasing the financial inclusion in the country as people who consider interest as haram will now find a viable alternative to interest based conventional finance.

5.3 Future Direction

This research focused on the study of Islamic banking financing on economic growth – evidence from Muslim populated Asian countries. Further research may extend the scope of this research by including discussion on conventional finance and comparing it with Islamic finance. Moreover, the model may be expanded to include variable on conventional finance may affect the Islamic banking financing and economic growth nexus.

5.4 The Future of Islamic Banking and Limitations

The key area for future development of the Islamic banking is following:

- Current problems, hurdles, and bottlenecks in the development of Islamic finance and their possible solutions.
- Regulatory, institutional, governmental, and political factors and it influence.
- Innovative Islamic banking financing with the introduction of innovative products and services.

The authorities need to curb those challenges and issues which are hindering the development of the Islamic banking system. For instance, in western societies there are numerous misconceptions about the philosophy of Islamic banking. The vocabulary of the Islamic banking is different from that of the conventional banking. Hence, there exist a universal terminology and interbank terms in the Islamic complaint banking. Thus, it must eliminate those misconceptions about the Islamic banking system that prevails in different communities and societies by describing the terms and vocabulary of banking. Secondly, the authority should address the issues of Islamic banking by providing special attention to this system. The main issue in these times is the unavailability of money and a formal financial markets for Islamic instruments for liquidity management of Islamic banks. The Islamic banking has a huge potential to engage the poor and small trader in the economic activities. Realizing and capitalizing on this fact can give a tremendous opportunity to these poor and small-scale traders who can perform better in the microeconomics of the country. In many Muslim nations the Islamic banking is working under no legal cover excluding exceptions. The legal cover is important to make the banks solvent as this will eliminate exploitation of unfair use of Islamic banking.

Conclusively, Islamic banking has a positive repercussion for the development of the economy. This kind of sharia compliant banking should be promoted in the countries to gain its positive implications. It has huge potential for investment and trading as well it provides a unique opportunity to increase consumption of a country. Thus, there is a dire need to focus on the development of Islamic Banking and make an efficient use of this system for enhanced economic development of Pakistan.

REFERENCES

Abduh, M., & Chowdhury, N. T. (2012). Does Islamic banking matter for economic growth in Bangladesh. *Journal of Islamic Economics, Banking and Finance, 8*(3), 104-113.

Abduh, M., & Omar, M. A. (2012). Islamic banking and economic growth: the Indonesian experience. *International Journal of Islamic and middle eastern finance and management*.

Aggarwal, R. K., & Yousef, T. (2000). Islamic banks and investment financing. *Journal of money, credit and banking*, 93-120.

Ahmad, K., & Ihsan, A. (2018). Impact of Islamic finance on economic growth–empirical evidence from Pakistan. *International Journal of Scientific & Engineering Research, 9*(7), 476-489.

Alam, M. S., Ali, M. J., Bhuiyan, A. B., Solaiman, M., & Rahman, M. A. (2020). The Impact of COVID-19 Pandemic on The Economic Growth in Bangladesh: A Conceptual Review. *American Economic & Social Review, 6*(2), 1-12.

Ali, M., & Azmi, W. (2017). Impact of Islamic Banking on Economic Growth and Volatility: Evidence from the OIC Member Countries (pp. 15-32).

Ang, J. B. (2008). What are the mechanisms linking financial development and economic growth in Malaysia? *Economic Modelling, 25*(1), 38-53.

Anwar, S., Junaidi, J., Salju, S., Wicaksono, R., & Mispiyanti, M. (2020). Islamic bank contribution to Indonesian economic growth. *International Journal of Islamic and middle eastern finance and management, ahead-of-print*. doi:10.1108/IMEFM-02-2018-0071

Archer, S., & Karim, R. A. A. (2012). The structure, regulation and supervision of Islamic banks. *Journal of Banking Regulation, 13*(3), 228-240.

Ashraf, S. H., & Giashi, A. A. (2011). Islamic banking in Iran: Progress and challenges. *Kuwait Chapter of Arabian Journal of Business and Management Review, 33*(830), 1-28.

Bacha, O. I. (2008). The Islamic inter bank money market and a dual banking system: the Malaysian experience. *International Journal of Islamic and middle eastern finance and management*.

Baron, R. M., & Kenny, D. A. (1986). The moderator–mediator variable distinction in social psychological research: Conceptual, strategic, and statistical considerations. *Journal of personality and social psychology, 51*(6), 1173.

Barro, R. J. (2013). Inflation and economic growth. *Annals of Economics & Finance, 14*(1).

Bhattacharya, S., & Thakor, A. V. (1993). Contemporary banking theory. *Journal of financial Intermediation, 3*(1), 2-50.

Bist, J. P. (2018). Financial development and economic growth: Evidence from a panel of 16 African and non-African low-income countries. *Cogent Economics & Finance, 6*(1), 1449780.

Bougatef, K., Nakhli, M. S., & Mnari, O. (2020). The nexus between Islamic banking and industrial production: Empirical evidence from Malaysia. *ISRA International Journal of Islamic Finance*.

Boukhatem, J., & Moussa, F. B. (2018). The effect of Islamic banks on GDP growth: Some evidence from selected MENA countries. *Borsa Istanbul Review, 18*(3), 231-247.

Caporale, G. M., & Helmi, M. H. (2018). Islamic banking, credit, and economic growth: Some empirical evidence. *International Journal of Finance & Economics, 23*. doi:10.1002/ijfe.1632

Carlsson-Szlezak, P., Reeves, M., & Swartz, P. (2020). What coronavirus could mean for the global economy. *Harvard Business Review, 3*(10).

Chowdhury, M. A. F., Haque, M. M., & Masih, M. (2017). Re-examining the determinants of Islamic bank performance: new evidence from dynamic GMM, quantile regression, and wavelet coherence approaches. *Emerging Markets Finance and Trade, 53*(7), 1519-1534.

Dahduli, M. S. (2009). Islamic banking and economic development. *Available at SSRN 1616624*.

Daly, S., & Frikha, M. (2016). Banks and economic growth in developing countries: What about Islamic banks? *Cogent Economics & Finance, 4*(1), 1168728.

Darrat, A. F. (1988). The Islamic interest-free banking system: some empirical evidence. *Applied Economics, 20*(3), 417-425.

Eggoh, J. (2010). Financial development, financial instability and economic growth: A reexamination of the relationship. *Region and Development, 32*, 9-32.

Elmawazini, K., Khiyar, K., & Aydilek, A. (2020). Types of banking institutions and economic growth. *International Journal of Islamic and middle eastern finance and management, ahead-of-print*. doi:10.1108/IMEFM-09-2018-0304

Furqani, H., & Mulyany, R. (2009a). Islamic Banking and Economic Growth: Empirical Evidence from Malaysia. *Journal of Economic Cooperation and Development, 30*, 59-74.

Furqani, H., & Mulyany, R. (2009b). Islamic banking and economic growth: Empirical evidence from Malaysia. *Journal of Economic Cooperation & Development*, *30*(2).

Hachicha, N., & Amar, A. B. (2015). Does Islamic bank financing contribute to economic growth? The Malaysian case. *International Journal of Islamic and middle eastern finance and management*.

Hamza, H., & Saadaoui, Z. (2018). Monetary transmission through the debt financing channel of Islamic banks: does PSIA play a role? *Research in International Business and Finance, 45*, 557-570.

Hanieh, A. (2020). New geographies of financial power: global Islamic finance and the Gulf. *Third World Quarterly, 41*(3), 525-546.

Hassan, M. K., Rabbani, M. R., & Ali, M. A. M. (2020). Challenges for the Islamic Finance and banking in post COVID era and the role of Fintech. *Journal of Economic Cooperation & Development, 41*(3), 93-116.

Hoggarth, D. (2016). The rise of Islamic finance: Post-colonial market-building in central Asia and Russia. *International Affairs, 92*, 115-136. doi:10.1111/1468-2346.12508

House, K. F. (2013). Islamic Finance in Asia: Development, Growth and Opportunities: KFH Research Ltd.

Imam, P., & Kpodar, K. (2016). Islamic banking: Good for growth? *Economic Modelling, 59*, 387-401.

James, C. (1987). Some evidence on the uniqueness of bank loans. *Journal of financial economics, 19*(2), 217-235.

Jeanneney, S. G., & Kpodar, K. (2011). Financial development, financial instability and poverty.

Jobarteh, M., & Ergec, E. H. (2017). Islamic finance development and economic growth: Empirical evidence from Turkey. *Turkish Journal of Islamic Economics, 4*(1), 31-47.

Kalim, R., Mushtaq, A., & Arshed, N. (2016). Islamic banking and economic growth: Case of Pakistan. *Islamic Banking and Finance Review*, *3*(1), 14-28.

Kassim, S. (2016). Islamic finance and economic growth: The Malaysian experience. *Global Finance Journal*, *30*(C), 66-76.

Kchouri, B., & Lehnert, T. (2018). Islamic Banking and Economic Growth: New Evidence.

Khan, M. F. (2013). Theorizing Islamic economics: Search for a framework for Islamic economic analysis. *Islamic Econ, 26*(1), 203-236.

Khan, M. S., & Mirakhor, A. (1989). The financial system and monetary policy in an Islamic economy. *Journal of King Abdulaziz University: Islamic Economics, 1*(1).

Kociemska, H. (2020). Islamic finance merging public finance within public–private partnership. *International Journal of Islamic and middle eastern finance and management*.

Komijani, A., & Taghizadeh-Hesary, F. (2018). An overview of Islamic banking and finance in Asia.

Law, S. H., & Singh, N. (2014). Does too much finance harm economic growth? *Journal of Banking & Finance, 41*, 36-44.

Lebdaoui, H., & Wild, J. (2016). Islamic banking and financial development. *Review of Middle East Economics and Finance, 12*(2), 201-224.

Lentner, C., Vasa, L., Kolozsi, P., & Zoltan, Z. (2019). New dimensions of internal controls in banking after the GFC. *Economic Annals-XXI, 176*, 38-48. doi:10.21003/ea.V176-04

Levine, R. (2003). More on finance and growth: more finance, more growth? *Review-Federal Reserve Bank of Saint Louis, 85*(4), 31-46.

Levine, R., Loayza, N., & Beck, T. (2000). Financial intermediation and growth: Causality and causes. *Journal of monetary Economics, 46*(1), 31-77.

Mifrahi, M. N., & Tohirin, A. (2020). HOW DOES ISLAMIC BANKING SUPPORT ECONOMICS GROWTH? *Share: Jurnal Ekonomi dan Keuangan Islam, 9*(1), 72-91.

Mishkin, F. S. (1995). Symposium on the monetary transmission mechanism. *Journal of Economic perspectives, 9*(4), 3-10.

Mishkin, F. S. (2007). Housing and the monetary transmission mechanism: National Bureau of Economic Research Cambridge, Mass., USA.

Moosavian, S. (2007). Islamic Banking (in Farsi). *Tehran: Monetary and Banking Research Institute*.

Mushtaq, A., Arshed, N., & Kalim, R. (2018). Islamic banking financing effect on growth. *5*, 69-87. doi:10.32350/ibfr.2018.05

Mustafa, H. W. (2018). *The Effect Of Islamic Finance On Economic Growth In Kenya*.

Nalan, I. (2018). Growth, Islamic banking and Schumpeterian vision: An empırıcal evidence from the Gulf Arab states. *International Journal of Islamic Economics and Finance Studies, 4*(1), 41-56.

Radulescu, M., Serbanescu, L., & Sinisi, C. I. (2019). Consumption vs. Investments for stimulating economic growth and employment in the CEE Countries–a panel analysis. *Economic research-Ekonomska istraživanja, 32*(1), 2329-2352.

Rafay, A., & Farid, S. (2017). Dynamic relationship between islamic banking system and real economic activity: Evidence from Pakistan. *Journal of King Abdulaziz University, Islamic Economics, 30*, 97-116. doi:10.4197/Islec.30-2.10

Rajan, R. G. (1992). Insiders and outsiders: The choice between informed and arm's-length debt. *The Journal of finance, 47*(4), 1367-1400.

Razmi, A., Rapetti, M., & Skott, P. (2012). The real exchange rate and economic development. *Structural Change and Economic Dynamics, 23*(2), 151-169.

Rioja, F., & Valev, N. (2004). Does one size fit all?: a reexamination of the finance and growth relationship. *Journal of Development economics, 74*(2), 429-447.

Saleem, S. (2007). Role of Islamic banks in economic development. *MPRA paper*(6449).

Samuelson, P. A., & Nordhaus, W. D. (1989). Economics: Business organization. *New York, itd: McGraw-Hill*.

Sarwer, M. S., Ramzan, M., & Ahmad, W. (2013). Does islamic banking system contributes to economy development. *Global Journal of Management and Business Research*.

Schumpeter, J. A., & Nichol, A. (1934). Robinson's economics of imperfect competition. *Journal of political economy, 42*(2), 249-259.

Shaukat, B., Zhu, Q., & Khan, M. I. (2019). Real interest rate and economic growth: A statistical exploration for transitory economies. *Physica A: Statistical Mechanics and Its Applications, 534*, 122193.

Tabash, M. I., & Anagreh, S. (2017). Do Islamic banks contribute to growth of the economy? Evidence from United Arab Emirates (UAE). *Banks & bank systems*(12,№ 1 (cont.)), 113-118.

Tabash, M. I., & Dhankar, R. S. (2014). The flow of Islamic finance and economic growth: An empirical evidence of Middle East. *Journal of Finance and Accounting, 2*(1), 11-19.

Thakor, A. V. (1995). Financial intermediation and the market for credit. *Handbooks in Operations Research and Management Science, 9*, 1073-1103.

Tohirin, A., & Ismail, A. G. (2011). MMM in the finance-growth nexus. *Investment management and financial innovations*(8, Iss. 3), 130-147.

Wahab, M., Mufti, O., Murad, M., & Khattak, A. (2016). The Study of Co-integration and Causal Link between Islamic Bank Financing and Economic Growth. *Abasyn Journal of Social Sciences, 9*, 134-146.

Wardhani, N., & Arshad, S. (2015). The Contribution of Islamic Banking to Indonesia's Economic Growth: The Evidence from the Vector Error Correction and Variance Decomposition Methods. *Management and Business Administration. Central Europe, 23*, 89-104. doi:10.7206/mba.ce.2084-3356.152

Yazdan, G. F., & Mohammad Hossein, S. S. (2012). Analysis of Islamic Bank's Financing and Economic Growth: Case Study Iran and Indonesia. *Journal of Economic Cooperation & Development, 33*(4).

Yüksel, S., & Canöz, İ. (2017). Does Islamic banking contribute to economic growth and industrial development in Turkey. *Ikonomika, 2*(1), 93-102.

Yüksel, S., Canöz, İ., & Özsarı, M. (2017). Causality relationship between interest rate of deposit banks and profit share rate of islamic banks in turkey. *Ikonomika, 2*(2), 131-148.

Yusof, R. M., & Bahlous, M. (2013). Islamic banking and economic growth in GCC & East Asia countries: A panel cointegration analysis. *Journal of Islamic Accounting and Business Research*.

Zeeshan, M., Han, J., Rehman, A., Saleem, K., Shah, R. U., Ishaque, A., . . . Hussain, A. (2020). Conventional Mutual Funds Out Perform Islamic Mutual Funds in the Context of Pakistan. A Myth or Reality. *International Journal of Economics and Financial Issues, 10*(4), 151.

Appendix A

Appendix A Individual Country Analysis

List of Asian countries with Islamic Banking	
1	Bangladesh
2	Brunei
3	Indonesia
4	Malaysia
5	Pakistan

1) Bangladesh

Structural Equation Modelling (SEM) Results

Variable		Estimate	S.E.	t-Stat	p-Value
LnISF	LnCon	0.027	0.016	1.641	0.101
LnISF	LnINV	0.041	0.025	1.662	0.097
LnISF	LnGDP	0.0002	0.001	0.2	0.842
LnCon	LnGDP	0.282	0.044	6.433	***
LnINV	LnGDP	0.449	0.029	15.475	***
RIR	LnGDP	-0.001	0.001	-0.778	0.436
REER	LnGDP	0.0005	0.0001	5.000	***
CPI	LnGDP	0.001	0	12.374	***

	Stat	p-Value
Total Effect	0.026	0.094
Direct Effect	0.0002	0.842
Indirect Effect	0.026	0.089

2) Pakistan

Variable		Estimate	S.E.	t-stat	p-Value
LnISF	LnCon	0.01986	0.00235	8.46027	***
LnISF	LnINV	0.04792	0.00577	8.30652	***
LnISF	LnGDP	0.00002	0.00013	0.14386	0.88561
LnCon	LnGDP	0.25017	0.01815	13.78176	***
LnINV	LnGDP	0.24044	0.00739	32.55682	***
RIR	LnGDP	-0.00057	0.00008	-7.52492	***
REER	LnGDP	0.00031	0.00002	15.15493	***
CPI	LnGDP	0.00232	0.00007	31.96178	***

	Stat	p-Value
Total Effect	0.1651	0.02985
Direct Effect	0.00002	0.86276
Indirect Effect	0.01649	0.03184

3) Brunei

Variables		Estimate	S.E.	t-stat	p-Value
LnISF	LnCon	0.26591	0.03821	6.95915	***
LnISF	LnINV	0.47327	0.29382	1.61078	0.10723
LnISF	LnGDP	**0.34536**	0.05423	6.36827	***

LnCon	LnGDP	0.61965	0.18319	3.38244	***
LnINV	LnGDP	0.04269	0.02382	1.79185	0.07316
RIR	LnGDP	0.00046	0.00043	1.05251	0.29257
REER	LnGDP	-0.01039	0.003	-3.46463	***
CPI	LnGDP	0.01819	0.0101	1.80013	0.07184

	Stat	p-Value
Total Effect	0.53033	.56007
Direct Effect	0.34536	.00016
Indirect Effect	0.18497	.16343

4) Indonesia

Variable		Estimate	S.E.	t-Stat	p-Value
LnISF	LnCon	0.003	0.004	0.747	0.455
LnISF	LnINV	0.0035	0.0045	0.7757	0.438
LnISF	LnGDP	0.0004	0.003	0.1377	0.8904
LnCon	LnGDP	0.8459	0.0065	131.0479	***
LnINV	LnGDP	0.1355	0.0058	23.5547	***
RIR	LnGDP	0.0003	0	7.047	***
REER	LnGDP	0.0005	0	13.089	***
CPI	LnGDP	0.0005	0	64.0781	***

	Stat	p-Value
Total Effect	0.0034	0.5003

Direct Effect	0.0004	0.9611
Indirect Effect	0.003	0.4918

5) Malaysia

Variable		Estimate	S.E	t-stat	p-Value
LnISF	LnCon	-0.0025	0.0018	-1.4323	0.1521
LnISF	LnINV	0.0169	0.0102	1.6582	0.0973
LnISF	LnGDP	-0.0001	0.0002	-0.3859	0.6996
LnCon	LnGDP	0.7338	0.0212	34.6735	***
LnINV	LnGDP	0.0108	0.0036	2.955	0.0031
RIR	LnGDP	-0.0021	0.0003	-7.5753	***
REER	LnGDP	-0.001	0	-23.1967	***
CPI	LnGDP	0.0012	0.0006	2.1022	0.0355

	Stat	p-Value
Total Effect	-0.0017	0.2231
Direct Effect	-0.0001	0.545
Indirect Effect	-0.0017	0.2561

Appendix B

DEFINITIONS AND MEANING OF TERMS USED IN ISLAMIC BANKING	
Sharia	Shariah: Islamic law as mentioned in the Quran and saying example of the Prophet Muhammad. A product is sharia compliant which fulfill the requirement of law and value of Islam.
Ijara	It is a leasing agreement which the Islamic bank buys a product or material for their customers and then leases it for a specific time. Also a customer can buy this form the bank at the ending time of the contract.
Mudaraba	It is a partnership in investment. An adopted financial technique by Islamic banking, usually, a constructed contract in which all the financial capital is offered by the Islamic bank while the dealing and business activities are lookover by the second party. The return is share per decided or agreed percentage. In case of the loss, if any is born by the investor.
Mudarib:	A person who look after the business in a Mudaraba contract. In other words, Mudarib is called an entrepreneur.
Rab-al-maal.	A person who provide the financial capital for the business in Muudaraba is known as the Rab-al-maal.
Murabaha	This is an interest free credit provided by the bank to the individuals for purchasing and buying. On the deferred basis, the bank buys the product and then sell it to the Customer.
Musharaka	Musharaka is known as the partnership. It is an investment on partnership in which profit sharing conditions and terms are agreed in before in a contract, and losses are agreed upon the invested amount. It is basically called the Private Equity
Riba:	The literal meaning of Riba is increase and addition. Technically, this means an increase or addition or excess advantage gained by the lender as in the pre conditions of the loan payments. This is a risk free and certain(guaranteed) return rate on a loan payment or an investment payment. Under these conditions and agreement, it is called Riba.

	Islam prohibited all kind of Riba in investment and consumption loan payment.

Sukuk	Sukuk is asset backed certificate generally called bond (asset backed bond). It is a form of commercial certificate that offers an investor with ownership in an primary asset, and a return grounded on this ownership. The issuing bank Islami or other entity needs to classify current assets to sell to the Sukuk investors, through SPV transference. The investors who bought it, then have a proportional or equal advantageous possession in these assets.
Maysir,	Maysir means gambling or all other activities which comes under the definition of gambling.
Gharar (uncertainty)	Gharar means uncertainty of an activity which are not predictable or transparent.

APPENDIX C

List of Interview Questions asked from Industry Experts

Q1	What is your opinion about interest or RIBA from an Islamic point of view?
Q2	How do you see this practice of Islamic banking in Pakistan whether they are really interest free or not?
Q3	Interest earned is one of the major sources of revenues of a commercial bank, If interest is not allowed in Islamic Banking, then how are Islamic Bank profitable?
Q4	What is your understanding of Maqasid e Sharia? How important is it for an Islamic bank to not only be Shariah compliant but also conform to Maqasid a Sharia? Why?
Q5	How can Islamic Banking play a role in economic development? If at all it does.
Q6	I examined the indirect channels of Islamic Banking and economic growth nexus by studying how Islamic Banking impacted consumption and investment in country. My results show that Islamic Banking positively effects both Consumption and Investment but the estimate for consumption is found to be greater than that of Investment. Can you talk us through some of modes of Islamic Banking that help to improve the household consumption levels in the country ?
Q7	Do you believe that that Islamic Banking is more efficient that Conventional Banking? Why it is so?
Q8	How has the growth of Islamic Banks been up to now? And is the growth more demand driven or supply driven?
Q9	Do you think Islamic Finance can be a way to reach those that are financially excluded? What has been the international experience been like for Islamic Financial Industry

Q10	While I was researching on this topic, I came across several research papers that stated that the Islamic Financial Industry was relatively safe from the adverse effect of the Global Financial Crises of 2007-08 as compared to commercial banks. What could have been the reasons behind it ?
Q11	**Is Islamic banking meant only for Muslims?**
Q12	How does Islamic Banking through its various modes of financing impact economic growth?
Q13	What is your opinion about some of the modes of financing available to finance trade and industry? How does it impact investment levels in the country
Q14	What is your opinion about the various modes of financing are available to people for consumption purposes?
Q15	How conducive is the regulatory environment for Islamic Banks in Pakistan?
Q16	Islamic finance & sustainable economic development have many common objectives, do you think Islamic banking can take lead in this area to ensure sustainable economic development and how we can promote the common objectives.