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# Does Islamic Banking System Contributes to Economy Development

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**Keywords** : *islamic banking, economic development, Pakistan.*

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# Does Islamic Banking System Contributes to Economy Development

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## I. INTRODUCTION

The relationship between economic growth in the broad sense, like increasing the size of financial services of banks and other financial intermediaries and financial transactions in capital markets and economic growth has long been a major developing economy. Islamic Banking has established itself as an emerging alternative to interest-based banks, and has grown rapidly in the last two decades, both in Islamic countries and non-Muslims. Islamic banks have recorded high growth in size over 60 countries around the world, and bankers predict that the Islamic bank can control more than 50% of deposits in Islamic countries over the next decade (Ahmad, 2004). Today, the financial and banking system, especially in activities related to economic development, all countries can play an important role in economic activity. Indeed, an economic system and has a direct relationship between the level of overall growth and development. While a necessary condition for economic growth, investment is an important factor for economic development. Thus, investors can play an

important role in financing economic development, giving credit to an economic system, particularly in banking. Generally, income and wealth distribution and a more Islamic and more equitable participation in the economy as a contribution to a larger bank, but the reason comes from the Islamic confirmed that, despite their claims to be there for your interest in the sequence. Since there are two main groups in any society with money to spare, but cannot or do not want to invest and produce, and can act as producers and even writers, but not enough money to invest, the primary responsibility of banks to raise money for the remaining depositors and deposits (mobilization) and provide the producers and creators.

There are about 50 years first Islamic bank was founded in 1950, in Pakistan is not to pay interest on the loan, only a small fixed fee to cover the operating costs of the bank (Wilson, 1983). The practices and activities of Islamic banks reflect the environment in which they are based. There are strong retail operations in Iran and Saudi Arabia. In the secular societies of northern Africa, Islamic banks compete on the quality of products rather than on religious grounds. In Kuwait, financing has focused on the petroleum sector and real estate investment and in the United Arab Emirates the emphasis is on trade and finance. Introduced in the modern banking system in Muslim countries, when it was politically and economically powerful 19th century was the first modern Islamic bank in Egypt to try to meet without the image of Islamic design, because they are afraid to be regarded as an expression of Islamic fundamentalism that was anathema Policy regime. After the Islamic Revolution in Iran (1979) concurrently with the steps being taken for the reformation and structural improvement of the banking system, studies were undertaken for the Islamization of the banks. The Islamic financial system in Malaysia has evolved as a viable and competitive component on the overall financial system as a driver of economic growth and development. (BNM Annual Report, 2003) In term of economic growth, Malaysia has a remarkable record of consistently high growth in the past three decades. The growth of GDP in real terms accelerated to 5.3 percent in 2005. As a country slightly shifted toward industrial country, industrial sectors and services contributed 80 percents to total of GDP of Malaysia. With total population 26.7 million, Malaysia maintains its

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per capita GDP above US\$ 3,000 since 1995. A sophisticated Islamic financial system and the enormous economic growth at the same time to withdraw our attention to examining whether the Islamic banking system that is currently used in Malaysia really contributes to long-term economic growth in Malaysia. For this, we will see the dynamic interactions between finance and growth through the application of models in which the financial system affects economic growth and economic growth arrests the financial system. When it is more developed in the financial sector, and that more funds can be used in the production, which was formed more than physical capital that can contribute positively to economic growth.

## II. OVERVIEW OF ISLAMIC BANKING CONCEPTS

Islamic banking is a financial system whose main objective is to achieve the teachings of the Koran. Islamic law reflects the commandments of God, and organizes all aspects of Muslim life, and therefore directly involved in Islamic finance, spirituality and social justice. Based on the theory of Islamic banking on the concept that is strictly forbidden in the interest of Islam and the teachings of Islam which provide the necessary guidance is based on the work of the banks. The fundamental principle that has guided my work in Islamic banking is that, despite the ban on trade in interest in Islam, and encourages and profit. Traditional bank uses the interest rate mechanism for the implementation of its financial operations. It was developed by Muslim scholar's completely different model of banking services that do not use, but the interest is based on change in the distribution of income for purposes of financial intermediation. The basic principle of Islamic law is that exploitation contracts or contracts of unfair risk or speculation are not permissible. Under Islamic banking, and all partners involved in financial transactions involved in the risk and the gain or loss on the project and not get a return on a pre-determined. This direct relationship between investment and profit is the main difference between Islamic and conventional banks, which has a main objective to maximize shareholder wealth. (Dar and Presley, 2000) "Various pillars exist that allow Islamic banks to deliver competitive performance and promote socially and ethically responsible business practices. Of these, the three main pillars that contribute to improvements in quality of life throughout society include Shari'a supervision, screening and community based investment". Sharia supervision of a qualified advisory board of Islamic law is an essential element of the structure of Islamic finance. It is assumed by the Board to be independent and monitors investment strategies,

implementation, monitoring and reporting. The second main pillar, known as exploration and includes activities, including or excluding the values of investment portfolios traded or mutual funds based on religious and moral conditions of Islamic law. Some companies are therefore not excluded in accordance with Islamic law and the actions of these companies.

Investment in community programs to provide capital to those who have no access to it through traditional channels. These investments allow the people of the community to improve living standards and help them develop small businesses and create jobs. (Zaher and Hassan, 2001).

## III. LITERATURE REVIEW

Instead of discussing the relationship between systems (Banking) Financial and economic growth, economists often discuss the relationship between financial development and economic growth, but each of the same reality. (Schumpeter, 1912) argued the importance of the banking system in the level and growth rate of national income in promoting economic development through the identification and financing of productive investments. Islamic banks working hard to overcome the shortcomings and difficulties in helping the economy to move to a higher stage of development of self-sufficiency, resulting in a positive impact on socio-economic harmony due to the equal distribution of income (Young, 1986, and Luintel Demetriades, 1996). (Ahmed Ansari, 1998) and (Rousseau and Wachtel, 1998, Shaw 2000, Erestes et al. 2001) and (PHASE and ABMA 2003) argue that the expansion in the financial system can have a positive impact on economic growth. (Robinson, 1952) believed that economic growth leads to financial sector development. (Christ and Christ, 1996) supports the hypothesis that the demand after the cause of economic growth in the financial sectors for development. It cannot be the financial system and therefore support the leading sectors in the growth process. Here is an act of expansion in the financial system as a result of real economic growth, or the next request. On the other hand, studies by (Odedokun, 1992) and (Luintel and Khan, 1999) prefer two way causality between finance and growth. The Islamic financial system, and experimental studies to date have been conducted to examine the efficiency and superiority and stability in Islamic banks as compared to conventional banks to achieve some milestones cash the ultimate goal that focuses towards the sustainability of real economic growth, reducing inflation and reducing unemployment. (Dara, 1988) found that the banking system, without the benefits of a more superior to the goal of cash found in the interim (Yousefi et al, 1997), and (Joseph and Wilson, 2005) there is no evidence superiority and stability of the system of interest free banking system compared to the Bank

interest menu. Integrated depth and according to (Abdoulie 1991, the Cave, Ahmad and actually Hammoud, 1998, my friend, in 2002, Iqbal 1997) and to maximize profitability is not the only concern of the institutes of the Islamic banking and principles based on Islamic banks in the moral and ethical values. They also claim that Islamic banks do not rely on the assurances of concrete and lead to better income distribution, allowing access to finance for the poorest classes of society, and lead to greater benefits for social justice and long-term growth. And directly affected by the nature of Islamic banking operations through the success or failure of customer projects as a result of the income distribution (Abdoulie, 1991). The relationship is based on a partnership, with cash being entrusted to banker for investment, and returns shared between depositors and bankers. Losses are carried by fund owners. This sharing principle is very different to traditional banking practices. It introduces the concept of sharing to financing and creates a performance incentive within the mind of bankers that relates deposits to their performance in the use of funds. Islamic bankers encourage people to invest as investment depositors receive a share in the bank's profits". Investors are motivated by the human desire toward ownership, high rewards and the satisfaction of being part of a successful project (Martan et al, 1984). According to (Iqba, 1997), "the economic development of Islamic countries can be greatly enhanced by the Islamic financial system due to the mobilization of savings that are being kept away from interest based banks and the development of the capital markets. This motivation to invest in Islamic banks may also stem from the fact that research shows that the share in the bank's profits may at times be higher than the fixed rate of interest given by conventional banks. According to (Iqbal, 1997), one can expect that the Islamic financial system is best for the elimination of debt financing, and improve the efficiency of allocation. In the Islamic banking system is experienced and stability in times of crisis, the share of investment depositors automatically at risk because of participation in the profits and losses, and this means that individual banks and the whole banking system is less likely to break (Zaher and Hassan, 2001). Focus on Islamic finance in the profitability and rate of return on investment as a result of an exchange of shares and benefits has the ability to channel financial resources to more productive investments, and therefore increases the effectiveness of the funding process and real sectors (Kahf et al, 1998). (Qureshi, 1984 and Nagvi, 1981 and 1982) "Claim that Islamic bankers are increasingly exposed to risk due to equity-based financing, however Islamic scholars believe that the elimination of interest increases stability. In financial theory a linear relationship exists between risk and

return, meaning that low risk is associated with low return and high risk brings about high return". (Chapra, 1992), the risk is a key element in making the investment, investors in the distribution of risks associated with those who are carrying out investment activities. Islamic finance offers depositors with some impact on investment decisions and gives banks and financial institutions to participate in the decision making process. This allows both for risk and decision making over a much larger number, and a variety of people, enabling greater participation in economic activities (Ziauddin, 1994). A further study by (Samad and Hassan, 1997) that compares an Islamic bank with a group of conventional banks shows that Islamic banks are less risky than conventional banks. Sarker, 1997), however, found that the risk involved in profit sharing is very high, but states that many external factors and obstacles interfered with the proper implementation of the Islamic banking system. However, not all agree with the importance of the financial system in the growth process. (Lucas, 1988) believes that economists badly over-stress the role of financial factors in economic growth. (Robinson, 1952) According to this view economic growth is the reason for financial development. It creates demands for particular types of financial arrangements and the financial system responds automatically to these demands. (Bageho, 1873) argues that the financial system played a critical role in igniting industrialization in England by facilitating the mobilization of capital for 'immense works' (Levine, 1997). Schumpeter was most famous to see growth, which strongly supports the idea that a positive relationship between bank performance and economic development through the granting of loans to entrepreneurs to get the best projects that lead to technological innovation through the mobilization of savings, and the draft risk assessment and management, transmission control, and facilitate transactions. McKinnon also supports the idea that there is a relationship between financial systems and economic development. (McKinnon, 1973) as follows: given money and finance, are also subject to a large extent by the banking system in the degree of importance far greater than those granted by most writers on Development. McKinnon also believes that capital markets can contribute to economic efficiency by increasing the rate of return on current capital. (McKinnon, 1973) as follows: The capital market in the economy developed successfully control the efficiency that have been developed in the current share capital for payment of the return on physical and financial assets toward the achievement of equality, and therefore a significant increase in the average yield. McKinnon also provide evidence for Argentina, Brazil, Chile, Taiwan, Korea, Indonesia, Germany and Japan. There is a large amount of literature that

discusses the relationship between financial intermediaries and economic development. We cannot cover all of it or even most of it in this chapter, so we will try to look at some of the literature briefly. (Beck *et al*, 2000, Bekaert *et al*, 2001 and Beck and Levine, 2004) strongly supported the idea that there is a positive relationship between financial development and economic growth. (Levine and Zervos, 1998) studied the empirical relationship between stock market development, banking development, and long-run economic growth. Their research shows that stock market liquidity and banking development are both positively and robustly correlated with contemporaneous and future rates of economic growth, capital accumulation and productivity growth. (Tang, 2006) using a modified growth model to investigate whether financial development would facilitate economic growth among the APEC countries, 1981-2000. I did this for Tang focuses in particular on the implications of the three aspects of financial development on economic growth: the stock market and the banking sector and capital flow. They also found that while there tends to be a positive relationship between development and financial intermediation, and both physical capital accumulation and private saving rates and these results are sensitive to changes in estimation techniques and measures to development of financial intermediation. (Bashir and Hassan, 2003) examine the relationship between financial development and economic growth in some Muslim countries (Egypt, Jordan, Morocco, Tunisia and Turkey). (Bashir and Hassan, 2003) noted that, financial development is expected to benefit from interest rate liberalization in terms of high savings rate, which increases the size of the investment. Used rate reduced to measure the degree of financial liberalization in the economy. Furthermore, in order to understand this trend between financial variables and real estate to examine the causes of five countries. According to (al-Bashir and Hassan, 2003) results, such as time series analysis and data are most useful in investigating the causal relationship between finance and growth. According to the (American economic development council, 1984), "Economic development is the process of creating wealth through the mobilization of human, financial, capital, physical and natural resources to generate marketable goods and services". The concept of the Islamic economic system as described in all its aspects focuses on the worship of the creator, which includes man's duty to develop life on earth, thus securing a decent standard of living for the individual. Islam stresses that man is the principle agent for developing life on earth and hence the development of man is a required condition for the development of society. (Ghazali, 1994) and the beginning of the goals and tasks of the system of Islamic banking are the economic well-being with full employment, and the

maximum rate of economic growth, equitable distribution of income and wealth, and the result of social justice and economic, and generating enough savings and the mobilization of productive capacity and stability in the value of money. (Chapra, 2000) "Economic growth, which is defined as an increase in Gross National Product (GNP) or increase in Gross Domestic Product (GDP), has been the main purpose of most economic studies and models from Adam Smith (the father of Classical Economics) until the present time. Even before Smith there were some opinions regarding this issue. Today growth is still an important topic of serious discussion among economists". In addition, (King and Levine, 1993) develop a model of internal growth with a focus on the link between finance and economic growth. Their model as a model of internal growth, which aims to: With the links between projects, finance and economic growth proposed by the visions of (Knight Frank, in 1951, and Joseph Schumpeter, 1912). (King and Levine, 1993) "In the endogenous growth models there are some factors which affect economic growth, including services provided by financial intermediation which have a positive effect on economic growth". The entire financial system and usually offers special features and services that may affect savings mobilization and allocation of resources and economic development. Financial development occurs when financial instruments, markets and intermediaries, despite the improvement do not necessarily eliminate the effects of information, application and transaction costs. Since the friction and there are many markets, and because laws and regulations, and policies differ markedly across economies, improvements can along any one dimension has different implications for resource allocation in terms of other differences (Levine, 2004). (Sarker, 1997, Samad and Hassan, 1997) concludes that if banks are compatible with Islamic banking laws and regulations appropriate and can provide effective services and banking to promote economic development. In the literature, it is clear that theoretically and empirically, economists consider Islamic banking is viable, acceptable and effective and also highly effective in developing the economy.

#### IV. AIMS AND OBJECTIVES

The aims and objectives of this research are to discuss the Islamic banking system in Pakistan and its financial instruments for mobilization and allocation of monetary resources. Identify the process of economic development in Pakistan and examine the contribution of Islamic banks in economic growth of Pakistan. This will be achieved by using qualitative analysis of semi-structured interview.

## V. METHODOLOGY

In this paper qualitative analysis of the interview questions used regarding the aspect of contribution of Islamic banking system in economic development country. The semi-structured interview has been chosen for the interview survey. 6 managers and advisors from the different Islamic banks of Lahore Pakistan were selected for face-to-face interviews. During the interview session I asked eight different types of questions regarding the contribution of Islamic banking system in economic development country.

Following are the questions:

1. Effect of Islamic banking on the mobilization of monetary resources?
2. Effect of Islamic banking on the allocation of monetary resources?
3. Effect of Islamic banking on encouraging people to deal with the banking system?
4. Effect of Islamic banking on the internal and external economic crisis?

1. Effect of Islamic banking on the mobilization of monetary resources?

Interviewee 1	It was positive
Interviewee 2	Resources increased
Interviewee 3	I think no positive effect
Interviewee 4	yes it was positive but it relies on explanation to the people
Interviewee 5	I don't know
Interviewee 6	I think it was positively effects on monetary resources

Interviewees were questioned about the ways in which Islamic banking has affected economic development and their opinions were coded. Table shows the opinions of interviewees with regard to the effect of Islamic banking in Iran on the mobilization of monetary resources. 66.66% of interviewees answered that converting from conventional banking to an Islamic banking system has had a positive effect on the mobilization of deposits. One of them, 16.66%, answered I don't know and one interviewee, 16.66%, answered that it is difficult to say anything, either positively or negatively.

2. Effect of Islamic banking on the allocation of monetary resources?

Interviewee 1	Monetary resources increased
Interviewee 2	There was no effect
Interviewee 3	It was positive
Interviewee 4	NO answer from respondent
Interviewee 5	I don't know
Interviewee 6	The effect was good

Table shows opinions of interviewees with regard to the effect of Islamic banking on the allocation

5. Effect of Islamic banking on inflation?
6. Effect of Islamic banking on employment?
7. Effect of Islamic banking on internal and external trade?
8. Effect of Islamic banking on real GDP?

## VI. RESULTS AND ANALYSIS

In discussing this issue we should look at the factors which lead to economic growth and then investigate the ways which financial systems, especially the banking system, can affect these factors. There are some factors which accelerate economic growth and some factors which are moderators and decelerators of economic growth. During the interview session I asked eight different types of questions regarding the contribution of Islamic banking system in economic development country. This part of paper will provide a qualitative analysis of the following questions.

of monetary resources. As the table shows two interviewees 33.33% did not answer the question and one interviewee 16.66% believes that it does not have any effect on allocated facilities. However, 3 interviewees 50% strongly believe Islamic banking has had a positive effect on allocated facilities.

3. Effect of Islamic banking on encouraging people to deal with the banking system?

Interviewee 1	I don't know
Interviewee 2	Positive
Interviewee 3	It has defiantly had a positive effect
Interviewee 4	It effect has been good
Interviewee 5	I don't think so
Interviewee 6	Mostly religious people have been encourage to deal with Islamic banking system

Table shows the opinions of the interviewees regarding the effect of Islamic banking on encouraging the people to deal with the banking system. As this table shows two interviewees 33.33% answered that they do not know or cannot answer accurately. However, 66.66% of interviewees believe that its effect has been good and positive.

## 4. Effect of Islamic banking on the internal and external economic crisis?

Interviewee 1	It has no positive effect because Islamic banks don't follows full Islamic principles.
Interviewee 2	I think it has positive effect.
Interviewee 3	Not respond.
Interviewee 4	Yes positive.
Interviewee 5	The effect against economic crisis is good.
Interviewee 6	not respond.

Table shows the opinions of interviewees regarding the effect of Islamic banking on the internal and external economic crisis. It shows that interviewees three and six (33.33%) did not respond to the questions and interviewee one (16.66%) believes that it does not have any effect because the banking system does not strictly adhere to the principles of Islamic banking. Interviewee two, four and five (50%) believes that their effect on external and internal economic crisis was good.

## 5. Effect of Islamic banking on inflation?

Interviewee 1	Not respond.
Interviewee 2	It has no positive effect because Islamic banks don't follows full Islamic principles.
Interviewee 3	It causes decreasing inflation.
Interviewee 4	No answer from respondent.
Interviewee 5	Yes it will work against inflation.
Interviewee 6	Inflation reduce.

Inflation is a factor which makes the process of growth and development slow so, if the Islamic banking system can decrease inflation, it will support the growth and development process. So this table shows the interviewee's point of view about this question. As this table shows interviewees one and four (33.33%) did not respond to the question and interviewee two (16.66%) believes that it does not have any effect. Interviewee three, five and six (50%) believes that, inflation would decrease if there were no other factors such as government expansionary monetary policies.

## 6. Effect of Islamic banking on employment?

Interviewee 1	Yes its creates employment opportunity
Interviewee 2	Yes positive effects on employment
Interviewee 3	Yes positive
Interviewee 4	I think no effect on employment
Interviewee 5	Yes it has good effect
Interviewee 6	Obviously have good impact

Employment is a very important issue regarding both economic growth and income distribution so it is necessary to choose a banking system which is able to increase employment over other systems. Table shows the opinions of the interviewees regarding the effect of Islamic banking in Iran on employment. As this table shows, only interviewee four (16.16%) believes that it has no particular effect above other systems because the banking system does not adhere strictly to the principle of Islamic banking. However, other interviewees, (83.33%), believe that Islamic banking has a positive effect on employment.

## 7. Effect of Islamic banking on internal and external trade?

Interviewee 1	don't think so.
Interviewee 2	Positively effect.
Interviewee 3	Not respond.
Interviewee 4	I don't know.
Interviewee 5	Positive effect on both type of trade.
Interviewee 6	I don't think so it has significant effect on trade.

Trade is a topic under consideration in economic literature regarding economic growth. It is so important that it has become centre for division of developmental strategies. As this table shows only interviewee six (16.66%) believes that it has had no more effect than other systems. Interviewee one and four (33.33%) is not sure that Islamic banking has a significant effect on trade and interviewee three (16.66%) is not respond this question. Two and Five (33.33%) interviewees, believe that the system has had a positive effect on both type of trade,

## 8. Effect of Islamic banking on real GDP?

Interviewee 1	Yes it has positive effect
Interviewee 2	Yes positive
Interviewee 3	No special effect because its binging time of Islamic banking system
Interviewee 4	It is help full to increase the real GDP rate
Interviewee 5	Not respond
Interviewee 6	It is effective

Growth rate of GDP is one of the main aims of the all economic activities so the main aim of the every banking system should be to increase GDP. Table shows the opinions of the interviewees regarding the effect of Islamic banking on GDP. As this table shows only interviewee three (16.66%) believes that it is binging time of Islamic banking in country and interviewee five (16.16%) did not answer the question. However, four interviewees, (66.66%) believe that Islamic banking in Iran has had a positive effect on GDP.

## VI. CONCLUSION

This document is a preliminary study on the relationship between a pilot Islamic banking and economic growth. The results generally show that in the long run, the financing of Islamic banking is positively and significantly associated with economic growth and accumulation of capital in Pakistan. Islamic financial system more stable than the traditional banking system due to the elimination of debt financing. It also reduces inflation in the economy and cannot provide the money to go higher than the supply of goods. Islamic banks are less risky than conventional banks, both for investors and entrepreneurs share some of the risks involved in the business. The aim of this paper was to consider the opinions of the interviewees regarding the role of Islamic banking in Pakistan in economic development. Six interviewees were asked about the types of effects of Islamic banking on economic development in the Pakistan. They were asked about 8 different types of effects. Their responses were as follows: (1) 66.66% of interviewees answered that converting from conventional banking to the Islamic banking system has had a positive effect on the mobilization of deposits; (2) 50% of interviewees agreed strongly on the positive effect of Islamic banking on allocated financial facilities; (3) 66.66% of interviewees believe that the effect of Islamic banking in Iran on encouraging people to deal with the banking system has been good and positive; (4) 50% of interviewees believe that the role of Islamic banks in the economic crisis is quite positive; (5) 50% of interviewees support the role of Islamic banking in the reduction of inflation; (6) 83.33%, believe that Islamic banking has a positive effect on the employment; (7) 33.33% of interviewees believe that the system has had a positive effect on trade, for which the provision of financial facilities to this sector; (8) 66.66%, believe that Islamic banking in Iran has had a positive effect on GDP. This result also indicates that improvement of the Islamic financial infrastructure in Pakistan may benefit economic development. Islamic banks can play a great role in Pakistan of today, by acting on few recommendations provided above and acting truly as Islamic banks not merely banks with word "Islamic" attached to them.

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