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Research Paper

ISLAMIC BANKING AS A TOOL FOR ECONOMIC GROWTH AND DEVELOPMENT

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ABSTRACT

The developmental role of Islamic banking in the finance and investment world has over the last two decades witnessed tremendous progress and acted as a catalyst to the economic growth of certain nations thus indicating that Islamic banking has critical roles to play for every developing economy in the 21st century and beyond. The concept of Islamic Finance and the tenets in which Islamic Banks operate is based on the Islamic Law "Shari'ah", called the fiqh muamalat, meaning "Islamic rules on transactions" and its practical application through the development of Islamic economics. These rules and the practices have their origins from the Holy Book of "Quaran". Other sources of the rules and practices of the fiqh muamalat are the "Sunnah" and other sources of Islamic law.

Citing empirical facts and working models, the purpose of this papers is to explore and examine the positive relationships that exists between the development of Islamic banking and the economic growth of a nation's financial sector with a strong case for developing economies. This paper projects the likely roles, structure and future of Islamic banking in restructuring the banking industry for increased participation in economic growth

The findings of this paper has practical implications for catalyzing socio-economic and sustainable development in national economy

KEY WORDS: *Islamic banking, Shari'ah, Economic development, Sustainability*

1. INTRODUCTION

1.1 Background

The stability and the robustness of the conventional banking system was flawed during the 2008/2009 global financial crisis which led to the global economic meltdown. This financial crisis sparked a global debate in which several questions were asked concerning the adequacy of the existing international economic and financial architecture and the search for a lasting and sustainable solution and the need to restore the financial transactions to their basic function of providing value adding services to the economy. This in all regards brings to the forefront the importance and critical need of Islamic Finance and banking which has its roots in the principles of the Shariah.

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The founding concept behind the Islamic Shariah law is the prohibition of all kinds of payment for obtaining loans or the acceptance of fees in terms of interests also known as usury or *Riba* in Islamic parlance. The term *Haram* (forbidden) associated with the Islamic Shariah law is used to refer to goods or services that are considered contrary to the Islamic Shariah principles. In addition, investments in businesses which provide these goods or services are also termed *Haram*.

In recent times, there have been a considerable advancement in the impact of Islamic banking in the global financial market and this could largely be attributed to an increase in the total volume of Shariah compliant assets. In the year 2010, the global Islamic assets was totaled to US$1.2 Billion and according to the Organization of Islamic Countries

Outlook series (2012), by end of the year 2011 the total volume of Shariah compliant assets was estimated to have reached US$ 1.1 trillion *(See Figure 1 below)*. This impressive growth in the global Islamic banking industry have been spurred by the member countries of the Organization of Islamic countries with a collective share of 98% in these assets although the growth has been flawed by many who feel that it has been made possible by the application of certain conventional principles and their improvements within the tenets of the Shariah principles hence its likely vulnerability to future global economic financial impacts and challenges.

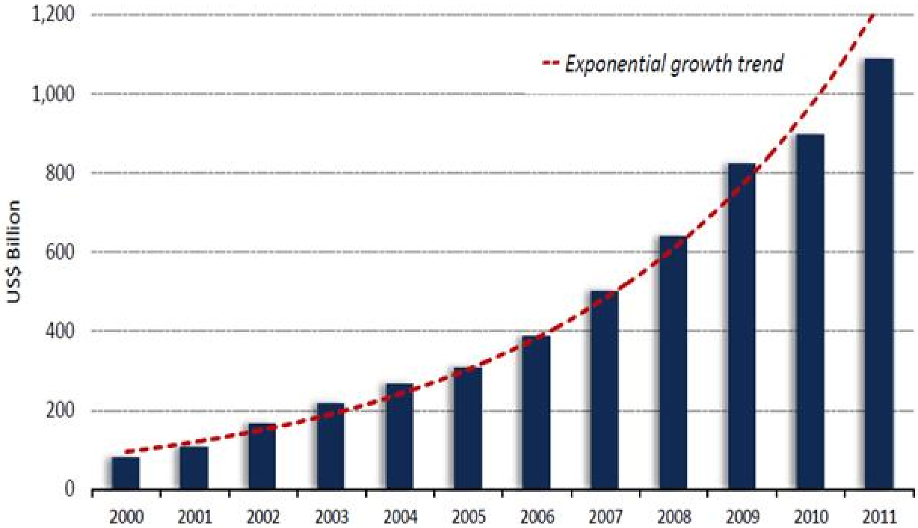

Figure 1: Global Assets of Islamic Finance

Source: OIC (2012)

1.2 Global Islamic Market: Profile

The global Islamic banking industry which is reputed to be a fast growing industry is hinged on the provision of 'delighted' products and services by the various industry players who seek to churn out brands and adopting differentiation marketing strategy typified by the nature and the consumer demand for the Islamic banking products and services delivered by the instruments of Islamic banking: Murabaha, Musharakah, Mudarabah, Istisna, Salam, and Ijarah

The global Islamic markets have their major concentration in Iran, Kingdom of Saudi Arabia (KSA), the United Arab Emirates (UAE), Malaysia, Kuwait, Qatar and Turkey by virtue of their Islamic assets and total assets ratio as shown in the visual display below (Figure 2)

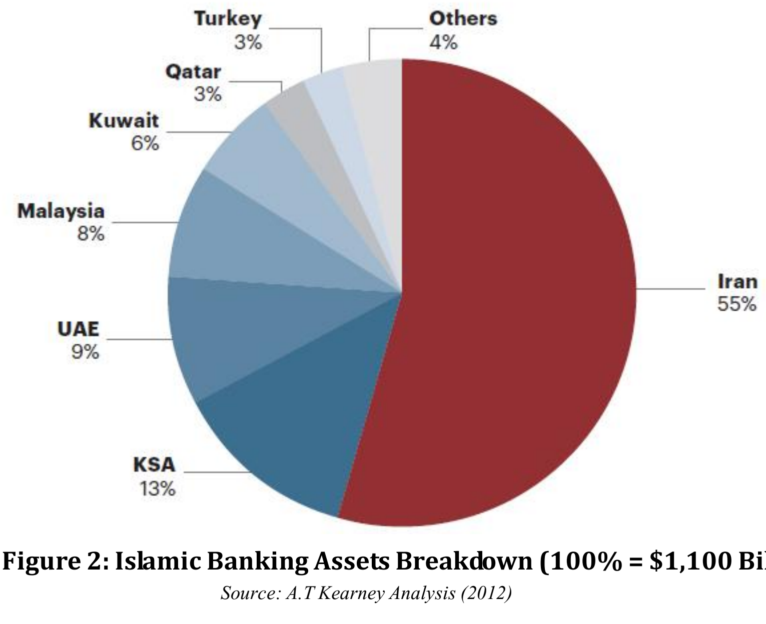

Figure 2: Islamic Banking Assets Breakdown (100% = $1,100 Billion)

Source: A.T Kearney Analysis (2012)

The global Islamic markets can be divided broadly into three segments based on Islamic Banking penetration. These market segments are (*See Table 1 below*);

1. Established
2. Emerging
3. Untapped

Indices	Established				Emerging			Untapped		
	Kuwait	KSA	UAE	Malaysia	Pakistan	Turkey	Indonesia	India	China	Nigeria
Muslim Population (Million, 2010)	3	27	6	17	175	73	209	162	22	85.1
GDP per capita ($ 2010)	40,517	23,201	59,533	15,022	2,516	13,150	4,250	3,408	7,544	2,866
Islamic assets ($ Billion, 2010)	62	142	94	86	6	28	10	-	-	-
Islamic assets as % of total assets	40%	38%	22%	17%	7%	5%	3%	-	-	-

Table 1: Islamic Banking Market Segments

The established segments of the global markets make up the world's most active markets for Islamic banking products and services and are geographically located in the South East Asia (Malaysia) and the Middle east (the United Arab Emirates, Kuwait, Iran, Saudi Arabia). The emerging segment consists of countries such as Pakistan and Indonesia which have a large Islamic population which offers huge prospects for the growth of Islamic banking in the nearest future while the largely untapped markets such as China, India and also Nigeria which has the largest black population in the world and with a vast Islamic population are potential viable markets for Islamic banking to thrive.

The Islamic banking industry in marketing and providing Shariah compliant products and services uses the Islamic banks as a platform to consummate a fair, well-defined and well-documented transaction between the end users of these products and the Islamic banks offering the products. It is also expected that information about the products, goods, and services on offer should be readily available, complete, and known to all parties, however speculation or interference with market forces of supply and demand is not allowed thereby creating an open and free market for everyone provided that Shariah and the laws of the land are not violated.

The adoption, and sustainability of the Islamic banking products and services in the relatively untapped markets are hinged on the targeting of customer segments that are most deeply concerned about Shariah compliant products and services as well as compliance with Shariah principles in their financial dealings and transactions. The perceived economic benefits of the Islamic banking system to the Individual and to the national economy at large is a fulcrum to Islamic banking being seen as a tool for economic growth and development as expounded in this paper.

2.ISLAMIC BANKING AND ECONOMIC DEVELOPMENT

2.1 Financial Sector Development

Countries that have a robust and well developed financial system with all other factors being equal, tend to have a more vibrant economy and this is due largely to the fact that the development of the financial sector is generally achieved via the development of the banking industry which performs a vital role in economic development by means of the banks which act as financial intermediaries and as facilitators of payments. Furthermore, the banks play a major role in the efficient allocation of resources and risk diversification. This fact is backed by Feldstein and Horioka, (1981) as well as King and Levine (1993) who in their research discovered a close correlation between financial sector development and growth which makes domestic saving and financial development a major driver of economic growth.

In times past there have been numerous studies that have been carried out to assess the socioeconomic consequences of the banking industry and their numerous impacts in the economy of a nation. However, many of these studies have focused more on the conventional system of banking leaving out the impacts the Islamic banks have had in the global financial system and their contribution to economic development in the nations in which they operate. This is due largely to the fact that the global economic impact of Islamic banking can only be traced to the last two decades which have experienced the rapid growth and consequence of Islamic banking there by posing a stiff competition with the conventional banking system in many countries due to the highly competitive and alternative products and services offered by the Islamic banks and financial institutions to the average customers as well as the Muslim customers who might rave for shariah compliant products. Despite the availability of this important alternative offered in Islamic banking, it is still virtually absent in many countries even those with a considerable Muslim population and according to Imam, P and Kpodar, K (2010) might be due to the lack of evidence of a strong correlation between Islamic banking and financial sector development which leads to the growth and sustainability of national economy. The findings of Imam, P and Kpodar, K (2010) also showed that the probability for Islamic banking to develop in a given country rises with the share of the Muslim population, income per capita, and whether the country is a net exporter of oil. Hence this paper examines Islamic banking impact around the world and identifies ways for adoption, expansion and strategic involvement of Islamic banking in financial sector development with a view to promoting nation al economic development and growth in developing countries, countries with a considerable number of Muslim population and beyond

2.2 Economic Role of Islamic Banking

The role played by the banking sector in the economic development of a country is one that cannot be overemphasized. The banking sector, serves as a back bone for the survival of the economies of every nation. However, with the recent waves of economic downturns been experienced globally especially the global financial and economic crisis of 2008-2009 which brought to the forefront a wide range of issues concerning the stability and soundness of the conventional financial system and also with the proliferation of many ideas and models for the strategic application of various financial principles to be adapted by individual nations it is therefore important that newer ways be adapted that will see nations better suited to strategically withstand adverse and contemporary economic problems.

Africa is the second largest continent and it plays host to several diverse and potentially large economies and on the other hand it also has many poor countries that are desperately in need of a model for economical sustenance and development. Many schemes and cooperative initiatives have been established in the past but the gains of these schemes seem to be punctuated by the mere fact that the "ordinary citizen" seems to find it difficult to keep up with the "strings" attached to such schemes which in the long run brings about sustainability problems of such schemes.

The aim of a good model for banking and finance that would spur economic development and growth should be one that empowers the ordinary citizen causing positive transformations which in turn empowers the individual nations economically because as earlier stated, the banking industry has a large role to play in influencing the economic development of nations. It is in light of this that the Islamic principles in creating and sustaining finance be adapted to creating a sustainable model for the banking Industry which would bring about a paradigm shift in which the ordinary individuals are been empowered in Nigeria and in the African continent as a whole.

It is important to note here that in the early times the principles governing Islamic finance where successfully applied. These principles that were guided by the Shariah law were used and they were very valuable when used as the basis for a flourishing economy in those times. Ironically, it is only in the late 20th century that a number of Islamic banks sprang up and were formed to apply these principles to private or semi-private commercial institutions within the Muslim community thereby generating increasing success and attracting more and more attention even outside the Muslim community occasioned by the nature of the impact created and sustained and also brought about by the near immunity the concept portrayed even at the times of the global economic meltdown that swept far and across the divides of almost all areas of the finance world.

The prohibition placed on the payment or the receipt of *riba* (Interest) is the main difference that exists between Islamic commerce and Non-Islamic conventional commercial transactions. By virtue of this singular difference, the purpose created by the Islamic financial and investment system is to empower individuals to earn their living in an equitably fair manner which profits them and prevents the exploitation of individuals thereby creating an atmosphere where everyone in the society benefits hence all together creating a foundation for the national economy to thrive

2.3 Islamic Banking: Catalyst for Economic Development

Economic development as defined by the American Economic Development Council (1984), is "the process of creating wealth through the mobilization of human, financial, capital, physical and natural resources to generate marketable goods and services". This definition has a relationship with the system in which the concepts of Islamic finance and economics are built. Islamic finance has its foundation and focusses majorly on the worship of the creator, development of life on earth as a duty placed on man by the creator thus securing a decent standard of living for the individual leading ultimately to the development of the society through the development of the individual (El-Ghazali, 1994).

In spite of this definition and the concept of Islamic economics as prescribed by the creator, many member countries of the Organization of Islamic Countries (OIC) as reported in OIC Outlook series, (2012) are plagued by a lack of access to finance which limits economic development. This fact was buttressed earlier by Wyman (2011) who reported the data from CGAP Financial Access 2009 Survey, stating the following:

- A global estimate of 70% of Muslims have no access to basic financial services
- Only 28% of the adult population in OIC member countries use formal financial intermediaries
- Less than 50% of adults in OIC countries in Sub-Saharan Africa have a deposit account (In developed countries the number of accounts exceeds the number of people by far)

In view of these above stated facts and for a framework of Islamic banking to be valuable and sustainable for economic development, the Islamic banks must offer their services in strict compliance with the principles of Shariah. Also the availability of a diverse and complete range of Islamic financial products and services with innovation and quality as key cannot be over emphasized as this specifically affects the outlook of the Islamic banks and the national economy as a whole. In countries like Malaysia, Islamic banking contributed largely to the development of its economy thus showing that Islamic banking has a strategic role in catalyzing economic development. Different researchers such as Adeola, H. (2007) have studied the economic effects of Islamic banking. The effects of Islamic banking on national economy are numerous and according to they include the following;

- Islamic banking fosters a Better integration of the real and financial sectors of the economy
- Islamic banking provides a platform for carrying out banking services in a more ethical manner due to the fact that the products and the services are Shariah compliant, and the banks would only indulge in economically viable financial transactions and investments. This improves the outlook of the banking industry. The ethics and principles of the Shariah as prescribed by the Holy Quran would ensure greater transparency in the transactions that take place between the client and the banks
- Instead of being lenders, Islamic banks will provide financing by coming in as traders (murabaha), lessors (Ijara) or partners (mudaraba; musharaka)
- It is well known in traditional finance literature that interest based debt finance is an important source of economic instability when compared with equity finance

3. ECONOMIC DEVELOPMENTAL TOOLS OF ISLAMIC BANKING

The earning of profits is a financial goal of every business as this symbolizes success. On the other hand, the charging of interests on business transactions is a cost that is borne regardless of the outcome of the business. Islam supports profits as this signifies creation of new wealth, but abhors the charging of interests. Islam encourages the earning of profit as profit symbolizes successful business dealing and creation of new wealth. Interest on the oether hand is a cost that is in place regardless of the outcome of business operations. Social justice reuires that lenders and borrowers share both profit and loss in an equitable manner and that the methiod of accumulating and distributing wealth in the economy is fair and represents true productivity (Igbal, 1997). This is where Islamic banking and modes of finance comes into play

There are certain instruments of Islamic banking that act as economic tools and are strategic to economic growth and development acting as a catalyst to speed up banking sector growth and sustainability of national economy

Nedal El-Ghattis (2011) expounded on these economic developmental tools which are; Murabaha, Musharakah, Mudarabah, Ijarah, Istisna, Salam

Murabaha: This instrument of Islamic banking is a kind of "cost-plus" transaction in which the bank buys the asset then immediately sells it to the customer at a pre-agreed higher price payable by instalments. This facility is often used in the way that mainstream banking customers might seek a mortgage when buying property.

This model of financing as reported by Nedal El-Ghattis (2011) is the most preferred for many Islamic banks due to the simplicity of the model. Although it has no direct effect upon poverty reduction, but indirectly it provides a good tool for an efficient deferred sale, providing business men the asset of its choice and providing banks profit for the effort and risk taken. Murabaha has little effect on the reduction of unemployment; and there is no clear study on the effect of Murabaha on inflation.

Musharakah: This is a partnership, normally of limited duration, formed to carry out a specific project. Participation in a Musharakah can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution. In this case, the bank enters into a partnership with a client in which both share the equity capital and maybe even the management of a project or deal, and both share in the profits or losses according to their equity shareholding.

Musharakah encourages partnerships, also creates jobs for many people in society, promotes enterprise and partnership ventures, creating jobs in the country, promotes business enterprise culture in the society and growth of skilled people. Musharakah has a potent effect on controlling inflation and spread of baseless credit, promoting joint ventures without potent investigations and research ensures business successes

Mudarabah: A form of investment partnership between a bank and a business that shares the risks and losses/profits between both parties at pre-agreed levels. A Mudarabah transaction bringing some of the benefits of a business loan to shariah-compliant businesscustomers, effectively requires the bank to take a stake in the business, with clients investing their time and expertise in running the enterprise.

Mudarabah is a very potent tool for removing interest from the society by providing an interest free tool for skill utilization and it can especially help in mobilizing resources of the society by employing them as a manager, while banks will provide the finance and also bear the chances of profit and loss, which is absent in interest based financing for venture capital. Mudarabah has a significant effect on reducing the unemployment in both the short and long run, as it encourages business management by skilled people and promotes commercial activity. Mudarabah also helps control inflation by promoting interest free business activities. Interest and credit creation of banks through lending are the major source of inflation in society.

Mudarabah involves bank or other capitalists bearing in both profit and loss, and not just making earnings through a predetermined interest rate exploiting the needs of individuals or firms.

Ijarah: This is a form of shariah law-compliant leasing involving the rights over the use of an asset under which the bank buys the asset then leases it to the customer over a fixed period in return for a pre-agreed monthly price. Provisions can be made for the customer to buy the asset at the end of the agreed period. Thought needs to be given to issues such as the provision of insurance, as the asset is effectively owned by the bank during the lease period.

Ijarah has no direct effect upon poverty reduction and has a little effect on reducing unemployment. However, it has great potential for protecting against inflationary harms to middle class people and entrepreneurs, by allowing the use of assets without sudden cash outflows.

Istisna: This is another form of forward sales contract, which is a longer-term financing mechanism under which a price is agreed before the asset described in the agreement is actually built. Sellers can then either create the asset themselves or subcontract,with buyers also having the option of paying the entire sum due either in advance or as installments during the manufacturing process.

Istisna is especially useful in the housing sector, boosting the construction demand, creating employment and wealth to society without harmful effects of interest. It has also good effects on the reduction of unemployment by boosting construction and house building activities in society. Istisna has a little effect on inflation control.

Salam: This is a kind of forward sales contract which requires the buyer to pay in advance for goods that are to be supplied later. Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at an appropriate time, instead of usurious loans, which ultimately deteriorates through the compounding of interest.

Salam also has great potential in reducing rural sector unemployment and reduces trend towards urbanization, by enabling farmers and agriculturists to work. Salam engages them at villages and towns, thus decreasing the unemployment burden. This generates agricultural and rural sector development and eventually more income for these poor people. Salam has a great effect on reducing inflation, where food stuff has reached its peak prices, the main way it cuts inflation isthrough ensuring increased aggregate supply and reduce food product deterioration by use of pesticide and fertilizers at appropriate times, boosting the yield of land and farms to much extent.

4. CONCLUSION

The Islamic banking Model would require a number of supporting institutions/arrangements to perform functions which are being carried out by various financial institutions in the conventional framework.

The significance of the "monitoring and evaluation" phase as for any new initiative cannot be overestimated and it is recommended that proper monitoring and evaluation of the program associated with the implementation of the Islamic banking model been proposed is necessary and should be given its rightful place at interval stages to determine its successful impact in national economic development and growth.

The effect of a bank's activity on economic growthdepends largely on which modes of finance and investment the bank undertakes most, and how much each one of these modes contributes to economic growth.This paper makes a strong case for Islamic banking as a tool that is strategic to achieving growth and developmentof national economy

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