DOES ISLAMIC BANKING SYSTEM CONTRIBUTE TO ECONOMIC DEVELOPMENT

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Abstract

The purpose of this paper is to understand the true meaning of Islamic banking system. This paper examine the role of Islamic banking system in the development of a country. This paper examine the relationship between Islamic banking and economic growth of Pakistan, also consider the impact of financial transformation, growth. In Muslim countries and in some non-Muslim countries, Islamic banking system work as part of banking system. Six interviews are conducted in which they were asked about the type of effect of Islamic banking system on economic growth. Most of the respondent give positive feedback about the banking system. Most of the world scholar said that Islamic banking system is more convenient for economic growth.

Key Words: Economic Development, Islamic Banking, Pakistan

Introduction

Islamic banking system is growing as a best alternative to conventional banking system. Islamic banking system grow itself rapidly from last two decades and gain a stronger position over 60 countries. According to bankers, Islamic banking will capture almost 50% of deposit in Islamic countries. For good economic growth, investment is a necessary condition for the growth of countries.

In 1950’s first Islamic bank was founded in Pakistan, which don’t pay interest on its loan, only charge a small amount of fee on its services which are their operating cost (Wilson, 1983). Islamic banks reflect the system and activities in which they are operates. Iran and Saudi Arabia are strong example where Islamic banking system work according to Islamic shirah. In Kuwait, Islamic system is focused in petroleum sector and in UAE, trade and financing are considered.

After revolution of Islamic banking system in Iran, certain studies were conducted for the progress of banking system. In term of economic growth, Malaysia has gained a remarkable position from last three decades. In 2005, its GDP raise to 5.3%. Country slightly shifted toward industries and industrial sector contribute 80% to the development of Malaysia. Malaysia keep its per capita income above $3000 since 1995.
Overview of Islamic Banking

The main purpose of Islamic banking system is to run on the teaching of Quran. Islamic law reflects God command in a Muslim theoretical life and spiritual life, and also organize its financial aspect and social life. Islamic banks are based on the concept of Islam that are strictly prohibited in Islam. In Islamic system interest is banned, while profit is allowed. In conventional banks interest rate is fix for the mechanism of financing. In Islamic law, speculation and contract with unfair risk are not allowable. Under Islamic system, all partners involved in financial activity will bear risk and return, but no one can gain return on a predetermine rate. The main difference between Islamic banking and conventional banks is that in Islamic banking there is direct relationship between investment and profit and its main purpose is to maximize shareholder wealth. (Dar and Presley, 2000) say that there are various pillar which promote Islamic system socially and ethically by promoting and providing competitive services.

Investment programs are started to provide the investment to those people who cannot start business through traditional way. (Zaher and Hassan, 2003)

Literature Review

Schumpeter, 1912 argued that importance of banking system in the economic growth of a country can be done through productive investment in country. Islamic banking helps in overcoming short falling and give a positive boost to economy to upward and boost a society to self-sufficiency economy through equal income distribution (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) say that Islamic banking have a positive impact on economic development. (Robinson, 1952) say that Islamic banking lead toward progress.

Dedokun (1992) and Luintel and Khan (1999) study two way of the relation between finance and growth. Some experimental studies have been conducted to examine the efficiency of Islamic banking system against conventional banking system through impact on inflation & employment rate. (Yousef et al, 1997), and (Joseph and Wilson, 2005) say that in Islamic banking system stability and superiority is not evidence as compared to banks which provides interest. (Abdouliie 1991, the Cave, Ahmad and actually Hammoud, 1998, my friend, in 2002, Iqbal 1997) say that only profit maximizing is not only main purpose of Islamic banks, they are based on the principle of ethics and values.

Islamic banking provide income distribution equally and provide cash to the poorest class of society by social justice, and in Islamic banking system there is no assurance of profit. Islamic banking operation are directly affected by the success or failure of customer’s operation. The relationship between customer and bank is that of partnership, and return will be shared between both depositor and banker. Loss also shared by both parties. This sharing principle is totally different from conventional banking system. It introduce the concept of sharing and provide an incentive for depositor to use the finance in a better way and get maximum return on its investment.

Through this investor are encourage to investment in bank because they will get a share in bank’s profits and it will create a human desire of ownership, respect and share in profit of a being a part of a successful project (Martan et al, 1984). According to (Iqbal 1997), Islamic countries can be economically grow if there saving are mobilized through Islamic system then the development of interest based banks and capital markets. This may come from the fact that return comes from Islamic banks is more than the return come from conventional banks. According to Iqbal 1997), through use of Islamic financing we can
reduce debt financing in our society. According to (Zaher and Hassan, 2001), Islamic banking system is always remain stable and have experience in time of crises.

Through Islamic banking system we can earn more return on investment on financial resources. (Qureshi, 1984 and Nagvi, 1981 and 1982) say that Islamic banking are more exposed to risk, however when interest factor is eliminate in our finance then the stability is increase to our return. In Islam there exist direct relation between risk and return. (Samad and Hassan, 1997) conducted a study in which they compared Islamic banking and conventional banking operations in which they found that the conventional banks carry more risk than the Islamic banks.

Sarkar, (1997) found that risk involved in profit sharing is high due to many external factors which are acting as obstacles. (Bageho, 1873) say that initiation of industrialization in England is start because of mobilization of capital. Schumpeter support the idea that there is direct relationship between bank performance and economic condition of a country. This is done by providing loans to entrepreneur on interest free basis. (McKinnon, 1973), also believe that there is direct relationship between banking operations and economic development of a country.

He say that we can bring efficiency in our economy by increasing return in capital market. (Beck et al, 2000, Bekaeot et al, 2001 and Beck and Levine, 2004) strongly support that there exist direct relation between financial intermediaries and economic development. (Levine and Zervos, 1998 found that there is positive relation between stock market development banking development and economic development.

This show that capital market liquidity and banking development have a direct impact on economic growth of a country. (Tang, 2006) used a modified model to study whether financial activities have impact on economic growth or not, he focus on three aspect, one is banking aspect, capital flow and stock markets. He do this in APEC countries. (Bashir and Hassan, 2003) examine the relationship between economic growth and financial development in some Muslim countries.

According to the (American economic development council, 1984), economic development is the process of mobilization of financial, human physical capital to generate marketable goods and services. The concept of Islam is worship of God, and its man’s duty to develop life on earth by securing human’s right. (Ghazali, 1994) say that main and foremost objective of Islamic banking system is development of human being by providing full employment, equal income distribution, giving high return to economic development thus giving justice to society.

Chaper (2000) say that economic development of a country is defined as GNP or GDP, and play very important role from the time of Adam till today. Financial system offer such feature in their product which mobilize saving in the society and help in development of an economy.

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.

References

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