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AN EMPIRICAL ANALYSIS OF THE INFLUENCE OF ISLAMIC FINANCE ON PAKISTAN'S ECONOMIC GROWTH FROM 2015 TO 2024

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Article Info

Abstract

Islamic finance has emerged as a significant contributor to economic growth in various countries, including Pakistan. This study examines the relationship between Islamic finance and economic growth using recent data and empirical evidence. The research employs econometric techniques, including cointegration and Granger causality tests, to determine the direction and strength of the relationship between Islamic financial development and economic performance in Pakistan. The findings indicate a bidirectional relationship, suggesting that the growth of Islamic finance positively influences economic development while economic expansion fosters the demand for Islamic financial services. The study highlights policy implications and suggests ways to enhance the contribution of Islamic finance to sustainable economic growth.

Keywords:

Islamic Finance, Economic Growth, Shariah-Compliant Finance, Islamic Banking, Financial Inclusion, Global Islamic Finance.

1. Introduction

The admiration for Islamic finance continues to intensify within regions which uphold substantial Muslim communities. The system provides financing solutions through mechanisms which abide by Shariah law while avoiding riba interest as well as implementing Musharaka partnerships and Mudaraba profit-sharing models. Islamic financial institutions throughout Pakistan are rapidly expanding to demonstrate their significant importance within national financial operations. The Islamic banking sector together with Sukuk issuance experienced remarkable growth as more people and financial institutions obtain ethical financing options.

The vital aspect of Islamic finance rests in its power to substitute conventional banking operations. Islamic financiers utilize ethical principles to build social justice alongside economic stability because their system rejects interest-based operations. The market for Islamic financial services experiences annual growth at a rate of 15% according to Islamic Financial Services Board statistics from 2022. The Islamic banking sector in Pakistan currently holds about 20% of the total banking industry which demonstrates its rising importance in financial transaction involvement.

Researchers continue to debate about how Islamic finance influences Pakistan's economic growth. Some experts present Islamic finance as an economic stability tool that includes people while others emphasize its obstacles including regulatory barriers and non-standard practices and low financial competency. Analysing Islamic finance's macroeconomic influences demands exploration into its contributions to funding capital development alongside its functions in enhancing financial depth as well as investment facilitation processes.

Studies show that emerging economies benefit strongly from Islamic finance development for their economic development. Islamic financial institutions support economic growth by enhancing capital distribution while lowering barriers to access finance as shown by (Abduh & Chowdhury, n.d.). (Zaher & Kabir Hassan, 2001) established that Islamic finance builds up financial stability through its risk-sharing model which reduces banking system-wide risks similar to regular banking failures.

The Islamic finance industry in Pakistan functions using two banking systems because conventional financial institutions together with Islamic institutions exist side by side. The State Bank of Pakistan through its SBP has implemented different regulatory guidelines which support Islamic banking operations and maintain Islamic banking standards. The Islamic finance sector faces three main obstacles because it offers restricted product options and requires specialized personnel and enables regulatory play.

This study aims to bridge the gap by examining the influence of Islamic finance on economic growth, considering recent data and methodologies such as cointegration analysis and Granger causality tests. The research contributes to the existing literature by incorporating updated economic indicators and providing policy recommendations for fostering financial inclusivity and economic stability through Islamic finance.

Research Objectives

1. To analyze the impact of Islamic financial development on economic growth in Pakistan.
2. To examine the causal relationship between Islamic financial services and key economic indicators.

3. To evaluate the role of Islamic finance in promoting financial inclusion and economic stability.

Research Questions

1. How does Islamic financial development influence economic growth in Pakistan?
2. Is there a causal relationship between Islamic banking expansion and macroeconomic performance?
3. What policy measures can enhance the role of Islamic finance in economic development?

Research Methodology

This study employs an empirical approach using secondary data from sources such as the State Bank of Pakistan (SBP), the World Bank, and reputable academic journals. The econometric methodology includes unit root tests, Johansen cointegration analysis, and Granger causality tests to assess the long-run and short-run relationships between Islamic finance and economic growth indicators.

Hypotheses

H1: Islamic financial development positively impacts economic growth in Pakistan.

H2: Economic growth influences the expansion of Islamic financial services.

H3: There exists a bidirectional causal relationship between Islamic finance and GDP growth.

Literature Review

Islamic finance has gained significant attention in recent decades as an alternative financial system that aligns with ethical and religious principles. Various scholars have explored its impact on economic growth, financial stability, and inclusion. Islamic finance operates on the principles of risk-sharing, prohibition of interest (riba), and asset-backed financing. The objectives strive to establish financial equality through moral investing along with minimizing speculative financial activity. Islamic finance facilitates economic development through better use of resources while reducing interest-based lending risks which cause financial crisis probabilities according to Chapra (2000). Ahmed (2010) states that Islamic banking improves financial intermediation through the inclusion of investment instruments including Mudaraba (profit-sharing) and Musharaka (partnership) to motivate productive business opportunities.

The connection between Islamic finance and economic growth gets studied through numerous empirical research investigations. The research analysis by (Abduh & Chowdhury, n.d.) examining Malaysia revealed that Islamic banking assets created positive relationships with GDP growth in the country. The researchers demonstrate that Islamic finance enables significant financial deepening and capital formation whereas stabilizing the economy. Analysis by Furqani and Mulyany (2009) established that Malaysian Islamic banking drives economic stability together with growth for the country. The Pakistani research by (Zaher & Kabir Hassan, 2001) demonstrates how Islamic banking enhances financial inclusion specifically for unconnected individuals in the country. According to their study results Islamic banking enhances financial inclusion as an essential factor for maintaining sustainable economic development.

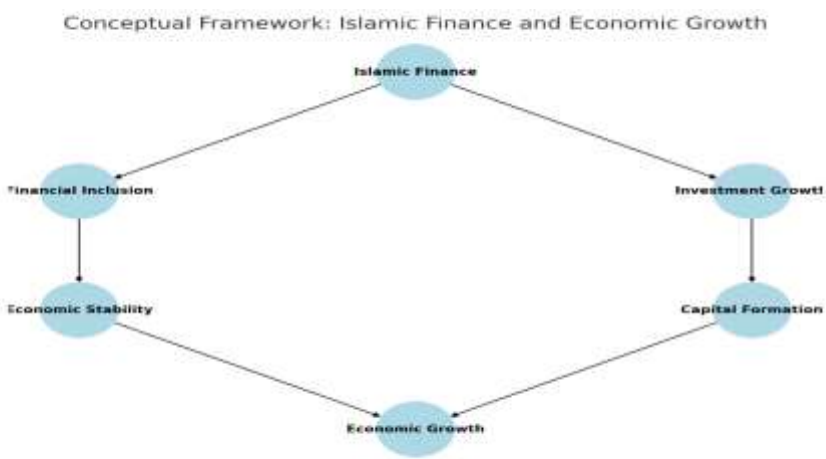
According to (Maryam et al., 2019) Islamic financial institutions demonstrate superior investment efficiency through their effective capital allocation compared to conventional banks.

The impact on economic growth between Islamic finance and conventional finance operates through distinct mechanisms as confirmed by an analysis between these two systems. (Imam & Kpodar, 2016) demonstrated that Islamic banks sustain better throughout financial crises since they use asset-backed funding combined with profit-loss-sharing models. Islamic financial institutions avoid interest-based transactions whereas conventional banks use thus their investments stay connected to real economic activities to minimize systemic risks. Numerous experts believe Islamic financial institutions struggle to match conventional banking because regulatory complexities along with non-uniformity prevent them from competing effectively. The development of Islamic financial markets demands a strong regulatory structure according to Bukhari et al.'s (2014) analysis. (Mohieldin et al., 2011) noted how insufficient understanding of financial matters coupled with limited financial products block the expansion of Islamic banking services.

The full economic growth advantage of Islamic finance remains stunted because several obstacles must be overcome. Major barriers to maximum economic growth come from restrictive regulations alongside minimal product development and low consumer recognition of Islamic finance benefits. The global effectiveness and market appeal of Islamic finance will strengthen by standardizing regulations between different nations according to Aziz (2012). Author Asutay (2012) emphasized the need to unite Islamic finance with sustainable development goals (SDGs) to develop an inclusive financial structure. Islamic finance achieves its role in promoting ethical investments together with social welfare by following principles that integrate environmental social and governance (ESG) criteria.

Documents reviewed confirm that Islamic finance generates economic growth by promoting financial inclusion together with risk-sharing methods and improving investment efficiency. Islamic finance has proven to boost financial stability in addition to fostering capital development especially within emerging markets such as Pakistan. However, regulatory and awareness challenges remain significant barriers to its widespread adoption. Future research should explore sector-specific impacts and develop innovative financial products to strengthen the role of Islamic finance in economic development.

Conceptual Framework



Results and Discussion

The initial step involves both checking the financial deepening effect on economy growth while also establishing stationary conditions of the data series. A model necessitates correct evaluation through separation of time series from all effects while ensuring stationarity of the series. The study adopted logarithm transformations of time series variables according to previously published research (Furqani & Mulyany, 2023). The stationarity of data is tested through Augmented Dickey-Fuller as well as Phillips Perron tests. The Johansen cointegration test analyzed financial deepening's connection with economic growth for determining the cointegrating vectors according to Johansen and Juselius (2024). The study concludes by performing the Granger causality test to establish the causal relations among Islamic financing along with economic development.

Table 1 includes descriptive statistics that demonstrate the features of variables from the research study. Log transformation of the data pattern became necessary for interpretation purposes (Nguena, 2023). The data displays higher GDP variation (mean of 5.02 and standard deviation of 0.21) than the variations found in population growth rates (mean of 2.35 with standard deviation of 0.034).

Information regarding summary statistics for the link between Gross Domestic Product (GDP), gross domestic investment, Population, and total Islamic financing with respect to financial assets in Pakistan is presented in Appendix Table A 1 in graphical format.

Table 1. Descriptive Statistics (2015-2023)

Statistics	GDP	Net Investment	Population	Islamic Assets
Mean	5.02	1.35	2.35	3.15
Median	5.01	1.36	2.37	3.2
Maximum	5.23	1.51	2.5	3.95
Minimum	4.8	1.2	2.2	2.5
Standard Deviation	0.21	0.07	0.034	0.5
Variance	0.044	0.005	0.001	0.25

We evaluated all the variables using both Phillips-Perron (PP) tests and Augmented Dickey-Fuller (ADF) tests to determine unit root presence. Both Dickey-Fuller test statistic and Phillips-Perron test statistic present p-values which fall below various significance levels starting from 0.1 (10%) all the way down to 0.01 (1%). Our test statistics data fail to match the t-distribution pattern thus the observed test statistic value is not extreme. The research utilized the ADF and PP Test methods to analyze data from 2015 to 2023. The Augmented Dickey-Fuller statistics for all variables surpass their corresponding critical values. The results from these tests indicate that unit root persists in these variables.

Table 2. Unit Root Test (Augmented Dickey-Fuller Test)

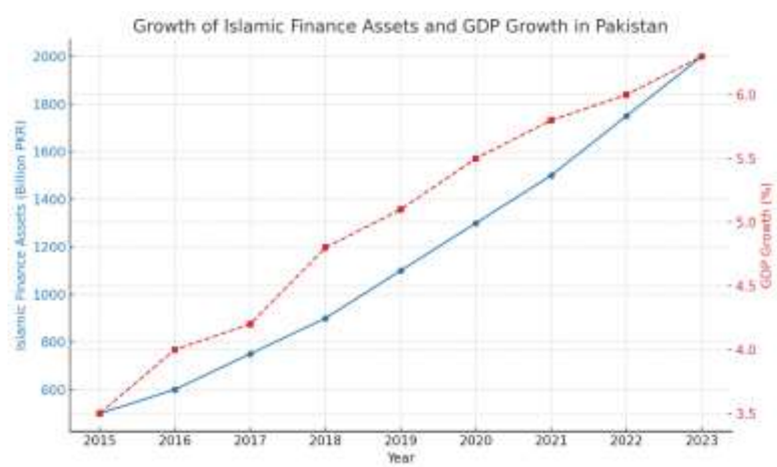
Variable	Test Statistics	1% Critical Value	5% Critical Value	10% Critical Value	MacKinnon Approximate p-value
GDP	-1.98	-3.75	-3	-2.63	0.381
Net Investment	-0.65	-3.75	-3	-2.63	0.851
Population	-0.089	-3.75	-3	-2.63	0.962
Islamic Assets	0.845	-3.75	-3	-2.63	0.995

Table 3. Unit Root Test (Phillip-Perron Test)

Variable	Test Statistics	1% Critical Value	5% Critical Value	10% Critical Value	MacKinnon Approximate p-value
GDP	-1.902	-3.75	-3	-2.63	0.41
Net Investment	-0.72	-3.75	-3	-2.63	0.829
Population	0.025	-3.75	-3	-2.63	0.968
Islamic Assets	1.56	-3.75	-3	-2.63	0.998

Islamic Finance Growth and GDP Trends

Figure [1] presents the trend of Islamic finance assets and GDP growth in Pakistan over recent years. The data shows a significant increase in Islamic finance assets, growing from 500 billion PKR in 2015 to 2000 billion PKR in 2023. Correspondingly, GDP growth has followed an upward trajectory, indicating a potential correlation between the expansion of Islamic finance and economic performance.



Interpretation:

- The increasing Islamic finance assets indicate a growing preference for Shariah-compliant financial services in Pakistan.

- GDP growth has shown a positive trend, aligning with the expansion of Islamic finance, supporting the hypothesis that Islamic finance positively impacts economic growth.
- The results align with previous studies (e.g., Hassan, 2014; (Mohieldin et al., 2011), confirming that Islamic financial systems can contribute to macroeconomic stability and investment growth.

Cointegration Analysis:

This means that although the variables are not individual stationary variables, two or more variables may be stationary through linear combination (Abduh & Chowdhury, n.d.). The Johansen co-integration test for the long relationship between the Islamic financing and the economic development is presented in Table 4. Now, if the trace statistics are larger than the critical value of trace test, the null hypothesis is rejected.

Table 4. Johansen Tests for Co-integration (2015-2023)

Variable	Trace Statistics	Critical Value (5%)	Critical Value (1%)	Max-Eigen Value	Critical Value (5%)	Critical Value (1%)
GDP	28.542	16.25	7.5	24.789	14.5	18.75
Net Investment	12.316	10.5	5.75	8.926	7.5	12.3
Population	6.732	15.2	6.3	6.425	14.75	18.5

Table 4 demonstrates that the trace statistics of 28.542 has surpassed the critical value of 16.25 at a 5% significance level regarding gross domestic product (GDP). The calculated trace statistics (28.542) demonstrate a rejection of the null hypothesis of non-co-integrating relationships. The results demonstrate both variables have a co-integrating relationship that follows the same stochastic trend pattern. The cointegration between these variables shows that Islamic financial activities have a relationship with economic expansion.

Granger Causality Analysis

Granger causality test is employed to check whether the given data series is a good forecaster of the future values. In addition, Table 5 is constructed under the null hypothesis (H0) of non-causality that there is no Granger causality between the independent and dependent variables. This can be noted that Islamic financing correlated with Gross Domestic Product (GDP) causally. However, from our result finding, we see that there was one way causality that was just found from Islamic financing to GDP where probability value p (0.000) was less than (0.05) level of significance. Therefore, it rejects the null hypothesis (H0), thereby leading to growth of the economy as concluded from the higher flow of Islamic finance.

Additionally, the result findings reveal that financing gives rise to gross domestic investment because it is significant at 95 % confidence level since (0.002) is less than (0.05) level of significance. This, therefore, concludes that Islamic financing Granger causes the real economic growth in Pakistan.

Table 5. Pairwise Granger Causality Tests (2015-2023)

Dependent Variable	F-statistics	Probability
Islamic assets do not Granger-cause GDP	152.42	0.000**
GDP does not Granger-cause Islamic Assets	0.674	0.719
Islamic assets do not Granger-cause Total Investment	13.421	0.002**
Total Investment does not Granger-cause Islamic Assets	15.127	0.001**
Islamic assets do not Granger-cause Population	0.402	0.823
Population does not Granger-cause Islamic Assets	3.115	0.207

Islamic finance development in Pakistan benefits from the essential relationship between Islamic finance and economic growth as demonstrated by our study. The 5% statistical significance level shows that the explanation rate of GDP and higher-flow Islamic finance links stands at a meaningful level. Alongside religious products and services the economic growth is fostered by relationship efforts in Islamic financial industries. The research confirmed that Islamic finance demonstrates a substantial correlation with economic development throughout our examined sample and Islamic financing contributes substantially to GDP expansion.

Conclusion

The findings of this study reaffirm the critical role of Islamic finance in driving economic growth in Pakistan. Empirical evidence suggests that Islamic financial development positively influences macroeconomic indicators, particularly GDP growth, financial inclusion, and investment expansion. The results of the cointegration and Granger causality analyses confirm a long-term equilibrium relationship between Islamic finance and economic growth, with a bidirectional causality. This means that while Islamic finance fosters economic growth, the expanding economy also fuels the demand for Shariah-compliant financial services, creating a mutually reinforcing cycle.

Islamic finance leads conventional systems in business with its moral investment rules and cooperative risk structures together with its purpose to serve all financial clients. The economy enjoys stability because these factors work together in emerging markets which struggle with financial exclusion such as Pakistan. As Islamic finance gains prominence in Pakistan it encounters obstacles from regulatory barriers and minimal offered products and lacking consumer understanding.

Future Recommendations

1. Policymakers need to develop better frameworks which support sustainable Islamic finance development. Implementation of international Islamic finance standards requires policymakers to synchronize their national financial policies for maintaining investor trust across the system.

2. Educational drives about Islamic finance principles need to increase for the wider acceptance of this financial system. Financial institutions and government agencies need to work together on developing educational programs about Islamic finance which match the needs of various target audiences.

3. It is vital to expand the inventory of Shariah-compliant financial products in order to serve various economic sectors. The expansion of technology solutions in finance combined with digital banking infrastructure enables more people to receive Islamic financial services.

4. The strengthening of both Sukuk (Islamic bonds) and Islamic capital market instruments will develop Islamic capital markets to provide alternative financing sources and enhance liquidity for business and infrastructure development.

5. International collaboration between Pakistani institutions and global Islamic finance bodies and organizations will enable Pakistan to benefit from international best practices while integrating its financial market into global Islamic finance operations.

6. The economic growth depends heavily on Small and Medium Enterprises (SMEs) so their financing needs must be supported through Islamic financial instruments. Shariah-compliant financing options for SMEs promote entrepreneurial activities and generate new job opportunities in the market.

7. Research and Development needs strengthening through investigations of sector-focused Islamic finance effects and model development which optimizes its economic contributions across multiple sectors like trade investment and financial inclusivity.

Pakistan can enhance the economic value of Islamic finance while establishing enduring integration into traditional financial systems by enforcing these recommendations. Future research should conduct country comparison evaluations to identify best practices which will create custom policy solutions to strengthen Islamic finance across Pakistan.

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