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A Critique of the Role of Islamic Banking in Economic Growth and Financial Stability of Gulf cooperation Council (GCC) Economies

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Abstract: This paper presents insights into the relationships between Islamic banking, economic growth and financial stability in GCC economies. The paper gives a critique on the impact of Islamic banking in the growth and stability of the economies of Gulf region. The critique analysis is given based on some of the previous published work by the authors on the relationships between Islamic banking, financial stability and economic growth in selected countries of Gulf region. The paper primarily is based on the analysis of four countries of GCC where Islamic banking has footprints. The countries are United Arab Emirates, Qatar, Kingdom of Saudi Arabia and Bahrain. The results of two empirical parts are presented through the paper. It explores that the contribution of Islamic banking in each country is according to the advancements of its financial systems and norms. In some countries, the relationship between Islamic banking and economic growth is supply-leading and in others is demand-following. It also shows that Islamic banking is a stable and less volatile during global financial crisis in 2008 in all countries under the study. The results of the critique viewpoints are encouraging the authorities and policy makers in the GCC countries to do further investments and projects using Islamic banking financing modes since they approved its stability under different financial crises and shocks.

Key worlds: Islamic banking, Economic growth, GCC, Economies, A critique.

1. INTRODUCTION

Islamic finance essentially enhances financial transactions connected to the real sector and far away from funding activities that are harm to the society. Islamic finance has been one of the emerging growing sectors over the last decades and has gained further growth in the time of the financial crisis. Nowadays, Islamic banking is crossing all borders and has marked huge growth, both in assets and its coverage around the world. This is, due to its ethical and social model. The huge growth rate of Islamic banking and its stability through global debt crisis pay the attention of every one of the society.

In spite of the major effects of the financial crisis which has affected the economies of all sectors of any country, the Islamic finance sector has been growing and has crossed more than a twenty nine percent growth in assets to reach more than U.S.$ 1.67 trillion in 2015. The Middle East, particularly Gulf region, which responsible for sixty two percent of world interest-free banking assets, is clearly a key hub of Islamic finance. The impressive growth rate of Islamic finance and its stability during financial crisis attracts the attention of many policy makers and financial experts worldwide. Despite the financial crisis which has plagued the economies of both industrialized and developing nations, the Islamic finance industry has been flourishing, and has enjoyed a 29 percent growth in assets to reach more than U.S.$ 600 billion in 2008 (Figure 1).

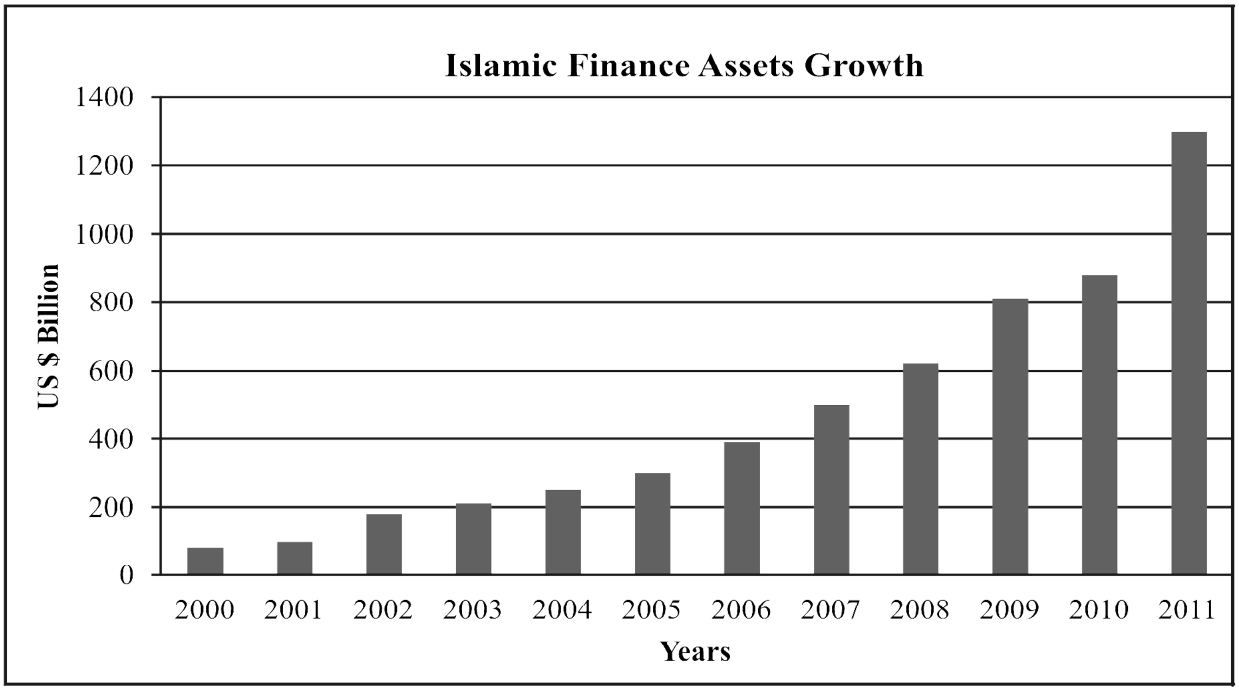

Figure 1: Islamic Finance Assets (2000-2011)

Source: Developed by the researchers

Banking has been the leading sector in the share of Islamic financial system, but of late the share of other products and institutions within the total share of Islamic financial assets has been steadily increasing (World Bank report, 2015). Islamic banking has accounts for more than 80% of the total Islamic finance assets; therefore the performance of Islamic banks is very important for the welfare and economic growth for any country.

The Middle East, particularly Gulf countries, which accounts for nearly 60% of global Islamic banking assets, is clearly a key nerve center of Islamic finance. This paper gives a critique of the relationship between the Islamic banking system, financial stability and growth of the economy.

The paper is organized as follows. Section one provides the introduction. Section two provides a summary of the relationship between Islamic finance and economic growth in the world and GCC. Section (3) shows the objectives and importance of the current study. Section (4) gives a critique of the first empirical part. Section (5) shows the second empirical results of the four selected countries of the Gulf region. Section (6) gives a critique of the second empirical part. Section (7) draws the conclusion of the paper.

2. ISLAMIC BANKING AND GROWTH OF THE ECONOMIES IN THE WORLD AND GULF CO-OPERATIVE COUNCIL (GCC)

All studies that examined the role of Islamic banking in the growth of the economy confirmed that there is a long-term relationship between Islamic finance and economic growth in the world. For example, in the UAE context Tabash and Anagreh (2017) confirmed the positive relationship between Islamic banking and economic growth and the same picture is drawn from Bahrain (Tabash and Dhankar, 2013). Also, another study of Qatar affirmed the long term association between Islamic banking investments and growth of the economy (Tabash and Dhankar, 2014). Furthermore, Islamic banking was considered as a viable financial system for growth of the Middle East economies (Tabash and Dhankar, 2014).

Regarding Islamic banking and financial stability, A study done by the same authors that checked the impact of the global financial crisis on the stability of Islamic banks in Kingdom of Saudi Arabia (KSA) revealed that Islamic banking is not affected by the global financial crisis 2008 (Tabash and Dhankar 2014). The most important players in Islamic finance are still the GCC countries, which responsible for the majority of assets. Also, the Islamic banking model is also making progress in countries such as Malaysia, Indonesia, Turkey and Pakistan. According to Competitiveness report (2015), "total Islamic finance assets of banks rose to seventeen percent between 2009 and 2013, hitting more than U.S. $778 billion. Of that, Gulf Cooperation Council (GCC) countries responsible for around U.S $ 517 billion, ASEAN countries

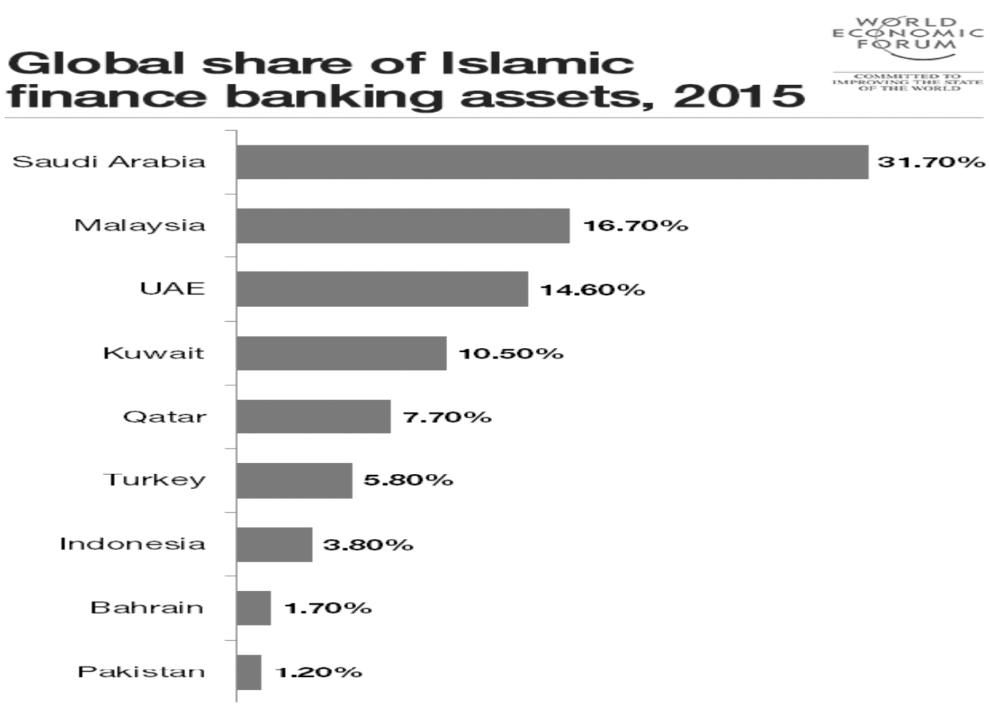

Figure 2: Global share of Islamic finance banking Assets

Source: Ernst & Young report (2014-2015) for U.S $160 billion and South Asia for U.S $ 23 billion; the rest of the world (especially Turkey) is making up the remaining of U.S $ 78 billion. It seems from Figure (1) that Saudi Arabia is account for 31.7 5% share of the global Islamic finance assets while Malaysia is the next with 16.7%. United Arab Emirates (UAE) and Kuwait is the third and the fourth respectively. Pakistan is the last in the list with 1.2 % share of assets. It is clear from Figure (2) that Gulf Co-Operative Council (GCC) accounts for 55.7 % of Global Islamic finance assets which is a very significant percent compared to other countries. Also, Table (1) gives average asset growth rates from 2006 to 2008. The assets growth rates have been growing in all countries with the highest growth shown by Bahrain of 43.77 % and lowest by Jordan of 8.28 %. Saudi Arabia, UAE and Kuwait were still giants in terms of assets growth rate of Islamic banks compared to Egypt, Jordan, Yemen, and Lebanon.

Table 1
Assets Growth Rate in Middle East Countries (2006-2008)

Middle East Countries	*Assets Growth Rate (%) 2006-2008*
Bahrain	43.77
Egypt	15.9
Jordan	8.28
Kuwait	33.185
Lebanon	253.82
Qatar	41.29
Kingdom of Saudi Arabia(KSA)	25.55
United Arab Emirates (UAE)	28.675
Yemen	13.685

Source: Ernst & Young report (2014-2015)

3. RESEARCH OBJECTIVES AND IMPORTANCE

The main objective of the study is to provide and give a critique on how Islamic banking enhancing economic growth and financial stability of select countries of Gulf region. The importance of this study comes from the fact that it brings to the surface the significant sector in the world economies, namely the Islamic finance economy. It affects each person in the universe and is powerful tool to the world economy. The paper gives a critique on the already published work in the links between interest-free banking, financial stability and growth of economies in the fourth mentioned countries.

4. A CRITIQUE VIEWPOINTS OF THE RELATIONSHIP BETWEEN ISLAMIC BANKING AND GROWTH OF THE ECONOMY: PART ONE

Based on the results, we can say that in United Arab Emirates, there is a significant relationship between Islamic banks' financing and growth of the economy. It is evident from the results that the relationship is positive, as Islamic banks' financing increases, the economic growth also increases. That shows that Islamic banking and growth of the economy relationships are accelerated in the same positive direction of the UAE, and the same picture can be observed with regard to Qatar, Kingdom of Saudi Arabia, and Bahrain

(See Tabash and Dhankar, 2013, 2014). This leads us to say that Islamic banking is deeply contributed to the development of economies, particularly to these countries of the Middle East. One of the main reasons for this is the equity finance mode in which Islamic banking is based. The reasons behind the positive relationship are related to the features of Islamic finance system.

It is structured on profit -risk sharing and the prohibition of debt financing (leveraging). Another reason is that the support of the governments of these countries to Islamic finance growth and development, along with, the huge investments from others who want to use interest-free products. For the results of causality between Islamic banks' financing and growth of the economies of the four selected countries, we put arrows to show the causality from growth of the economy to Islamic financial development and vice-versa as shown in Table (2).

Table 2
The direction of Causality

Countries	*Variables*		
	GDP	*GFCF*	*FDI*
Group 1: "From Islamic financial development to economic growth"			
UAE	→	→	→
Qatar	→	→	→
KSA	→	→	→
Bahrain	→	→	→
Group 2: "From economic growth to Islamic financial development"			
UAE	-	-	←
Qatar	←	-	-
KSA	-	-	-
Bahrain	←	-	-

Source: Developed by the researchers

The results obtained from Table (2) for causality checks illustrates that a causality relation found from the Islamic banking to economic growth and from economic growth to Islamic financial development. It means unique and bidirectional relationships exist.

In case of United Arab Emirates, the results support strong evidence on supply-leading hypothesis which implies that financial development enhances economic growth for GDP and GFCF. This means that Islamic financial system is an efficient financial system that improves the flow of money for the growth of the economy. In this regard, government of UAE should develop and maintain sound policies to enhance Islamic banking sector to promote economic growth of the country. In contrast, the results do not show the same relation for FDI where the relationship is bi-directional. It means that UAE has an efficient banking system and a dynamic economy which creates a good atmosphere for foreign direct investment and through FDI comes in home economy. Therefore, FDI can enhance interest-free banking which in return brings FDI. For bringing FDI, UAE governments must pay attention on interest-free banking by enhancing open markets through trade, investment and financial freedom.

In case of Qatar and Bahrain, the results obtained from Table (2) show that the direction of the causality is the same for both of the countries. This is expected, as there is a similarity between the two countries in the regulations of the banking system and the degree of progress in financial markets. The findings depict the relationship of supply-leading hypothesis which implies that financial development enhances economic growth for GFCF and FDI. On the other hand, the results do not show the same case for GDP. This implies that financial development plays a central role in economic growth and that economic growth leads to further growth of financial system in the economy.

The results of the Kingdom of Saudi Arabia (KSA) obtained in Table (2), show a good evidence on supply-leading hypothesis, which implies that financial development improve economic growth for all variables. These findings indicate that the Kingdom of Saudi Arabia have a modern Islamic financial sector that can push overall economy. In other words, financial sector development in KSA precedes and induces growth in the real sector by channeling investible funds from small savers to large investors. However, government of the Kingdom of Saudi Arabia should enhance foreign investments in all sectors.

It is clear from the results of the four selected countries that there is a strong relationship between Islamic banking and growth of the economies in the long–run. It is revealed that the causality results for the selected countries are supporting supply-leading hypothesis, except for FDI and GDP which is bi-directional in UAE, Qatar, and Bahrain. This implies that financial sector and real sector are interrelated to each other in some cases.

Overall, this study provides solid picture for that interest-free banking development is a unique factor of economic growth in the selected countries of Gulf region. These findings are similar to Demetriades and Hussein (1996), Luintel and Khan (1999) which indicates a well-functioning financial system is a necessary to reach steady economic growth in Middle East countries. On the other hand, the findings are a bit different from (Boulila and Trabelsi, 2004) who support the demand-following hypothesis.

Different results would be interpreted by the substantial variation in the degree of financial development in these countries, for example, Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE have advanced financial systems, while in some other countries such as Iran, Libya, Sudan and Syria have made somewhat limited progress in this area (Creane *et al.*, 2004).

Based on the other results of the empirical part that examined the Islamic banking and financial stability, we revealed that the Islamic industry has remained unaffected during the global financial crisis that hit the world economy in 2008 onwards. Qatar and Bahrain show similar indicators for capital adequacy and liquidity ratios for the period of the study.

The findings of both countries present a good support for the reliability of their Islamic financial system under foggy conditions. The central banks of the two countries have initiated strategic policies for Islamic finance growth and progress, besides a good regulatory and supervision environment was created. For KSA, the findings show better evidence in favour of the stability of interest-free banking system but it still needs some positive measures to help and strengthen its financial system. So, it is suggested that the government of the Kingdom of Saudi Arabia should initiate some steps to open its trade, along with increasing the financial market freedom.

5. A CRITIQUE VIEWPOINTS OF THE RELATIONSHIP BETWEEN ISLAMIC BANKING AND FINANCIAL STABILITY: PART TWO

This part shows the role of Islamic finance in enhancing financial stability in the four selected countries of Middle East. The results of the four countries are summarized together with regard to the relationship between Islamic financial system and financial stability, since financial stability is a critical factor in the growth of the economies of these countries and the world as well. In this part, the relationship between development of Islamic finance and financial stability is shown; time series data from 2005 to 2010 for all full-fledged-Islamic banks operating in the selected countries is taken. Then, the trend analysis method is utilized where yearly financial ratios of Islamic banking sector are computed using Microsoft Excel. After that, liquidity ratios and capital adequacy ratios are determined. One Way Analysis of Variance (ANOVA) is used to test the hypotheses using SPSS. The results of the liquidity and capital adequacy are presented below. The results between Islamic banking and financial stability are presented in the following sections.

5.1. Liquidity Ratios Results

- **Investments Assets Ratio (IAR)**

Table (3) presents average results of IAR of all Islamic banks in the selected countries of Middle East from 2005-2010. From the analysis of figure (3), it is clear that the liquidity of the full-fledged Islamic banks is improving through the time irrespective of the global financial crisis 2008. On average, Islamic banks registered IAR 55.9% during 2010 for Bahrain, while it stands at 63.35% in 2008 for Qatar.

Table 3
Average Investment Asset Ratio (2005-2010)

Years	*Average Investment Assets Ratio (%)*			
	UAE	*Qatar*	*KSA*	*Bahrain*
2005	83.17	57.46	74.97	64.79
2006	86.93	51.13	73.60	64.28
2007	85.65	58.56	62.14	57.22
2008	88.84	63.35	74.67	65.69
2009	85.13	56.46	46.11	64.81
2010	76.50	55.90	66.63	63.12

From Figure (3), it is showed that the IAR ratio is favorable for all Islamic banks but there exists a decline in IAR of Islamic banks from 2008 onwards in the selected countries. This is consistent with prior studies that showed Islamic banking sector is a more liquid sector (Aktas, M. (2013), Rafiuddin and Alam, Z. (2012), and Samad & Hassan (2000).

- **Testing of Hypothesis**

A One way ANOVA is used to test the hypothesis as shown in Table (4).

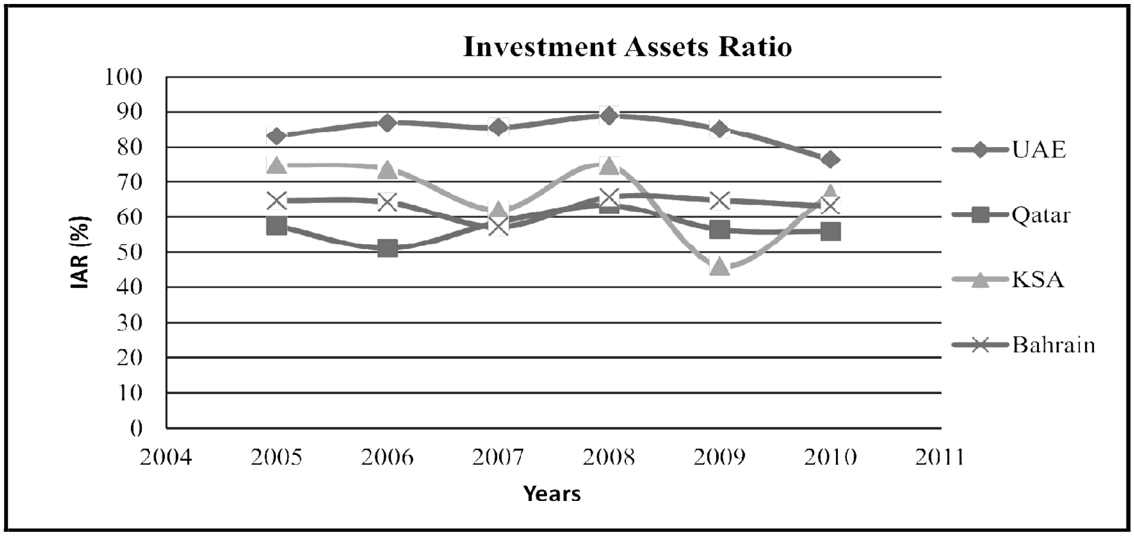

Figure 3: Investment Asset Ratio

Table 4
One Way ANOVA (IAR)

Countries	*(Investment Assets Ratio)*			
	F test	*P. value*	*level of significance*	*Decision regarding Ho*
UAE	1.298	0.393	0.05	Since 0.393 > 0.05, accepted
Qatar	2.233	0.255	0.05	Since 0.255> 0.05, accepted
KSA	7.026	0.074	0.05	Since 0.074> 0.05, accepted
Bahrain	0.430	0.685	0.05	Since 0.685> 0.05, accepted.

It is clear from Table 4 that the P value is more than 0.05 level of significance (Ho accepted). This leads us to say that Islamic banking is not affected by global financial crisis 2008.

- **Liquid Assets Ratio (LAR)**

Table (5) presents average results of LAR of all Islamic banks in the selected countries from 2005-2010. It is clear from figure (4) that the liquidity of the Islamic banks for the selected countries has increased in 2008 except for KSA. Islamic banks have achieved a high (LAR) ratio of 32.44% in case of Bahrain in 2008. Islamic banks showed a higher run off ratio from 2008 onwards.

Table 5
Average Liquid Asset Ratio (2005-2010)

Years	*Average Liquid Asset Ratio (%)*			
	UAE	*Qatar*	*KSA*	*Bahrain*
2005	18.33	16.90	22.46	34.35
2006	14.49	23.33	21.86	39.55
2007	17.17	21.87	33.96	42.72
2008	12.89	16.56	26.03	32.44
2009	17.72	22.93	31.68	33.55
2010	23.72	37.34	22.68	35.23

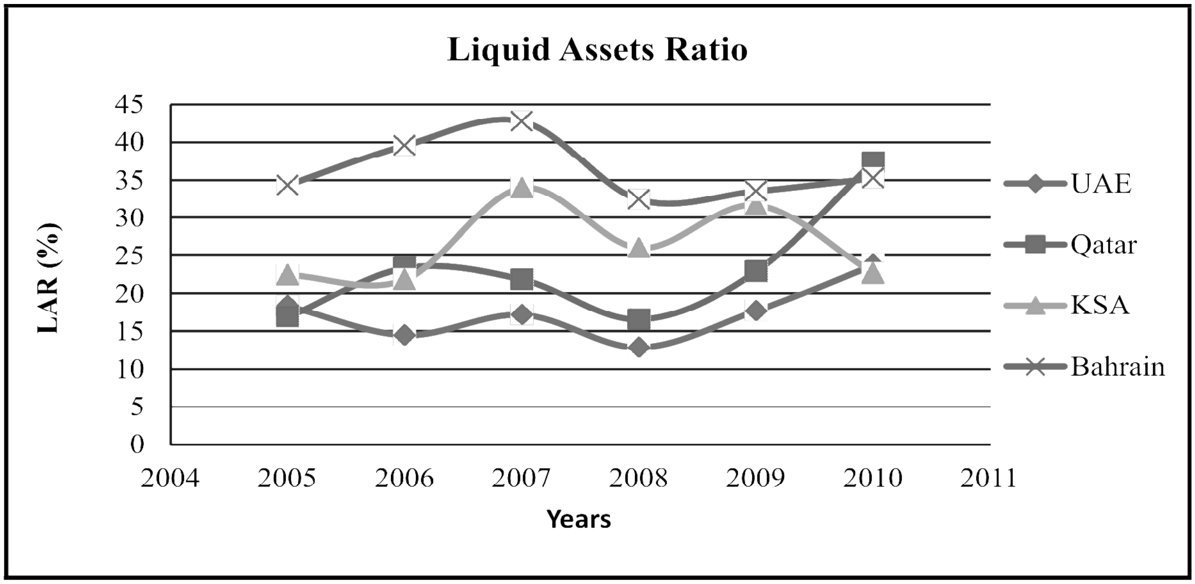

Figure 4: Liquid Asset Ratio

- **Testing of Hypothesis**

One way ANOVA has been applied, as shown in Table 6

Table 6
One Way ANOVA (LAR)

Countries			*(liquid Assets Ratio)*	
	F test	*P. value*	*α (0.05) level of significance*	*Decision regarding Ho*
UAE	1.531	0.348	0.05	Since 0.348> 0.05, **accepted**
Qatar	1.591	0.338	0.05	Since 0.338 > 0.05, **accepted**
KSA	3.004	0.192	0.05	Since 0.192 > 0.05, **accepted**
Bahrain	0.523	0.792	0.05	Since 0.792> 0.05, **accepted.**

The p values are 0.348, 0.338, 0.192 and 0.792 for the four respective countries, and these are more than α (0.05) level of significance, which means that null hypothesis is accepted. It is clear from the table that there is no significant difference in (LAR) before, during, and after the global financial crisis. This result shows that Islamic banks are not affected by global financial crisis.

5.2. Capital Adequacy Ratios Results

- **Equity Total Assets Ratio (EQTAR)**

Table 7 presents average results of EQTAR of all full-fledged Islamic banks in UAE, Qatar, KSA, and Bahrain, from 2005-2010. From the analysis of Figure 5, it is evident that the (EQTAR) of the full-fledged-Islamic banks is stable during the study period which includes 2008 global financial crisis. Figure 5 also presents that Islamic banks are enjoying high (EQTAR) throughout the time period of this study which means that Islamic banks have quite a large capacity of absorbing loan losses. This is consistent with prior studies like Siraj, K. and Pillai, P. (2012), Sehrish, S. *et al.* (2012), kader and Asapota (2007) which found that Islamic banking sector is more equity financed than conventional banks.

Table 7
Average Equity Total Assets Ratio (2005-2010)

Years	*Average Equity Total Assets Ratio (%)*			
	UAE	*Qatar*	*KSA*	*Bahrain*
2005	79.97	19.69	24.69	51.76
2006	56.80	27.73	21.12	54.09
2007	69.69	32.18	19.46	55.67
2008	64.75	25.86	20.12	55.52
2009	69.40	29.33	24.80	58.24
2010	55.90	26.82	26.43	52.77

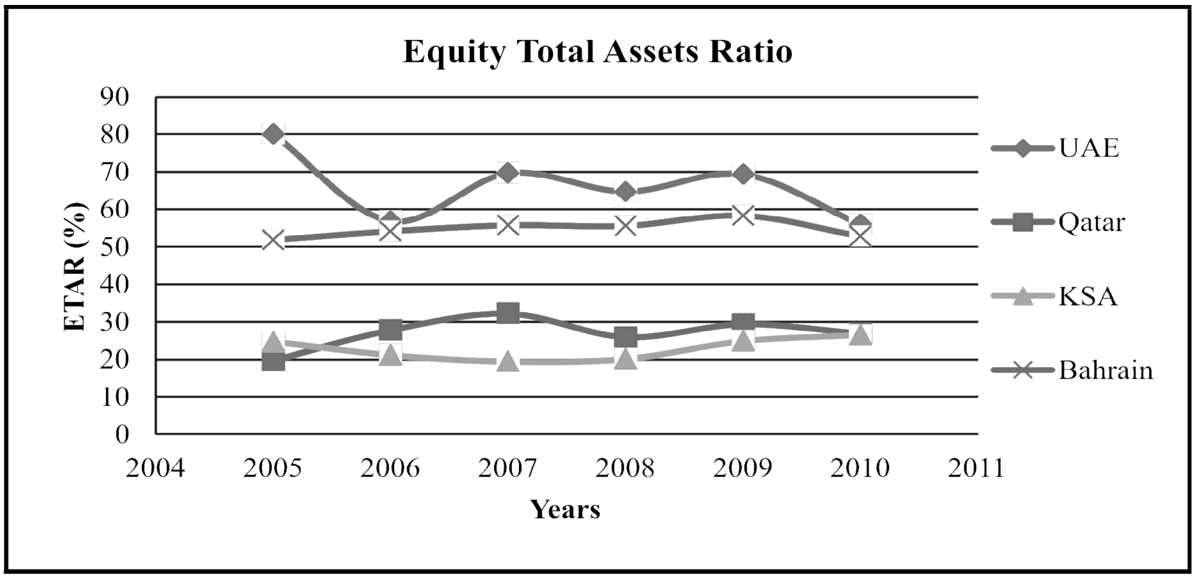

Figure 5: Equity Total Assets Ratio

- **Testing of Hypothesis**

One way ANOVA has been used and the results are shown in table 8

Table 8
One Way ANOVA (EQTAR)

Countries	*Avg. Equity Total Assets Ratio (%)*			
	F test	*P. value*	*level of significance*	*Decision regarding Ho*
UAE	0.148	0.868	0.05	Since 0.868> 0.05, **accepted**
Qatar	0.868	0.504	0.05	Since 0.504 > 0.05, **accepted**
KSA	6.657	0.079	0.05	Since 0.079 > 0.05, **accepted**
Bahrain	0.780	0.534	0.05	Since 0.534> 0.05, **accepted**.

The p values of the four countries respectively are 0.868, 0.504, 0.079, and 0.534, and these values are more than á (0.05) level of significance, which means the null hypothesis is accepted. It may be indicated from the analysis that there is no significant relationship and difference in (EQTAR) before, during, and after the global financial crises. This result indicates that Islamic banks have been protected from the crisis which goes on to show the stability of Islamic banks.

- **Equity / Liabilities (ELR)**

Table (9) presents average results of ELR of all Islamic banks in the selected countries of Middle East from 2005-2010. From the analysis of Figure 6, it is evident that the (ELR) of the Islamic banks is stable during the study period. It registered a high value 107.25% in 2005 for UAE and 52.69% for Qatar in 2007. The results indicate that Islamic banks have quite a large capacity to absorb the financial shocks.

Table 9
Average Equity Liabilities Ratio (2005-2010)

Years	*Average Equity liabilities Ratio (%)*			
	UAE	*Qatar*	*KSA*	*Bahrain*
2005	107.25	25.48	36.71	61.08
2006	71.90	42.2	31.84	58.12
2007	85.49	52.69	24.26	46.63
2008	78.77	38.44	26.11	43.77
2009	84.29	48.73	40.12	49.15
2010	68.61	21.3	38.12	39.06

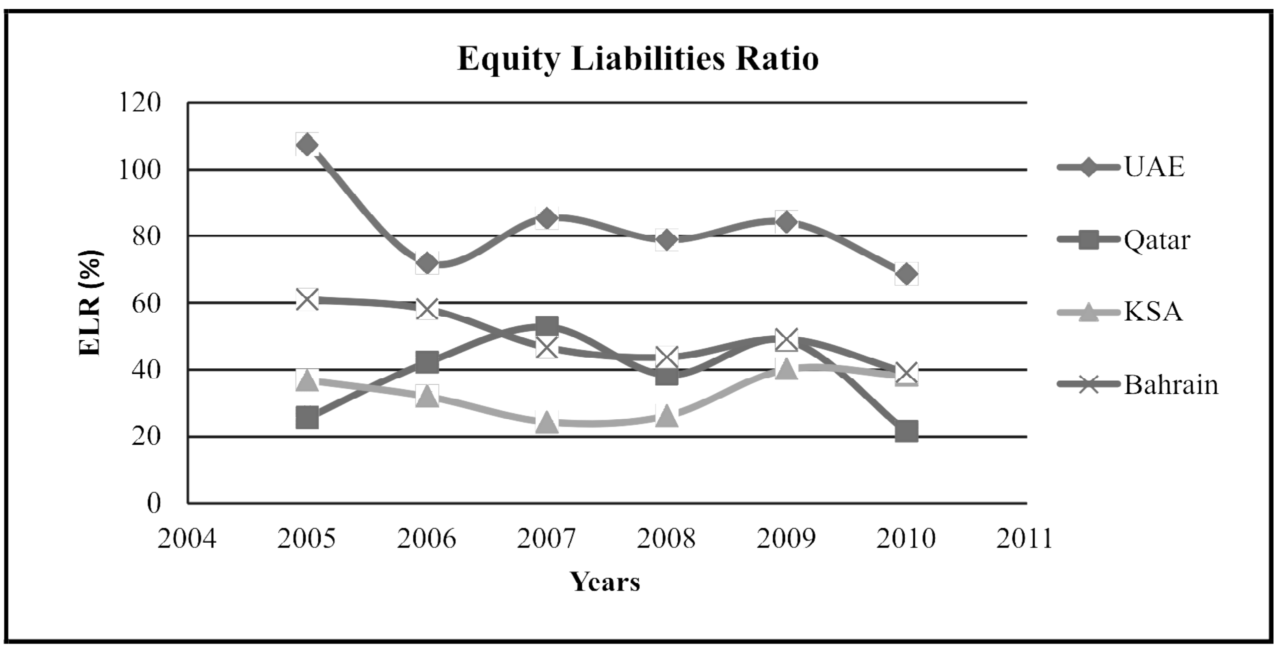

Figure 6: Equity Liabilities Ratio

- **Testing of Hypothesis**

One way ANOVA test has been used. Results are shown in Table 10.

Table 10
One Way ANOVA (ELR)

Countries	*Average Equity liabilities Ratio*			
	F test	*P. value*	*level of significance*	*Decision regarding Ho*
UAE	0.337	0.738	0.05	Since 0.738> 0.05, **accepted**
Qatar	0.405	0.669	0.05	Since 0.504 > 0.05, **accepted**
KSA	22.772	0.021	0.01	Since 0.02 > 0.01**, accepted**
Bahrain	7.556	0.067	0.05	Since 0.534> 0.05, **accepted**.

The p values for the selected countries are 0.738, 0.504, and 0.534 respectively, and these values are more than α (0.05) level of significance, except for KSA where P value 0.02 is more than (0.01) level of significant, meaning that the null hypothesis is accepted. The findings show that Islamic banks are less risky than that of conventional banks in the selected countries of Middle East. These results are consistent with those of Samad and Hassan (2000), Shafique et al. (2008) and Abdulleand Kassim (2012), Aktas, M. (2013).

6. A CRITIQUE OF THE SECOND EMPIRICAL PART

The results of the second empirical part reveal that the Islamic industry has remained unaffected during the global financial crisis that hit the world economy in 2008 onwards. A closer look at the capital adequacy and liquidity ratios in United Arab Emirates show good results compared to Qatar, KSA, and Bahrain. This means that United Arab Emirates has a competitive environment and good regulations for Islamic banking industry compared to other countries. Qatar and Bahrain show similar indicators for capital adequacy and liquidity ratios for the period of the study. The findings of both countries show a strong evidence for the stability of their Islamic financial system under different financial shocks. The central banks of the two countries have initiated strategic policies for Islamic finance growth and progress, besides a good regulatory and supervision environment was created.

For the Kingdom of Saudi Arabia, the results provide good evidence in favor of the stability of Islamic Financial system but it still needs some positive measures to help and strengthen its financial system. So, it is suggested that the government of the Kingdom of Saudi Arabia should initiate some steps to open its trade, along with increasing the financial market freedom.

7. CONCLUSIONS

In this paper, the results of the role of Islamic banking in the growth of the economies of selected countries of Gulf region have been discussed critically. Four countries of Gulf region namely United Arab Emirates (UAE), Qatar, Kingdom of Saudi Arabia and Bahrain were chosen for the study. The findings of the four countries are supporting the viewpoint that Islamic banking has a positive impact on the economy, due to its distinctive characteristics.

The results of causality support the supply-leading viewpoint that Islamic financial system has helped in the economic growth of these countries. Furthermore, the results show that there is no impact of the global financial crisis on the stability of Islamic banks of these countries. The results of United Arab Emirates are more promising compared to other countries. Overall, this study provides better evidence supporting the view that the Islamic financial development is an important determinant of economic growth in the selected countries of Gulf region.

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