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THE ROLE OF ISLAMIC FINANCIAL SYSTEM ACTIVITIES TOWARDS ECONOMIC GROWTH

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Abstract: *Finance has generally used various straits through which it affects economic growth. This study identified the main channels of Islamic financial development transmitting economic growth. The study also analysed the channels and showed how channels for determining economic growth are used by Islamic financial development. To do this, the study adopted a library research method. The study concludes that investment quantity or capital accumulation, and capital efficiency or capital productivity from Islamic financial activities are the main channels through which the Islamic financial system uses to increase economic activity in a country, and thus achieve economic growth. Consequently, the study suggested that Islamic financial institutions use the funds available to them wisely to finance potentially viable, short-term or long-term successful investments. The report also suggested that Islamic financial institutions have appropriate oversight and efficient capital and risk management.*

Keywords: *Islamic Financial Activities, Economic Growth, Capital Accumulation, Productivity of Capital*

Introduction

The growth accumulation, according to endogenous growth theories, is based on the quantification of the degree to which production differences are caused by the accumulation of physical and human capital and the extent to which they contribute to the effectiveness of capital use (Pagano, 1993). This led to a suitable investigative instrument to assess the effect on the successful main drivers of economic growth through physical accumulation of capital as well as resource production and investment productiveness, such as banks, government policy and financial deepening and development. (Romer 1996).

Capital accumulation can also be regarded as quantity of investment. Gurley and Shaw (1955) revealed that financial markets spur economic growth through physical capital accumulation enhancement. This assertion was also supported by the finding of Friedman and Schwartz (1969). Capital accumulation affects growth of an economy; it is through the increase in the capital formation resulting from the rise of investment expenditure, which would boost the

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output income and raise the GDP positively, and should be a negative effect in vice versa. The increase in capital is the outcome of the capital expansion

Efficiency of capital is also termed as quality of investment. Financial institutions eventually assign funding in order to achieve productivity to projects with the highest marginal value (Pagano 1993). Through information collection and processing, and then evaluation of alternative investment projects providing risk sharing and management, financial institutions increased capital productivity, thus encouraging economic growth. This means that financial institutions allow economic units to invest in a long-term high risk initiative that is, of course, highly productive (Abubakar, 2015). When the output of factor inputs, such as labour and capital, is increasing, productivity affects GDP. When the input factor increases, capital's marginal productivity increases. As capital's marginal productivity rises, more goods and services are produced in the economy and GDP thus increases. (Abubakar 2015). Moreover, total output decreases, which means dipping into GDP, when the factor inputs decline.

The accumulation of capital and productivity from financial sector traditionally determined growth. However, this assertion was evidently from the conventional financial activities. Islamic financial activities (IFS) can also determine growth through the same channels. The means by which individuals and corporations in the Islamic and non-Islamic world sources capital and participating in financial transactions, (through banks and other financial institutions) following Islamic principles or Islamic law (Shariah), is refers to what is called Islamic financial activities. Although it is the core of the system to prohibit the receipt and payment of interest. It is supported by other principles of Islamic teaching which promote rights and duties of people, property rights, and equitable distribution of wealth, share of risks, compliance with obligations and the sacredness of contracts (Haron and Wan Azmi 2009).

Research and studies in the past did not explore the connectivity between interest free-based financial activities and the growth of the economy and identified the channels through which the IFS activities is clearly towards economic growth. There is a need for a study to clarify it. Does Islamic financial activities affect growth through any channel? This is the main issue of concern. Even though past studies like that of Kassim (2016) and Gani (2015) empirically analysed the connectivity, but does not clearly identified the channels of transmitting growth. Thus, the main objective of this study is to sightsee the link between interest-free financial activities and the growth of an economy. It will also to demonstrate how Islamic financial system identified quality and quantity of investment as channels of determining growth. The study will furthermore cover all the activities of Islamic financial system and limits its scope on the channels through which IFS is gearing towards economic growth.

To achieve the stated objectives, this study adopted library research conceptual method to analyse the impending issues of the study. A library research can be employed at the times when a study is decided to be conducted on a kind of situation which is primarily grounded in theory. In other words, the study research question is literature-based and involves only a methodology of theoretical analysis requiring selection and discussion of descriptive materials as well as a comparative investigation of the targeted theories defining the issue under scrutiny. Under such circumstances, the objective is not to discover something about a specific phenomenon; rather, the study aims at reaching a judgement about the merit of main theories defining the related concept in order to understand it as one of the realities of the world.

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Naturally, the right thing to do here is a library-based or theoretical study. On this basis, it is appropriate to regard "library research" as a research methodology proper (Biria, 2017)

This study is in four different parts. It started with is the introduction and the background, the main issues and objectives were stated. The review of the related concepts followed. The third part is the analysis of the link connecting Islamic financial system activities and growth. It also demonstrates how Islamic finance determine growth. The conclusion with suggestions recommendations is the last part.

Conceptual and Theoretical Review

This part of the study reviewed concepts and theories that were directly related to the study. It highlights theories and also defined and explained the related concepts clearly for easy comprehension.

There are many theories that link financial activities with economic growth. The recent revival of research interest in the relationship between financial intermediation and growth has mainly limited insights and techniques from the endogenous growth model. This shows that self-sustaining development in relation to economic choice, technological level, income distribution, and structural arrangement of institutions such as financial institutions, can occur without exogenous technical progress (Romer, 2006). Therefore, before the emergence of endogenous models, capital and labour were the only two components of production in the conventional growth models that dominated literature. In this sense, the concept of capital is restricted to physical and financial capital, while human capital does not play a role (Sinha and Macri 2001) Thus, de Gregorio (1996) and Mankiw et.al (1992) aggregate productions function is another endogenous model of growth that reflects financials role in growth. This research also highlighted the endogenous theory of growth model of AK which express the role of financial activities towards economic growth. In the AK model, aggregate output is a linear function of the overall capital stock (Aziakpono 2003). It is written as: Yt= AKt (Total output is Yt and Total capital stock is Kt). The model assumes that the population is constant and that only one commodity produced for consumption and investment within the economy. When investments are made in products, there shall be a tendency of depreciation to take place for a specified period of time (Pagano, 1993).

The concepts that were directly related to this study comprise but not limited to the following:

Finance

Finance is an economic division devoted to the distribution and management of resources and acquisitions and investment expenditure as well. Money and market issues are covered in finance. Finance is defined as an institutional set of for fund management activities. The decision to raise the funds and use them in particular is the main issue in finance. It is also an industry in which money and other assets are managed (Kettell, 2011).). The science and art of determining whether funds are used effectively by an organisation is regarded as finance. Business organisations can make decisions about their funding sources, revenues, expenditures and investments through financial analysis in order to compete with other businesses (OECD, 2004).

Kettell (2011) Explains that "exchange" is a concept that can easily replace finance. Finance is just an exchange of available resources. It's not only money exchange and money management

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that is about finance. Another type finance is a barter system of trade. Therefore, finance is an art to manage various resources available, including capital, properties, investments and securities. The main features of finance according to Kettel (2011) are the investment and profitable opportunities, the optimal combination of the fund, the internal control and the decision-making for future. Now finance is divided up into two, Islamic finance (without interest, uncertainty and gambling) and conventional or traditional finance.

Financial sector/ system

According to OECD (2004) the financial system is a structure consisting of institutional units and markets that interact to finance investment and promote the financing of commercial activity in a sophisticated way. It can also be described as a group of economic institutions which help to match the savings of a person with the investment of another person. Financial intermediation is the principal role of financial institutions in the economy. Financial intermediation includes channelling the funds of investors to creditors through institutional intermediaries. (OECD 2004). This means to intermediate between those with surplus fund and ready to offer it to those in deficit and ready to accept fund for investments; it usually involves the transformation and management of risks. Financial system transactions thrive on the willingness of financial institutions to mediate their money at relatively high interest rates while keeping it on deposit at relatively low interest rates. Financial intermediation is usually carried out by the institutions within the financial sector.

Based on traditional settings of financial intermediation, there are two categories of financial institutions: depository bodies including banks and non-depository bodies, such as capital market, equity and insurance companies. The banks receive surplus funds as deposits from the individuals and institutions, and allocate them to deficit side as loans, whereas the capital market as a non-depository entity is an institution where the deficit side (companies) brought and makes available equities and debt for surplus entities (e.g. individuals, institutional investors, etc).

Nevertheless, there is an increasing interest, particularly in the Muslim world, in recent times in finding an alternative financial intermediation, as the traditional financial intermediaries are focused on interest, while prohibition of usury or interest in Islam is clearly outlined in the holy Quran (Hallaq 2009). Therefore, the alternative was Islamic financial intermediation. Islamic financial intermediaries such as traditional financial institutions are operated by Islamic financial institutions. It was also divided into depository (banks) and non-depository (market) institutions. The Islamic banks are operating as depository bodies, which play the roles of intermediate institution based on profit and lost sharing; which means that investment loans are not issued, they are the financing of investments and the supplying capital for investments while sharing profit or losses. As a non-depositary body, the capital market provides marketable profit and loss mutual equity and debt financial products that bridge the gap between the surplus side and the deficit side of the economy. (Haron and Wan Azmi 2009).

Banking Sector/System:

The banking sector is an economical industrial subsector. It is the business and economic section devoted to the holding of other people's financial assets. The industry is using these financial assets as a lever for wealth creation (Investopedia, 2018). It is also known as a network of institutions and regulations offering a wide range of financial services. Banking requires institutions in its setup that kept money for customers and makes payments on demand to the consumer and also to the third party on behalf of the customer. Another primary function of the banking system is to provide loans for companies and individuals. Certain services that banks offer include investment coverage and insurance. Two different types of banking exist, interest-based traditional banking (conventional) and interest-free (Islamic) banking. Conventional banks basically require the payment and receipt of interest on deposits and loans, whereas Islamic banks is where profit and loss are shared, it is a trade-based entity. Such operations are governed by legislation and public authorities such as central banks of each nation (Farlex, 2017).

Financial market:

A financial market is a medium in which buyers and sellers sell and buy financial products, such as equities, mutual funds, stocks, bonds, derivatives, foreign exchange, commodities, debenture bonds and so on. It can be described as a place where people and businesses engage in many different financial transactions (MSG, 2018). The financial market is a structured global framework or system for financial assets development and trade. Financial market is considered as a market in which traders purchase and sell assets. It is markets in which businesses raise cash to expand. This is where firms reduce risk and investors are making money. (Amadeo, 2019). It could be a physical location or a virtual location across a network (e.g. the Internet). Individuals or firms in possession of a particular asset or security and want to dispose (the supply or deficit side) interrelate with firms or individual investors that are willing to acquire it (the demand or surplus side). Changes in the market forces determine prices in this particular market. If market demand is high, market supply changes lead to market prices decreasing and vice versa. If supply on the market remains stable, demand would lead to market prices increasing and vice versa (Andrew, 2019). Islamic financial market also exists the same as in other financial institutions.

Capital market

The capital or stock market is also a market in which people invest for a longer period, which is over a year. Different financial institutions raise and invest money from individuals on the capital market for a longer period. In fact, the stock market is split into the primary and secondary markets. A primary market is a segment of the market in the form of IPOs (Initial Public Offering), where different companies issued new stocks, shares and bonds to investors. The primary market is a market form in which stocks and securities are first issued by organisations. Whereas secondary markets are a kind of capital markets in which previously issued stocks and shares are bought and sold (MSG, 2018). Capital markets are also split in two. It consist Islamic capital markets and traditional conventional capital markets. The Islamic capital market is a type of market that transacts interest-free security transactions and it is based on the provisions of the Islamic Shariah. The market is divided in Islamic bonds, Sukuk markets, equities stock markets and derivatives products market. There are also a primary and secondary market in Islamic capital market.

Capital accumulation

The accumulation of capital is the mechanism by which additional capital resources used in the production process. It refers to as the quantity of investment. In order to overcome capital depreciation, capital accumulation will need to surpass the amount of money needed. Depreciation is wearing and tearing out of capital, so capital investment is essential to overawed it (Pettinger 2012). The accumulation of capital includes additional capital acquisitions. When the corporation secures more assets, the accumulation of capital happened. The assets can be

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cash, physical or immaterial. In any situation, the role of assets are to generate flow of income in form revenue and profits. Institutions and organisations accumulates assets from different sources or ways; it can be acquired through buying up of additional firm together with its assets, issue stocks and bonds, ploughing profits, among others. Accumulation of capital is an indicator or a preparation for growth in a particular enterprises and organisations; it is a signal of interest for investors willing to buy or become part of the management.

Productivity of capital:

Generally speaking, productivity is an average measure of production efficiency. It can be expressed as the output-to-input ratio utilised in the process of production, which is output per input unit. Total productivity can therefore be defined as a situation when the productivity measure includes all outputs and inputs. The total productivity metric is expressed as economic values of the outputs and inputs. The difference between the output and the value of the input is what determines the income generated in the process of production. Capital Productivity is a measure of the overall output, and thus the target to be maximized during the production process. Productivity measurements using one or more inputs or variables but not all are known as partial productivities. Productivity of capital is the capital effectiveness, it is where an enterprise is efficient, successful and productive. Productivity of capital is an important factor in clarifying material living standards and is the subject of deciding the rates of return. (Sinha, 2016).

Economic Growth

Growth is best defined in an economic sense as a long-term expansion of the economic productive potentials. An increased employment rate and higher living standards will result in sustainable economic growth. The annual percentage change in actual gross domestic product (GDP) measures short-term growth. Growth also means a significant change in production level of goods and services within an economy over a certain period (Financial Times, 2014).

Growth of an economy is split into nominal and real or actual growth. Nominal growth includes inflation, while real growth is nominal growth less inflation. In general, economic growth benefits from technological innovation and external positive factors. In other words, the ability to create goods and services can also be described as economic growth. It means a more productive economy, but this doesn't necessarily mean a growth. This form of growth is triggered by proliferation of people and resources as well as modern technology. (Van Den Berg 2016).

For order of an economy to attain development, therefore, growth is required. In other words, it is difficult without growth to achieve economic development. However, even without development, growth is achieved because it results in an increase of the gross national product (GNP) of an economy as it has no other configuration. Development can be viewed as a process or phenomenon which is multi-dimensional. Development can be achieved when GNP increases above the increase in per capita income. It could also be an indicator of economic growth if population conditions are changed.

An Analysis of the Channels for Transmitting Economic Growth by Islamic Financial Development (IFD)

The Islamic Financial Development (IFD) can also be related to growth and influences the growth based on Islamic financial deepening or Islamic Financial Intermediation activities (IFI activities). The financial system affects economic growth through two main channels: the capital accumulation and the capital productivity (Waheed and Yunous 2010). Capital accumulation or the quantity effect is an expansion in savings and capital investment, while capital productivity is an increase in productivity or efficiency, it is also referred to as the quality of investment. Therefore, the quantity effects or increases in investments (capital accumulation) and the quality effects or increases in the productivity / efficiency (capital productivity) are what this study identified as the channels and ways through which Islamic financial intermediations stimuluses the growth of an economy.

The capital accumulation or the quantity effect is when the surplus-side corporations and individual households deposited money in Islamic financial institutions. This improves the depth of Islamic finances. It can also be clarified as the liquidity of the banks rises when deposits are made into Islamic financial institutions as savings or investments. High liquidity in Islamic financial institutions means that capital and investment funds are available for deficit side of the economy. The investment level will rise naturally, money will be made available for capitalisation and more goods and services will be produced, and therefore, economic growth will be achieved.

The quality effects (efficiency) or increase in productivity is another channel of transmitting growth by Islamic financial intermediations or deepening to economic growth. It can be accomplished by gathering and analysing information about feasible, efficient and prolific investments that Islamic financial institutions need to fund. A screening and selecting of potential users of Islamic finance funds will then take effect, and then the prolific investments will funded as requested. The assessment will lead to distributive efficiency. Distributive efficiency will boost capital productivity for the economy as a whole and thus achieve economic growth.

Figure I explain the ties between Islamic financial intermediary and deepening (through the formation of capital and capital productivity) and economic growth. In the figure, the relation between Islamic financial development and economic growth is shown. Islamic financial development is influenced by Islamic banking capital accumulation and Islamic capital market capital accumulation. It happened when the Islamic financial activities took place through the halal banking activities and halal capital market financial intermediation. It means surplus fund are deposited into the Islamic banks or invested in Islamic capital market. The potential users of the deposited or invested fund can be selected through their proposals and applications by Islamic financial institutions. The Islamic financial institutions can then utilise the fund by financing selected feasible and viable projects and trade. This financing will increase the level of capital accumulation. When more capital accumulated, there is a high chance of establishing more enterprises in the economy, and it will increase the goods and services production level in the economy, henceforth attain growth. In other words, when there is an expansion in capital, more products will be created in the economy, and hence the growth of the economy will be stimulated.

Islamic financial intermediation can once again promote economic growth if there is an efficiency in production as a result of financial intermediation and deepening of Islamic banks and Islamic capital market. It occurs as a result of depositing or investing the surplus funds in the institutions. The Islamic financial institutions will then screen and select the viable business ideas that are bankable from deficit side of the economy. After the selection and screening, the distributive efficiency will make the viable and bankable proposals and application on productive venture to flourish. The distributive efficiency will also allow the unproductive venture to flop. It will lead to an upsurge in capital productivity that is more output be produced from less input. When there is an increase in capital productivity, more products will be created, thus, stimulates economic growth as a whole.

Furthermore, it can be said that financial deepening in Islamic financial sector increases the proportion of savings of the institutions and channelled it to investment through efficiency and bargain in the intermediation cost. The efficiency and cost reduction could affect the output growth, which will lead to the growth of the whole economy. However, Islamic financial activities can also affect savings by offering incentives for depositors in the form of a significant portion of profit and other financial additional financial services offering. It can also stimulate economic growth by increasing the marginal productivity value of capital, by tracking and assessing projects as well as by efficient risk management. This analysis in line and supports that of Waheed and Yunus (2010).

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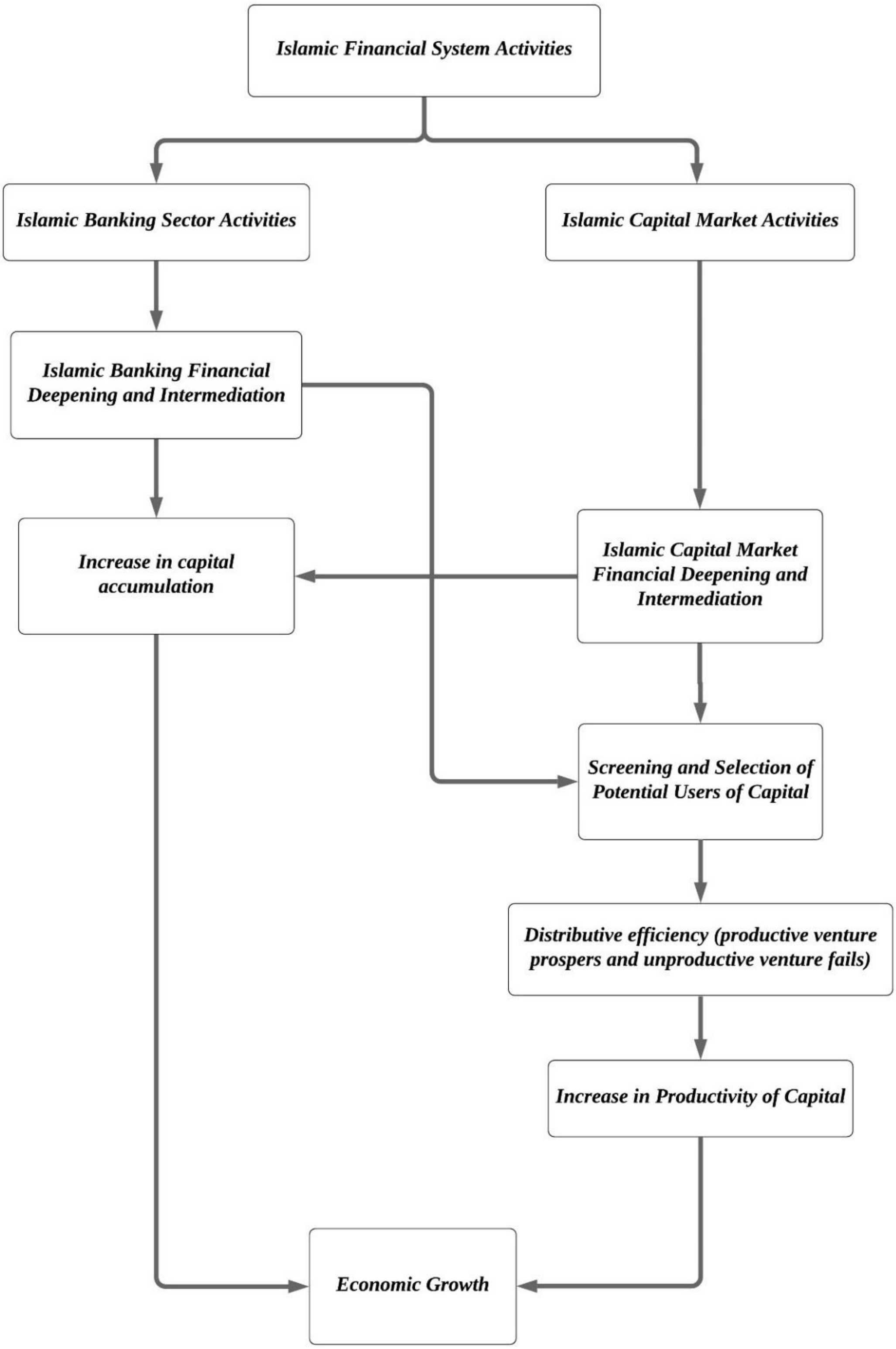

Figure I Islamic financial system development and economic growth link.

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Conclusion

The study analyses the channels which Islamic finance affected economic growth. It identified accumulation of capital and capital productivity as the main channels of which growth is transmitted. The study also demonstrated how the capital accumulation (investment quantity) and capital productivity (investment efficiency) served as those channels. This study concludes that more deposits and availability of funds in Islamic financial institutions means more chances of providing capital for investment, hence provides an avenue to produce more economic goods within the country. It further concluded that efficient utilisation of capital sourced from Islamic financial institutions will increase the production volume in the economy, thus, achieve growth. Therefore, investment quantity and capital efficiency from Islamic financial activities are the main straits through which Islamic financial system used in increasing economic activities within a country, which will lead to an increase in GDP, thus, achieving economic growth. The study recommended that Islamic financial institutions should utilise the fund available to them judiciously in financing investment that are potentially viable, be it short-run or long-run. It will provide an expansion in the production volume within the economy and achieve desired growth. The study furthermore recommended proper supervision and effective capital and risk management. It will ensure efficient production and lead to an expansion in the economy's production volume, which can bring an economic growth. Additionally, another channel that may spur long-term growth is through levitation of human capital, and it can be made by simple and easy financial operation and eliminate all constraints and limitations. The ratio between physical and human capital can also be manipulated. The human capital channel was not discussed in this study, it therefore been recommended for further study.

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