# ISLAMIC FINANCE IN PROMOTING ECONOMIC GROWTH IN NIGERIA

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**ABSTRACT**

*Islamic finance has become an increasingly integral part of the global financial system and gradually growing and having attention of the global financial system. The development of Islamic finance in Nigeria, as a recent phenomenon, the paper investigates the contribution of Islamic finance towards the growth of Nigeria economy. Series of data from 2012-2015 was used on annually basis for Gross Domestic Product and Trade as explanatory variable while IBFinancing used to measure the relationship between the country's economic growth, for the analysis, granger causality and ordinary least square (OLS) tests were used. The findings results show that there is a strong positive relationship between Islamic bank's financing and economic growth in Nigeria, which reinforces the idea that a well-functioning banking system promotes economic growth. Furthermore, the causal relationship happens only in both directions that form Islamic bank's financing to economic growth. The paper recommend the standard and codes application of Islamic finance, develop Shari'ah compliant money market and capital market development for the Islamic finance to fulfill its mandate.*

Key words: Islamic finance, Economic Growth, financial institution in Nigeria

## Introduction

Islamic financial service industries have made up significant growth all over the world, during the last four decades, it has grown from a small entity to mainstream financial intermediaries system, and it is often called a financial service which enhances the growth in assets size, geographical spread and overall development of both the institutions and financial regulators. The industry has been quit innovative in introducing system of new assets classes and combining the progress of financial engineering, sound risk management principles at the ethical teachings of Islam and that establish itself as a resilient and viable financial system in contributing to overall growth and stability of the global financial system.

Islamic finance refers to as financial instruments based on Islamic principles and structure, the Muslims transaction structure against payment of interest, gambling and speculation (Tabash and Dhankar, 2014). It can also be defined as the structuring of financial services in accordance with Muslim tradition (Kamar, Norat, Pinon, Prasad, Towe, Zeidaine and IMF staff team, 2015). This rules and practices emanated from the primary and secondary Islamic law that contains consensus of school of thoughts such as deductive reasoning and personal reasoning after the Qur'an and Hadith. The Shariah prohibit interest, Gharar (excessive uncertainty) and gambling in financing of prohibition activities that are considered harmful to the community or society.

According to the World Bank (2014), more than three hundred (300) financial intermediaries in fifty eight (58) countries exclusively adopted the practices of Islamic finance around the globe, the Islamic finance market and its Shariah compliance banks are repositioning their activities to maintain the position of being resilience in the world. Islamic finance industry has kept grown with an average of Compound Annual Growth Rate (CAGR) 29.9% annually as at December 2016, the assets are estimated to exceed US $900.

The contributions from Sub-saharan Africa particularly Nigeria remain low compared to the other regions around the globe. According to (World Population Prospectus) the populations of Nigeria is about 182 million people living in the country, with over 50% of the population being Muslims, thus contributed and impacted on the growth of the Nigerian economy.

Islamic financial services in Nigeria consists of Islamic banking, Islamic insurance (Takaful) and Islamic bond (Sukuk) was recently launched in sub-sahara Africa in Osun State of Nigeria. The Osun State government in Nigeria through Special Purpose Company (SPC) issued the first Islamic bond (Sukuk) in October, 2013. That worth ($70.6 Million) equivalent (₦11.4 billion) 60 billion Debt Issuance programme to establish two (2) elementary schools, two (2) middle schools and twenty (20) high schools, which was issued at the rate of 14.75% per annum and matures on 8$^{th}$ October, 2020 (Oladunjoye, 2014). Many researchers justified that the development of Islamic financial system plays a significant role in an economy that leads to the assessment of efficiency and closely merged to economic growth such as Iqbal (1997) Farqan and Mulyany (2009) Abuh and Chowdury (2012) which centered to Gulf and Asia countries. The paper investigates the significant relationship between Islamic finance and Nigerian's economic growth. Islamic finance institutions have direct connection with economic growth that been classified into financial development enhance economic growth and causality between finance and growth.

## Literature Review

The relationship between economic growth, financial intermediaries and financial development has been a debated issues whether financial sectors is contributing to the growth of economic development. Patrick (1966) contributed to the literature by indicating two parties in the causal relationship between economic growth and financial development that is to indicate the demand-following creation of modern financial institutions, which resulted in the financial assets and liabilities demanded by investors' saver in the real economy. The method employs that financial system can sustain a leading sector for the growth of economy. Gold Smith (1969) and Gurley and Shaw (1955) have rejected the claim and instigate that the developed financial market enhanced the economic growth by facilitating savings mobilization and investment. Romea-Avila (2007) confirmed the positive repercussion on finance and growth. He further examined the relationship between economy and growth, with emphasis on deregulation of finance and harmonization of banking law on economic growth. The results revealed that the financial institutions impacts positively on the growth of economy in the European Union. Fase and Abama (2003) argued that the expansion of financial system has a positive impact on financial development, that could act as supply leading and resources transfer from the traditional system. Inviting low-growth sector to participate, promote and stimulate the modern high-growth economy system.

According to Imam (2010), Shariah law is been proactive items of protecting right of property in providing solid form of operation which bank can operate, regardless of country's legal system, moreover, Islamic banks cohere with both man made law and Shariah law which conventional banks can operate within by signifies the importance of economic growth.
Bagehot (1873), argue that the conventional financial system that excel based on creditworthy and pooling risk accelerate economic growth. Stiglitz and Weiss (1981), indicate that conventional banks must classify under imperfect information or moral hazard in borrower-lender relationship by transferring potential risk of information asymmetry to borrowers through higher interest rate. Although Islamic bank provide the solution of imperfect information between lender-borrower by providing profit and loss sharing as an alternative system of incentivizes financing. Siddiqi (1999) agreed that funds allocated to projects are more innovative and expected better results and incentivizes banks to public or private borrowers.
Hasan and Dridi (2010) agreed that Islamic banking system increase stability and stimulating economic growth that in line with Shariah-compliant and promote entrepreneurs based on profit loss sharing.

Furqani and Mulyan (2009), investigated the brought interaction between Malaysia's Islamic banking and the economic growth of the country by employing the Vector Error Correction Model (VECM) to understand whether the system influences the growth of the system. They used times series and Gross Fixed Capital Formation (GFCF) for the analysis the trade and activities to represent real economic sectors. The findings revealed that in the long-run there is evidence of relationship between Gross Fixed Capital Formation and Islamic bank to support the demand of increase Gross Domestic Product causes by enhancing development of Islamic banks.

Farahani, Sadr and Hossein (2012) examines the relationship between short-run and long-run of Islamic banking and economic growth in Indonesia and Iran, based on integration Autoregressive Distributed Lag(ADL) and error correlation models. The findings indicated the relationship between Islamic finance and economic growth based on short-run and long-run, Islamic banks' financing with economic growth are positively correlated with capital accumulation of the countries. Apparently, the results concludes that improvement in the Islamic financial system in Iran and Indonesia may enhance the development and the economic welfare of the both countries

Dhankar and Tabash (2014) examine the contribution of Islamic finance towards the economic growth of the United Arab Emirates (UAE) specifically the relationship between the two. Time series data was used from 1990-2010. The Islamic financing credited the private sector through a proxy modes of financing, Foreign Direct Investment (FDI), Gross Fixed Capital Formation (GFCF) and Gross Domestic Product (GDP) were also used as proxies for the real economic growth. Granger Causality test, Co-integration test and Unit-root test were adopted. The empirical findings revealed that there is positive relationship between Islamic banks' financing and UAE economic growth, waking up and well-functioning banking system enhance the economic growth, which resulted to indicate causal relationship happens only in a single direction which promotes or supported the theory of Schumpeter's (supply-leading theory). However, the results showed that Islamic finance has immensely contributed to the development of investment and attracted Foreign Direct Investment (FDI) inflow in UAE.

Abusabha and Masound (2014) examines empirically into the applauded role played by financial market in leading growth with evidence from the Middle East and North Africa (MENA) Islamic finance. The research employs econometrics techniques that consists co-integration test, unit-root test, ARDL Granger causality that consists the Middle East and North Africa data period of 2000-2014. Empirical findings showed that both co-integration and granger test support a long and short term with positive relationship between economic growth and Islamic finance, higher development in Islamic finance banking the real the economic growth.

**Methodology**

The study discuss the approaches used of both quantitative and qualitative demission that is to show the role and effect of the Islamic finance in enhancing the economic growth, by adopting the descriptive statistics in analyzing the data, similarly, the mean sample, maximum, minimum and standard deviation were also considered. Time series from 2013-first quarter 2017 that has been considered due to the limited data on Islamic finance which is a new field. Some data was extracted from Bureau of statistics and Central Bank of Nigeria (CBN) website, other sources such as Journals, Textbook and Magazine etc. The Granger causality and Ordinary Least Square model are noted in the relationship between the two variables which does not involve causation. However, the model specification is diagrammatic representation of an economic growth phenomenon which indirectly described the huge number of population that is in line with abstraction from reliable source. Based on the data available, the period used from 2012 to first quarter 2017 of the time series is to investigate the relationship between the Islamic banks' Assets financing and Nigerian GDP from the time Islamic banking took up in Nigeria.

**Models Specification Used In the Analysis**

Consider a multiple regression model with two explanatory variables $X_1$ and $X_2$ and dependent variable Y. therefore have a model:

**Ordinary Least Square**

$Y_i = \alpha + ß_1 X_1 + ß_2 X_{2i} + u_i$

**Granger Causality**

$y(t) = \sum \alpha_i \, y\,(t-i) + c_1 + v_1(t)$

$i=1$

$x(t) = \sum \alpha_i \, x\,(t-i) + c_1 + u_1(t)$

$i=1$

The time series Y (IBFinancing) granger causes time series X (GDP), the patterns in X are approximately repeated in Y after some time lag (means two variables are been repeated and indicated the position of each variables) thus, past values of X can be used for the prediction of future values of Y, the data shows by how much the value of independent variable changes if the value of dependent variable changes even by unit. The Granger causality test is a statistical hypothesis and that can be shown through analyzing series of t-test and that provide significant information for determining whether one time series in future forecasting another first proposed value. However, the Ordinary Least Square test used to indicates the granger causality results, interestingly, that would suggest another liming run relationship between variables at the expected significant level.

**IBF** : Non interest banking system that consistent with Shari'ah compliance such as (Musharaka, Mudaraba, Murabaha, Ijara, Istisna and Tawaruq etc.)

**GDP** : Gross domestic product is a common statistical measure the income level or value of economy in a country within a given period of time.

**TRADE** : Net trade

The first part of the study is to define the relationship between Islamic finance and economic growth, the above model was used, for a correct evaluation, time series, OLS and co-integration were used to analysed and maximize the likelihood test performed to determine the number of co-integration vector (Johansen, 1988) for granger causality to test the causality between Islamic bank financing and economic growth.

**Results and Findings**

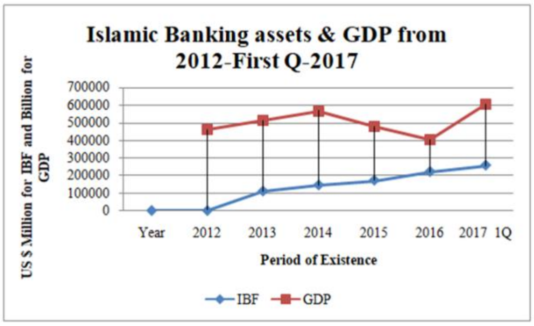
Table 1 below presents the statistic summary of the used variables in the Nigerian econometric analysis. Subsequently, the figure identify the relationship between the IBF and Nigerian GDP

**Table 1 Statistics (US $ Dollar)**

| ***STATISTICS*** | ***IBF*** | ***GDP*** | ***Trade*** |
|---|---|---|---|
| Mean | 162,255 | 486,000 | 30,915,420 |
| Maximum | 220,979 | 568,000 | 21,880,800 |
| Minimum | 110,835 | 405,000 | 40,776,250 |
| Std. Dev. | 89355 | 60,778 | 4,071,692 |
| **Observations** | **6** | **6** | **5** |

**Source: Computed by Authors**

**Figure 1**




The table1 indicates that the maximum value for IBF in Nigeria in 2012 was at its infant stage of establishing and that reached in 2013 to 220,979.00 from minimum of 110,835.00 with standard deviation 89355. The maximum value for GDP 2012 reached 568,000.00 from 405,000 billion of GDP in 2012 with standard deviation of 60,778.00. The regression indicated the relation coefficient between the IBF and GDP expect in some cases of the year 2015 and 2016 where IBF increases in assets and the GDP fall with less than 500 billion in 2015 and less than 400 billion in 2016. The IBF assets continue growing in 2017 whereby the GDP appeared with positive sign of growth with 568 billion at first quarter of 2017 as indicated in figure 1.

**Table 2 Johansen's test Granger Causality Test**

| Null Hypothesis | F-Statistic | Probability | Remarks |
|---|---|---|---|
| IBF does not Granger Cause GDP | 1.52209 | 0.32802 | Reject Ho |
| GDP does not Granger Cause IBF | 0.65698 | 0.67197 | Reject Ho |
| Trade does not Granger Cause GDP | 0.15855 | 0.94893 | Reject Ho |
| IBF does not Granger Cause Trade | 11.7556 | 0.01747 | Accept Ho |

**Source: Computedby Authors**

The granger causality constructed under null hypothesis as indicated from. The table above shows that there is causal relationship between Islamic Bank's Financing and Gross Domestic Products. However, the results indicates two ways of causality exist from the both Islamic Banking and Economy Growth in the country despite the smallest probability value 0.32802 and 0.67197 at the greater than 5%, so the alternative hypothesis is accepted and reject the null hypothesis that would analysed that the Islamic banking is receiving the momentum development. Furthermore, the results further indicate that there is a unidirectional causality between the trade and GDP, but refuted to justified the causality between IBF and trade with probability of 0.01747 which clearly stated that the level of significant at 5%level, as (0.05106) and (0.01747) less than 5%. IBF granger causes of development of GDP and promotes the economic growth despite the level of development is at slightest level of 0.32802 that is to say the higher flow forecast of Islamic finance and its development in the country would led to the growth of country's economy.

Table 3

Ordinary Least Squares

| Country | Variable | t-statistic | p-value |
|---|---|---|---|
| Nigeria | IBFinancing | -7.4571 | 0.16955 |
| | GDP | 0.57552 | 0.59576 |
| | Trade | 1.83369 | 0.16406 |

.05 p≤

**Source: Computed by Authors**

The results of the above OLS indicates the respective relation between the IBFinancing, GDP trade, the absolute value to be considered of OLS significance at level of less <0.05% which confirmed by the P-value, therefore, reject null hypothesis and accept alternative hypothesis. From the figures given above the IBfinancing with GDP currently being moving in same direction with IBF, despite there is no huge gap between the figures provided for GDP compire with IBF as indicated t-test is negative -7.4571 with greater p-value of 0.16955 greater > 0.05 at same with GDP Hence, the failure to reject the alternative hypothesis indicates that the two series are stationary.

**Conclusion**

The paper investigated the relationship between the contemporary Islamic finance and Economic growth, the research employs the Johansen Test of Co-integration test and to granger causality test, while empirical analysis was used and determined the relationship. The results indicate a long run relationship despite the result is not strong enough to compare to the Nigerian GDP that would impact positive relationship in the economic growth. Furthermore, the results indicate the granger causality test of IBFinancing does not granger relation with trade, which accept the null hypothesis as indicated. Apparently, the evidence shows that all the variables GDP and trade are significant variables even throughout the trade accept the null hypothesis but reject the null hypothesis in OLS table as indicated above. The paper finds out that the existing bi-directional causality between Islamic bank financing and Nigerian GDP. The findings show that the improvement in Islamic finance in Nigeria will enhance the development in long run growth and economic welfare and reduction of poverty in the country. Furthermore, the results indicate the causality relationship with low level of causality and that cause, due to the pioneering stage of Islamic finance in the country.

**Recommendations**

i) The standards and codes for applying Islamic finance should be defined to ensure consistent financial deepening and application nationally and internationally

ii) Develop *Shariah* compliant money market that will allow Islamic banks to manage their liquidity effectively to free resources and handle other growth enhancing projects.

iii) Institutional, tax and legal reforms should be undertaken in both the capital and money markets to help Islamic finance fulfill it mandates or targets

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