

Assessing the efficiency of Islamic banks in achieving Economic growth - al Salam Bank of Algeria as a model -

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Received date : 03-04-2024, Accepted date : 05-05-2024, Publication date:02-06-2024

Abstract:

Several papers have been written by researchers about how the banking industry affects GDP, but the impact of this on Algeria's economic growth has not received much attention.

This study investigates the efficiency of Islamic banking (AL SALAM Bank of Algeria in order to achieve economic growth in Algeria, we need to use annual time series data covering the period from 2016 to 2022. Private sector financing from AL SALAM Bank as an indicator for Islamic bank financing; GDP as a proxy for economic growth. The Ordinary least square technique (OLS) is applied to examine this link.

The results validate that AL SALAM Bank financing has a positive significant effect on GDP in Algeria, which supports the Schumpeter's supply-leading hypothesis.

Keywords: Islamic Bank financing, Economic Growth, Algeria, Schumpeter hypothesis, OLS

Jel Classification Codes : G 21, O40, B10, C30.

Introduction:

Islamic banking has become one of the fastest-growing sectors in the last decade, particularly after the global financial crisis in 2008. Through 2022, the assets of the global Islamic finance sector are projected to have grown by 11% to USD 4.5 trillion., with Islamic banks holding 72% of the total assets of this industry. Forecasts indicate that the industry will grow to approximately USD 6.7 trillion by 2027. (Islamic finance development Report, 2023)²

In fact, the emergence of Islamic banking has been an interesting topic due to the unexpectedly high development and growth rate. These observations motivated the researchers to investigate the relationship between the Islamic financial system and economic growth.

For instance, following the seminal work and subsequent studies by Schumpeter (1911), Goldsmith (1969), and Levine (2005) ...etc, extensive research in the

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financial economic field has put attention on the connection between GDP along with Islamic banking.

These differing viewpoints regarding the connection between Islamic finance and GDP growth, as well as the limited research on this link in Algeria, pushes us to verify this relationship in Algeria, particularly following the recent events in Algerian economy, and issuance of regulation No 20-03.

Therefore, the question of this research is: **to what do extent Al Salam Bank contribute economic growth in Algeria?**

1. Theoretical background & Literature Review:

Regarding the theoretical relationship between the financial sector and economic growth, economists take varying stances., there are three trends in the literature of this relationship, this part presents the studies that illustrate this controversy in the direction of the relationship between the two variables.

1.1. Banks and economic development:

Several studies have attempted to establish the causal relationship between the financial sector and economic growth (Schumpeter, 1911)³, (Goldsmith, 1970)⁴, (Mc Kinnon, 1973)⁵, (Beck & Levine, 2004)⁶; (Levin, 2005)⁷, (Beck & Demirguc-Kunt, 2006)⁸. The supply-leading hypothesis assumes that the creation of financial

³ Schumpeter, J. (1911). The Theory of Economic Development. Cambridge : Harvard University Press.

⁴ Goldsmith, R. (1970). Financial Structure and Development. The Economic Journal, 80(318), pp. 365-367.

⁵ Mc Kinnon, R. (1973). Money and Capital in Economic Development. Washington: DC: Brookings Institution.

⁶ Beck, T., & Levine, R. (2004). Stock Markets, Banks and Growth: PANEL evidence. Journal of Banking and Finance, 28, pp. 423-442.

⁷ Levin, R. (2005). Finance and Growth: Theory and Evidence. IN handbook of Economic Growth, pp. 865-934.

⁸ Beck, T., & Demirguc-Kunt, A. (2006). Small and Medium-size enterprises: Access to Finance as a Growth Constraint. Journal of Banking & Finance, 30(11), pp. 2931-2943.

institutions and markets increases the supply of financial services and thus leads to real economic growth. (Calderon & Liu, 2003)⁹ conversely, (Robinson, 1952)¹⁰; (Singh, 1997)¹¹; (Stern, 1989)¹²; (Odhiambo, 2008)¹³; (Beck and Levine, 2000)¹⁴; (Nazlioglu, Ege, & Bayrakdaroglu, 2009)¹⁵; (Ductor & Grechyna, 2015)¹⁶, contend that finance doesn't have a causal impact on economic growth. Rather, they think that because there's more demand for financial services, banking and economic growth have been linked together. (Demand leading causality pattern). (Bm & Uddin, 2016)¹⁷ However, there are also economists such as (Hugh T, 1966)¹⁸; (Odedokun, 1992)¹⁹; (Demetriades & Hussain, 1996)²⁰; (Wood, 1993)²¹; (Akinboade, 1998)²²; (Greenwood & Bruce, 1997)²³; (Luintel & Khan, 1999)²⁴; (Shan & Qi, 2006)²⁵; (Akinlo &

⁹ Calderon, C., & Liu, L. (2003, October). the direction of causality between financial development and economic growth. *Journal of Development Economics*, p. 322.

¹⁰ Robinson, J. (1952). *The Generalisation of the General Theory and other Essays*. London : The MC Millan Press Ltd.

¹¹ Singh, A. (1997). Financial Liberalization, stock markets and economic development. *The Economic Journal*, 107.

¹² Stern, N. (1989). *The Economics of Development: a survey*. the *Economic Journal*.

¹³ Odhiambo, N. (2008). Financial Depth, Savings and Economic Growth in Kenya: A Dynamic Causality Linkage. *Economic Modeling*, 25, pp. 320-325.

¹⁴ Beck, T., & Levine, R. (2000). Finance and the Sources of Growth. *Journal of Financial Economics*, 58, pp. 261-300.

¹⁵ Nazlioglu, S., Ege, I., & Bayrakdaroglu, A. (2009). Financial Development and Economic Growth: Cointegration and Causality Analysis for Turkey. *Banking Finance Letters*, 01, pp. 59-66.

¹⁶ Ductor, L., & Grechyna, D. (2015). Financial development, real sector and economic growth. *International Review of Economics & Finance*, 37, pp. 393-405.

¹⁷ Bm, H., & Uddin, M. (2016, Jun 07). does Islamic bank financing lead to the economic growth? an empirical analysis for Malaysia. *MPRA*, p. 6.

¹⁸ Hugh T, P. (1966). Financial Development and Economic Growth in Underdeveloped countries. *Economic Development Cultural Change*, 14(1), pp. 174-189.

¹⁹ Odedokun, M. (1992). Supply-Leading and Demand- Following relationship between Economic Activity and Development Banking in Developing countries: An Empirical Analysis. *Singapore Economic Review*, 37, pp. 46-58.

²⁰ Demetriades, P., & Hussain, K. (1996). Does Financial Development Cause Economic Growth? time series evidence from 16 countries. *Journal of Development Economics*, 51, pp. 387-411.

²¹ Wood, A. (1993). Financial Development and Economic Growth in Barbados: a causal evidence. *Savings and Development*, 17, pp. 379-380.

²² Akinboade, O. (1998). Financial Development and Economic Growth in Botswana: a test for causality. *Savings and Development*, 22, pp. 331-348.

²³ Greenwood, J., & Bruce, S. (1997). Financial Markets in Development and the Development of Financial Markets. *Journal of Dynamic and Control*, 21, pp. 145-181.

²⁴ Luintel, K., & Khan, M. (1999). A Quantitative Reassessment of the Finance- Growth nexus: evidence from a multivariate VAR. *Journal of Development Economics*, 60, pp. 381-405.

²⁵ Shan, J., & Qi, J. (2006). Does Financial Development Lead Economic Growth? the case of China. *Annals Of Economics and Finance*, 7(1), pp. 197-216.

Egbetund, 2010)²⁶; (Ghirmai, 2004)²⁷; (Shahbaz & Leean, 2012)²⁸; (AbuBader & AbuQuarne, 2008)²⁹; identify that the financial sector and economic growth favour a bi-directional causality (two-way causality) (Pinshi & Anselme, 2020)³⁰

1.2. Islamic banking- economic development nexus:

There are a limited studies that have empirically investigated the correlation between the Islamic banking & the economic growth. The literature shows that the most researchers have used different proxies to represent Islamic banking.

(Furqani & Mulyany, 2009)³¹, were the pioneers of this topic in Malaysia. They used a quarterly data from 1997 to 2004. Their research revealed that Islamic banking is promoting economic growth and there is a significant long-run bi-directional link between Islamic finance & GDP per capita, fixed investment and trade. (Farahani, Yazdan, Sadr, & Hossein, 2012)³² and (Tajgardo, 2013)³³, also they used the credits of Islamic banking as a proxy for growth in the financial sector in twelve Asian countries, they discovered a strong bi-directional relationship among them. (Muhammad Abduh & Mohd Azmi Omar, 2012)³⁴ looked into the association, short-term as well as long-term, on the Indonesian GDP growth and Islamic banking, they used quarterly data (2003:1-2010:2). Using an ARDL model, GDP and GFCF factors serve as indicators of economic growth, and Islamic finance serves as a gauge of the expansion of the Islamic financial sector.. In the short and long terms, the study showed a strong bidirectional relationship between these variables.

²⁶ Akinlo, A., & Egbetunde, T. (2010). Financial Development and Economic Growth: the experience of 10 sub-Saharan African Countries revisited. *The Review of Finance and Banking*, 02, pp. 17-28.

²⁷ Ghirmay, T. (2004). Financial Development and Economic Growth in Sub Saharan African countries: evidence from time series analysis. *African Development Review*, 16, pp. 415-432.

²⁸ Shahbaz, M., & Lean, H. (2012). Does Financial Development Increase Energy Consumption? the role of industrialization and urbanization in Tunisia. *Energy Policy*, 40, pp. 473-479.

²⁹ Abu-Bader, S., & Abu-Qarn, A. (2008, September- October). Financial development and economic growth: The Egyptian experience. *Journal of Policy Modeling*, 30(5), p. 888.

³⁰ Pinshi, C., & Anselme, M. (2020, December). financial development an economic growth in the Democratic Republic of the Congo: supply leading or demand following, *Journal of Advanced Studies in Finance*, 11(2).

³¹ Furqani, H., & Mulyany, R. (2009). Islamic Banking and Economic Growth: Empirical Evidence from Malaysia. *Journal of Economic Cooperation and Development*, 30(2), pp. 59-74.

³² Farahani, G., Yazdan, Sadr, & Hossein, S. (2012). Analysis of Islamic Bank's Financing and Economic Growth: case study Iran and Indonesia. *Journal of Economic and Development*, 33(4), pp. 1-24.

³³ Tajgardo, G. (2013, April). Islamic Banking and Economic Growth: Evidence from Asia. *Journal of Modern Accounting and Auditing*, 9(4), pp. 542-546.

³⁴ Abduh Muhamad, & Mohd Azmi Omar, M. (2012). Islamic Banking and Economic Growth: The Indonesian Experience. *International Journal of Islamic and Middle Eastern Finance and Management*, 5(1), pp. 35-47.

(Ali Al- Oqool, Okab, & Bashayreh, 2014)³⁵ analysed this topic in the case of Jordan, they utilized the deposits & finance of Islamic banks as proxy of Islamic financial sector and RGDP as an indicator of economic growth over the period 1980-2012. The study's results show that there is a bidirectional long -run Granger causality between the variables.

(Ainatul & Salina, 2022)³⁶ have examined the linear correlation between Islamic banking & economic growth in Malaysian for the quarter of (2007:1-2019:4) using the ARDL technique of cointegration. The study proved that there was a positively negligible short-term connection among Islamic banking and economic growth. Meanwhile, the long-run link was positively significant (the supply-leading hypothesis).

According to the foregoing, even though prior research on Islamic banks and economic growth has not received much attention, especially in the context of Algeria's economy.

1.3. Islamic Banks in the Algerian economy:

Islamic finance has become more prevalent as a new source of finance in the Algerian economy, via the establishment of Al Salam Bank and Al Baraka Bank of Algeria.

Since then, Islamic finance in Algeria has continuously increased till 2018, when the Bank of Algeria formally released one essential regulation to manage the current banking system (Regulation No 18-02, 2018)³⁷.

Eventually, (Regulation No 20-03, 2020)³⁸ was promulgated, thereby abolishing the previous regime. It gave an attempt to pinpoint banking transactions related to Islamic banking and its guidelines for financial institutions, thereby opening the way for Islamic finance products of all kinds, whether through Islamic windows in traditional banks or the opening of new Islamic banks.

In 2022, the volume of Al Salam Bank asset's amounted to more than 1906 million dollars; with a volume of financing over than 1243 million dollars. (AL SALAM BANK, 2022)³⁹

2. Methodological aspects:

2.1. Study variables:

The relationship between Islamic banking and Algeria's economic growth is investigated in this study. The data used here are annual from 2016 to 2022. Two data sources—GDP and IBF (Islamic Bank Financing to the Private Sector)—were used due to the lack of information.

³⁵ Ali Al- Oqool, M., Okab, R., & Bashayreh, M. (2014). Financial Islamic Banking Development and Economic Growth: A case study of Jordan. (C. C. Education, Éd.) International Journal of Economics and Finance, 6(3), pp. 72-79.

³⁶ Ainatul, A., & Salina, K. (2022). Islamic Banking Sector Development and Economic Growth: Empirical Evidence from Malaysia. (T. I. Malaysia, Éd.) International Journal of Economics Management and Accounting, 30(2), pp. 451-480.

³⁷ Regulation No 18-02. (2018).

³⁸ Regulation No 20-03. (2020).

³⁹ Al Salam Bank Report (2022).

Table N° 01: An overview of variables & data sources

variables	Definition & unit	Data source
GDP	Gross Domestic product as a proxy for growth (dependent variable)	(World Bank, 2024) ⁴⁰
IBF Salam	Algerian Islamic bank (Al Salam Bank as a sample) funding to the private sector as an indicator for Islamic bank financing (independent variable)	(annual reports AL Salam Bank, 2016-2022).

Source: Author's Compilation

To measure the relationship between Islamic financing and economic growth in Algeria, we employ a simple regression equation (Ordinary Least Squares). All the time series are transformed into Logarithms.

The regression equation that incorporates logarithm is as follows:

$$LOG(GDP) = b_0 + b_1 LOG(IBF Al Salam) + \varepsilon_t$$

2.2. Results & Discussion:

2.2.1. Ordinary Least Squares (OLS):

OLS method is used to examine the nature & form among two or more variables.

⁴⁰ World Bank, Data. Consulted on 30 January 2024
<https://data.worldbank.org/indicator/NY.GDP.MKTP.CN?locations=DZ>

Table N° 02: The results of OLS

Dependent Variable: LGDP Method: Least Squares Date: 02/05/24 Time: 21:55 Sample: 2016 2022 Included observations: 7				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
LIBFSALAM	0.206490	0.064850	3.184111	0.0244
C	13.10213	1.174351	11.15691	0.0001
R-squared	0.669718	Mean dependent var		16.83963
Adjusted R-squared	0.603661	S.D. dependent var		0.151756
S.E. of regression	0.095539	Akaike info criterion		-1.623617
Sum squared resid	0.045638	Schwarz criterion		-1.639071
Log likelihood	7.682658	Hannan-Quinn criter.		-1.814628
F-statistic	10.13856	Durbin-Watson stat		1.431426
Prob(F-statistic)	0.024425			

Source: Outputs Eviews 12.

Based on the data in Table 02, the regression equation of the following standard model was reached:

$$\text{LGDP} = 0.206489615779 \cdot \text{LIBFSALAM} + 13.1021309594$$

From the results of the estimated model, we can draw the following:

- regarding the fixed limit value, the value of "t" as calculated is 11.16, which is higher than the value found in the table at the significant level 5%, also the fixed limit factor is significant (prob < 5%);
- These results suggested that IBF SALAM has a positive significant on GDP over the period 2016-2022; and that confirm the truth of the study's hypothesis;
- When the IBF SALAM rises by 1%, GDP rises by 0.2%. However, this positive effect is still weak due to a several factors, including the Algeria's recent entry into this industry;
- The value of R-squared is 0.66, which indicates that 66% of the changes in GDP are related to IBF SALAM, while the rest is related to other factors not included in the model;
- The value of the F-statistic is 10.13 with a probability value of 0.024, which is inferior to the significant value of 5%. Therefore, we accept the H1 (the model is significant).
- The test of Durbin-Watson statistics has a value of 2.13, which is superior to R-squared. This indicates that there is no problem of spurious regression among the model variables.

2.2.2. Breusch Godfrey correlation:

The Breusch-Godfrey test is a derivative of the Durbin-Watson test that notices higher-order serial associations. It entails including lagged residual values as additional explanatory factors in the regression equation and assessing their significance.

Table N° 03: Autocorrelation test results

Breusch-Godfrey Serial Correlation LM Test: Null hypothesis: No serial correlation at up to 2 lags			
F-statistic	5.237682	Prob. F(2,3)	0.1050
Obs*R-squared	5.441601	Prob. Chi-Square(2)	0.0658

Source: Outputs Eviews 12.

Based on the table 03, we conclude that; The value of F-statistical probability is 0.10, it is higher than 5%. However, we accept the H_0 , thus there exists no autocorrelation issue via the model.

2.2.3. Heteroskedasticity test

The following indicates how the test's estimation results are displayed:

Table N° 4: heterogeneity of variance test results

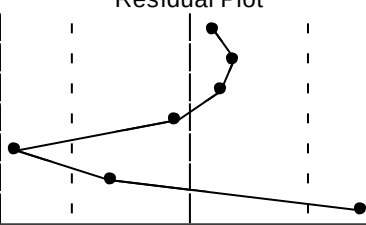
Heteroskedasticity Test: ARCH			
F-statistic	0.559556	Prob. F(2,2)	0.6412
Obs*R-squared	1.793960	Prob. Chi-Square(2)	0.4078

Source: Outputs Eviews 12.

Based on the table 04, we observe that the probability of ARCH test is $0.4 > 5\%$. This implies to accept the null hypothesis, so we conclude that the model is relatively free from heterogeneity of variation (constant variation).

2.2.4. Actual, fitted, Residual table:

Table N° 05: Actual, fitted, Residual table

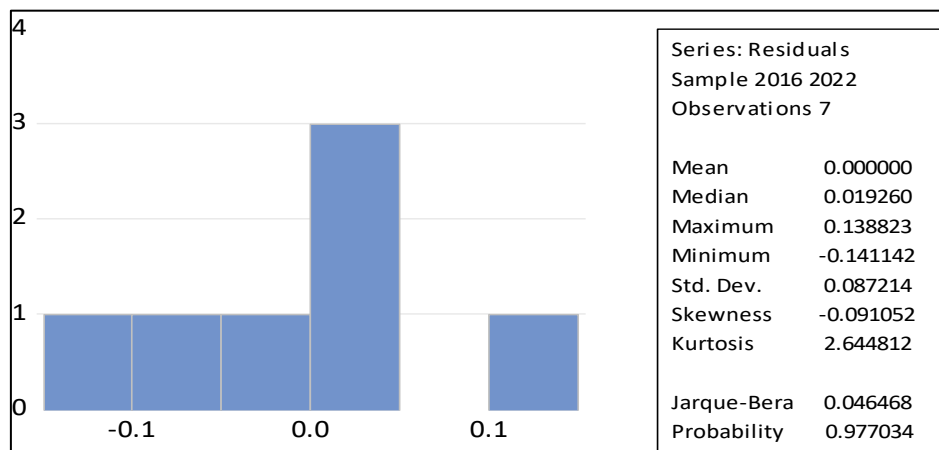
obs	Actual	Fitted	Residual	Residual Plot	
2016	16.6785...	16.6592...	0.01925...		
2017	16.7534...	16.7188...	0.03453...		
2018	16.8307...	16.8055...	0.02515...		
2019	16.8359...	16.8486...	-0.0126...		
2020	16.7320...	16.8731...	-0.1411...		
2021	16.9101...	16.9740...	-0.0639...		
2022	17.1365...	16.9977...	0.13882...		

Source: Outputs Eviews 12.

the table 05 and residual plot show the residual fluctuations during the time period, and it indicates some imbalances over the period 2020 – 2022, so that they are out of the way to move within it (due to a disruption in the economy).

2.2.5. Normality test

Figure 01: normality test outputs



Source: Outputs Eviews 12.

From the figure above, to determine whether the residuals are normally distributed, we apply the Jarque Bera test. The Jarque Bera statistical probability is higher than 5%. Therefore, we accept that the residuals are normally distributed.

Conclusion:

In order to reveal the existing relationship between Al Salam bank financing and economic growth in Algeria over the period 2016-2022, using the OLS technique. Estimating the regression equation revealed a statistically significant relationship between IBF ALSALAM and GDP, estimated at 0.2, which explains its low impact on growth.

Based on the results obtained through the study, the researcher suggests the following:

- Al SALAM Bank of Algeria requires more transparency in disclosing the financing formulas approved by it, which further helps in evaluating the development policies it aims to achieve;
- The necessity of activating an Islamic capital market in Algeria to complement the work of Algerian Islamic banks in order to further diversify in offering their products for subscription, which works to greater mobilization of financial resources and expand the scope of investment and thus achieve economic development in Algeria;
- The Algerian authority must integrate Islamic banks in Algeria, in preparing and implementing its economic development plan so that there is more integration and coordination in setting development goals and achieving them effectively.

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