# THE IMPACT OF ISLAMIC FINANCIAL DEVELOPMENT ON MALAYSIAN ECONOMIC GROWTH

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**2020**

# THE IMPACT OF ISLAMIC FINANCIAL DEVELOPMENT ON MALAYSIAN ECONOMIC GROWTH

**by**

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**A thesis submitted in fulfilment of the requirements for the degree of Doctor of Philosophy**

**June 2020**

## ACKNOWLEDGEMENT

In the name of Allah, the most gracious the most merciful. I am glad to see myself completing this research and completing my study as well. Praise be to Allah Master of the day of judgement, and his messenger Prophet Muhammad peace be upon him. My sincere and profound gratitude goes to my mentor (ex-supervisor) in the person of Associate Professor Dr Zakaria Bin Bahari for his untiring support, advice, guidance and his time giving to me during conducting and writing this research. He is more than a mentor to me but a father and a friend. My gratitude also goes to my humble supervisor Dr Azreen Hamiza Abdul Aziz, she is a pleasing person. I am highly grateful to ISDEV founder, the entire ISDEV USM lecturers and other ISDEV supporting staff, they are like family to me. I am especially thankful to director and deputy director ISDEV for their support and advice, and I enjoyed their company.

My gratitude also extended to my colleagues and friends such as Dr Abdulsalam Abubakar, and Dr Muhammad (Shamsudeen) Ibrahim for their contributions towards the completion of this research. I am also grateful to my friends and relatives at USM who's warmly friendship and support made me sailed during my study; these friends include, Aminu Lawan (lazada), Suleman Haruna Kazaure, also, Hamza Isah and my Nephew Shamsudeen Ibrahim Makudawa not forgotten. The company and kindness of Arshaad Mohiadeen (India-UAE) and Abdulrahman (Yemen) will never be forgotten. My friends from Pakistan such as Anees and Salman I thank you very much for everything. My colleagues at ISDEV like Mal. Aminu Yakubu, Mal. Auwal Salisu Nguru, Mal. Muhammad Maiduguri, Tahir Alam Pakistan, Hazrin, my best friend Pak Catur, Maryam Idris, Shukri, Baihaqi, Alif, Ridwan, Hafiz, Fazleen, Arini and the entire ISDEV students I say thank you very much for your fantastic company. Other friends like Dr Aliyu Mukhtar Katsina, Ado Kano, Dr Haruna Rawayau, Abu Sani, Muazah Kedah, and Noor Haniza Penang I am grateful to you all. My IKCOE colleagues at USM like Hamza Abubakar Maths, Nura Maths, Aminu Rawayau and all other Nigerians in USM Thank you very much.

My sincere and profound gratitude will explicitly be conveyed to my mother and my precious thing, for tirelessly praying for me to have a successful study, thank you Hajiya, may Allah (SWT) grant you janatul firdaus, ameen. Moreover, I pray to almighty Allah to shower his blessings and forgiveness continuously upon my father Alhaji Musa Gani, may his soul rest in janatul firdaus ameen. I am grateful to my wife (Maryam) and my kids (Khadija and Zayyan) for their endurance and patience as we were not together throughout my stay for this study. I also extend my gratitude to my big brother Barr. Ahmad Musa, and my remaining brothers and sisters in Alhaji Musa Gani family, as well as the entire extended family of Alhaji Gani. Last but not the least I will like to show my gratitude to my employers Isa Kaita College of Education Dutsinma, Tertiary Institutions Trust Fund (TETfund) for the study leave and sponsorship giving to me respectively to pursue the PhD Degree.

May Allah reward and shower his blessings to all those that I mentioned and those that I did not say if, in one way, or ‘the other contributed to the successful completion of my PhD program.

Alhamdulillah.

Ibrahim Musa Gani.

**TABLE OF CONTENTS**

# LIST OF TABLES

**Page**

## LIST OF FIGURES

**Page**

## LIST OF ABBREVIATIONS

| | |
|---|---|
| AAOIFI | Accounting and auditing organisation for Islamic financial Institution |
| ADF | Augmented Dickey-Fuller |
| AIC | Akaike information criterion |
| AMG | Augmented mean group |
| AR | Abnormal returns |
| ARDL | Autoregressive distributed lag |
| ASEAN | Association of south-east Asian nations |
| BBA | Bay-bithamani ajil |
| BNM | Bank Negara Malaysia |
| BNMNs | Bank Negara Malaysia monetary notes |
| BOFID | Banks and other financial institutions decree |
| BPG | Breusch-Pagan-Godfrey |
| CAC | Corporate affairs commission |
| CAMEL | Capital adequacy, asset quality, management, earnings liquidity |
| CCE | Common correlated effects |
| CEO | Chief executive officer |
| CLRM | Classical linear regression model |
| CPI | Consumer price index |
| CUSUM | Cumulative sum |
| CUSUMSQ | Cumulative sum of squares |
| DFE | Dynamic fixed effects |
| DOLS | Dynamic ordinary least squares |
| DOSM | Department of statistics Malaysia |

| | |
|---|---|
| DW | Dublin Watson |
| ECT/M | Error correction term/model |
| ECOWAS | Economic Community of West African states |
| EU | European union |
| FD | Financial development |
| FDI | Financial Development index |
| FMOLS | Fully modified ordinary least squares |
| FSAL | financial sector asset and liabilities |
| GCC | Gulf co-operation council |
| GDP | Gross domestic product |
| GFCF | Gross fix capital formation |
| GIFR | Global Islamic financial report |
| GII/GIC | Government investment issue/certificate |
| GMM | Generalised method of moment |
| GNP | Gross National product |
| GOVT | Total government expenditure |
| HQC | Hannan-Quinn criterion |
| IAIB | International association of Islamic banks |
| IBD | Total Islamic banks deposits |
| IBF | Total Islamic banks financing |
| IBFI | Islamic banking financial Intermediation |
| ICM | Islamic capital market |
| ICMC | Total Islamic capital market capitalisation |
| ICMFI | Islamic capital market financial intermediation |
| IDB | Islamic development bank |

| | |
|---|---|
| IDS | Islamic debt securities |
| IFD | Islamic financial development |
| IFI | Islamic financial institutions |
| IFS | Islamic financial system/sector |
| IFS | International financial statistics |
| IFSACL | Islamic financial sector Asset/capital and liabilities |
| IFSB | International Islamic financial services board |
| IIBI | International Islamic bank institute |
| IID | Independently and identically distributed |
| IMF | International monetary fund |
| INI | Islamic negotiable instruments |
| INF | Inflation rate |
| IPI | Industrial production index |
| IPO | Initial public offering |
| IRF | Impulse rate fusion |
| ISMT | Total Islamic market turnover |
| ISRA | International shariah research academy |
| J-B | Jarque-Bera |
| JJ | Johansen and Juleus approach |
| KPSS | Kwiatkowski-Philips-Shmidt-Shin |
| LBC | Lower boundary critical values |
| LGDP | Log of gross domestic product |
| LGOVT | Log of total government expenditure |
| LIBD | Log of total Islamic banks deposits |
| LIBF | Log of total Islamic banks financing |

| | |
|---|---|
| LIBOR | London interbank offered rate |
| LICMC | Log of total Islamic capital market capitalisation |
| LINF | Log of the inflation rate |
| LISMT | log of total Islamic capital market capitalisation |
| LM | Lagrange multiplier |
| MENA | The Middle East and North African countries |
| MPFFA | Micheal porter five forces analysis |
| MFDFA | Multifractional de-trended fluctuation |
| MG | Mean group |
| NIDC | Negotiable Islamic debt certificate |
| NSE | Nigeria stock exchange |
| OECD | Organisation for economic co-operation and development |
| OIC | Organisation of Islamic countries |
| OLS | ordinary least squares |
| PCA | principal component analysis |
| PLS | Profit and loss sharing |
| PMG | Pooled mean group |
| PP | Philips Perron |
| REIT | Real estate investment trust |
| RIR | Real interest rate |
| SBC | Schwartz-Bayesian criterion |
| SIC | Schwarz information criterion |
| SMEs | Small and medium enterprises |
| SVAR | Structural vector autoregression |
| SWT | Subhanahu wataala |

| | |
|---|---|
| SWOT | Strength, weakness, opportunity and threats |
| TFP | Total factor productivity |
| TSR | Tawhidi string relation |
| UAE | United Arab Emirates |
| UBC | Upper boundary critical values |
| UNIDO | United Nations industrial development organisation |
| VAR | Vector autoregression |
| VDC | Variance decomposition |
| VECM | Vector error correction model |
| 2SLS | Two-stage least square |

# LIST OF SYMBOLS

| | |
|---|---|
| $A$ | Production parameter |
| $CV_t$ | Other control variables |
| $d$ | Differentiation |
| $ECT / ECM$ | Error correction term or model |
| $FD_t$ | Financial development |
| $H_0$ | Null hypothesis |
| $H_t$ | Level of technology/productivity |
| $H_1$ | Alternative hypothesis |
| $I_t$ | Investment |
| $I - \lambda$ | Lost savings |
| $L_t$ | Raw labour Input |
| $\ln$ | Log of the variables |
| $p$ | Total number of lags |
| $R^2$ | Coefficient of the determinant of the equation |
| $k$ | Number of explanatory variables |
| $K_t$ | Capital stock |
| $Ku$ | Kurtosis coefficient |
| $S$ | Skewness coefficient |
| $S_t$ | Savings |

| | |
|---|---|
| $X$ | Value of residuals |
| $X_t$ | Independent variables |
| $\overline{X}$ | Mean of the residuals |
| $Y_t$ | Aggregate output/dependent variables |
| $Z_t$ | Vector of regressors |
| $\tau$ | Tau Statistics/critical values |
| $t\tau$ | t-statistics of the series |
| $\Delta$ | Changes/first difference operator |
| $\alpha$ | Intercept/measurement of the share of capital |
| $\alpha_1\alpha_2$ | Parameters to be estimated in unit root test |
| $\sum_{i=1}^{p}$ | First lagged value of the error term from co-integration regression |
| $\phi$ | Coefficient of the error term |
| $\pi$ | Depreciation |
| $\delta$ | Parameters to be estimated in unit root test |
| $\beta$ | Intercept and estimation parameters |
| $\varepsilon_t$ | Error term/white noise |
| $\sigma_t^{\alpha}$ | The ratio of physical to human capital |
| $1-\alpha$ | Quality-adjusted labour |

**IMPAK PEMBANGUNAN KEWANGAN ISLAM KE ATAS PERTUMBUHAN EKONOMI MALAYSIA**

## ABSTRAK

Protagonis pembangunan kewangan dalam mempengaruhi pertumbuhan ekonomi melalui pengumpulan modal dan produktiviti modal telah menjadi isu utama dalam literatur pertumbuhan ekonomi. Pembangunan kewangan konvensional berasaskan faedah mengemukakan beberapa bukti-bukti empirikal mengenai isu ini. Namun begitu, kemunculan dan kejayaan kewangan Islam merupakan pencapaian besar dalam pembangunan kewangan global. Persoalannya, boleh kah pembangunan kewangan Islam dapat mempengaruhi pertumbuhan ekonomi? Oleh itu, kajian ini ingin mengkaji kesan perkembangan kewangan Islam terhadap pertumbuhan ekonomi Malaysia. Malaysia merupakan negara yang terkemuka dari segi aktiviti kewangan Islam (NST 2018). Kajian ini mengkaji pembangunan pasaran modal dan perbankan Islam sebagai ukuran pembangunan kewangan Islam (IFD) terhadap pertumbuhan ekonomi melalui pengumpulan modal dan produktiviti modal pada tahun 1998 sehingga tahun 2018. Kajian ini juga menentukan hubungan sebab akibat antara IFD dan pertumbuhan ekonomi Malaysia. Selain itu, kajian ini juga mangaplikasikan teknik siri masa ko-integrasi, yang melibatkan *autoregresif distributive lag* (ARDL) oleh Pesaran dan Shin (2001) untuk menentukan hubungan jangka masa panjang dan hubungan jangka pendek antara IFD dengan pertumbuhan ekonomi. Seterusnya Granger *Vector Error Correction Modal* (VECM) digunakan bagi menentukan hubungan sebab akibat antara petunjuk IFD dengan pertumbuhan ekonomi di Malaysia. Dapatan kajian menunjukkan pembangunan pasaran modal dan perbankan

Islam mempunyai hubungan yang positif dan signifikan dengan pertumbuhan ekonomi dalam jangka masa panjang. Walau bagaimanapun, petunjuk pembangunan perbankan Islam (IBF dan IBD) dan salah satu petunjuk pembangunan pasaran modal Islam (ICMC) mempunyai hubungan yang tidak signifikan dengan pertumbuhan ekonomi dalam jangka pendek. Pengumpulan modal dan produktiviti modal menunjukkan hubungan yang positif dan signifikan dengan Keluaran Dalam Negara Kasar (KDNK). Hal ini menjadi saluran kepada pembangunan kewangan Islam dipengaruhi oleh pertumbuhan ekonomi Malaysia dalam jangka masa panjang dan jangka masa pendek. Bukti empirikal selanjutya menunjukkan bahawa sebab akibat dua arah wujud antara petunjuk pembangunan perbankan Islam dengan KDNK serta pasaran modal Islam dengan KDNK. Penemuan ini sebahagian besarnya menjelaskan hubungan antara penggunaan dana yang cekap daripada institusi kewangan Islam dengan segmen yang lebih besar daripada sektor isi rumah dan swasta di Malaysia serta tahap output yang tinggi di negara ini. Implikasi dasar utama kajian ini ialah institusi kewangan Islam (IFI) perlu memainkan peranan menggerakkan dana lebihan melalui inovasi pelbagai produk dan perkhidmatan yang mempunyai faedah jangka pendek serta kualiti perkhidmatan yang lebih baik. Dalam masa yang sama, IFI perlu memastikan bahawa bahagian yang lebih besar daripada pembiayaan disalurkan ke sektor produktif yang sebenar supaya boleh membawa pulangan yang lebih cepat. Kajian ini juga mencadangkan keperluan untuk memperkukuhkan produk-produk yang berasaskan perkongsian untung rugi dalam pembiayaan portofolio institusi kewangan Islam di Malaysia.

**THE IMPACT OF ISLAMIC FINANCIAL DEVELOPMENT ON MALAYSIAN ECONOMIC GROWTH**

## ABSTRACT

The protagonist of financial development in influencing economic growth through capital accumulation and productivity of capital has been the central issue in the economic growth literature. The interest-based conventional financial development provided several empirical shreds of evidence on this issue. However, the emergence and success of Islamic finance is a great achievement in a global financial development. Can Islamic financial development be able to influence economic growth? Therefore, this study aims to investigate the impact of Islamic financial development on Malaysian economic growth. Malaysia is the leading country in term of Islamic financial activities (NST 2018). This study examined Islamic banking and capital market development as the measures of Islamic financial development (IFD) on economic growth, through capital accumulation and productivity of capital, over the period from 1998 to 2018. It also determined the causal relationship between IFD and Malaysian economic growth. The study adopted time series co-integration techniques, which involve autoregressive distributive lag (ARDL) by Pesaran, Shin and Smith (2001), to determine the long-run and short-run relationship between IFD and economic growth. It further employed Granger vector error correction model (VECM) to determine the causal relationship between IFD indicators and economic growth in Malaysia. The findings show that Islamic banking and capital market development has a positive and significant relationship with economic growth in the long-run. On the other hand, the indicators of Islamic banking development (IBF and

IBD) and one of the indicators of Islamic capital market development (ICMC) have an insignificant relationship with economic growth in the short-run. Capital accumulation and productivity of capital show positive and significant relationship with GDP hence served as the channels through which Islamic financial development influenced Malaysian economic growth in both the long-run and the short-run. The empirical evidence further shows that a bidirectional causality is found to exist between Islamic banking development indicators and GDP on the one hand, and Islamic capital market indicators and GDP on the other hand. These findings largely explain the connection between effective utilisation of funds from Islamic financial institutions by a more significant segment of the household and private sectors in Malaysia and the high level of output in the country. The prime policy implications are that Indeed, Islamic financial institutions (IFIs) must play their role of mobilising surplus funds through the innovation of a wide range of Islamic financial products and services that have short term benefits, improved service quality, among other things. Equally, IFIs should ensure that a more considerable portion of their financings goes to a real productive sector which can, in turn, bring a quick return. This study also suggested the need for strengthening the profit and loss sharing based products in financing portfolios of Islamic financial institutions in Malaysia.

# CHAPTER 1

# INTRODUCTION

Financial activities, economic growth and development are vital in any given economy. Therefore, this study focuses on the finance-growth nexus. Finance-growth nexus regarded as the connexion between financial activities and economic growth. The aim is to investigate the impact of Islamic financial system development on Malaysian economic growth. This chapter will discuss the root and preface of this research and also gives an insight into the study. The chapter as an introductory chapter which states the reason for conducting the research and its targeted goals. It comprises the background, problem statement, study objectives and research questions, operational definitions as well as the scope and limitations. It also includes research significance and the organisation of the study.

## 1.1 Background of the Study

The primary function of the financial sector in an economy is financial intermediation. Financial intermediation is the mobilisation and allocation of savings from the surplus units of an economy to the deficit units with efficiency. Decades ago, financial system development and economic growth links had spawned a massive deal of interest amid academicians, policymakers, as well as economists (Moshabesha, 2010). The earliest discovery of finance-growth relationship can be traced back into the seventeenth century, where Bagehot (1873) stressed the relationship, impact and role of banks, money market and money on economic growth. It was emphasised by Schumpeter (1911) who opined that credit is highly needed for the entrepreneurs to magnify productivity within the economy. It can be through the financing of innovations in production techniques (Ang, 2007). Other notable economists that share the same view with Bagehot and Schumpeter are the Gurley and Shaw (1955), Goldsmith (1969) and Hicks (1969), whom all opined that financial development spurs the growth of an economy.

Islamic financial development is another branch of financial development that hugely contributed towards the growth of an economy. Islamic bank's precedence is investments on *Shariah* permitted products, based on *Musharakah*, *Mudarabah,* and *Murabaha*. It will intensify the levels of output the economy produced, as well as providing more jobs opportunities, which will in turn brings economic growth and development (Al Sarraf, 1993). Islamic banks and Islamic capital markets are dealers of equity, not a dealer of credit like a conventional bank. Customers deposited funds and utilised the funds in the form of profit and loss sharing investments, where in the process, both parties involved gained. It provided more funds available for auxiliary investments and growth (Azizul-Huq, (1982).

Islamic banking and finance, furthermore, could make a significant contribution to economic growth because it always acts as an institution of development where capital created for further investments (Elnaggar, 1987). Islamic banking and finance consist tools for behavioural changes principally through changing of individuals' spending behaviour by nurturing a 'saving mindset' on the individuals. A product like *Qard hasnah* loan scheme by Islamic banks is an instrument for development as it enlarges the society's economic base; upsurges purchasing power is thereby intensifying the market size and growth, decreasing unemployment, and also encourages savings and guides consumption (Elnaggar, 1987). Islamic financial activities are favourable to the growth of an economy as it generates employment and expands the activities of agricultural and manufacturing sectors as well as caters for individuals' basic needs. These provide a room to empirically investigate the impact of Islamic financial activities on the growth of Malaysian economy in order to support the existing conceptual views and framework. Thus, the background of the study is divided into three main sub-headings for further discussion, namely; development of financial sector, development of Islamic financial sector and Malaysian economic growth.

### 1.1.1 Development of Financial Sector

The financial sector development of a financial economy comprises different sectors, which includes banking sector development and nonbanking sector development. The latter divided into financial markets, insurance companies, pension fund administrators, mutual fund management, among others. The Banking sector of an economy has its effect on economic growth. The effect can be actualised by promoting investments through the accumulation of capital and enhancing the productivity of the capital. This sector is the backbone of any financial system. It is playing a significant role in the attainment of the growth of an economy through financial activities. The main activities of the banking sector in an economy are the mobilisation and pooling of savings, evaluating and monitoring investment ideas, diversification of risks, among others. These achieved through the accumulation of capital and its productivity (King & Levine 1993a).

The earlier theoretical arguments on banking sector development – growth relationship was advanced by two prominent scholars. It includes Mckinnon (1973) in his model which focuses on the complementarity hypothesis, and Shaw (1973) in his debt intermediation hypothesis. They based their argument on the higher level of banks financial intermediation (transferring wealth from surplus side to deficit side through accepting deposit and giving out loans or credits) due to financial liberalisation, which in turn causes the growth of the economy positively (Ang, 2007).

Financial liberalisation necessitates the deregulation of an interest rate and causes the obliteration of credit policies (directed) and institutes a reserve requirement which is low for the banks. It will raise the real interest rates, as well as the savings and investments. The Findings of researchers such as King and Levine (1993b), Allen and Ndiakhuma (1998), Blum, Federmair, Fink, and Haiss, (2002), and Aziakpono (2003) evident that financial liberalisation fuels financial development. According to their findings, in the process of financial development, increase in investment and accumulation of capital is achieved, which leads to the growth of an economy.

The capital market is another branch of finance that stimulate growth of an economy through accumulating capital and ensuring productivity. It is an exceedingly specialised and organised financial market with an ability to facilitate and mobilising savings and investments, which indeed make it a critical agent for the growth and development of an economy. Therefore, the relationship (which is positive) between capital market through capital accumulation  the real economy has long been proclaimed in economic theories (Anyanwu, 1996).

The capital market deals with a range of financial instruments that create economic activities through pooling price and exchange of assets with attractive yields, liquidity and risk characteristics. It also encourages financial savings. Capital market is necessary for the government and other institutions seeking for long-term funds as it is a supplier of a long-term fund (Gani & Sani, 2015). Firms and enterprises can raise more funds through issuing equity, which is perpetual life ownership. It can also be through debenture/bond debt securities, which are structured to mature in varying periods of years ranging between the medium to long-term of usually five and twenty-five years, respectively. (Mbat, 2001).

Deltuvaitė and Sinevičienė (2014) exhibited that the banking sector and market sector development level is higher in countries with higher GDP per capita. Nevertheless, capital markets become much more pertinent to the accumulation of the capital process. It means financial sector development affects the economy in different patterns and the connection between the structure of the financial system and the growth of the economy exists. Deltuvaitė and Sinevičienė (2014) also pointed out that there may be a higher expectation of economic growth in countries which their financial system is market-based because it is more pertinent in the process of stimulating investment.

Both the bank-based and the market-based intermediations are needed for healthy and faster growth of an economy, and not any of them supported alone even though the whole of financial development is vigorously associated with economic growth (Levine, 2002).

Financial activities and financial development can affect economic growth through capital accumulation and productivity of capital. Capital accumulation is the process of realising additional capital stock used in the productive process. Capital accumulation means the quantity of investments fund. Capital accumulation will need to exceed the amount of capital necessary to overcome capital depreciation (Pettinger 2017). Capital accumulation encompasses additional purchases of capital. Capital accumulation happened when a company secures assets. The assets can be physical, intangible or financial. Capital accumulation is an indication of preparation for growth, especially for companies and organisations. As for investors, it is a signal of interest in an acquisition or in becoming part of the institution's management. The Productivity of capital generally is an estimation of the production efficiency. It is the output per unit of input. It is the ratio of outputs compared to inputs utilised in the processes of production (OECD 2011). The productivity of capital is the situation when an organisation is being efficient and successful. Capital productivity is an essential factor in explaining material standards of living and is at the heart of determining rates of return. (Sinha, 2016).

### 1.1.2 Development of Islamic Financial Sector

It is essential to note that, the banking sector model or hypothesis (financial liberalisation) benefits and capital market contributions affirmed by theories and discussed earlier in this study were conventional economics views and doctrines. Thus, the contributions or the return investors gained are 'interest rate' based. Interest rate serves as the measure of the loan value (price), which is a rent of money. Hence, according to Islamic rules, regulations, and principles (*Shariah*), any deal involving interest is vividly prohibited (Hasnuddeen, 2009). The prohibition of receiving, paying or any deal related to interest has been stated categorically in different chapters of the Holy Quran. Allah prohibited all Muslims from interest dealings, and under no circumstances, interest can be taken or given. Sunnah of Prophet Muhammad (SAW) also supported the Quran verses in prohibition and discouraging interest.

Moreover, interest has also been criticised rigorously and equally doomed by other religions such as Christianity, Buddhism, Jewish, and Hinduism. Furthermore, noticeable thinkers in the history of human being disown interest; Aristotle labelled it as "the birth of money for another money" (Ahmad, 1993). It translates that Muslims were sanctioned and under no circumstances to partake in traditional or conventional financial activities. Nevertheless, in this era of human life, financial deals and practices are a necessity. For countries also, financial activities are vital for economic growth and development. Therefore, necessarily, Muslims must have an alternative financial system that follows Islamic *Shariah* provisions and traditions. This scenario inspired Muslims to implement Islamic economic policies and ideas into practice.

The introduction of a financial system where the concept of trade and share the profit or loss come into the limelight. The system is tagged “Islamic finance”, and it will serve as a replacement of interest-based financial system for Muslims and want it accepted as the modern financial system as well as an alternative to the interest-based conventional financial system. This type of finance is to be guided by Islamic *Shariah* and its sources. This revolution in the financial system led to the introduction of Islamic banking platform structured on Profit and Loss Sharing (PLS) principle to replace interest-based structured banking. Islamic capital market, which generates profit or loss to replace interest rate-oriented capital market was also introduced. It is justified that Islamic finance may contribute more on economic growth because Islamic finance structured on trading and profit/loss sharing among the participants through banking and capital market. Furthermore, Islamic finance manages its liquidity through or on the real sector more than conventional financial institutions (Kassim 2016).

The Islamic finance idea has long been in existence as far back since during the reign of the Prophet Muhammad (SAW). The existence of such a system with the philosophy of non-exploitation among people focuses on investing in a socially responsible business (Hasnuddeen, 2009). The modern finance with profit-sharing motive rather than interest can be traced back since during Ottoman Empire, where

Muslims traders are making commercial and financial transactions with Spanish counterpart on the interest-free basis (Chapra, 1992). Even though when Europeans started colonising Muslims countries (except Turkey and Afghanistan) until the Second World War, almost all Islamic based institutions were weakened and to some extent vanished. However, the Islamic identity of the people becomes a significant factor for the struggle of freedom. The aspiration for the re-affirming Islamic way of living was, hence, natural when a fresh beginning made after the Muslims state got independence (Tahir, 2009).

Islamic finance started getting ground three to four decades ago. It began with the establishment of Islamic banks and followed with financial markets in different Muslims countries. Banking and trading in financial assets and securities without interest came into practice. Islamic finance is challenging and competing with the interest rate-based financial intermediaries that were fervidly prohibited in Islam and discouraged by the other religions. (Ahmad 1993).

The most idiosyncratic elements that describe the nature and scope of Islamic finance, as interpreted by *Shariah* scholars, are the prohibition on "wear and tear" of interest, either "nominal" or "excessive," compound or simple, fixed or floating. It also includes the focus on fair and equitable contracts, forbidding uncertainty, the existence of an underlying asset in any contracts, and the link of financing with productivity. Others are the desire for risk-sharing, the opportunity to share in the profits, and the proscription of unethical investments (Al-Hares, AbuGuzelah & El-Galfy, 2013). However, this idea of Islamic finance is welcomed and accepted in many countries around the world, specifically the Middle East and Asian countries where there is a high concentration of Islamic religion faithful. One of those countries is Malaysia.

### 1.1.3 Malaysian Economic Growth

The Islamic financial industry on Malaysia's socio-economic development is significant because it provided a variety of products in the form of financial contracts and mode of financing. It increases GDP growth through refining finances for production activities, trade and other economic activities. It discourages Muslims to engage in hoarding and encourages them to save more. Those activities contribute to accumulate more capital and mobilise saving and investments (Anwar, 1991).

The Malaysian economy is among the fastest-growing Asian economies that have a flamboyant financial system which is well designed and developed (BNM, 2019). After the establishment of the Islamic pilgrim fund called *Tabung Haj* Malaysia in 1963, the Malaysian Islamic financial system was born. The Islamic banking act in Malaysia enacted in 1983. It gave the birth of the first fully-fledged Islamic bank known as Bank Islam Malaysia Berhad, which started its operation in 1984 (Alaabed & Masih 2016). One exclusive thing about Malaysia is that both of the interest rate-based and Islamic financial institutions exists and operates within its financial institutions simultaneously (Anwar & Haque 1991). Non-interest Islamic finance in Malaysia started at slow rate progress with the only a bank as its institution before it turned and transformed into a system with multiple institutions which include capital market, Takaful, among others. The national *Shariah* advisory council was formulated to oversee the system and enforce *Shariah* compliance on the institutions.

Malaysia has 37 *Shariah* compliance banks (which include 16 full-pledge Islamic banks, 11 banks with Islamic banking window, 3 international Islamic banks and 6 Islamic development banks) with the extensive distribution network of more than one hundred and fifty branches of the full-fledged Islamic banks, and over two thousand Islamic banking counters that offer non-interest banking products and services based on the Islamic Banking Scheme (BNM, 2020). The banks provide a wide-ranging of Islamic financial products and services, which include deposits accounts (savings, current, and investment). It also offers a variety of financing products and services which includes vehicle financing, plant and machinery financing, property financing, hire purchase, project and working capital financing, trade financing, education financing, and many more.

The banking system designed a secured and efficient as well as effective system of payment. It also uses modern technology that provides access to all the services of the banks to the various sectors of the economy (BNM, 2018). Based on the framework of a sound and healthy economy and strong macroeconomic fundamentals between the years 2000 to 2003, Islamic banking activity in Malaysia experienced rapid growth. During this period, the banking system total assets rose to 9.7% in 2003 from 6.9% in 2000. The market share of deposits of the whole banking system rises to 10.4 % in 2003 from 7.4% in 2000, and financing by total banking also rose from 5.3% in 2000 to 10.3% in 2003. Islamic banking in Malaysia owned and controlled over 25% of the total assets of banks with the projection to reach up to 40% by the year 2020 (BNM, 2017). Moreover, as at December 2019 the asset size of Islamic banks alone stood at RM 835.19 billion (BNM, 2020). This evidence suggests that the Malaysian Islamic financial sector has been able to extend financing even during the recessionary periods which might have helped in the recovery of the Malaysian economy.

Islamic capital market in Malaysia, on the other hand, is also one of the quickest developing financial markets in the world. It provided Islamic equities and Sukuk indices which generate profit as a return on investment and substituted interestbearing instruments. Islamic equities and Sukuk offer mitigation against risk and instability, especially during the period of crisis (Kenourgios, Naifar, & Dimitriou, 2016). Malaysia has the most active and liquid Islamic capital/equity market. As at the end of 2012, there are a total of 817 Islamic securities indexed on the Bursa Malaysia *Shariah* Index, which represents 89% of all securities listed, the market bears a market capitalisation of more than 300 billion US dollars (Najeeb & Vejzagic, 2013). Islamic capital market in Malaysia as at first quarter of 2018 has a total of over RM 1,148 billion capitalisations of *Shariah*-compliant private liabilities companies (PLCs) with 59.14 % *Shariah* based on market capitalisation (Bursa Malaysia 2018). It shows that the Islamic capital market in Malaysia has a more significant market capitalisation than the traditional conventional capital market. It also shows a significant increase in three years (from 2015, where it amounts to RM1, 086.20 billion). Malaysian Islamic capital market owned 687 out of 906 numbers of PLCs with 75.83 % *Shariah* based on number PLCs. It confirmed the dominance of *Shariah* complaint deals in overall Malaysian financial market (Bursa Malaysia 2018). Moreover, Malaysian Sukuk market has an outstanding amount of RM781.05 billion as of 2018; compared to three years back (2015) when it was RM607.93 billion, these evident a significant increase in the strength of the market. The total size of the Malaysian Islamic capital market as in the year 2015 is RM 1,694.13 billion, but in the first quarter of 2018, it increases to RM1,930.07 billion (Bursa Malaysia 2018).

An Islamic financial sector (IFS) which consist Islamic banking, Islamic capital market and Takaful in Malaysia is fundamentally developing in its activities, just as in its assets and capital for as long as ten years. In spite of the fact that the Malaysian economy experienced a downturn in 2001 and 2009, the assets/capital of the Islamic financial industry substantially expanded from RM1.8 billion in 2008 to

RM2.4billion in 2009 which is an increase of over 76% (2009 is one of the Malaysian years of economic downturn) (BNM, 2020). This evidence proposes that the Islamic financial sector in Malaysian has broadened its financing more, notwithstanding during the recessionary years, which may have helped in the recuperation of the Malaysian economy. Islamic finance growth maintained its trend of positive and significant growth in the entire industry for the past 13 years between 2007 and 2019. It spurred the growth of the whole financial sector's assets and liabilities which also maintained a trend of growth for the past 13 years, and it confirmed the strength and contribution of Islamic finance to the Malaysian economy (Bank Negara Malaysia, 2019).

Malaysian national output or gross domestic product (GDP) has been growing positively in a single digit (as shown in Table 1.1) at 6.15% (2007), 4.45% (2008) and 7.08% (2010) but it experienced negative growth of –1.80% in 2009. It continued to grow thereafter at 5.20% (2011), 5.25% (2012), 4.80% (2013), 5.47% (2014), 4.86% (2015), 7.45% (2016), 5.90% (2017), 4.90% (2018) and 3.60% (2019) (DOSM, 2020). Malaysian GDP growth prods the growth of the entire financial sector assets and liabilities, which likewise keep up the pattern of development for as long as thirteen years. Islamic financial industry demonstrates its strength quality and its commitment towards contributing to the Malaysian economy.

Table 1.1 shows the GDP growth of Malaysian economy for twelve years and financial industry assets and liabilities (FSAL) growth together with Islamic Financial system assets/capital liabilities (IFSACL) growth of Malaysia (which comprise both Islamic banking and nonbanking Islamic financial institutions).

Table 1.1

*GDP and Financial Assets/Liabilities Growth in Malaysia*

| **Years** | **GDP Growth** (%) | **FSAL Growth** (RM MILLION) | **IFSACL Growth** (RM MILLION) |
|---|---|---|---|
| 2007 | 06.15 | 12,802,558.00 | 1,671,148.00 |
| 2008 | 04.45 | 14,278,094.00 | 1,888,665.90 |
| 2009 | -01.8 | 15,152,484.00 | 2,454,678.60 |
| 2010 | 07.08 | 16,501,380.00 | 2,963,195.00 |
| 2011 | 05.20 | 18,768,871.00 | 3,503,001.00 |
| 2012 | 05.25 | 21,115,715.00 | 4,257,528.60 |
| 2013 | 04.80 | 22,862,665.00 | 4,820,229.70 |
| 2014 | 05.47 | 24,622,198.00 | 5,350,021.90 |
| 2015 | 04.86 | 26,978,495.00 | 6,115,836.90 |
| 2016 | 07.45 | 28,024,686.00 | 6,665,533.80 |
| 2017 | 05.90 | 29,148,753.00 | 7,114,429.10 |
| 2018 | 04.90 | 30, 399,432.00 | 7,887,762.30 |

Note- GDP: gross domestic product, FSAL: Whole financial sector assets/liabilities, and IFSAL: Islamic financial sector assets, capital, and liabilities. (Source: Bank Negara Malaysia, 2019)

Table 1.1 shows the Malaysian output growth in form of GDP for twelve years, from the year 2007 to 2018, and the growth of the whole Malaysian financial sector assets and liabilities as well as Islamic financial sector asset and liabilities growth. The table shows that output growth is increasing positively every year (as explain earlier) at the average of 4% to 7% except in the year 2009 (when Malaysia experienced economic crisis). the highest output growth within these years was in 2016 and the lowest in 2008 when the economy is heading to crisis. The total assets and liabilities of Malaysian financial sector was also increasing tremendously in the past 12 years at an average of RM 1million to RM 2million every year. It recorded a success even during 2009 economic crisis. This gesture also goes to the growth of Islamic financial sector asset and liabilities. The growth of IFS assets and liabilities in Malaysia is positive and at the average of RM 1million to RM 1.5million annually.

These output growth and Islamic financial sector growth recorded by Malaysian economy is tremendous. The Malaysian economic growth and Islamic financial sector growth are the main issues in this study. Therefore, the increasing growth in both sectors pave away to investigate whether the growth of Islamic financial sector contributed a significant impact on the Malaysian economy.

## 1.2 Problem Statement

Financial services serve as one of the most prominent activities in any given economy. Those activities might be able to affect the economic growth of a country. Therefore, different opinions on this matter surfaced among scholars. Some of the scholars were on the belief that financial activities have an impact on economic growth. The most prominent among them on this issue is Schumpeter (1911), Gurley and Shaw (1955), together with Goldsmith (1969). Mckinonnon and Shaw (1973) shared the same views and provided financial liberalisation hypothesis to support their argument. However, scholars like Arestis and Glickman (2002) discredited financial liberalisation arguments, especially in developing countries which are characterised by unstable prices and high fiscal indiscipline. Arestis 2005).

Scholars such as Robinson (1952) and Lucas (1988) disagreed with the argument that financial development has an impact on the country's real economy. Robinson (1952) asserts that "where enterprise tops finance follows." Similarly, Lucas (1988) indicated that financial intermediaries "overstressed" indicators of economic growth. This issue of whether financial development provide any significant impact on the economic growth is still relinquishing within countries economy worldwide. The impact of financial development on the growth of an economy need to be investigated empirically in order to establish an evidence.

However, the formations of those contentions centred on the interest-based financial activities where 'loan fee' or interest rate is the premise of the processes. In numerous instances, interest-based financial activities failed to spur the real economy of numerous nations, particularly the developing economies, and the burden of servicing the excessive interest rate or the loan fee which the countries' economy accumulated has consumed most of the income of those countries (Chapra, 2008). For instance, in Nigeria since 2011 there is a sharp increase in debt servicing as a percentage of the capital expenditure of the country, between 1981 and 2015, it rose up to 59%. It will affect the growth of the country's economy and aggravate unemployment and poverty within the country (Kareem 2017). Thus, based on these assertions, the arguments of the conventional scholars on finance-growth nexus can be termed as vague, and new bases for the debate and establishing a new empirical evidence which is not based on interest-rate is needed.

Consequently, a present development of transmuting Islamic economics principles and ideas into practice leads to the introduction of interest-free Islamic financial intermediaries. This development provided a new base for arguments and establishing new empirical evidence on finance-growth nexus. Islamic financial intermediary is a system that replaces the loan fee or interest rate with a profit/loss sharing. It was designed to comprise more of equity financing and less of debt financing, unlike conventional finance which was dominated by debt financing. However, Islamic finance activities must comply with *Shariah* provisions and also by the Islamic economics principles (ISRA, 2012). Islamic financial activities played an important role in financial intermediation. It provides a room for the accumulation of capital and the productivity of the capital (Abubakar 2015)

Several types of research works like that of  Fufa and Kim (2018), Abubakar, Kasim and Yusoff (2015), Freytag and Fricke (2017), Capolupo (2018), Alaabed and Masih (2016) among others, were carried out on the relationship between finance and the growth of the real economy. The studies assert that interest-based financial intermediation and development affects the economy positively and to some negatively. What about interest-free Islamic financial activities and development? Can it be capable of affecting growth of an economy in both the short-run and the long-run? However, very few studies were conducted to find out whether interest free Islamic financial development has made a substantial impact on the growth of the real economy in both the short-run and the long-run.

There is a need for more empirical research that can establish the short-run and the long-run impact of Islamic financial development on economic growth. The need for establishing the evidence in both the short-run and the long-run is necessary. It is in the sense that it will provide an evidence in the short-run when the wages and prices of other inputs to production are "sticky," or inflexible and the tools of monetary and fiscal policy have real effects on the economy, as it affects production and employment. While in the long-run, these input prices have enough time for adjustment and variations. It can only affect nominal variables such as prices and profit/loss (Beggs 2020). When a study of this nature is conducted, it will provide an evidence in both short-run and long-run that can be used for policy recommendation.

Nevertheless, the impact of Islamic financial development on the growth of the real economy in both the short-run and the long-run likely differs from that of conventional finance, especially on the Malaysian economy which has a dual financial system with a robust Islamic financial system that recorded an average growth of 20% to 22% annually (BNM 2018). The likely differences can occur as a result of dissimilar approaches and principles regulating the two financial systems. To this end, there is a need for more research works especially empirical research on Malaysian Islamic financial development and economic growth. Even though, very few of such studies already conducted by researchers, but there are also different areas and measures in the short-run and the long-run that were not been explored. Moreover, there are measures (variables) that were not been combined together to establish an empirical evidence in both the short-run and the long-run in Malaysia. Furthermore, the few studies on the impact of Islamic finance to the real economy do not consider the channels through which their intermediation activity influences growth, which is through either investment or efficiency/productivity of capital. Lastly, the years covered for the studies differ, most of the studies covered 10-15 years, and Islamic finance is now over 30 years of existence in Malaysia. These issues need an urgent attention through conducting a new empirical study. Therefore, this motivated this research to be conducted and would try to establish an evidence and add to the existing knowledge.

Taking into consideration the two significant players in the sector (Islamic banking and Islamic capital market) and to be measured with a new combination of variables and data as well as covering a longer period. Does the Islamic financial sector development have any significant impact on Malaysian economy through any recognised channels and directions? This question raises an issue that need to be investigated thoroughly, so that a new evidence can be provided on Malaysian economy. Therefore, this study is of paramount important to the Malaysian economy, especially policy makers, academicians and researchers.

## 1.3 Research Objectives

Broadly, the general objective of this research is to evaluate the existing relationship between Islamic finance and the growth of the economy. It is to determine the relationship between Islamic financial development and the growth of the Malaysian economy.

The study employed valid measures, new variables as well as recent data, and applied an appropriate and rigorous econometric technique to investigate the following specific objectives:

1. To examine the impact of Islamic financial development on Malaysian economic growth.

2. To identify the channels through which the impact of Islamic financial development is conveyed to the real economy of Malaysia.

3. To assess the causal effect between Islamic financial development and economic growth of Malaysia.

## 1.4 Research Questions

The following are the questions in which this research will attempt to answer in the course of achieving the stated objectives:

i. What are the impacts of Islamic banking financing (saving allocation) and the Islamic banking deposits (saving mobilisation) on the Malaysian economic growth in both the short-run and the long-run?

ii. What are the impacts of the Islamic capital market capitalisation and the Islamic stock market turnover on the growth of the Malaysian economy in the short-run and the long-run?

iii. What is the impact of Islamic financial development on the growth of the Malaysian economy?

iv. Through which channels do Islamic banking financing, and deposits influence Malaysian economic growth in both the short-run and the long-run?

v. Through which channels do Islamic capital market capitalisation, and Islamic stock market turnover affects Malaysian economic growth in both the short-run and the long-run?

vi. Through which channels do Islamic financial development affects the Malaysian economic growth in both the short-run and the long-run?

vii. What will be the direction of the causal relationship between the indicators of Islamic banking (financing and deposits) and the growth of the Malaysian economy?

viii. What will be the direction of the causal relationship between the indicators of Islamic capital market (market capitalisation and stock market turnover) and the growth of the Malaysian economy?

ix. What will be the direction of the causal relationship between the indicators of Islamic financial development and the growth of the Malaysian economy?

x. What will be the direction of the causal relationship between the productivity of capital, capital formation, and Malaysian economic growth?

The following table shows the research questions together with the objectives to achieve when appropriately answered.

Table 1.2

*Summary of Research Objectives and Research Questions*

| S/No | Objectives | | Research Questions |
|---|---|---|---|
| 1. | To examine the impact of Islamic financial development on Malaysian economic growth. | i. | What are the impacts of Islamic banking financing (saving allocation) and the Islamic banking deposits (saving mobilisation) on the Malaysian economic growth in both the short-run and the long-run? |
| | | ii. | What are the impacts of the Islamic capital market capitalisation and the Islamic stock market turnover on the growth of the Malaysian economy in the short-run and the long-run? |
| | | iii. | What is the impact of Islamic financial development on the growth of the Malaysian economy? |
| 2. | To identify the channels through which the Islamic financial development impact is conveyed to the real economy of Malaysia. | i. | Through which channels do Islamic banking financing, and deposits influence Malaysian economic growth in both short-run and long-run? |
| | | ii. | Through which channels do Islamic capital market capitalisation, and Islamic stock market turnover affects Malaysian economic growth in both the short-run and the long-run? |
| | | iii. | Through which channels do Islamic financial development affects the Malaysian economic growth in both the short-run and the long-run? |
| 3. | To assess the causal effect between Islamic financial development and economic growth of Malaysia. | i. | What will be the direction of the causal relationship between the indicators of Islamic banking (financing and deposits) and the growth of the Malaysian economy? |
| | | ii. | What will be the direction of the causal relationship between the indicators of Islamic capital market (market capitalisation and stock market turnover) and the growth of the Malaysian economy? |
| | | iii. | What will be the direction of the causal relationship between the indicators of Islamic financial development and the growth of the Malaysian economy? |
| | | iv. | What will be the direction of the causal relationship between the productivity of capital, capital formation, and Malaysian economic growth? |

## 1.5 Operational Definitions

Defining important terms is essential to ensure a common understanding of key concepts and terminologies in the research, particularly if the terms are unusual or not widely known (Goes & Simon, 2015). It is where the most common terms to use severally and repeatedly in the research were defined and been explained. Therefore, the most common terms used in this research are; Impact, Financial System Development, Islamic Financial System Development, Economic Growth, Finance-Growth nexus/ Islamic finance Growth nexus, Short-Run and Long-Run

### 1.5.1 Impact

Literary Impact is a marked effect or influence of something either object, individual or system on the other. Specifically, in this study, the ‘impact’ is the related economic impact. Broadly, Economic impact means to examine the effect of an event on the economy in a specified sector, ranging from micro to macro level. It usually estimates the changes in revenue, finances, business profits, employment, and the likes. The economic event that assessed may include implementation of a new policy or project. An economic impact naturally estimates the changes in economic activity between two different scenarios, which is in counterfactual case, one assumed that an economic event occurs, and the other assumed it does not occur (Weisbrod & Weisbrod 1997).

### 1.5.2 Financial System Development:

There may be no single definition of financial system development (FD), but it described as an improvement in the efficiency and competitiveness of the financial sector. Increase in the range of available financial services, expansion in the diversity of institutions which operate in the financial sector, the rise in the amount of money that intermediated through the financial sector. Discouraging lending by public banks, and extensively increasing in the capital allocation by private financial institutions to private firms, companies and enterprises, while responding well to market signals. It also includes effective financial intermediation, the improvement in the financial sector regulation, financial inclusion, and financial stability (DFID 2004).

### 1.5.3 Islamic Financial System Development (IFD):

Islamic financial system development (IFD) is the improvement in the efficiency and competitiveness of interest-free, uncertainty-free and halal financial services that are available and operating within Islamic financial institutions, and expansion in the diversity of the institutions (Haron & Wan Azmi 2009). It also includes the increase in the funds intermediated within and through the system extensive private sector enterprises financing (Mohd. Adib, 2013). Furthermore, IFD includes a reasonable response to market signals (unintentional or passive passage of information or indication between participants of a market). It also includes improvement in the regulations, especially the *Shariah* advisory board and other regulatory bodies and necessary financial inclusion (IIBI 2017).

### 1.5.4 Economic Growth:

Growth in economics is a long-term expansion of the potentialities of production processes in a given economy. Sustainable economic growth would bring an increase in the rate of employment and a better level of standard of living (Van den Berg 2016). Short term growth estimated by the annual proportional (percentage) change in total national output (GDP). Economic growth is usually as a result of technological innovation and positive forces from external sources. In other words, economic growth is an increase in the ability to create goods and services. It means that an economy can be more productive, but it does not necessarily mean to be. This kind of growth caused by abundance in human and material, as well as advanced technology (Van den Berg 2016). Economic Growth is divided into real and nominal growth. Real growth is substantial economic growth without inflation, while nominal growth includes inflation.

### 1.5.5 Finance-Growth/ Islamic Finance-Growth Nexus:

Finance-growth nexus refers to the relationship that exists between the financial system (be it Islamic or conventional) and the real economy of a country or countries. It has been widely debated since the 19th century, starting from Bagehot in 1873 to Schumpeter in 1911 down to the present time Islamic finance. Many types of research confirmed the existence of the relationship; some research found it as significant in both of the short-run and the long-run, some in the long-run or in the short-run only. Also, its causal relationship confirmed; some scholars found it as demand following that is financed causes growth. Some as the supply leading, which means growth causes finance and lastly some confirmed it as bi-directional, which is both of the two, are feeding it other (Aziakpono 2003).

### 1.5.6 Short-Run

The short-run is commonly characterized in macroeconomics as the time period over which the wages and prices of other production inputs are "sticky" or inflexible. In the short-run, many macroeconomic models conclude that the tools of monetary and fiscal policy have real effects on the economy, the affect is more on production and employment (Beggs, 2020).

### 1.5.7 Long-Run

The long run is defined as the period of time over which the input prices varies, which means it has time to adjust. The output prices (prices of products sold to consumers) are more flexible than input prices (prices of materials used to make more products). The input price is more constrained by long-term contracts and social factors (Beggs, 2020)

## 1.6 Scope and Limitation of the Study

Although in its broadest definition, financial institutions comprise banking and non-banking institutions. Therefore, this study is concerned explicitly with the Malaysian financial institution (banking institutions and capital market), the total investment and production efficiency. The economic growth of Malaysia is also a concern of this study. Banking and nonbanking institutions in Malaysia are classified into conventional institutions and Islamic (interest-free) based institutions. The focus scope and coverage of this study is only interest-free Islamic financial institutions activities since its inceptions in Malaysia. It is with the view to determine the extent of Islamic financial institutions contributed to the Malaysian economic growth through the channels of stimulating investments and production efficiency.

The limitation of this study is that the study is limited to only one country's economy, it does not measure panel of countries to see whether there are any significant differences. Another limitation of this study is that it only focused on the activities of Islamic banking and that of Islamic capital market. Furthermore, the study