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Islamic Economic Model for Sustainable Development

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Abstract

In a growing body of literature, importance of financial sector development and growth on human development has been emphasized but so far little empirical evidence to support this. Islam is a progrowth religion but the concept of development in Islam is multidimensional, understanding the relationship between finance, growth and human development would help us better explain and develop a sustainable pro-Islamic economic growth model, which would help eradicate mass poverty, income inequality and develop human capital in the Muslim world. This study aims to investigate how finance and growth affect human development from Islamic economic development perspective by using standard time series technique, ARDL. The study finds that there is a long term relationship between finance, growth and human development. Human development is found significantly correlated with the growth in the long run. It can be argued that financial development supports growth and growth ultimately promotes human development in the long run, also, macroeconomic stability is found significant for sustainable economic growth. However, oil price is found not correlated with growth in the long run for the economy.

Keywords: Islam, Economy, Growth, Sustainable Development, Model

Introduction

The history of economic development in Islam has started in Medina since the first Islamic state was established by our Holy Prophet (SAWS). Anwar (1987) while proposing an interest-free economic model argues that the failure of the traditional approaches to economic development is evident from the mass poverty, co-existence of hunger and affluence, exploitation of poor by rich and the powerful, increasing disparities at the regional and international levels, the unsuitability

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of production and consumption processes to environmental needs, and the irrational use of non-renewable resources. Mirakhor and Askari (2010) state that until the last decades of the twentieth century, development thinking had evolved within a framework of "missing person," namely, the human being. The goals of the Islamic concept of economic development cannot be explained in terms of Gross National Product and increase in per capita income only. It must be explained in terms of raising the absolute income levels of the poor to eradicate poverty, meeting material or non-material human needs, the conservation of natural resources, wildlife, and ecological environment (Mannan, 1989). Bacha & Mirakhor (2014) confirm that importance of capital markets and the financial sector for economic growth and development in Muslim countries. On the other hand, Cizakca (2014) argues that even though Islamic finance has developed significantly in the recent past, however, this development alone, without fulfilling certain preconditions in the rest of the economy, cannot generate economic growth. Fundamental theory behind our study is endogenous growth theory, an economic theory which argues that economic growth is generated from within a system as a direct result of internal processes (Romer, 1994; Aghion et al., 1998; Solow, 2000). On the other hand, many economists argue finance is a relatively unimportant factor in economic development. Particularly, Robinson (1952) contends that financial development simply follows economic growth. Later, Lucas (1988) terms the relationship between financial and economic development "overstressed" (cited in King & Levine, 1993). Finance and growth are positively correlated and finance plays important role in growth in the long run (Goldsmith, 1969; King and Levine , 1993; Demirguc-Kunt and Levine, 2004; Beck, Levine, and Loayza, 2000; Beck et al.,2014). On the other hand, negative and non linear relationship between finance and growth has also been reported (Deidda and Fattough, 2002; Arcand, 2011; Huang and Lin, 2009; Law and Singh, 2014). We can state that in spite of voluminous amount of research the issue is still remain somewhat controversial.

Human development, one of the fundamental ideas of economic development, and its relationship with growth is not straight forward. There are two strands of the literature on economic development that are relevant here but have tended to remain rather distinct. The predominant one has been concerned with the determinants of Endogenous Growth, going back to classical times, extending to neo-classical growth models and, more recently, the "new growth

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theory" models. The second strand asks what the ultimate objective of economic development is and how to measure it, including a discussion of the determinants of HD(Mankiw, Romer and Weil, 1992; Benhabib & Spiegel, 1994). Boozer et al. (2003) argue that human development is not only a product of economic growth but also an important input to it. At the same time, Pischke (1998) argue that access to informal credit contribute to development by facilitating entrepreneurship among the poor and increasing their capacity to manage risk(Pischke, 1998; Pischke, 2012). Financial development increases average growth (Beck et al., 2007; Gennaioli et al., 2011; Monacelli et al., 2011; Clarke et al., 2013). However, Lee & Hong (2011) argue that the contributions of education and total factor productivity in Asian past economic growth remain relatively limited. No significant relationship between finance, growth and human development was found (Demirguc-Kunt and Levine, 2004). While there is no doubt that a developed economy needs a sophisticated financial sector, at the current state of knowledge there is no theoretical reason or empirical evidence to support the notion that all the growth of the financial sector in the last forty years has been beneficial to society (Zingales, 2015) . From the above discussion, we can argue that relationship between finance and growth is not clear, moreover, how finance and growth can promote human development, a key indicator of real economic development of an economy in Islamic economics, did not get enough attention from the economist A humble attempt has been made in this study to investigate the relationship between financial development, growth and human development, we have chosen Malaysia as a case study to examine how financial development has supported growth and examine how this growth really promotes to human development. Malaysia is an emerging economy in the south-east Asia with a per capita GDP of more than 10,000 USD and has a vision to become a developed economy by 2020 and considered as a bright example among Muslim community for upholding the true value of Islamic teaching, only country from 56 OIC countries to be included in the Islamicity index developed by Askari (Askari, 2013). This paper tries to investigate the long and short-run determinants of finance, growth and human development in Malaysia. We employ yearly data over the period 1973-2013 by using a robust and advanced time series technique, Autoregressive Distributed Lag (ARDL) cointegration method which is applicable regardless whether the variables are I(1) or I(0). Finance, growth and human development is found cointegrated in the long run, i.e. thereis a long-run relationship between these variables.

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There exist bi-directional finance and growth relationship, it can be argued that, finance is initially leading the growth but in the long run growth actually leads the finance. Human development is found significantly positively correlated with growth but the magnitude is not conclusive. Short term volatility in oil price and exchange rate has lag effect on growth, which might ultimately affect the growth in the long run.However, oil price is found not correlated with growth in the long run for Malaysian economy. Finally, it can be argued that financial development supports growth and growth ultimately promotes human development in the long run, also, macroeconomic stability is found significantfor sustainable economic development.

The paper is organized as follows. Section 2 reviews on the relevant theoretical and empirical literature. The theoretical model specification, data and the ARDL cointegration methodology are explained in section 3. The empirical results and discussions are presented in section 4. The last section ends with the concluding remarks and policy implications of the paper.

Historical Analysis of Islamic Economic Model

The history of economic development in Islam has started right from the concept and establishment of the first Islamic state in Medina after the Holy Prophet (SAWS) migrated from Makka. The Prophet (SAWS) has established the principles of a welfare state and clearly specifies the rules of every stakeholder and the most importantly the institution, Bait-ul-mal (As-Sadr, 1989). After reining for centuries the Muslim have diverted from the true principle and teaching of Islam and more importantly Islamic economic development guideline (Cizakca, 2014) as a consequence Islamic economics had been in hibernation for unexpectedly long time and only four decades ago it revived and has got some kind of momentum for the last few decades.

Anwar (1987) while proposing an interest-free economic model argues that the failure of the traditional approaches to economic development is evident from the mass poverty, co-existence of hunger and affluence, exploitation of poor by rich and the powerful, increasing disparities at the regional and international levels, the unsuitability of production and consumption processes to environmental needs, and the irrational use of non-renewable resources. As a result, several economists have stressed the need for taking account of social, cultural and religious factors in

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choosing the development paths, rather than adhering to the Western development strategies. Anwar (1987) further argues that full employment and price stability are among the major economic goals of all the Muslim countries leaning towards economywide interest-free reforms. He further argues that in an interest-free economic system the savers and entrepreneurs will obtain the same real rates of return, they intended at the time of fund transfer if their contracts are concluded on the basis of interest-free Islamic principles even in the presence of inflation or deflation, thereby leading to steady economic development. Mirakhor and Askari (2010) state that until the last decades of the twentieth century, development thinking had evolved within a framework of "missing person," namely, the human being. During the 1970s, the intellectual and practical field of development totally changed its focus to human beings, both as the means and as the end of the development process (Mirakhor & Askari, 2010). The goals of the Islamic concept of economic development cannot be explainedin terms of Gross National Product and increase in per capita income only. It must be explained in terms of raising the absolute income levels of the poor to eradicate poverty, meeting material or non-material human needs, the conservation of natural resources, wildlife, and ecological environment (Mannan, 1989), in other words, major foundational elements of development in Islam are: individual self-development, the physical development of the earth and its natural resources, and the development of human collectively (Mirakhor & Askari, 2010; Askari, 2014;). In addition, the goals of the Islamic concept of development must be designed for the preservation of moral and spiritual values, as reflected in the concept of 'Tazkiyah' (moral purification plus growth). Establishment of an Islamic financial system is one of the pioneering efforts needed to reform all economic institutions in accordance with the principles of Islamic Economics. Anwar (1987) argues that advantages of financial markets are greater diversification of portfolios, the possibility of alterations in risk levels, and the transfer of resources from savers to investors, all of which permit increased investment opportunities and higher levels of economic development. Bacha & Mirakhor (2014) confirm that importance of capital markets and the financial sector for economic growth and development in Muslim countries. On the backdrop of current global financial crisis, they further argue that conventional capital markets that are heavily biased toward debt and debt-based instruments are inherently unstable, therefore, they propose a risk-sharing framework that minimizes debt – if not avoids debt completely – and brings about

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renewed stability. Bacha & Mirakhor (2014) states that Malaysia and Bahrain have attempted to build comprehensive Islamic capital market (ICM). They further argue that although governments, such as those of Malaysia are determined to develop their ICM, policy making at the macroeconomic level remains conventional – especially monetary policy. On the other hand, Cizakca (2014) concludes that even though Islamic finance has developed significantly in the recent past, however, this development alone, without fulfilling certain preconditions in the rest of the economy, cannot generate economic growth. He identifies the rule of law, the democratic package, the basic freedoms, and the avoidance of sectarian violence. Askari (2013) argues that in most Muslim societies, efficient institutions, rules and rulecompliance to promote development are not embraced and practiced, therefore, in many countries that profess Islam and are labeled as Islamic today, we see injustice and underdevelopment. He further argues that despite the fact the Islamic basis of development is multidimensional, having its moral, social, political and economic dimensions, moral and spiritual development need to be integrated into the very concept of economic development right from the beginning. Thus, economic development in Islam is not simply materialistic development. The spiritual and moral phases are assigned capital importance and they were made explicitly in 'Takaful' or 'Tadamun' or mutual social security of Islam. The ideal pattern of Islamic belief, which contains enough motivational properties regarding work, can influence actual patterns of Muslim behavior. It is possible to motivate economic achievement, thereby accelerating economic development through a systematic program of moral, educational training and more evident in the context of present disorder in the financial sector (Zingales, 2015). In the following part we are going to look at the finance growth theory and consider how financial development and growth contributes to human development. As many Muslim countries have abundance of natural resources, the impact of one of the key strategic resource oil on human development is also going to be investigated. Fundamental theory behind thisstudy is endogenous growth theory, an economic theory which argues that economic growth is generated from within a system as a direct result of internal processes (Romer, 1994; Aghion et al., 1998; Solow, 2000). More specifically, the theory notes that the enhancement of a nation's human capital will lead to economic growth by means of the development of new forms of technology and efficient and effective means of production. This view contrasts with neoclassical economics, which contends that technological progression and

other external factors are the main sources of economic growth. Supporters of endogenous growth theory argue that the productivity and economies of today's industrialized countries compared to the same countries in pre-industrialized eras are evidence that growth was created and sustained from within the country and not through trade. Since the Second World War, the world economy has been growing faster than ever before. The USA and the former Soviet Union the winner, Japan and Germany the loser of the war had become the global growth engine until late twentieth century. In the recent past, Brazil, Russia, India, China and South Africa (BRICS) have shown phenomenal growth until 2007-2008 financial crisis. Adam Smith, Thomas Malthus and David Reicardo could be regarded as the main precursors of modern growth theory. Growth has been a central issue for economists for over a century and many theories were developed in 1950's and 1960's, and some early growth models are collected in Stiglitz and Uzawa (1969) (cited in Jovanovic, 2000). Since 1980 arrival of better data set has helped economists to answer better the rationale (factors that determine growth)behind the past growth and future predictions (Jovanovic, 2000). Growth is a complex phenomenon and many theories have been developed to explain this phenomenon. Voluminous amount of research has been conducted in this field and has been growing continuously. One of the most prominent areas of growth research is the study of finance-growth nexus. In his ground breaking research Schumpeter (1911) (cited in King & Levine, 1993) argued that the financial intermediaries play an important role in technological innovation and economic development. In his seminal work, Financial Structure and Development, Raymond W. Goldsmith (1969) wanted to accomplish three goals. Firstly, how financial structure – the mixture of financial instruments, markets, and intermediaries operating in an economy – changes as economies grow. Secondly, impact of overall financial development – the overall quantity and quality of financial instruments, markets, intermediaries – on economic growth. Finally, whether financial structure influences the pace of economic growth, in other words, does the mixture of markets and intermediaries functioning in an economy influence economic development. Goldsmith (1969) argues that one of the most important problems in the field of finance, if not the single most important one, almost everyone would agree, is the effect that financial structure and development have on economic growth (Goldsmith, 1969 cited in Demirguc-Kunt and Levine, 2004, 3). On the other hand, many economists argue finance is a relatively unimportant factor in economic development.

Particularly, Robinson (1952) contends that financial development simply follows economic growth. Later, Lucas (1988) terms the relationship between financial and economic development "overstressed" (cited in King & Levine, 1993). After Glodsmith's groundbreaking empirical research many empirical works have been carried out to investigate finance-growth relationship. King and Levine (1993) studied 80 countries over the 1960- 1989 period to investigate the relationship between higher level of financial development and faster rate of economic development, physical capital accumulation and economic efficiency improvement. In their comprehensive research in this field,Demirguc-Kunt and Levine (2004) confirm that in the recent past, researchers have shown that financial development has positive impact on economic growth, not due only to simultaneity bias, at firm level (Demirguc-Kunt & Maksimovic, 1998), industry level (Rajan &Zingales, 1998; Wurgler, 2000) and pooled cross-country, time series studies (Beck, Levine, and Loayza, 2000; Beck et al.,2014). On the contrary, a study conducted by Stephen Cecchetti and Enisse Kharroubi recently outlined the negative link between the finance sector and growth, after a certain point. They further argue that when an economy is immature and the financial sector is small, then growth of the sector is helpful (Cecchetti & Kharroubi, 2012). Singh and Law(2014) by using dynamic panel threshold technique on 87 developed and developing countries found that more finance is not necessarily good for economic growth and highlight that an optimal level of financial development is more crucial in facilitating growth (Law and Singh, 2014). Arcand (2011) found that finance starts having a negative effect on growth when credit to private sector reaches 100% of GDP. Non-linear positive relationship between finance and growth (Deidda and Fattough, 2002), the positive effective is more evident in the low-income countries than in the highincome countries (Huang and Lin, 2009). Therefore, we can argue that the finance-growth relationship is not settled yet, in spite of, vast literature contributed in understanding this dynamic relationship. Now, we are going to look at the literature on how finance growth nexus affect human development (HD). There are two strands of the literature on economic development that are relevant here but have tended to remain rather distinct. The predominant one has been concerned with the determinants of Endogenous Growth (EG), going back to classical times, extending to neo-classical growth models and, more recently, the "new growth theory" models. The second strand asks what the ultimate objective of economic development is and how to measure it, including a discussion of

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the determinants of HD. We take the position that a long and healthy life represents the "bottom line" objective of human activity, even though this issue continues to be contested. Human development has been defined as enlarging people's choices in a way which enables them to lead longer, healthier and fuller lives (UNDP). We shall consider the HD of a country as consisting of the health and education of its people, recognizing that this is very much a reductionist interpretation. There two approaches in this nexus, a standard approach is to treat human capital, or the average years of schooling of the labor force, as an ordinary input in the production function (Mankiw, Romer and Weil, 1992). Another is associated with endogenous growth theory, the growth of total factor productivity as a function of the level of education or human capital, life expectancy. The presumption is that an educated and healthy labour force is better at creating, implementing, and adopting new technologies, thereby generating growth. Benhabib and Spiegel (1994) in their seminal work study the role of human capital in economic development and proposed a new model. The significance of this alternative model in terms of its empirical implications is that human capital stocks in levels, rather than their growth rates, now play a role in the determining the growth of per capita income(Benhabib & Spiegel, 1994).

Conclusion and Way forward

Economic development in Islam cannot be explained in terms of growth in real income only. It must be explained in terms of raising the absolute income levels of the poor to eradicate poverty, meeting material or non-material human needs, the conservation of natural resources, wildlife, and ecological environment. Even though, the concept of development in Islam is multidimensional, understanding the relationship between growth and human development, also finance and human development would help us better understand and develop a sustainable pro-Islamic growth model, which will help to eradicate mass poverty, income inequality and develop human capital in the Muslim world to lead from the front. The reemergence of Islamic finance after such a long period of hibernation indicates the urgency and necessity of a unique model of growth and development based on true Islamic principles. Recent debate on whether finance reduces poverty and promotes human development has got momentum among the policy makers and economists. Against the backdrop of global financial crisis in 2007-2008, the issue has even become more vital, consequently, huge government bailout with taxpayers money, corporate

fraud, LIBOR manipulation, and many more finance scandals create doubt about role of finance in economy (Zinagles, 2015). The voluminous amounts of research in finance-growth nexus suggest positive relationship between finance and growth, but there are counter arguments and empirical evidence against this theory. In our study, we have investigated economic development, in terms of human development, a foundational goal of Islamic economy and how finance and growth affect human development. Very few empirical research argue that finance supports growth and growth ultimately promotes human development but most of these studies were conducted in a developed economy, like in OECD or G-20 countries, so the same inference cannot be made on the least developed or developing countries. In our study wetry to investigate the long- and short-run determinants of finance and growth and their impact on human development in Malaysia with the help of a standard time series technique, ARDL,which is applicable regardless whether the variables are stationary or non-stationary at their level and differenced form. From the analysis of our result we can conclude that finance, growth and human development are found cointegrated in the long run. It is found that life expectancy (LL), liquidity liabilities to GDP (LF) and exchange rate (LX) have significant effects on the real GDP per capita in Malaysia.Human development, life expectancy, is found significantly positively correlated with growth but the magnitude is inconclusive, One reason could be, relationship between life expectancy and growth is reverse, that is life expectancy may depend on the growth which is more sound and theoretically supported. This helps us to conclude that life expectancy is an important determinant of growth of an economy.

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