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DOES SUKUK FINANCING PROMOTE ECONOMIC GROWTH? AN EMPHASIS ON THE MAJOR ISSUING COUNTRIES

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Abstract

For the past few decades, Islamic finance has imposed itself as a viable alternative / complementary system to the long existing conventional financial system. Nevertheless, recent research has claimed that Islamic finance as it is currently practice, does not promote economic growth. Hence, the objective of this study is to empirically test this claim, by examining the potential effect of Islamic finance in the specific form of Sukuk issuance on the economic growth represented by three proxies, namely, Gross Domestic Product (GDP), Gross Capital Formation (GDP) and trade activities. The data covers not only GCC (Gulf Cooperation Council), but also other countries including Malaysia, Indonesia, Turkey, Pakistan, Singapore, China, Brunei, Kazakhstan, Germany, United Kingdom (UK), The Gambia and France. The data were collected from the Islamic Finance Information Services (IFIS) and the World Bank databases, and were subsequently analysed through Toda and Yamamoto Granger Non Causality test. Accordingly, the findings indicated that the Sukuk issuance had an influence on the GDP and GCF only when all the countries were pulled together, otherwise no effect was identified for Saudi Arabia and the GCC.

Keywords: Islamic Finance, *Sukuk*, Economic Growth, Financial Development, Saudi Arabia.

SUKUK FİNANSMANI İKTİSADİ BÜYÜMEYİ TEŞVİK EDER Mİ? SUKUK ÇIKARAN ANA ÜLKELER ÜZERİNE BİR ÇALIŞMA

Özet

Geçen bir kaç on yıl içinde İslami finans kendisini uzun süredir mevcut olan geleneksel finans sisteminin bir alternatifi / tamamlayıcısı olduğunu gösterdi. Ancak, son araşmalar İslami finans'ın mevcut uygulamasıyla iktisadi büyümeyi desteklemediğini iddia ediyor. Dolayısıyla, bu çalışmanın amacı bu iddianın ampirik testini İslami finans'ın Sukuk uygulamasının potansiyel etkilerini inceleyerek test etmektir. Sukuk uygulamasının iktisadi gelişmeyi gösterdiği düşünülen üç değişken üzerindeki etkilerine bakılmıştır.

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Bu üç değişken Gayri Safi Yurt İçi Hasıla (GSYİH), Gayri Safi Sermaye Oluşumu ve Ticaret faaliyetleridir. Veri seti sadece Körfez Ülkeleri Birliği'ndeki ülkeleri değil aynı zamanda Malezya, Endonezya, Türkiye, Pakistan, Singapure, Çin, Brunei, Kazakistan, Almanya, İngiltere, Gambia ve Faransa gibi diğer ülkeleri de içermektedir. Veri seti İslami Finans Enformasyon Servisi (IFIS) ve Dünya Bankası'ndan alınmış ve Toda and Yamamoto Granger Non Causality testiyle analiz edilmiştir. Elde edilen bulgulara göre Sukuk uygulamasının sadece bütün ülkeler dahil edildiğinde GSYİH ve Gayri Safi Sermaye Oluşumu üzerinde etkisinin olduğu, aksi takdirde Körfez Ülkeleri Birliği ve Suudi Arabistan'da bir etkisinin olmadığı bulunmuştur.

Anahtar Kelimeler: İslami finans, sukuk, iktisadi büyüme, finansal gelişme, Suudi Arabistan

1. Introduction

The development of Islamic finance is traced back to the 1970s, the period characterized with oil crisis and global recession. Triggered by the lesson learn from the persistence financial crisis especially the recent global financial crisis in 2007, *Sukuk* issuance has been enormously witnessed in both developed and developing countries.

The origin of *Sukuk* can be traced back to the 1st Century AH during the Umayyad Caliphate. Imam Malik mentioned in his Al-Muwatta "Yahya related to me from Malik that he had heard that receipts (*Sukuk*) were given to people in the time of Marwan Ibn Al-Hakam for the prodeuce of the market at al-Jar. People bought and sold the receipts (*Sukuk*) among themselves befor they took delivery of the goods. Zayd Bin Thabit and one of the Companions of the Messenger of Allah *swt*, went to Marwan Ibn Al-Hakam and said, "Marwan! Do you make usury halal?" He said, "I seek refuge with Allah! What is that?" He said, "These receipts (*Sukuk*) which people buy and sell before they take delivery of the goods." Marwan therefore sent a guard to follow them and to take them from people's hands and return them to their owners.[4]

The word *Sukuk* is a plural form of the Arabic word *Sakk* which means "to strike one's seal on a document" (McMillen, 2007). In its plural form, it is used as generic term for "note", "certificate", or "bonds". It generically refers to *Shariah* compliant debt instrument in practice (Standard & Poors, 2012: 12). The *Sukuk* refers to 'participation right in the underlying asset' (Iqbal and Tsubota, 2006). In the literature, the *Sukuk* has been defined in several different ways. However, we focus only on the three definitions which are most authoritative in nature.

The Accounting and Audit Organization for Islamic Financial Institutions (AAOIFI), in its *Shariah* standard 17(2), defines *Sukuk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services, assets of particular projects or special investment activity" (AAOIFI, 2008). It was defined as "certificates that represent the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset" by the Islamic Financial Services Board (IFSB) in its Capital Adequacy Standard (IFSB 2) (IFSB, 2008). Securities Commission Malaysia (SC), in

[4] Al-Muwatta' Book 31, Number, 31.19.44.

its Guideline on Islamic Securities 2004, defined *Sukuk* as a "document or certificate which represents the value of an asset" (SC, 2004).

If the above three definitions are compared, the definition provided by the SC Malaysia is broader and include the other two definitions. However, differences exist in the kinds of asset that can qualify under regulatory bodies' (i.e. AAOIFI and IFSB) definition and the SC's definition (ISRA, 2011).

There are at least fourteen different types of *Sukuk* structures recognized by the AAOIFI based on assets, debt, equity and services (Habib, 2010). These *Sukuk* structures are based on three underlying forms of Islamic finance, namely, *Murabahah* (synthetic loans/purchase orders), *Musharakah*/*Mudharabah* (profit-sharing arrangements) and *Ijarah* (sale-leasebacks), or combinations of these (Jobst, 2007). The *Sukuk* representing ownership of real assets or usufruct are negotiable and can be traded; conversely if representing debt or money can be exchanged on par value only (Habib, 2010).

Since its inception, *Sukuk* have been successful in providing funds to corporations and governments across the globe. However, they were also criticised for a number of aspects. These include their suspected contribution to the economic growth and development, the nature of their structure and their compliance with the *Shariah* rules, the actual existence of the underlying assets and the investors' claims on these assets, etc. (Abdul Rahim, 2013; Saeed and Salah, 2013).

Accordingly, the objective of the study is to scrutinise one of the main abovementioned issues associated with *Sukuk*, namely, the effect of *Sukuk* financing on economic growth on a number of *Sukuk* issuing countries. In other words, the study attempts to answer the following question: Does *Sukuk* financing have a significant effect on economic growth and development?

For this matter, the study uses secondary data in form of time series collected from IFIS and the World Bank databases. The countries covered are Malaysia, Saudi Arabia, UAE, Indonesia, Qatar, Turkey, Pakistan, Bahrain, Singapore, China, Brunei, Kuwait, Kazakhstan, Germany, United Kingdom (UK), The Gambia and France.

The remainder of the paper is organised as follows: Section two presents an overview on *Sukuk*. Section three reviews the literature in this area. Section four presents and explains the methodology used for this study. Section five discusses the findings, and finally section six concludes the paper.

2. Overview on the Sukuk Market

As far as the GCC countries, Table 3 indicates that UAE is leading the corporate *Sukuk* issuance with 46 issuances followed by Saudi Arabia with 32 issuances, and Kuwait with 18 issuances. With regard to sovereign *Sukuk*, Bahrain is leading the issuances with 15 following by UAE with 10 issuances and Qatar with 5. Finally, Saudi Arabia is leading the Quasi-sovereign *Sukuk* with 16 issuances, followed by UAE with 13 issuances.

Table 1. *Sukuk* Comparison by Type of Issuance

Countries	Corporate *Sukuk*	Sovereign *Sukuk*	Quasi-Sovereign *Sukuk*
Saudi Arabia	32	1	16
Bahrain	6	15	2
Kuwait	18	0	4
Qatar	8	5	0
UAE	46	10	13

Source: IFIS

In contrast to the global issuances of *Sukuk*, Malaysia is the first global *Sukuk* issuer with a total of nearly USD46 billion, followed by Saudi Arabia with nearly USD11 billion, then UAE and Indonesia with over USD6 billion. The least issuing countries are France and The Gambia with circa USD1 billion.

Table 2. Global Issuance Data by Value for 2012
(USD million)

Countries	Issuance value
France	1
The Gambia	1
United Kingdom	11
Germany	55
Kazakhstan	79
Kuwait	105
Brunei	161
China	197
Singapore	261
Bahrain	629
Pakistan	942
Turkey	2398
Qatar	5450
Indonesia	6213
UAE	6539
Saudi Arabia	10517
Malaysia	45624

Source: IFIS

As it is indicated in Table 3, these *Sukuk* issuances were mostly structured as investment *Sukuk* (31%), *Mudharabah Sukuk* (29%), *Murabahah Sukuk* (11%), *Ijarah Sukuk* (9%), *Sukuk Al-Wakalah Bel Istithmar* (6%), and *Sukuk Al-Musharakah* (3%). Similarly, these issuances mostly concern the financial services (22%), real estate and construction (11%), oil and gas (8%), power and utilities (5%), food and dairy products (3%), and transport and government institutions (1%).

Table 3. *Sukuk* Issuances Breakdown

Structure	Percentage	Sector	Issuances
Investment *Sukuk*	31	Financial services	22
Mudharabah	29	Real estate and construction	11
Murabahah	11	Oil and Gas	8
Mixed	11	Power and Utilities	5
Sukuk Al-Ijarah	9	Food and Dairy Products	3
Sukuk Al-Wakalah Bil Istithmar	6	Transport	1
Sukuk Al-Musharakah	3	Government Institutions	1

Source: IFIS

3. Literature Review

The study of financial development-economic growth nexus emerged in the early 19th century. The subsequent financial economic theoreticians e.g. McKinnon (1973) and Shaw (1973) demonstrated that the restriction of financial systems through various measures impedes financial development which is essential to the economic growth. Similarly, the theory highlights the significance of the economic growth to the financial development notably through the impact of financial services on capital accumulation and technological innovation (Abu-Bader and Abdu-Qarn, 2006).

Subsequently, a growing body of literature has covered this topic in several contexts and using various estimations for both financial development and economic growth (Sunde, 2012; Stievano, 2004; Halicioglu, 2007; Abu-Bader and Abu-Qarn, 2006; Al-Malkawi and Abdullah, 2011; Pradhan, 2009; Conley, 2012; Stolbov, 2012; Khan, 2000; Shan and Jianhong, 2006; Ujunwa, Ekumankama, Umar and Adamu, 2012; Al-Malkawi, Marashdeh and Abdullah, 2012). Generally there are at least three types of causal relationships found between financial development and economic growth, namely, supply-leading, demand-following and bi-directional causal relationships. It is noteworthy that these studies were mainly focusing on the banking sector and stock markets, while they have generally under-researched the bond market, which is considered one of the major sources of financing as well (Fink, Haiss and Hristoforova, 2003). The latter, though has received less attention in both theoretical and empirical studies, has been proven to be a major antecedent of economic growth (Fink et al., 2003).

The above stream of studies were recently extended to the Islamic finance-economic growth nexus with the emergence and development of modern Islamic finance. Islamic finance emerged as an alternative/complement to the existing conventional finance. In line with the Islamic principles and teachings, Islamic finance prohibits *riba*, *gharar*, and gambling, as well as other practices that violate the principles of justice and equitable distribution that are fundamental values in Islam. It is worth noting that Islamic finance has witnessed tremendous growth in the last few decades, and has been introduced in many countries, not only in the Muslim world, but also in other non-Muslim countries. Hence, Islamic financing is a potential alternative for macroeconomic development in these countries.

Currently, the studies on Islamic financing and economic growth nexus are still scarce. One of the early studies was by Furqani and Mulyani (2009) who have examined

the Islamic finance and economic growth nexus in the case of Malaysia. The authors used quarterly data from 1997 through 2005, and have applied co-integration and Vector Error Correction Models (VECM). Their findings indicated that in both the long run and short run, there is evidence of bi-directional relationship between Islamic financing and fixed investment.

In the same context, Abdul Manap, Abduh and Omar (2012) have also examined the relationship between Islamic banking development and economic growth in Malaysia using Toda-Yamamoto and Bootstrap granger non causality tests. The study covered the period of 1998 through 2012 in quarterly form. The findings provide evidence of unidirectional relationship from Islamic financial development towards economic growth.

In a more recent study, Abduh and Omar (2012) have investigated the short- and long run relationships between development of Islamic banking and the economic growth in Indonesia, using quarterly data spanning from 2003 through 2010. By using Autoregressive Distributed Lag (ARDL) model, the authors found an evidence of a bi-directional relationship between both the variables.

Similarly, Abduh and Chowdhury (2012) explored the relationship between Islamic finance development and economic growth in the case of Bangladesh. The authors used quarterly data spanning from 2004 through 2011 and applied co-integration and Granger causality tests. Their findings indicated that in both short and long run, there is a unidirectional relationship running from Islamic financing to economic growth.

In a different context, Goaied and Sassi (2010) studied the relationship between Islamic financing and economic growth in selected Middle East and North African (MENA) countries. The authors used unbalanced panel data set and applied system GMM estimation for dynamic panel model. Their findings indicated that there is no significant relationship between Islamic financing and economic growth in the selected markets. Nevertheless, the main weakness of this study is that the countries selected are of different economic and financial development, and the spread between these two might not be consistent across MENA countries. Thus, the output of the study might be biased.

In a related context, Azouzi and Echchabi (2013) examined the relationship between Islamic finance development and economic growth in the case of Kuwait from 2004 through 2011. The authors applied cointegration, VECM and granger causality tests to attain their objective. Their findings revealed that there were no association between the two elements, neither in the short run, nor in the long run.

It is worth noting that the studies scrutinising Islamic finance and economic growth nexus, have considered the aggregate Islamic financing without identifying the pure effect of *Sukuk* financing. The latter is considered one of the significant sources of financing under Islamic finance.

4. Methodology

As the objective of the study is to investigate the possible effect of *Sukuk* issuance on the economic growth and development, the study covers most of the *Sukuk*

issuing countries. The countries covered are Malaysia, Saudi Arabia, UAE, Indonesia, Qatar, Turkey, Pakistan, Bahrain, Singapore, China, Brunei, Kuwait, Kazakhstan, Germany, United Kingdom (UK), The Gambia and France. Hence, it covers countries from most of the regions. The data covers the period from 2005 through 2012.

One proxy is used for the *Sukuk* issuance, which is the volume of *Sukuk* issuances over the years for the mentioned countries. These data were obtained from Islamic Finance Information Service (IFIS). On the other hand, economic growth is represented by three proxies, namely, Gross Domestic Product (GDP), Gross Capital Formation (GCF) and trade activities. These data were obtained from the World Bank database. Accordingly, following regression equations were derived:

$$\begin{aligned} GDP_i &= \beta_0 + \beta_1 SKK + \varepsilon \\ GCF_i &= \beta_0 + \beta_1 SKK + \varepsilon \\ TRD_i &= \beta_0 + \beta_1 SKK + \varepsilon \end{aligned} \qquad (1)$$

Where GDP[5] is the Gross Domestic Product at its current USD estimation, the GCF[6] is the Gross Capital Formation at its current USD estimation, TRD is the sum of exports and imports of goods and services measured as a share of gross domestic product (World Bank definition). The model is analysed using Toda and Yamamoto (1995) approach to Granger Non Causality test.

5. Findings

The results in Tables 5, 6 and 7 present the Granger causality output between *Sukuk* issuance and economic growth proxies for Saudi Arabia, GCC, and the pool of international countries, respectively. In this regard, Table 5 reveals that the *Sukuk* issuance in Saudi Arabia does not have any effect on the economic growth. This finding was consistent for all the three proxies. This is similar to the findings of Wilson (2014), but contradict the findings of Wilson (2014).

This implies that the economic development and growth in Saudi Arabia cannot be promoted through Islamic financing/*Sukuk* issuance. This might be due to the size of

[5] "GDP at purchaser's prices is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current U.S. dollars. Dollar figures for GDP are converted from domestic currencies using single year official exchange rates. For a few countries where the official exchange rate does not reflect the rate effectively applied to actual foreign exchange transactions, an alternative conversion factor is used" (World Bank definition).

[6] "Gross capital formation (formerly gross domestic investment) consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." According to the 1993 SNA, net acquisitions of valuables are also considered capital formation. Data are in current U.S. dollars" (World Bank definition).

Sukuk issuance in the country which is still not internationally competitive. It might also be due to the fact that the economy still relies on the conventional financial market for development.

Table 5. Causality Summary for Saudi Arabia

	GDP	GCF	TRADE
SUKUK ISSUANCE	0.005868 [0.9389]	0.027458 [0.8684]	0.001945 [0.9648]

Note: The figures in brackets are the probability values

Further, Table 6 shows similar results for the GCC region. However, it appears that the probability significant values have slightly increased. This might imply that the *Sukuk* issuance for the other GCC countries is more relevant to the economic growth compared to Saudi Arabia. This can be shown in the financing history of the other GCC countries e.g. UAE, which has recently been widely relying on Islamic financing.

Table 6. Causality Summary for the GCC

	GDP	GCF	TRADE
SUKUK ISSUANCE	0.518488 [0.7716]	3.338600 [0.1884]	1.519981 [0.4677]

Note: The figures in brackets are the probability values

In contrast to the above results, Table 7 indicates that *Sukuk* issuance has a very significant impact on the GDP as well as the GCF of the pool of *Sukuk* issuing countries. This might be explained by the large share of issuance contributed by countries like Malaysia, Indonesia and Turkey. This contradicts the claims by Wilson (2014).

This implies that the non-GCC countries are more benefiting from the *Sukuk* issuance in terms of economic development and growth. This could be related to the high reliance of the GCC countries on oil and gas income, and the lack of economic diversification, which might make the Islamic financial development less relevant in their context.

Table 7. Causality Summary for a Pool of Issuing Countries

	GDP	GCF	TRADE
SUKUK ISSUANCE	45.06575 [0.0000]	877.1316 [0.0000]	2.033079 [0.7297]

Note: The figures in brackets are the probability values

6. Discussions and Conclusions

The objective of the study was mainly to identify the potential effect of *Sukuk* financing on economic growth in major *Sukuk* issuing countries. The findings indicated that the *Sukuk* issuance had an influence on the GDP and GCF only when all the countries were pulled together, otherwise no effect was identified for Saudi Arabia and the GCC.

This finding has significant contributions to the literature, regulators and policy makers as well as to the practitioners. Specifically, the study enriches the literature by extending the study on Islamic finance and economic growth nexus to a mixed context of major issuing countries. Similarly, it uses relatively new data that reflects the recent economic growth and *Sukuk* financing in major issuing countries. More importantly, the study is one of the earliest to outline the pure effect of *Sukuk* financing on economic growth, instead of studying the aggregate Islamic financing. Moreover, the findings provide insights to the policy makers and practitioners on the possible measures to implement in order to optimally use *Sukuk* financing for the development of the economy.

Though the current study has brought about significant contributions, it might still be subject to a number of limitations. Firstly, the study focused on major issuing countries. Secondly, it has used data from 2005 to 2012, and this period witnessed a number of crises and bubbles, which were ignored in this study. Hence, future studies are recommended to consider the possible influence of the crises and bubbles that occurred during the study period. Similarly, the future studies are recommended to use various control variables across countries such as the level of corruption, the culture, etc.

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