Hochschule für Wirtschaft und Recht Berlin
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Bachelor Thesis

Economic Impact and Stability: Analyze the impact of Islamic banking on economic stability and growth

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Abstract: Islamic banking has emerged as a viable alternative to conventional finance, particularly in countries with significant Muslim populations. This thesis examines the role of Islamic banking in fostering SME growth and financial inclusion in OIC (Organization of Islamic Cooperation) countries. The study explores how key Islamic principles, such as profit and loss sharing, interest prohibition, and asset-backed financing impact financial inclusion and SME growth, thus increasing economic stability and development. Using secondary data, the findings highlight the challenges SMEs face in accessing Islamic finance, the potential of Islamic financial instruments in bridging the funding gap, and the potential of Islamic banks increasing financial inclusion of religiously excluded populations. The study concludes that while Islamic banking plays an important role in financial inclusion and SME growth in OIC countries, their impact remains limited. Regulatory and operational challenges hinder their full potential. Recommendations include standardizing regulatory frameworks for Islamic banking, developing innovative SME products and increasing Islamic financial literacy programs.

Keywords: Islamic banking, SMEs, financial inclusion, economic growth, Shari'a-compliant finance, profit-and-loss sharing.

1. Introduction

After World War II, many Muslim countries gained independence and tried different political and economic systems, like socialism and nationalism, to develop and become more independent. However, these systems did not meet expectations, leading to a stronger belief in Islamism—the idea that only an Islamic way of life, based on Shari'a law, could bring real freedom and success. This led to the creation of Islamic banking, which avoids interest and focuses on shared risks and asset-backed financing.

Since then, Islamic banking has grown rapidly, spreading to more than 50 countries, including parts of Europe, the US, and Australia. The industry continues to expand by 10–15% each year, with over 300 institutions managing more than $1 trillion in assets. The rising demand for Shari'a-compliant financial products, along with their ethical and stable nature, has made Islamic banking popular worldwide. Today, it is an important part of the global financial system, influencing economies in both Muslim and non-Muslim countries.

2. Materials and Methods

This research adopts a methodology that entails a review of literature on Islamic banking, economic stability, and the role of Islamic finance in SMEs support and financial inclusion especially in the OICs. This study employs secondary data derived from peer-reviewed articles, World Bank and Islamic Development Bank reports, and official statistics on SME financing and macroeconomic indicators in OIC countries. The study analyzes how Islamic banking principles influence financial accessibility, SME growth, and economic stability, considering both theoretical frameworks and real-world applications.

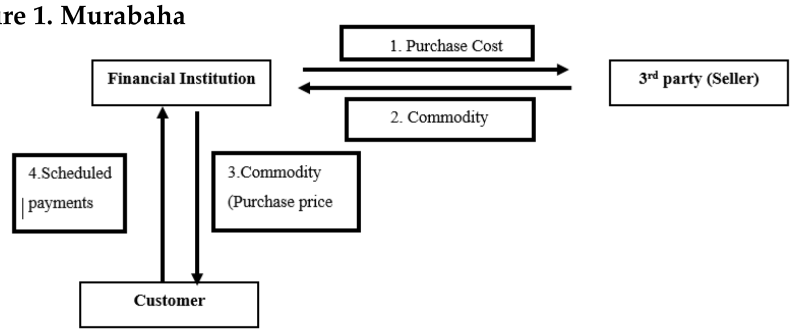
3. Results

3.1. Islamic Financial Principles

3.1.1. Murabaha

Shah and Niazi (2019, pp. 3–4) describe Murabaha as a sales-based financing model where the seller discloses the purchase cost and profit margin. Islamic banks use it as a Shari'a-compliant alternative to loans, purchasing goods and reselling them at a markup. Unlike interest-based loans, banks must take ownership before resale.
El-Gamal (2000, p. 10) similarly explains that Murabaha ensures transparency in pricing and is not considered Riba, as profits come from sales rather than interest. Ownership by the financial institution before resale is essential to its compliance with Islamic principles. However, Hasan (2010, pp. 8–10) and Gundogdu (2014, pp. 205–207) criticize Murabaha, arguing that its fixed profit rates resemble disguised interest and shift all risks to borrowers, contradicting Islamic finance's profit-and-loss sharing principles.

Figure 1. Murabaha



3.1.2. Mudarabah and Musharakah

Mudarabah and Musharakah both provide Shari'a-compliant alternatives to interest-based financing but differ in structure. Mudarabah is a profit-sharing partnership where a financier (rabbul-maal) provides capital, and an entrepreneur (mudarib) manages the business, sharing profits but not losses (Sapuan, 2016, p. 350–351). It has historical roots in Arabian trade and exists in restricted and unrestricted forms (Hamzah et al., 2013, p. 1055).

Musharakah, meaning "sharing," involves joint investment, with all partners contributing capital and sharing both profits and losses (Mejella, 1329; Arshad & Ismail, 2010, p. 147). Usmani (1998) emphasizes that profit-sharing ratios must be pre-agreed, and Van Schaik (2001, p. 48) notes that while Musharakah allows shared risk and effort, it is rare in Islamic banking due to banks’ reluctance to engage in active management.Tatiana et al. (2015, p.82) provides two figures that illustrate the distinctions between Mudarabah and Musharakah.

Figure 2. Mudarabah

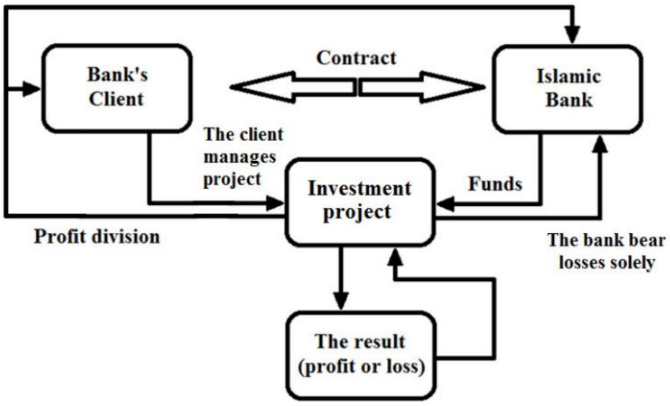
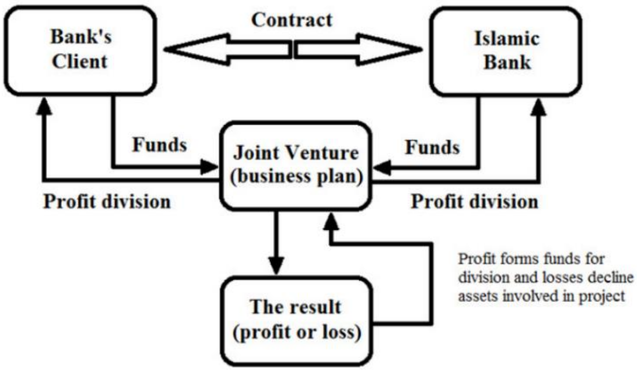


Figure 3. Musharakah



3.2. Islamic Banking’s Impact on SME Growth

Islamic finance supports SME growth by offering risk-sharing models such as Mudarabah and Musharakah, enabling long-term investment in high-risk, high-return projects that contribute to economic growth (Huda, 2012, p.179). By tying financing to tangible assets and business outcomes, Islamic finance fosters stability, job creation, and financial inclusion while reducing SMEs' reliance on speculative interest rates (Elasrag, 2016, p.9-10). Case studies from Turkey show that Islamic banks demonstrate a stronger commitment to SME financing than conventional banks, with lower non-performing loan rates and a larger share of lending directed to SMEs (Aysan et al., 2016). Similarly, in Bahrain, the government-backed Islamic financing program Tamkeen has led to increased SME contributions to GDP and employment (Matarneh & Almanaseer, 2015, pp. 53-55).

In South Africa, Islamic finance has expanded financial access through zero-interest loans and profit-sharing, diversifying the banking sector and fostering financial inclusion (Hove et al., 2014, cited in Muhmad et al., 2020, p.55). In Jordan, Islamic finance has helped reduce unemployment by providing tailored financial and administrative support to SMEs, allowing entrepreneurs to participate in profit-sharing arrangements without the burden of fixed monthly payments (Mumani, 2014, cited in Muhmad et al., 2020, p.55).

However, challenges remain. Many Islamic banks favor Murabaha, a debt-like instrument, over true profit-sharing models due to risk aversion, limiting their ability to support SMEs effectively (Huda, 2012, pp.180-183). In Nigeria, limited awareness, higher profit margins, and regulatory inconsistencies further hinder SME access to Islamic finance (Adekoya, 2022, pp. 358-359). In Malaysia, collateral requirements, documentation barriers, and long processing times make it difficult for SMEs to secure Islamic financing (Haron & Ibrahim, 2016, p.394, 403).

3.3. Islamic Banking's Impact on Financial Inclusion

Islamic economic principles promote fairness, equal opportunity, and equitable resource distribution, aligning with financial inclusion goals by ensuring access to financial services for all (Mohieldin et al., 2011, pp. 7-8; Iqbal & Mirakhor, 2011, p. 60). Islamic banking offers an alternative for the unbanked Muslim population, as 40% reject interest-based loans, highlighting its potential for inclusion (Amin, 2021, p. 41). However, financial exclusion due to religious reasons varies by country, with higher rates in Iraq (21%) and Afghanistan (15%) but much lower in Saudi Arabia (1%) and Malaysia (0%) (Global Findex, 2021).

Islamic banks address financial barriers through profit-and-loss sharing (PLS) instruments like Mudarabah and Musharakah, reducing collateral burdens and integrating ethical financing principles (Kamalu & Ibrahim, 2021, pp. 171-172). The concept of financial migration also shows growing confidence in Islamic banking due to pricing, service quality, and accessibility (Jouti, 2018). Moreover, Islamic banks performed efficiently post-2008 financial crisis due to asset-backed financing and risk-sharing mechanisms (Halim & Hafez, 2019; Ouerghy, 2014, p. 9).

Islamic finance enhances financial inclusion in OIC countries, exceeding global averages in small firm credit access and bank funding of investment, though underperforming in working capital financing (Naceur et al., 2015, p. 10-11). Islamic microfinance expands borrowing in Africa and Asia but struggles with low savings uptake due to product similarities with conventional banking (Akhter et al., 2019, p. 342, 349). Redistributive mechanisms like Zakat, Waqf, and Qard-Hassan play crucial roles in financial inclusion by supporting marginalized communities and promoting economic self-sufficiency (Mohieldin et al., 2012, p.

8). Institutionalizing these tools enhances their impact, as seen in Egypt's Al Baraka Bank Zakat Fund, which ensures transparent fund distribution (Al Baraka Bank, n.d.).

Despite its potential, Islamic banking faces barriers such as regulatory gaps, limited awareness, and preference for low-risk debt-like financing (Shaikh et al., 2017; Zamer, 2018, p. 121). Many Islamic banks favor Murabaha over equity-based PLS models due to risk and liquidity concerns (Ali & Hussein, 2017, pp. 48-49). Structural limitations in OIC countries also hinder financial inclusion efforts (Naceur, Barajas, & Massara, 2015, p. 20).

To overcome these challenges, reforms should focus on SME support, product affordability, digital accessibility, and regulatory development (Zamer, 2018, pp. 4-5; Mohieldin et al., 2012, pp. 49-50). Non-Banking Financial Institutions (NBFIs) like Egypt's Bokra offer innovative Shari'a-compliant financing solutions, addressing gaps left by traditional Islamic banks (Osam, 2023).

4. Discussion

SMEs play a crucial role in economic growth within OIC countries by creating jobs, reducing poverty, and fostering innovation. However, they face significant barriers to accessing finance, including high collateral requirements, weak credit information systems, and restrictive regulations. Islamic banks are theoretically well-equipped to address these challenges by offering Shari'a-compliant financing models based on fairness and risk-sharing, such as Mudarabah (profit-sharing) and Musharakah (joint ventures). These models provide SMEs with funding without requiring excessive collateral while promoting long-term partnerships.

In practice, however, Islamic banks rely heavily on debt-like instruments such as Murabaha (cost-plus financing), which offers stability but moves away from the core principles of Islamic finance. Systemic challenges, including a lack of standardized regulations and high operational costs, further limit the use of profit-sharing models. As a result, while Islamic banks provide valuable alternatives to conventional finance, their full potential in supporting SME growth remains unrealized due to regulatory gaps, operational risks, and competitive pressures.

Regarding financial inclusion, Islamic banks help reduce religious financial exclusion by providing Shari'a-compliant services that attract individuals who previously avoided traditional banks. This encourages financial participation, leading to increased economic activity and ethical investment. However, financial inclusion extends beyond simply having a bank account. Many marginalized groups, including SMEs, still struggle to access credit due to regulatory constraints, financial illiteracy, and a lack of awareness about Islamic banking.

Islamic financial instruments, such as Mudarabah and Musharakah for entrepreneurs and Qard-Hasan (interest-free loans) and Zakat (charitable giving) for vulnerable populations, can enhance financial inclusion. However, strict banking regulations and operational challenges limit their full adoption. To maximize their impact, regulatory reforms are needed to standardize and promote equity-based financing. Strengthening financial infrastructure, improving transparency, and developing SME-focused financial products will help Islamic banks better align with their ethical principles. Until these reforms are in place, Shari'a-compliant non-banking financial institutions (NBFIs) and Islamic microfinance institutions can help bridge existing gaps.

To maximize Islamic banks' impact, regulatory reforms are needed to standardize and promote equity-based financing processes. Additionally, efforts to strengthen financial infrastructure, reduce informational asymmetry, and develop innovative SME-focused financial products will allow Islamic banks to better align with their ethical principles and fully realize their role in driving sustainable economic growth and financial inclusion. Additionally, employee training in Islamic financial principles, and financial literacy programs are also critical. Until the reforms are achieved, financial institutions such as Shari'a compliant NBFIs and Islamic microfinance institutions can help bridge the gaps currently unaddressed by Islamic banks.

Future research should explore the potential for Islamic banks to develop innovative financial products that enhance both financial inclusion and SME growth. Additionally, examining the role of NBFIs in addressing gaps left by Islamic banks could provide valuable insights into expanding financial access.

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