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EFFECT OF FOREIGN DIRECT INVESTMENT RATES AND REMITTANCES ON ISLAMIC FINANCIAL INSTITUTIONS' GROWTH IN EMERGING ECONOMIES

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ABSTRACT
This study aimed to find out how important macroeconomic factors have affected the growth of Islamic banking sector in Pakistan. At the moment, Islamic banking is one of the industries that is expanding at one of quickest rates across Islamic world, particularly in Pakistan. The rate of foreign direct investment and the number of remittances were the two macroeconomic factors that the researchers looked at in order to evaluate whether or not macroeconomic variables had effect on Islamic banking growth. Scholars used model known as autoregressive distributed lag model, and they used quarterly data for all variables between years 2005 and 2021. As per results of long-run ARDL that were evaluated, foreign direct investment (FDI) has a negative and insignificant impact on growth of Islamic banking in short term, whereas remittances have positive and insignificant effect on growth of the Islamic banking. Both FDI and remittances have a positive effect on growth of Islamic banking in Pakistan over long term, with the remittances having a greater influence than FDI. In spite of fact that Islamic banks and non-Islamic banks are in competition with one another, existence of Islamic banks in a country provides solution that is acceptable for people who are religiously inclined and makes a substantial contribution to expansion of the banking sector.

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INTRODUCTION

Finance is key factor that enables financial institutions and financial help to the general public to function effectively and efficiently. Islamic finance refers to creation of capital in accordance with Shariah law in the Muslim world, and Islamic banks and other lending institutions are its principal suppliers (Kamalu, Ibrahim & Ahmad, 2022). Historically, Islamic finance refers to a kind of financial product established consistent with Shariah by financial institutions (Aderemi & Ishak, 2023). Islamic institutions are financial organisations whose activities adhere to the Quran's tenets (Aman, Sharif, & Arif, 2016). Financial institutions exist to provide the funding through lending money, hence fostering the growth of capital. In addition to number of deposit and loan services, Islamic financial institutions provide a range of commercial services to both people and enterprises (Mamun & Kabir, 2022). In recent years, Islamic finance has become one of financial world's greatest leaders (Ascarya, Husman & Tanjung, 2023). Investors' growing interest in Islamic finance is one of key reasons for its rising popularity from east to west and north to south. Especially in Middle East & Southeast Asia, this is region of rising significance for Muslims residing in countries with large Muslim population (Lim, Tolentino & Manapat, 2022).

To invest funds in conformity with their principles, Muslim investor select non-interest-bearing assets considered appropriate by their religions (Ofori, Gbolonyo, Dossou & Nkrumah, 2022). In order to meet these financial needs, market forces are altering their behaviour to suit a large diversity of the Islamic banking needs. There exists global alternative to conventional finance in Islamic countries and other rising economies. For the last three decades, its yearly growth rate has been between 10 and 22%. This $2,2 trillion market has been growing for decades. Experts predicted in last year that the Islamic assets worldwide will top $3.5 trillion by 2021 (Mansoor, Siddiqui & Movement, 2019). Present route of development of Islamic finance may be traced back to foundation of Barclay bank in Cairo, Egypt, more than a century ago, which conducted a number of financial transactions related to building of the Suez Canal. Throughout the 1930s, India, Pakistan, and other nations that are now part of the Indo-Pak Muslim world established contemporary Islamic finance and economic theory. Egyptian bank Ahmed-el-Naga, established in 1963, has been servicing clients globally for more than 50 years. Government of Philippines created a bank for Islamic sharia operations in 1973. Consequecntly, in the early 1970s, various nations in Middle East initiated Islamic banking (Islam, Liu, Khan, Islam & Sultanuzzaman, 2021).

Pakistan was among countries that launched Islamic banking. In accordance with Shariah, one of the goals of human rights is to provide shelter and other necessities of life for all individuals (Maqasid Al-Shariah) (Jawaid, Siddiqui, Kanwal & Fatima, 2023). Due to cost of purchasing the house, still, vast majority of individuals are still compelled to finance their home acquisition. Islamic philosophy of Riba prohibits its use in the standard mortgage loans (Mansoor, Siddiqui & Movement, 2019). In Islam, conventional house loans issued by traditional banks on the basis of Riba are banned (prohibited). Islamic banks offer large variety of Islamic banking products and services, like Islamic mortgages and Islamic credit plans, to individuals, organisations, and enormous investment corporations (Mamun & Kabir, 2022). Examples of debt-based financial arrangements that include Murabaha, Bay Bithaman Ajil (BBA), Ijarah, and Istisna. Musharakah Mutanaqisah, known as Diminishing Partnership, is form of equity-based financing & changes in conventional interest rates have beneficial effect on Islamic banking funding (Ullah, Zhao, Riaz & Zheng, 2021). Islamic banks offered their products so as to compete with conventional banks for investors and to attract investors for Islamic banks. Islamic banks launched their diverse products so as to strive with conventional banks (Khan, Khan, Uddin, Khan & Marwat, 2023). Based on Islamic law, these solutions offer Sharia-compliant safety for foreign money transactions.

At instances of significant interest rate hikes, it is expected that the financiers would boost their demand for the Islamic finance, hence reducing their interest payments on conventional loans (Rosly, 1999). BBA is one of the most common methods for investors to obtain capital since it provides greatest return on investment. Due to the adaptability of Islamic doctrines, popularity of Islamic banks has increased, as evidenced throughout global financial crises, with an annual growth rate of 10 to 15% from 1995 to 2005 (Khan, Hassan, Shahid & Finance, 2007). As per Shahinpoor (2009), these Islamic banking regulations dictate that the money may only be used for transactions between companies and people. Some Islamic banking rules prohibit the use of available funds for the illicit activities, like interest payments (riba), gambling (maisir), or gharar trade (Akbar, Akbar, Yaqoob, Hussain & Yasmin, 2023). Profitability is key aim of any business organisation whose function is to generate revenue; hence, purpose of a business is to generate income. Purpose of this research is to ensure that macroeconomic variables affect expansion of Islamic banks in Pakistan and to identify, analyse, and assess their impact on the Islamic bank growth. Therefore, the purpose of this study is to identify the most important macroeconomic variables affecting the desired development of Islamic banks, as well as to assist managers and policymakers in minimizing influence of macroeconomic variables on performance of Islamic banks.

LITERATURE REVIEW

The financing modes and procedures used in conventional finance, which are based on interest, are diametrically opposed to financing modes and approaches used in Islamic finance, which do not charge interest (Zehra, Umair, Shabbir & Mallouli, 2022). The Islamic financial system is based upon concept of working together to achieve common goals (Chapra, 2000). It is likely that emergence of Islamic banks as financial institutions would have a substantial influence, in particular on countries that are populated by large Muslim populations (Abrar, Abbas, Kousar & Mushtaq, 2022). The researchers found evidence in favour of poverty reduction, especially in rural areas, and they anticipated a significant positive relationship between population growth and Islamic financial development. This was done in light of fact that they uncovered evidence in favour of poverty reduction (Abedifar, Molyneux & Tarazi, 2013). It has been experimentally assessed (Rosly, 1999): theoretically, changes in the conventional interest rates have beneficial effect on amount of Islamic banking funding. Islamic banking is characterized as an organized, methodical, unobtrusive financial system that is managed consistent with Islamic standards. Islamic banking is comprised of two primary risk-sharing and return-sharing instruments. An important and intriguing research was extracted from work of Johnson (2013), which revealed that majority of Muslims in any given community is a critical element for the success of Islamic Finance.

This study was significant because it found that the majority of Muslims in any given society is a crucial factor for the success of Islamic Finance. This suggests that some of the advantages of convergence may be obtained by making effective use of Islamic financial systems. This study indicated that the variables of monetary policy (M2, IR, and GDP), in addition to Islamic bank deposits, were the ones that were determined to be ones that were found to be most significant and stimulating (Hudaya & Firmansyah, 2023). According to the findings of other research, the rates of monetary policy, inflation, rate on Treasury bills, and rate on savings deposits have all had an effect on M2 in Islamic finance (Olawande, Emoh & Ijasan, 2012). The research looked at the comparable effects that shockwaves of monetary policy shocks have on Islamic finance and conventional loaning in Malaysia. It investigated influence of monetary policy shockwaves on a dual banking system from perspective of the government. Research that has been carried out over the course of the last several years have made it clearly apparent that Islamic banks, in the event that there is a shift in the monetary policy, it would surely affect them more. This is something that has been extremely clear (Aderemi & Ishak, 2023). This is in part due to types of products that are accessible on the balance sheet, which are more susceptible to changes in policy. (Kassim, Majid, Yusof & Development, 2009). Based on study done by Kasri, (2010), it would be logical to assume that the deposits of Islamic banks are affected by the real income, rate of return, real rate of interest of conventional banks and the number of branches of Islamic banks.

Similarly, analysis of Adebola, Yusoff, Dahalan, & Accounting (2011) demonstrated that the IR of conventional banks influences levels of financing of Islamic banks in Malaysia. As a result of the results he came to conclusion that as opposed to conventional banks, Islamic banks provide an alternative to its financing. Moreover, it was shown that both finance and IR had a negative impact on Islamic banking funding. According to findings of research carried out by (Abduh & Finance, 2011); (Al-Fawwaz, Alawneh, & Shawaqfeh, 2015); and for the Jordan by (Nahar et al., 2016); a negative association was seen between inflation rate and Islamic finance. They came to the conclusion based on their study that Islamic financing is to blame for both rise in output within the economy as well as drop in overall pricing of goods and services across the board. The idea that remittances make a significant contribution to the national savings of nations like Pakistan is shown by the data presented in tables that is located above (Rahman et al., 2023). According to a number of studies, remittances provide a constructive contribution to national savings (Khawaja et al., 2023). Moreover, the national savings in a nation like Pakistan are not significantly impacted by the deficit or investments made by the government. According to the findings of Zahid, Basit, and Research (2018), GDP growth, REM, and M2 all play positive and substantial roles, but inflation rate, interest rate, savings all have negative relationship with one another.

RESEARCH METHODOLOGY

This analysis is quantitative in nature. In addition to obtaining all of data from the website of State Bank of Pakistan, several variables were calculated using WDI. In order to fully realize the contribution that Islamic banks have made to growth of nation's banking system; it is needed to examine Islamic banks. From 2005 and 2021, scholars used quarterly data for all variables (ARDL). So, the primary population of this research consists of Islamic financial institutions in Pakistan. More precise, this study's sample reflected Pakistan's banking industry. Following equation was tested through the multiple analysis. $\mathbf{GIBt}=\beta\mathbf{0}+\beta\mathbf{1REM\ Recievedt}+\beta\mathbf{2FDIt}+\varepsilon\mathbf{it}(1)$. The present study deals with the effects of FDI and Remittances received on the development of Islamic banking in Pakistan. The following model is selected for the analysis. GIB is growth of Islamic banks. “FDI” is foreign direct investment. Moreovber, REM Received is given by “REM Received”. The error term is denoted by “$\varepsilon\mathbf{it}$”. It is assumed that error term contains the effects of missing variables which are not included in the model but affect growth of Islamic banking in Pakistan.

It also assumed that error term is normally distributed with zero mean and constant variance. It further assumed that the error term is not serially correlated over time. One of the major assumptions about the above equation is related to the specification of the model. It is assumed that there is no specification bias in model. The autoregressive distributed lag model (ARDL) is assumed to be the correct specification of the model. The ARDL version of the equation, with appropriate lag structure selected by the lag length criteria, is estimated by the Ordinary Least Square (OLS) method that is vital for attaining desired outcomes of research. Moreover, a test of co-integration based on the bound test is conducted. Short run and long run coefficients are estimated. It is because of fact that macroeconomic variables may have different effects in the short run as well as in long run. The estimated results are tested for basic assumptions of the classical linear regression. Most appropriate and robust results are reported for discussion and analysis.

RESULTS OF STUDY

This chapter investigates the relationship between remittance flows, foreign direct investment (FDI), and Islamic banking growth in Pakistan. Theoretically, remittances and FDI inflows may lead to a growth in total assets of Islamic banking in Pakistan, especially if Muslim households choose to store remittances in Islamic banks as range of investment and savings products. Yet, FDI may also help a country's banking sector's liquidity status. Similar to preceding chapter, evaluation of this chapter starts with descriptive statistics. Table 1 demonstrates the correlation coefficients. The correlation coefficient between log of Islamic banking's total assets and FDI is negative, but the correlation coefficient between log of total assets and remittances is positive. This table does not demonstrate cause-and-effect relationships. It is unclear whether FDI has a negative impact upon the log of total assets or if the log of total assets has a negative impact on FDI. Similarly, the correlation coefficient between remittances and the log of total assets is not significant.

Table 1

Correlation Coefficients

	LN_OF_TOTAL_ASSET	FDI	REM_RECEIVED
LN_OF_TOTAL_ASSET	1		
FDI	-0.51892	1	
REM_RECEIVED	0.69281	-0.69102	1

Time series data may be stationary or non-stationary. Assuming time series data is stationary, one may estimate a basic single-equation model using Ordinary Least - square method (OLS). Nevertheless, if a time series is not stationary, that is, if there is a unit root process in the time series, then use of OLS to estimate basic linear regression model may provide false correlation coefficients. In other words, estimation of a linear regression model using non-stationary time series data will provide coefficients that are not statistically valid. On the one hand, the model's R-Square will be greater, indicating a better fit, yet on other hand, individual coefficients may be statistically significant, but the results will still be deceptive. In this context, table no. 4.3 is claimed to be aware of the unit root problem in the time series in the data. In this connection, when just the intercept is included in the regression equation, FDI is non-stationary at level, as shown in same given table. Consequently, when trend and intercept are added to the regression equation, however, same FDI series become stationary at level. It indicates that findings were inconsistent.

Table 2 revealed case of remittance time series, it is nonstationary at level regardless of intercept or trend plus intercept is included in regression. When a time series is non-stationary at certain level, it is possible to determine whether or not it becomes stationary when the first difference is calculated. In this instance, all series are stationary at first difference, which means that FDI and remittances are integrated of order one. When time series are integrated in same sequence, co-integration is probable. In this instance, test given in table provides the results of the Bound test. 6.19 is value of bound test. This value is comparable to minimum and maximum critical values. Comparing value of statistics to one percent crucial values reveals that it lies between the two limits. Nonetheless, if critical value is at least 2.5%, the value of test statistic exceeds upper limit. It indicates that at 2.5 key levels of bound test, there is evidence of a co-integration relationship.

Table 2

Unit Root Test (Results of ADF Test)

	Level	
Variables	Intercept	Trend & Intercept
LN_OF_TOTAL_ASSET	-3.565694 (0.0003) ***	-1.326108 (0.1950)
FDI	-2.198104 (0.1488)	-2.139953 (0.0791
REMETANCES	-0.353805 (0.9102)	-1.692344 (0.7125)
	First Difference	
Variables	Intercept	Trend & Intercept
LN_OF_TOTAL_ASSET	-4.39858 (0.0004) ***	-4. 913144 (0.0002) ***
FDI	-2.1319910 (0.0656)**	-3.532451 (0.0515)**
REMETANCES	-5.646918 (0.0000)***	-5.518210 (0.0004)***

Table 3

ARDL Bounds Test

	Level	
Test Statistic	Value	k
F-statistic	7.492825	2
	Critical Value Bounds	
Significance	I0 Bound	I1 Bound
10%	4.11	4.91
5%	3.59	4.21
2.5%	4.53	5.09
1%	5.61	4.29

Table 4

Breusch-Godfrey Serial Correlation LM Test

F-statistic	4.424591	Prob. F(2,60)	0.4102
Obs*R-squared	9.516824	Prob. Chi-Square(2)	0.5181

Table 5

Heteroscedasticity Test: Breusch-Pagan-Godfrey

F-statistic	9.259115	Prob. F(4,62)	0.0000
Obs*R-squared	25.05595	Prob. Chi-Square(4)	0.0000

Scaled explained SS	20.60283	Prob. Chi-Square(4)	0.0004

With the aid of Table it has been determined that there is evidence of relationship between the variables that is in long run equilibrium. At this stage of procedure, it is vital to examine the regression equation for serial correlation and heteroscedasticity. Tables show results of both examinations. Stated probability values in both tables fall so far below crucial threshold that null hypothesis cannot be accepted. Null hypothesis that model contains no evidence of serial correlation or heteroscedasticity cannot be accepted. Conclusion may be drawn from data shown in table.

Table 6

Heteroscedasticity Test: ARCH

F-statistic	61.38393	Prob. F(1,64)	0.0000
Obs*R-squared	29.45405	Prob. Chi-Square(1)	0.0000
Scaled explained SS	19.10283	Prob. Chi-Square(4)	0.0004

The estimated coefficients of the co-integration relationship are shown in table. At 10% level of significance, error correction coefficient is negative and -0.027267, and it is significant. This suggests that 2.7% of any imbalance in current quarter will be corrected in subsequent quarter. It indicates that system will gradually return to equilibrium. Model includes three lag values of total assets as explanatory variables. First two delays indicate a positive influence, but third lag indicates a negative consequence. First lag is not statistically significant, but subsequent two delays are statistically significant to large degree. This indicates that lag structure of log of the total assets is inconsistent with present log of total assets values. Short-run effects of foreign direct investment and remittances are not statistically significant. Impact of FDI is negative, whereas effect of remittances is favourable. It implies that an increase in FDI leads in a decline in overall assets of Pakistan's Islamic banks. Similarly, an increase in net flow of remittances results in an increase in overall assets of Islamic banks. Nonetheless, FDI and remittances have beneficial long-term impact on overall assets of Islamic banks. Also, coefficient of foreign direct investment is not significant, but coefficient of remittances is quite significant. It indicates that one unit rise in net inflow of remittances results in a 0.75 unit increase in expansion of Islamic banking.

Table 7

Short Run and Long Run Estimates

Cointegrating Form				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(LN_OF_TOTAL_ASSET(-1))	0.03174	0.1294	0.365	0.7913
D(LN_OF_TOTAL_ASSET(-2))	0.20604	0.1344	3.485	0.0002
D(LN_OF_TOTAL_ASSET(-3))	-0.3107	0.1149	-3.196	0.0009
D(FDI)	-0.0419	0.0320	-1.452	0.3111
D(REM_RECEIVED)	0.0503	0.0107	1.196	0.2379
CointEq(-1)	-0.0472	0.0546	-1.812	0.1752
Long Run oefficients				
Variable	Coefficient	SD	t-Statistic	Prob.

FDI	0.4455	0.3835	1.4530	0.154
REM_RECEIVED	0.5636	0.2743	2.9780	0.012
C	6.1681	2.7959	2.1054	0.030

DISCUSSION

The findings of current research clearly established relationship between observed variables which indicated that all the independent variables has significant relationship with the outcome variables. Further, the results of the current research are in line with findings of current research (Camara, 2022; Mamun & Kabir, 2023; Pham, Gan & Hu, 2022). It is imperative that Pakistan authorities investigate effect that Islamic banking has had on general progression of banking in the country in light of rapid expansion of Islamic banking in Pakistan. This is because Islamic banking has had significant impact on overall progression of banking in country. Reaffirmation on this front serves another purpose, which is to act as encouragement for the ever-increasing popularity of Shariah-compliant goods among Islamic financial institutions. This piece of study is not only the first of its type in Pakistan but also the first of its kind anywhere in the globe to address this issue based upon the empirical grounds. In light of the fact that Islamic banks and non-Islamic banks are currently engaged in fierce competition with one another, the existence of Islamic banks not only provides the workable solution to the citizens of the country who are religiously minded, but it also plays an important part in the expansion of banking industry in Pakistan.

The results of an empirical data study demonstrate that Islamic banking contributes to growth of the banking industry. The findings of study is in line with the findings of previous studies as multiple scholars found significant effect between observed variables (Akbar, Akbar, Yaqoob, Hussain & Yasmin, 2023; Lim, Tolentino & Manapat, 2022; Mamun & Kabir, 2022; Ofori, Gbolonyo, Dossou & Nkrumah, 2022). The fact that the coefficients for total assets and Islamic banking penetration reinforce one another demonstrates that the Islamic banks have played an increasingly significant role in the financial system of Pakistan. In addition to that, the report provides recommendations about policy and management implications for decision-makers and managers of Islamic banks in Pakistan in different circumstances and situations for diverse outcomes. On the policy front, it is possible to propose that the percentage of Islamic banks has to be increased even more, and those individuals who are financially excluded could find the confidence to utilize products offered by Islamic banks. It would be beneficial for the managers of these banks to sustain and strengthen the push to mobilize resources via the development of deposits and the creation of the credit. This would be the factor that falls within the purview of management.

CONCLUSION

The study has been used quarterly data for Islamic banks in Pakistan for the period of 2005 to 2021. The data was extracted from the Annual Banking Statistics, a publication of State Bank of Pakistan and the World development indicators (WDI) of World Bank. For relevant literature different database search was carried out by gathering different data sources from the study, like online journals, written papers, news accounts, and news articles. Therefore, information collected from most of these outlets is quantitative and, as way to highlighted macroeconomic factors that affecting Islamic banking growth in Pakistan, has given the information related to financial technology. In this connection, the collected data, provided the details on the current situation and established the predicted results on macroeconomic factors that affecting Islamic banking growth begin as an instrument for boosting the economic banking growth in Pakistan. Therefore, the reputable information presented the real and accurate details on the latest work commence; in this comprehensive research, these are a more effective method of collecting the data.

The banking sector progress is provided by taking total assets which serves as the dependent variable. The independent variables include Real and effective exchange rate and inflation. The main theoretical rational behind this hypothesis is nominal channel of inflation pass through. Economic theory explains that inflation measured by consumer price index means greater cost of living, which can lower savings and thus investment. Choice of independent variables has been determined through extant literature and in context of the banking system in Pakistan. A complete description, of the variables used. Thus, in order to verify the relationship between the macroeconomic factors and Islamic banking growth in Pakistan analysis has been perform like descriptive analysis for checking the strength of study. Thus, in order to make the study more reflective and easier to track, hence, the findings and analysis chapter has been described which provide insights of the macroeconomic factors that affecting desired Islamic banking growth in Pakistan.

Limitations & Future Direction

The study owns certain limitations in terms of single country analysis and lacks generalization of results. However, it supports findings made in a multi country study by Gheeraert (2014). Given that the Islamic banking has reached its critical mass, a natural extension of the study might be to examine whether Islamic banking serves as a substitute for or complement to non-Islamic banks in Muslim majority country like Pakistan. However, this can be an agenda for the future.

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