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The impact of islamic finance on economic development in Malaysia .Cointegration & VECM models

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Abstract :
With the growing number of islamic finance worldwide, many researchers have been interested in their advantages and ability to improve the financial sector, therefore, the purpose of the current paper is to study the impact of islamic banks and finance on economic development in Malaysia as one of the leading countries in the field of islamic banking, so that the Cointegration and vector error correction model (VECM) was used for the period 1995-2020.
The results of the study concluded that there is a long-term equilibrium relationship between islamic finance and economic development in Malaysia.
Keywords: Islamic finance, Economic development, Cointegration, VECM model.
Jel Classification Codes: G21,O11,C82.

Introduction:

Islamic finance has witnessed rapid development in the world, including more than three hundred institutions in more than sixty countries, on the ability of Islamic banks to provide new sources of financing to support economic growth, in addition to the activity of capital markets and the integration of global stock exchanges with Islamic activity.

Malaysia is considered one of the largest leading countries in the field of islamic finance due to its large centers of islamic financial assets and the establishment of distinguished departments to serve islamic investments, funds and currency, in addition to the popularity of the islamic capital market so that it has become a basic

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pillar for measuring the levels of growth and development of the Malaysian economy. In addition to providing medium and long-term financing investment opportunities, providing services and products that comply with islamic Sharia under the supervision of many jurists, experts and consultants specialized in the financial and economic aspects of religion.

Most experts and scholars of islamic economics and finance, who believe in the islamic financial industry and its foundations, agree on its positive role in economic development. However, there is an urgent need to clarify the relationship between islamic finance and economic development through an econometric study in Malaysia, as it is one of the largest environments regulating and encouraging islamic finance, so the following problem can be raised:

What is the impact of Islamic finance on economic development in Malaysia?

We proposed two main hypotheses for our research, which are:
1. The islamic finance activities has a positive effect on the economic development in Malaysia.
2. The islamic finance activities has a negative effect on the economic development in Malaysia.

The objective of this study is to analyze the relationship between the development of islamic banking activity, export, import, and the gross domestic product in Malaysia from 1995 until 2020.

Because of the great importance of the islamic finance, there is a substantial literature, to deal with the topic. As a result, there are many publications treating the islamic finance, and their changes over time are discussed /Seyada & Gulzar (2020)/ Adil Saleem & others (2021). There are also a number of articles proposing various methodologies in order to deal with this topic.

- Seyada & Gulzar (2020): Considering that islamic finance is one of the fastest growing sectors of the global financial system, this paper examines the impact of islamic finance including islamic banking and islamic bonds, on economic growth in major islamic countries. So that this study dealt with the assets of islamic banks, financing of islamic banks, the total value of the issued sukuk and the real GDP as variables for the study. This was done using PMG for the ARDL framework.

The results of the study found that in the long run, the assets of islamic banks, islamic bank financing and islamic bonds are highly correlated with real GDP in islamic countries.[1]

- Adil Saleem & others (2021): This study aims to examine the dynamic interaction of islamic financial depth (IFD), islamic financial intermediation (IFI)

[1]Seyada, A. N., & Gulzar, S. (2020). Impact of islamic finance on economic growth: an Empirical analysis of muslim countries. *The singapore economic review* .

and asset quality with economic growth in a dual banking system. The paper uses autoregressive distributive lag (ARDL), error-correcting model (ECM) and Granger causality to examine long- and short-term correlation using quarterly data for Pakistan from 2005 to 2019. The authors ran two models to analyze materiality depths (islamic and conventional), brokerage (islamic and conventional), and asset quality in both financial systems. The results of the study concluded that there is a long-term relationship flowing from financing to growth in both islamic and traditional financing models. Moreover, the results indicate that robust financial intermediation plays an imperative role in driving economic growth in both financial sectors. Thus, the presence of a higher degree of islamic financial assets in the economy contributes to economic growth in the short term.[1]

1-The theoretical side:

In this section, we will present a definition of islamic finance and mention its most important products, in addition to giving an overview of islamic finance at the global level and Malaysia.

1.1. Definition of islamic finance:

Islamic finance is the provision of material or financial financing to various establishments and institutions in ways that are consistent with the principles of islamic law, which makes them contribute to achieving economic development. islamic banking refers to a banking system that is based on two principles: the principle of profit and loss sharing and the principle of profit. These two principles attempt to remove interest, uncertainty, risk and speculation from the different approaches of investments.[2]

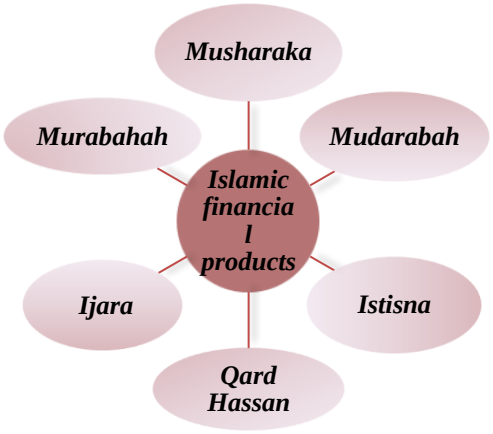
1.2. Islamic financial products:

Islamic banks and islamic branches have developed many islamic financial products that have contributed to the increasing development of islamic finance, so that these products were considered the main pillar for expanding the scope of Halal transactions at the expense of Haram transactions, the most important of these products are shown in the following figure:

[1]Adil, S., & Others. (2021). Islamic financial depth, financial intermediation, and sustainable economic growth: ARDL approach. *Economies review* .

[2] Korichi, H. S., & others. (2019). Islamic Finance and Regional Development in MENA Region: An Empirical Evidence from the Golf Cooperation Countries. *Algerian review of economic development* , p 330.

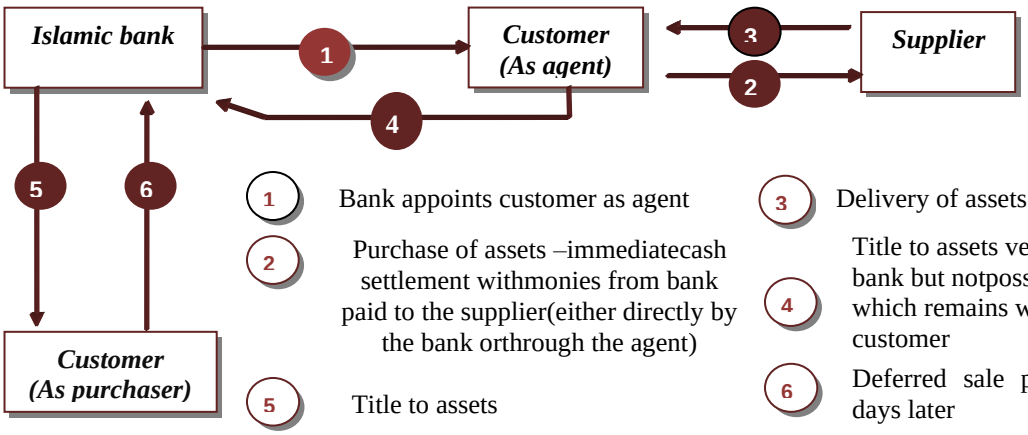
Figure 1.Islamic financial products



Source: Prepared by the researchers

Murabahah: Murabahah or simple murabahah is defined as the sale of a commodity at the price that he bought it with an increase in a known profit. As for the murabahah for the one who ordered the purchase or compound murabahah, it is the sale in which two or more parties negotiate and contract to carry out this negotiation, whereby the commanding person asks the person to buy a commodity for himself and the ordering the one who is ordered to buy it from him and make him profit in it, provided that they make a sale after the officer has acquired the commodity.

Figure 2.The Murabaha contract



Source: Prepared by the researchers based on (Herbert, 2010, p. 08).

Musharaka: is an islamic contract that was approved in 1979 at the islamic Banking Conference held in Dubai. Thus musharaka is a word of Arabic origin which literally means participation, in the context of business and trade, this means a joint venture in which all partners share the profits or losses of the joint project.[1] thus, the musharaka is a contract concluded between the bank and the customer whereby the bank finances the project subject of the partnership with an amount of money, and the customer with another amount, so that the bank and the customer become owners of the company's capital, so that the profits are divided between them according to the agreement. As for the loss, it is in proportion to each party's share in capital.[2]

Mudaraba: mudaraba contract is defined as "a bilateral contract between two parties in which the first party provides money, and the second party works on it in the way agreed upon in terms of work and profit-sharing."

Qard Hassan: "charitable, benevolent or interest-free (unremunerated) loans for socially beneficial purposes. Modest service charge is permissible".[3]

Ijara: The Ijara contract is very similar to leasing, in that it involves three agents: the bank, the tenant of the property and its supplier.[4] Thus, Ijara is a contract that includes the transfer of the usufruct right (manfa'a) from the lessor (the bank) to the lessee (the customer).[5]

1.3.Islamicfinance: a global view

Islamic finance has witnessed a global development, and therefore we will analyze in this section some statistics about Islamic finance in the world and in Malaysia.

The Islamic finance sector grew by 14 % in 2019, equal to US $1.99 trillion in global assets. This compares with only 1% growth in 2018 and an average annual growth of 5% over the period 2015 to 2018.

Global islamic finance assets are expected to reach $ 3.69 trillion in 2024, with Malaysia, Indonesia, Bahrain, the UAE and Saudi Arabia ranked among the top five developed countries in the world in the field of Islamic finance, and the following figure shows the islamic finance assets growth (2012-2019):

[1]Korbi, F. (2016). La finance islamique : une nouvelle éthique ? :Comparaison avec la finance conventionnelle. *Thèse doctorat* , p50.

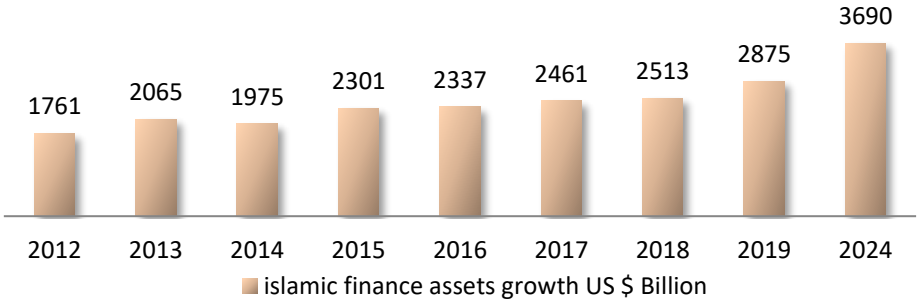
[2]Michael, J., & Millen, M. (2009). Contemporary islamic finance: an introduction to essential structural concepts. *International Law News* .

[3]Korichi, H. S., & others. (2019). Op. cit., p 333.

[4]Korbi, F. (2016). Op. cit., p59.

[5]Korichi, H. S., & others. (2019). Op. cit., p 331.

Figure3. Islamic finance assets growth (2012-2019)

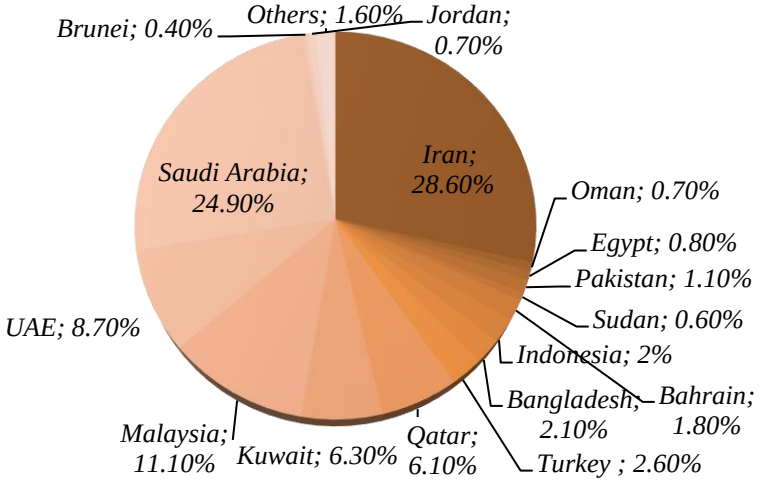


Source: Prepared by the researchers based on (Refinitiv & ICD Report, 2020)

Through the above figure, we note that global islamic finance assets have grown in recent times, and according to the Global Islamic Finance Report, global islamic finance assets increased by 14 % year on year, with a total of $ 2.88 trillion in 2019, and we also note that growth is expected to increase to reach in 2024 $ 3,69 trillion.

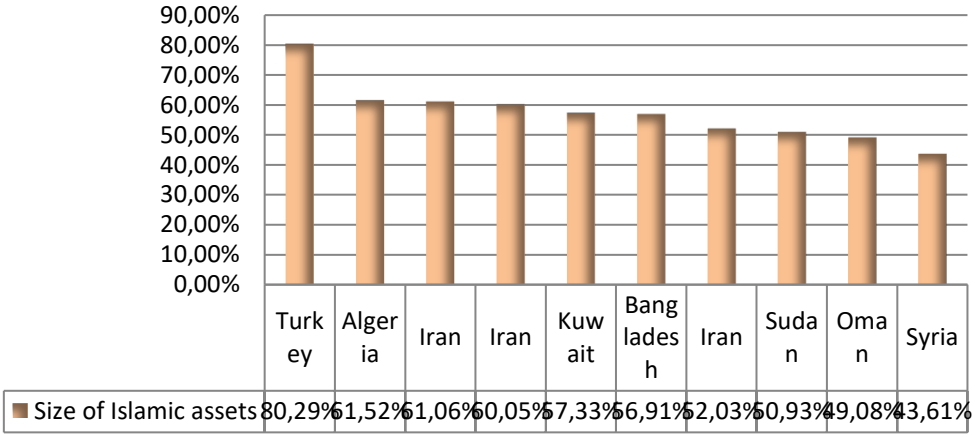
In 2019, Iranian banks occupied the largest share of the volume of assets, at a rate estimated at 28.6%, so that it witnessed a significant decrease compared to the second quarter of 2018 (32.1%), followed by Saudi Arabia with an estimated rate of 24.9%. With 11.1%, followed by the United Arab Emirates at 8.7%, then Kuwait, which is still 6.8% compared to 2018, then Qatar, Turkey, Bangladesh, Indonesia and Bahrain, and this is what the following figure shows:

Figure 4. The shares of global Islamic banks' assets for the year 2019



Source: Prepared by the researchers based on (stability reporte, 2020)

Figure 5. The fastest growing Islamic banks in the world for the year 2019



Source: Preparedby the researchers based on (Cherfi & Ameur, 2020, p. 937)

The above figure shows the ten fastest growing islamic banks in the world in 2019 with assets of more than 500 USD million, so that the Turkish bank (Ziraat Katilim Bankasi) ranked first with a growth rate of 80.29%, followed closely by the Algerian Salam Bank with a rate of 61.52%, then the two Iranian banks (Gharzolhasaneh mehr) and (Export development), with estimated rates of 61.06% and 60.05%, respectively. The list also included the following banks: Warba Bank, Union bank limited, Tourism Bank, Bank of Khartoum, Alizz Islamic Bank and Syria International Bank.
We notice through the figure that most of the fastest growing banks in the world are from the Arab region, which reflects the supremacy of Arab Islamic banks in the world in terms of growth and expansion.

Islamic banking services have developed in the GCC (The GCC member states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.) countries since the emergence of Islamic banking services in 1975 with the establishment of Dubai Islamic Bank, so that the Islamic services diversified to include Takaful insurance, islamic loans (Qard Hassan), islamic deposits, shariah-compliant asset management, and other islamic financial products. Below is a review of the experience of GCC countries in islamic finance.

Table 1. GCC Islamic Banks' Key Funding and Liquidity Metrics (2013-2018)

(%)	2013	2014	2015	2016	2017	2018
Growth in customer deposits	N.A.*	14.0	6.0	5.4	6.4	2.5
Liquid assets/total assets	24.7	23.4	22.1	21.3	21.0	21.4
Customer loans (net)/customer deposits	87.1	88.8	92.3	93.2	93.3	92.6

Source: (Islamic finance outlook, 2020)

***** N.A : Not available

Through the above table, we notice that the deposits of customers of islamic banks in the GCC countries grew at a slight rate of 2.5% in 2018, compared to 6.4% in 2017, and thanks to the relatively weak loan growth, the financing profile of these banks remained stable and comparable to their traditional peers, so that the ratio of loans to total deposits amounted to 92.6% for Islamic banks at the end of 2018 compared to 93.3% in 2017.

Malaysian islamic work has flourished since 1963 with the establishment of the Tabung Haji government to achieve profitable savings for Muslims wishing to perform the Hajj, so that the Malaysian Islamic market is considered a world leader due to the popularity of its products that are in line with the principles of Islam and its strong political will[1].
Malaysia is a global leader in islamic finance. The overall breadth and depth of Malaysia's Islamic finance ecosystem is among the best in the world, from the number and variety of its Islamic financial institutions, their profitability and resilience, to its sophisticated regulatory system for islamic finance.

Table2. Malaysia's leading position in islamic finance, 2018

Islamic Finance Sector	Malaysia Assets	Malaysia Global Rank by Assets	Malaysia Assets, Share of World Total
Total	$521 billion	3	20.6%
Banking	$214 billion	3	12.2%
Takaful	$9 billion	3	19.6%
Other financial institutions	$52 billion	1	37.1%
Sukuk	$219 billion	1	46.6%
Funds	$27 billion	2	25.0%

Source:(Abayomi & Others, 2020)

The above table present the Malaysia's leading position in islamic finance in 2018.Malaysia's islamic finance assets of $521 billion ranked third globally, close behind 2 nations with much larger Muslim populations than Malaysia's approximately 20 million: Iran ($575 billion assets,24 80 million Muslims) and Saudi Arabia ($541 billion, 30 million).(Abayomi & Others, 2020, p. 32).

2- Econometric modeling of islamic finance and economic development

In this section, we will present a modeling of the relationship between Islamic finance and economic development in Malaysia for the period 1995-2020

2.1. Presentation of the model & variables

In this section we will first present the empirical model, then we will determine the study variables.

[1]Korbi, F. (2016). Op. cit., p 40.

2.1.1. Presentation of the model

To estimate the relationship between islamic finance and the economic development in Malaysia, we used the following reduced equation:

$$GDP = \beta_0 + \beta_1 DIBA + \beta_2 X + \beta_3 M + \varepsilon_{it} \quad (01)$$

Where:

- GDP: Gross Domestic Product;
- β_0: constant;
- β_1, β_2, β_3.... Coefficients of explanatory variables;
- DIBA: The development of Islamic banking activity;
- X: Export;
- M: Import.

Equation n° 01 can be expressed in logarithmic form as follows:

$$(02) lnGDP = \beta_0 + \beta_1 lnDIBA + \beta_2 lnX + \beta_3 lnM + \varepsilon_{it}$$

2.1.2. Presentation of variables

The following table shows the data of the econometric study

Table 3. Islamic finance, Financial development: variables and sources.

Variables	Description	Notation	Data source
Economic development	Gross Domestic Product	GDP	https://data.worldbank.org/country/MY
Islamic finance	The development of Islamic banking activity (Total islamic loans as a percentage of GDP)	DIBA	Autors' calculations based on Bank scope database of Malaysia
Export	-	X	The World bank https://data.worldbank.org/country/MY
Import	-	M	https://data.worldbank.org/country/MY

Source: The achievement of researchers

2.2. Econometric results

This section will present the correlation between variables. Additionally, the results from all techniques is presented thoroughly "Unit root test, Johansan test, VECM Model".

2.2.1. Correlation Matrix

In order to test the relationship between the economic growth and the explanatory variables, it is necessary to look at the correlation matrix.

Simple correlation measures the degree of connection between these two phenomena represented by variables. If we are looking for a relationship between three or more variables, we will then use the concept of multiple correlation."[1]
The correlation coefficient between two variables can be calculated according to the following relationship:

$$r_{x,y} = \frac{cov(x,y)}{\delta_x \delta_y} = \frac{\sum_{i=1}^{n}(x_i - \bar{x})(y_i - \bar{y})}{\sqrt{\sum_{i=1}^{n}(x_i - \bar{x})^2}\sqrt{\sum_{i=1}^{n}(y_i - \bar{y})^2}}$$

$$r_{x,y} = \frac{n\sum_{i=1}^{n} x_i y_i - \sum_{i=1}^{n} x_i \sum_{i=1}^{n} y_i}{\sqrt{n\sum_{i=1}^{n} x_i^2 - \left(\sum_{i=1}^{n} x_i\right)^2}\sqrt{n\sum_{i=1}^{n} y_i^2 - \left(\sum_{i=1}^{n} y_i\right)^2}}$$

With:

- Cov(x, y): covariance between x and y
- $\delta_x\delta_y$: standard deviation of x and standard deviation of y
- n: number of observations.

The correlation coefficient is between 1 and -1, and cases can be summarized as follows:

- R= 1, the variables are positively correlated;
- R= −1, the variables are negatively correlated;
- R= 0, the variables are not correlated.

Table 4. Correlation matrix

	GDP	DIBA	X	M
GDP	1			
DIBA	0.57	1		
X	0.95	0.48	1	
M	0.97	0.63	0.24	1

Source: The achievement of researchers based on outputs of EViews 10.

Through the correlation matrix, we note that there is a strong positive correlation between the dependent variable and the explanatory variables, and a weak correlation between the explanatory variables.

2.2.2. Lag time period

The lag time period is chosen in the cointegration model according to the Akaike information criterion (AIC), this is shown in the following table.

Table 5. Number of lag time period

Variables	GDP	DIBA	X	M
Number of lag	01	01	01	02

Source: The achievement of researchers based on EViews 10.

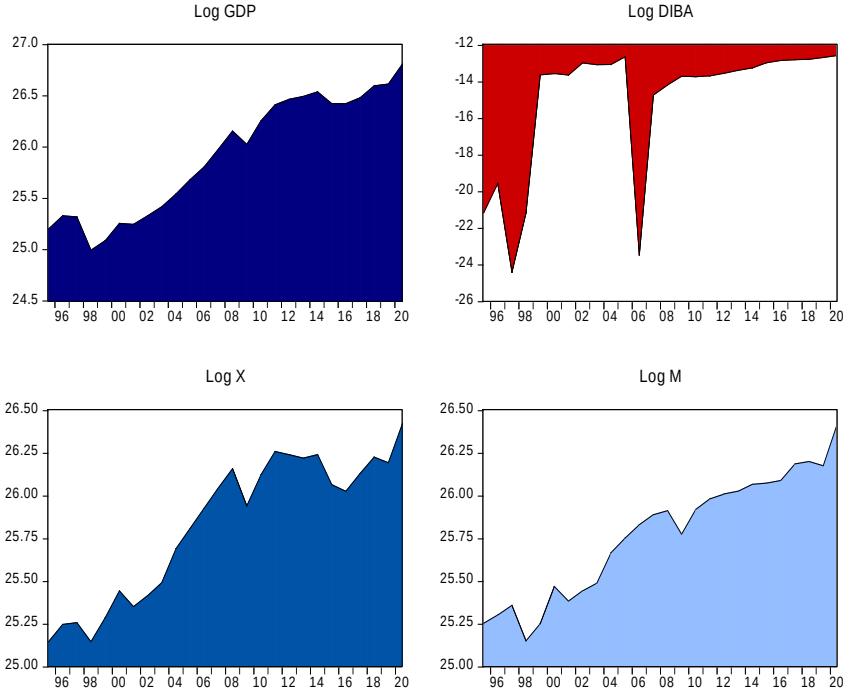
The table n° (05) shows the optimal number of lag time period, cointegration (1, 1, 1, 2) using AI criteria.

[1] Bourbonnais, R. (2015). *Économétrie Cours et exercices corrigés.* Paris: Dunod, p 19.

2.2.3. Graphical presentation of variables

The following figure shows a graph of the variables of the econometric study.

Figure 6.Graphical presentation of variables (LGDP,LDIBA,LX,LM)



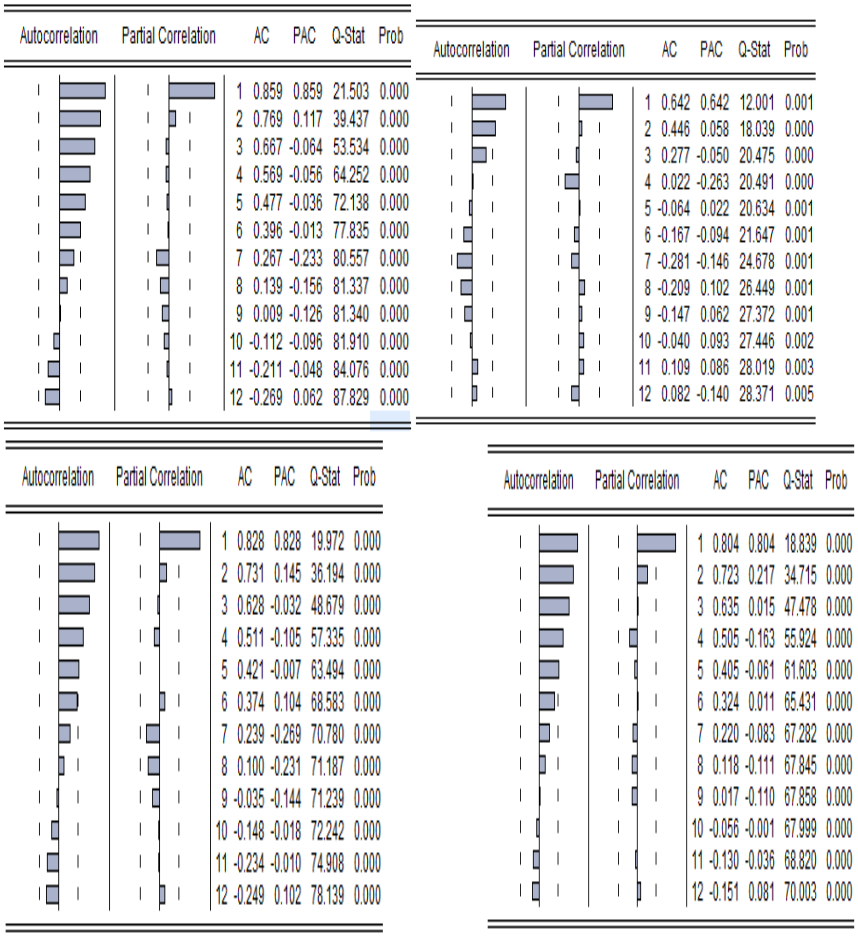
Source: Results obtained from Eviews 10.

The graphical representation of our raw series shows that there is a trend. So probably these series are not stationary, for the confirmation we will apply the stationarity test.

2.2.4.Autocorrelation test

The following figure shows the autocorrelation of residuals.

Figure 7. Testing the significance of the coefficients of the autocorrelation function for time series (LNGDP, LNDIBA, LNX, LNM)



Autocorrelation	Partial Correlation		AC	PAC	Q-Stat	Prob
		1	0.859	0.859	21.503	0.000
		2	0.769	0.117	39.437	0.000
		3	0.667	-0.064	53.534	0.000
		4	0.569	-0.056	64.252	0.000
		5	0.477	-0.036	72.138	0.000
		6	0.396	-0.013	77.835	0.000
		7	0.267	-0.233	80.557	0.000
		8	0.139	-0.156	81.337	0.000
		9	0.009	-0.126	81.340	0.000
		10	-0.112	-0.096	81.910	0.000
		11	-0.211	-0.048	84.076	0.000
		12	-0.269	0.062	87.829	0.000

Autocorrelation	Partial Correlation		AC	PAC	Q-Stat	Prob
		1	0.642	0.642	12.001	0.001
		2	0.446	0.058	18.039	0.000
		3	0.277	-0.050	20.475	0.000
		4	0.022	-0.263	20.491	0.000
		5	-0.064	0.022	20.634	0.001
		6	-0.167	-0.094	21.647	0.001
		7	-0.281	-0.146	24.678	0.001
		8	-0.209	0.102	26.449	0.001
		9	-0.147	0.062	27.372	0.001
		10	-0.040	0.093	27.446	0.002
		11	0.109	0.086	28.019	0.003
		12	0.082	-0.140	28.371	0.005

Autocorrelation	Partial Correlation		AC	PAC	Q-Stat	Prob
		1	0.828	0.828	19.972	0.000
		2	0.731	0.145	36.194	0.000
		3	0.628	-0.032	48.679	0.000
		4	0.511	-0.105	57.335	0.000
		5	0.421	-0.007	63.494	0.000
		6	0.374	0.104	68.583	0.000
		7	0.239	-0.269	70.780	0.000
		8	0.100	-0.231	71.187	0.000
		9	-0.035	-0.144	71.239	0.000
		10	-0.148	-0.018	72.242	0.000
		11	-0.234	-0.010	74.908	0.000
		12	-0.249	0.102	78.139	0.000

Autocorrelation	Partial Correlation		AC	PAC	Q-Stat	Prob
		1	0.804	0.804	18.839	0.000
		2	0.723	0.217	34.715	0.000
		3	0.635	0.015	47.478	0.000
		4	0.505	-0.163	55.924	0.000
		5	0.405	-0.061	61.603	0.000
		6	0.324	0.011	65.431	0.000
		7	0.220	-0.083	67.282	0.000
		8	0.118	-0.111	67.845	0.000
		9	0.017	-0.110	67.858	0.000
		10	-0.056	-0.001	67.999	0.000
		11	-0.130	-0.036	68.820	0.000
		12	-0.151	0.081	70.003	0.000

Source: Results obtained from Eviews 10.

We notice from the correlation function of the time series (LNGDP, LNDIBA, LNX, LNM) that the coefficients calculated for the deviations K = 1.2..3… .12, it is outside the confidence domain $P_{k(1.2.3\ldots12)} \neq 0$, which means that it differs considerably from zero.

2.2.5. Unit root test

It is necessary to conduct stationarity testing by relying on the various commonly used tests represented in the ADF & PP tests so that we applied them to each variable separately.

ADF: The Augmented Dickey-Fuller test was performed on each time series and the level teams were continuously selected until the probability value presented in the level was smaller than the 5% level. (Tran & Thanh, 2020, p. 28).

The forms of the ADF test are given by the following equations**:**

$$\Delta yt = yy_{t-1} + \sum_{i=1}^{p} \beta_i \Delta y_{t-i} + u_t$$

$$\Delta yt = \alpha_0 + yy_{t-1} + \sum_{i=1}^{p} \beta_i \Delta y_{t-i} + u_t$$

$$\Delta yt = \alpha_0 + yy_{t-1} + \alpha_2 t \sum_{i=1}^{p} \beta_i \Delta y_{t-i} + u_t$$

The lag determined by the Akaike Information Criterion (AlC) or Schwartz Bayesian Criterion (SBC), or more usefully by the lag length necessary to whiten the residuals (i.e. after each case we check whether the residuals of the ADF regression are autocorrelated or not through LM tests and not the DW test). (DIMITRIOS & G.HAL, 2007, p. 297)

PP: The Phillips-Perron testis based on a non-parametric correction of Dickey Fuller's statistic with the aim of overcoming the problem of autocorrelation between random errors.

We reached the results shown in the following table:

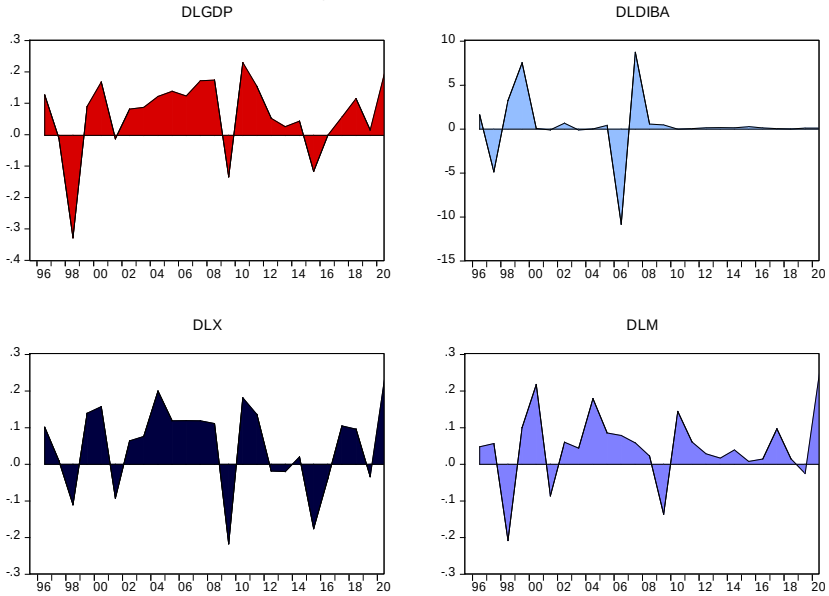
Table 6. Results of unit root test (ADF & PP) for all variables

Variable	t-Statistic		Critical values		Probability		Order
	ADF	PP	ADF	PP	ADF	PP	
LGDP	-4.272720	-4.273300	-3.612199	-3.612199	0.0130	0.0129	I(1)
LDIBA	-6.336099	-6.382195	-3.612199	-3.612199	0.0001	0.0001	I(1)
LX	-4.517645	-4.509561	-3.612199	-3.612199	0.0077	0.0078	I(1)
LM	-4.868057	-4.665404	-3.612199	-3.612199	0.0036	0.0056	I(1)

Source: The achievement of researchers based on outputs of EViews 10.

The table n° (06) illustrates the finding results of the ADF & PP tests for the four variables, we note from it that the variables are stationary at the first difference.
Thus, the following figures show the stationarity of the time series at the first difference, and a test of the stationary series at the first difference to ensure stationarity at the level.

Figure 8.Graphical presentation of variablesat the first difference(DLGDP,DLDIBA,DLX,DLM)



Source : Results obtained from Eviews 10.

From figure n° (08), we notice that the series with the first difference are stationary at the level.

2.2.6. Cointegration test:

The study of cointegration makes it possible to test the existence of a stable long-term relationship between two non-stationary variables, including lag variables and exogenous variables. There are several tests of cointegration, the most general being that of Johansen (1988). Whatever test is chosen, it is meaningful only on long non-stationary series. Therefore, the analysis of cointegration makes it possible to clearly identify the true relationship between two variables, investigating the existence of a cointegrating vector and eliminating its effect if any.

Two series x and y are said to be cointegrated if the following two conditions are satisfied: they are affected by a stochastic trend of the same order of integration and a linear combination of these series makes it possible to reduce to a series of order of integration inferior.

Finally, the Johansen cointegration test uses two statistics: the trace statistic and the maximum eigenvalue statistic. (Louis, 2009).
The following table presents a trace of Johansen (1988) to determine the number of cointegrating vector:

Table 7.Trace test

Hypothesized No.of CE (s)	Eigenvalue	Trace statistic	Critical value 0.05	Prob
None	0.766675	65.11070	47.85613	0.0006
At most 01	0.514000	31.63826	29.79707	0.0303
At most 02	0.317378	15.04269	15.49471	0.0584
At most 03	0.238310	6.260959	3.841466	0.0123

Source: The achievement of researchers based on outputs of Eviews10.

According to table n° (07), we reject at the 5% threshold, the null hypothesis H_0: absence of a cointegration relation (65.11070>47.85613) against the alternative hypothesis (There is at least a cointegrating relation between the variables).
We accept H_1: there is at most 2 cointegrating relation, against H_0: there is at least 1 cointegrating relation, at the 5% threshold (31.63826>29.79707).
Then, we accept H_0: there are at least 2 cointegrating relations, at the 5% threshold (15.04269<15.49471), against H_1: there are at most 3 cointegrating relations.

The equation obtained from the cointegration relationship is as follows:

GDP= 0.0047 DIBA- 1.25X+1.05M -0.047

2.2.7. Vector error correction model (VECM)

The error correction model was us to define both short-term and long-term relationship at the same time. (Maurel, 1989)

Dynamic equation:

D(DLGDP) = - **1.22023801052***(DLGDP(-1) + 0.0047065633251*DLDIBA(-1) - 1.25198764026*DLX(-1) + 1.0510656047*DLM(-1) - 0.0471104660024) + 0.206635041049*D(DLGDP(-1)) - 0.134136130899*D(DLGDP(-2)) - 0.0027897749558*D(DLDIBA(-1)) - 0.0149438739531*D(DLDIBA(-2)) - 1.05237962007*D(DLX(-1)) - 0.194400101242*D(DLX(-2)) + 1.06738414487*D(DLM(-1)) + 0.163373419086*D(DLM(-2)) + 0.0251392801744

According to the dynamic equation, we notice that the error correction coefficient is negative -1.22. So there is an error correction mechanism, it is concluded that there is a short-term to long-term adjustment of 122% in the unit of time.

Conclusion:

The financial islamic industry gained more popularity in both Muslim and non Muslim countries in recent decades.
This paper is an initial empirical study on the relationship between islamic finance and economic development in Malaysia in the long-run. For that reason, we use cointegration technique and Vector Error Correction Model (VECM).

In general, the results show that the development of islamic banking activity in the long term is positively and significantly related to economic growth in Malaysia. In this regard, islamic banks and finance have effectively played their main role as financial intermediaries facilitating the transfer of savings from surplus families to deficit families. Thus, we can say that the current policies of Bank Negara Malaysia to develop a comprehensive Islamic financial system in Malaysia are considered effective. Thus, improving the islamic financial infrastructure in Malaysia may benefit economic development and is important in the long run for economic well-being.

In the case of exports, the result indicates that there is an inverse relationship between islamic bank financing, islamic financial products and international exports. We believe that this may be due to the fact that the share of islamic bank financing in international trade activities is relatively small and is not important for promoting international trade. However, with the current commitment to develop an inclusive islamic financial system and to be more liberal and integrated with the international financial system.

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