Impact of Islamic Modes of Finance on Economic Growth through Financial Stability

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Abstract

This study aims to investigate the relation between Islamic banks performance and economic growth. It attempts to answer the question whether Islamic banks are a prerequisite for economic development or whether their financial stability a consequence of it. The study follows quantitative method by employing cross sectional data context analysis. The data is collected from six banks over six countries through the period 2011-2013. Pearson regression is used to measure causal relation between GDP and banks performance representing in Islamic modes of finance, Z score. The regression tests shows significant relation between modes of finance and GDP R=0.79, there is negative causal relation between Z score and GDP, negative relation between Ijara, Murabahah modes and GDP. Also the test shows significant negative relationship between modes of finance except Mudaraba and Z score R=0.93. However there is insignificant relationship between Zscore and Murabahah, Mudaraba. Two models are developed according to regression tests.

Keywords: Ijara; Istisna; Musharaka; GDP; Z score

Introduction

The goal of Islamic banking and finance is to bring greater justice and strive to achieve socio-economic development. Islamic financial system can serve as a tool to foster economic growth and human well-being. Promoting risk-sharing instead of debt-financing, reduces poverty and inequalities which are the necessary objectives of that need to be addressed by economic development policy makers. Islamic banks handle fund from sever to investors through Islamic modes of finance.

Islamic modes of finance are designed to facilitate financing by the principles in Islamic Sharia, such as Mudārābah, Mushārāka, Ijāra, Istisna and Salām. In addition financial intermediation is an important indicator of economic development as well as economic growth. The objective of this study is to determine the relationship between Islamic modes of finance and Islamic financial intermediation, and its relation to financial stability in Islamic banks. So that to choose the most successful mode that should be encouraged to apply in Islamic economy. After international financial crisis most of the works in Islamic finance field focuses on the financial risk and financial stability of the Islamic banks, therefore to avoid mistakes which was took by conventional financial system. However the main goal of Islamic bank to enhance social justice and human being of the Muslim through successful financial intermediation that can lead to economic development, poverty alleviation, wealth distribution.

This study tries to investigate causal relation between Islamic modes of finance and economic growth, financial stability at the same time. Hence to choose which of Islamic modes of finance should be encouraged by supervisors and policy makers to apply in Islamic financial system.

The paper is structured from six sections as follows: section one shows literature review, related to economic growth and financial stability, section two shows Islamic modes of finance background: stisna, Ijara, Mudarbah, Murabahah, Musharakah. Section three shows research design: problem, methodology, significance of the study, section four shows variable discussion and data analysis, section five concludes results, and last section six shows appendixes and reference.

Literature Reviews

Literature is divided in to two categories, the first one focuses on the relation between Islamic finance and real economy, and the second one focuses on the relation between Islamic finance and financial stability.

Literature focuses on the relation between Islamic finance and real economy

Schumpeter [1] argued that importance of banking system in the economic growth of a country can be done through productive investment in country. Islamic banking helps in overcoming short falling and gives a positive boost to economy to upward and boost a society to self-sufficiency economy through equal income distribution [2]. Ahmed, Ansari, Rousseau, Wachtel, Fase and Abma [3-5] say that Islamic banking have a positive impact on economic development. Robinson [6] said that Islamic banking lead toward progress

Dedokun, Luintel and Khan have studied two way of the relation between finance and growth. Some experimental studies have been conducted to examine the efficiency of Islamic banking system against conventional banking system through impact on inflation and employment rate. Yousef et al., Joseph and Wilson said that in Islamic banking system stability and superiority is not evidence as compared to banks which provides interest.

Beck et al. [7] strongly support, that there exist direct relation between financial intermediaries and economic development. Demetriades, Luintel, Ahmed, Ansari, Rousseau, Wachtel, Fase, Abma, Xu, Arestis and Demetriades [2-5,8,9] argued that expansion of the financial system could have appositive repercussion on economic

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Received March 28, 2017; Accepted March 30, 2017; Published March 31, 2017


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Hafas et al. [10] they had examined the dynamic interactions between Islamic banking and economic growth of Malaysia by employing the cointegration test and vector Error model (VECM). Their results showed that in the long-run Islamic bank financing is positively and significantly correlated with economic growth and capital accumulation of Malaysia. Abdul Adeel has studied the relationship between Islamic banking and economic growth. Their results generally showed that in the long run, the financing of Islamic banking is positively and significantly associated with economic growth and accumulation of capital in Pakistan. Ali [11] also argued that even the credit types of Islamic financing, like Murabaha and Ijara transactions, which provide credit against usufruct or tangible asset, require Islamic banks to know the client’s purpose and use of finance. These modes also require ownership of the asset by the bank, albeit for shorter duration in case of Murabaha and longer duration in case of Ijara finance. This increases the likelihood (or ensures) that the funds are used for their stated purposes. Thus, it keeps credit tied to real economic activity for each transaction and throughout the tenor of contract.

Nidal El-Ghattis cited by Ahmed 2012 argues that in contrast to conventional methods of financing, Islamic financing is not centered only around credit worthiness of the client but rather on the worthiness and profitability of the project to be financed. And The Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution, which results into greater benefits for social justice and sustainable growth.

Dridi and Hasan [12] demonstrate Islamic banks showed stronger credit growth than conventional banks during the financial crises in almost all counties, they have suggested that Islamic banks made a greater contribution to macroeconomic and financial stability by making more credit available. Oliver Agha [13] stresses that Islamic finance should serve as a stabilizing force in the global economic order, because deposits in Islamic banks (which are not loans but true investment deposits on a Mudaraba basis) are reinvested in the real economy for goods/services without any artificial money expansion. Ahmed El-Galfy and Khiyar [14] they reviewed the literature related to the relationship between Islamic financing, in general, and Islamic banking, in particular, and financialization and economic growth. They have demonstrated that Islamic banking is a main channel of economic growth. Also they recommended a future research should investigate the impact of Islamic banking on economic growth using panel data analysis rather than time-series analysis.

Hafnida et al. [15] their Findings showed that Islamic mode of finance which include murabaha, mushārakah, muḍārabah, ‘istīnsīnā, ījārah. Affect positively on the financial intermediation (economic growth).

Literature related to financial stability

There are several workers had outlined the financial stability in Islamic banks. Most of them search about the stability of Islamic banking and its comparison with conventional banking such as: Vasleios Pappas, Marwan Izzeldin, Ana Maria Fueles [16], they defined failure risk (credit risk, deposit withdrawal risk, operational risk), they compared Islamic and conventional banks regarding the sensitivity of failure risk. They have demonstrated that: Islamic banks well capitalized, characterized by large liquidity levels, and lower leverage, have large operational risk, failure risk of Islamic banks is significantly lower than that of conventional banks, Islamic banks have lower insolvency risk and loan default risk, this result is complements recent findings [17], also they demonstrated that expansion in loan portfolio is not associated with a larger probability of failure Martin and Heiko [17] they found that small Islamic banks tend to be financially stronger than small commercial banks, large commercial banks tend to be financially stronger than large Islamic banks, small Islamic banks tend to be financially stronger than large Islamic banks which may reflect challenges of credit risk management in large Islamic banks. Pejman et al. [18] demonstrated that: Islamic banks have low credit risk as compare to their conventional counterparts. Also they had showed that Islamic banks in general have lower degree of stability compared to the conventional counterparts. Hassan et al. [19] they used Z score stationary around some long-run desired level determined by total asset, credit to assets ratio concentration of the banking sector and share of Islamic banking their findings: individual heterogeneity matter more than the conventional or Islamic nature of the bank regarding financial stability. Pejman et al. [20] they had demonstrated that small Islamic banks appear more stable; loan quality of Islamic banks is less responsive to domestic interest rates compared to conventional banks. Ahmed Belouafi and others they have provided a critical review of the Islamic Economics (IEs) and Finance (IF) literature that have examined the stability of the Islamic Financial System (IFS) and its institutions vis-à-vis the conventional interest-based system. They have been able to analyze thirty four investigations over a thirty year period from 1983 to 2013. However there is no any work among empirical literature concerned with Islamic modes of finance and its relation to financial stability. Two fundamental tenets have been highlighted from this review to constitute important ‘built-in’ features that may stand behind the inherent stability of the Islamic financial institutions. These are: risk-sharing and asset-backing principles. This by no means should be interpreted as an underestimation or unimportance of other tenets of Islamic finance, on one hand, and the fact that the current practices of IFIs adhere strictly and ‘whole-heartedly’ to these paradigms.

Ali [21] his paper have examined the impact of the Islamic banks market structure on the overall bank risk, using Z-index. The results showed high overall Islamic bank stability. Consistent with the NPFs, the Z-index results indicated that Islamic banks enjoy higher franchise value and greater stability also his results of Z-index implement showed that the investigated Islamic banks might use their market power to increase their financing rates which in turn increases their credit risk, but at the same time protects their charter value by rule of risk sharing and high capitalization level.

Chakroun and Mohamed [22] had analyzed the impact of Islamic banks on financial stability by studying the effect of market share in terms of credit supply, their empirical results showed that the increase in market share in terms of the offering of loans by Islamic banks negatively affects financial stability, and thus leads to the increase of market share in terms of credit supply for conventional banks improving financial stability.

Financial stability definition: As for the broad definition, the Reserve Bank of Australia (the Australian Central Bank), for instance, defines FS as a situation in which “financial intermediaries, markets and market infrastructure of the financial system facilitate the smooth flow of funds between savers and investors and by doing so, helps promote growth in economic activity” [23].

Financial stability measurement: The Z score model had developed to measure financial strength which indicates the stability
of institutions. This model first developed in 1968, Altman’s primary improvement over prior methods was to apply discriminates analysis which simultaneously took into account multiple variables to ascertain financial strength. As an open system users enjoy the benefits without the additional cost incurred with the proprietary black box system. No hidden magic –only solid financial analysis.

The Z score has continued to evolve over time with new version developed specifically for private companies. It gained wide acceptance from auditors, management accountants courts, and data base systems used for loan evaluation. The formula’s approach has been used in a variety of contexts and countries. Forty years of public scrutiny speaks to its validity.

The method examines liquidity, profitability, reinvested earnings and leverage which are integrated into a single composite score. It can be used with past, current or project data as it requires no external inputs such as GDP or market price.

\[ Z = a \text{ proxy variable of insolvency risk} \]
\[ X1 = \text{working capital/total assets} \]
\[ X2 = \text{retained earnings/total assets} \]
\[ X3 = \text{earnings before interest and tax/total assets} \]
\[ X4 = \text{total book equity/total liabilities} \]

A higher score indicates greater financial strength with a lower probability of default and vice versa.

The method examines liquidity, profitability, reinvested earnings and leverage which are integrated into a single composite score. It can be used with past, current or project data as it requires no external inputs such as GDP or market price.

Zones of discriminations

\[ Z > 2.6 \] - "Safe" Zone
\[ 1.1 < Z < 2.6 \] - "Grey" Zone
\[ Z < 1.1 \] - "Distress" Zone

Islamic modes of finance background

Central to Islamic finance is the fact that money itself has no intrinsic value. As a matter of faith, a Muslim cannot lend money to, or receive money from someone and expect to benefit. This means that interest (known as Riba in Islam) is not allowed and making money from money is forbidden. Money must be used in a productive way, by which wealth can only be generated through legitimate trade and investment in assets. The principal means of Islamic finance are based on trading. Any gains relating to the trading are shared between the party providing the capital and the party providing the expertise. As a result, the Islamic banks have developed four main Islamic financing techniques, which are: Murabaha, Musharaka, Ijara and Murabaha.

Mudaraba (trust financing): Mudaraba is a partnership of a financier and a managing partner. The financing partner (the financier) entrusts his capital to the managing partner (entrepreneur), who in turn contributes his knowledge and entrepreneurial skills to the project. The financing partner is not involved in the actual management of the partnership. This makes trust financing the preferred form of partnership for banks. Profits are shared in a pre-determined ratio. However, in the event of a loss, the financing partner bears the loss, while the managing partner loses his effort and time, unless this loss was caused by the irresponsible behaviour of the managing partner [14].

In that sense, Islamic banks themselves are regarded in the Islamic Fiqh as Mudaraba companies, where the depositors are regarded as the financier and the bank’s management (or the shareholders in general) is regarded as the entrepreneur.

Musharaka (Joint Venture or Profit and Loss Sharing "PLS"): Musharaka means a profit and loss sharing joint venture. It is intended to combine the talents of two or more partners in a business enterprise, where each of them contributes capital, managerial expertise, efforts and other essential services in equal or varying degrees. Accordingly, they share in both risks and financial results on the basis of their share in capital and efforts. Since most banks do not wish to be actively involved with the management of a venture, this form of partnership is not commonly applied in Islamic banks [25].

Ijara (Leasing): Ijara is simply an Islamic lease agreement. It is defined by AAOIFI as: "Ownership of the right to the benefit of using an asset in return for a consideration". In this type of financing, the bank purchases a piece of equipment selected by a client, and then leases it back to him/her for a specified rental over a specific period. The duration of the lease, as well as the basis for rental, are set and agreed in advance [26]. In some cases, the bank may lease a tangible asset from a third party and subleases it to its client [27]. The Islamic banks are currently practicing this technique in circumstances, under which clients opt to buy the item(s) eventually. In such circumstances, Ijara is practiced either in the form of "Ijara-wa-Iktana" or "Ijara with diminishing Musharaka". The contract of "Ijara-wa-Iktana" extends the concept of Ijara to a hire and purchase agreement. It includes a promise from the client to buy the equipment at the end of the lease period, at a pre-agreed price. Rentals paid during the period of the lease constitute part of the purchase price. In other words, the monthly payment will consist of two components, i.e., rental for the use of the equipment and instalment towards the purchase price. Often, as a result, the final sale will be for a token sum. However, the contract of "Ijara with diminishing Musharaka" is widely used for home-buying services. Diminishing Musharaka means that the bank reduces its equity in an asset with any additional capital payment the client makes, over and above his/her rental payments. The client’s ownership in the asset increases and the bank’s ownership decreases by a similar amount each time the client makes an additional capital payment. Ultimately, the bank transfers ownership of the asset entirely over to the client.5 The liquidity risk in both types of Ijara contract will therefore be limited as the sale price is built into the rental instalments [28].

Murabaha (Mark-up financing or Cost-plus financing): Murabaha is defined in the Islamic Fiqh as the sale of goods at cost plus an agreed profit mark-up. It is very important in this type of Islamic financing that the seller truthfully informs the purchaser of the price at which he purchased the product and stipulates an amount of profit in addition to the original cost [14,29]. Thus, Murabaha is, in theory, a form of trade financing. It is simply a sales contract that fixes the price of certain goods or items, plus a specified percentage mark-up (profit). However, it is currently practiced as an agreement between a final buyer (the customer) and a middleman (the Islamic bank), by which the Islamic bank plays the role of financier. In this case, a client requests the bank to purchase the selected goods according to certain specifications. Once the bank purchases the goods, it resells them to that client at the cost plus a certain profit. The Murabaha contract in such a case is called "Murabaha to the Purchase Orderer" [28,30,31].
Ahsalam: Salam is deferred delivery contract. It is essentially a forward agreement where delivery occurs at a future date in exchange for spot payment of price [32].

Istisna: Istisna is a contractual agreement for manufacturing goods, allowing cash payment in advance and future delivery or a future payment and future delivery of the goods manufactured, as per the contract [33].

Research Design

Statement of the problem

As we knew Islamic finance have grown rapidly in recent time, also there is general conception that Islamic banks are more stable during last financial crisis than conventional counterpart; however there is no clear consensus about the relation between Islamic finance and economic development, so that this study investigates how can Islamic modes of finance effect on economic growth and bank financial stability at the same time.

Objective

This study aims to develop new model that will interpret the relation between Islamic finance models and real economic growth, financial stability.

Methodology

This study follows quantitative method by employing cross sectional data context analysis. The data is collected from six banks over six countries through the period 2011-2013. Pearson regression is used to measure causal relation between GDP and banks performance representing in Islamic modes of finance, Z score. Data is collected from banks annual reports and central banks annual reports.

Significant of the study

The study develops new simple model to describe the relation between Islamic modes of finance and real economy growth.

Also the study fills the gab because there are no previous studies were conducted in the relation between Islamic modes of finance and financial stability of the banks.

Data Analysis and Discussion

The study analyzes the relation between Islamic modes of finance as independent variables and Z score and GDP as dependent variables.

Firstly the study uses correlation test to discover whether Z score and Islamic modes of finance can move in the same direction.

Table 1 shows the result as we notice all studied Islamic modes of finance are correlated significantly by negative relation to Z score factor except Mudaraba is correlated un significantly by positive relation to Z Score factor.

From Table 2 the conclusion that should be understood Mudaraba the best mode of finance that can be lead to financial stability of Islamic banks; also Istisna the second one that Islamic bank can apply to lend their clients because it has the lowest negative relation to Z score.

Although correlation test shows only the direction of the relation, the researcher applies causal relation test (regression) to investigate whether Islamic modes of finance effect on the financial stability of Islamic banks or not.

From Table 3 we can conclude that Islamic modes of finance cause 94% of the Z score change, and other factors cause only 6% of the Z score change. This big challenge Islamic finance experts should make a research efforts which can help Islamic banks how to make Islamic modes of finance lead to financial stability.

From Table 4 the researcher discovers that there is no significant causal relation between Z score and two model of finance (Murabah, Mudaraba).

**Correlation is significant at the 0.01 level (1-tailed).
*Correlation is significant at the 0.05 level (1-tailed).
**Correlation is significant at the 0.01 level (1-tailed).

**Table 1**: Correlations of Islamic modes of finance.

<table>
<thead>
<tr>
<th>Islamic modes of finance</th>
<th>Degree of correlation with Z score</th>
<th>Significance level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ijarah</td>
<td>-0.585</td>
<td><strong>Correlation is significant at the 0.01 level (1-tailed).</strong></td>
</tr>
<tr>
<td>Murabah</td>
<td>-0.451</td>
<td><strong>Correlation is significant at the 0.01 level (1-tailed).</strong></td>
</tr>
<tr>
<td>Musharaka</td>
<td>-0.384</td>
<td><strong>Correlation is significant at the 0.01 level (1-tailed).</strong></td>
</tr>
<tr>
<td>Istisna</td>
<td>-0.271</td>
<td>Correlation is significant at the 0.05 level (1-tailed).</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>0.278</td>
<td>Correlation is significant at the 0.05 level (1-tailed).</td>
</tr>
</tbody>
</table>

**Table 2**: Negative relation between Islamic modes of finance and Z score from the highest negative relation to the lower one.
Therefore researcher makes another linear regression test to build significant mode as shown in Tables 4-6.

From Table 6 we can conclude that Islamic modes of finance (Ijara, Musharakah, Istisna) cause 92% of the z score change, and other factors cause only 8% of the Z score change (Tables 7 and 8).

Z score=3.99 - (0.0000003125) musharaka finance - (0.000000396) Ijara finance - (0.0000025) Istisna finance

From this model we can conclude that there is a negative causal relation between Islamic modes of finance and Z score.

This result goes consistently with Chakroun and Mohamed [22], they have demonstrated that the increase in market share in terms of the offering of loans by Islamic banks negatively affects financial stability, and thus leads to the increase of market share in terms of credit supply for conventional banks improving financial stability.

Also this result goes consistently with Ali [21], his results of Z-index implement showed that Islamic banks might use their market power to increase their financing rates which in turn increases their credit risk, but at the same time protects their charter value by rule of risk sharing and high capitalization level.

The researcher also tries to investigate the relation between Islamic modes of finance and economic growth through financial stability of Islamic banks Tables 9-11 show the result.

We can conclude from Table 9 Islamic modes of finance and Z score can cause 88% of the GDP change, only 12% of the GDP change can be caused by the other factors.

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
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<tbody>
<tr>
<td>1</td>
<td>0.936*</td>
<td>0.876</td>
<td>0.866</td>
<td>0.58961</td>
</tr>
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</table>

*Predictors: (Constant), Murabah finance, Ijara finance, Istisna finance, Mudaraba finance, Musharaka finance

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
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<tr>
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<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>3.688</td>
<td>0.174</td>
<td>21.227</td>
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<td></td>
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<td>Murabah finance</td>
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<td>(Constant)</td>
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<tr>
<td></td>
<td>Musharaka finance</td>
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<td>-.772</td>
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<tr>
<td></td>
<td>Ijara finance</td>
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<td></td>
<td>Istisna finance</td>
<td>-2.501E-006</td>
<td>.000</td>
<td>-.421</td>
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</table>

*Predictors: (Constant), Istisna finance, Ijara finance, Musharaka finance

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*Dependent Variable: Z score factor

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<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
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<td>0.929*</td>
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*Predictors: (Constant), Istisna finance, Ijara finance, Musharaka finance

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<td></td>
<td>Total</td>
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<td>62</td>
<td></td>
<td></td>
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*Dependent Variable: Z score factor

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*Dependent Variable: Z score factor
GDP rate = 12.39 + 0.00000156 musharaka finance - (0.00000055) Ijara finance + 0.0000063 Istisna finance - (0.00000052) murabah finance + 0.0000045 mudaraba finance - (2.32) Z score.

From the above Table 11 we can notice that standard error of all variables except Z score and the constant equal zero. Thus interprets the significance of the model. Also the result of the test shows that there is positive causal relation between all studied models of finance and GDP except Ijara and Murabah.

This result goes consistently with Hafnida et al. [15] their Findings showed that Islamic modes of finance which include murāba, mushārakah, muḍārabah, 'istiṣnā, ijārah. Affect positively on the financial intermediation (economic growth however this result contrast them in Murabaha and Ijara effects negatively on financial stability).

Also this result is goes by contrast to Ali [27] he has argued that the credit types of Islamic financing, like Murabaha and Ijara transactions it keeps credit tied to real economic activity for each transaction and throughout the tenor of contract.

**Conclusion Results and Lessons Learned**

**Conclusion results**

1. There is negative causal relation between musharaka mode of finance and Zscore.
2. There is negative causal relation between Ijara mode of finance and Zscore.
3. There is negative causal relation between istisna mode of finance and Zscore.
4. There is negative causal relation between Zscore and GDP.
5. There is negative causal relation between Ijara modeof finance and GDP.
6. There is negative causal relation between Murabah modeof finance and GDP.
7. There is positive causal relation between Musharakh mode of finance and GDP.
8. There is positive causal relation between Ijisna mode of finance and GDP.
9. There is positive causal relation between mudaraba mode of finance and GDP.
10. Murabah modes of is correlated significantly by negative relation to Zscore, but there is no significance causal relation between Murabah and Z score.
11. Mudaraba modes of is correlated significantly by positive relation to Zscore, but there is no significance causal relation between Mudaraba and Z score.
12. The best mode of finance that can minimize financial stress and raise GDP at the same time is Istisna.
13. Murabah can lead to financial stress in the banks and decrease GDP rate at the same time.
14. All Islamic modes of finance except Mudaraba and Murabah are minimizing financial strength in the banks and maximize GDP rate at the same time.

**Lessons learned**

1. Banks supervisors and decision makers at Islamic banks should encourage Istisna mode of finance
2. Banks supervisors and decision makers at Islamic banks should search hard to discover appropriate financial tool in Islamic banks which can maximize financial strength and GDP in national economy at the same time.
3. Banks supervisors and decision makers at Islamic banks should decline amount of lending by Murabah modes of finance.
4. Banks supervisors and decision makers at Islamic banks should decline amount of lending by Ijara modes of finance.
5. Future studies should be made in the relation between Islamic modes of finance to confirm the results of this study.

References