The Nexus between Economic Freedom and Islamic Bank Performance in the MENA Banking Sectors

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The Nexus between Economic Freedom and Islamic Bank Performance: Empirical Evidence from the MENA Banking Sectors[1]

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The present study provides new empirical evidence on the impact of economic freedom on Islamic banks' performance. The empirical analysis focuses on Islamic banks operating in the MENA banking sectors during the period 2000-2008. We find that the larger, more diversified, and better capitalized Islamic banks tend to be relatively more profitable, while credit risk and expense preference behaviour seem to exert negative impact. The findings suggest that greater financial freedom positively influence the profitability of Islamic banks operating in the MENA banking sectors. Interestingly, the impact of monetary freedom is negative implying that higher (lower) monetary policy independence reduces (increases) Islamic banks' profitability, providing support to the benefits of government interventions.

JEL Classification: G21; G28
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1.0 INTRODUCTION

Islamic banking is a relatively recent addition to the global financial markets. Its conventional brick and mortar root can be traced back to the early 1960s when Myt Ghamar Bank was formed in Egypt in 1963. Between 1963 and 1971 the bank provided Muslims with a place to deposit their savings in accordance to the *Syari'a* principles[4]. Despite its humble beginning, Islamic banks have blossomed throughout the world and are looked upon as a viable alternative system which has many things to offer.

Although it was initially developed to fulfill the needs of Muslims, Islamic banking has now gained universal acceptance. According to El-Qorchi (2005), the number of Islamic financial institutions increased from a single institution in 1975 to approximately 486 financial institutions operating in more than 75 countries worldwide[5]. Total assets of Islamic financial institutions are estimated at US$250 billion and are tipped to be growing at 15% per year, three times the rate of conventional banks. The rapid growth rate confirms the growing importance of Islamic banking and finance in the global financial markets.

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1 All findings, interpretations, and conclusions are solely of the authors' opinion and do not necessarily represent the views of the institutions.

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4 The basic tenets and principles of Islamic banking are built upon the avoidance of usury (*riba*') and the prohibition of impermissible activities as clearly mentioned in the Quran, the Islam's holy book and the traditions of Prophet Muhammad (*sunnah*): "Believers! Do not consume *riba'*, doubling and redoubling..." (3.130); "God has made buying and selling lawful and *riba'* unlawful..." (2:274).

5 The estimates of the number of Islamic financial institutions vary considerably between institutions. For instance, the International Monetary Fund (IMF) estimate that the number of Islamic financial institutions has increased to more than 300, while the Association of Islamic Banking Institutions Malaysia (AIBIM) suggests that there are around 486 Islamic financial institutions around the world.