The Influence of Culture on Economic Outcomes: An Exploration of Islamic Finance as a New Transmission Channel

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Islamic finance is one of the most prominent phenomena over the last decade in the banking industry in the Middle-East and South-East Asia. It has recently spread in non-Muslim countries, such as the UK or the US. Globally, assets on the books of Shariah-compliant commercial banks have exceeded 350 Billion USD in 2005 and grown by an average of 29% annually from 2000.

In spite of the substantial size and growth of this segment, the role of Islamic banking in the economy is still heavily debated and very few empirical work is available. This paper studies the impact of Islamic banking on financial sector development. It circumvents the lack of data through a newly-constructed and comprehensive database, "IFIRST", covering Islamic commercial banks worldwide over the period 2000-2005. This database is, to our knowledge, unique in the industry.

After controlling for standard determinants and potential endogeneity, using religion as an instrument, we find strong and significant empirical evidence of a positive role of Islamic banking on countries' financial sector development, as measured by private credit over GDP.

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