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The impact of Sukuk on the country's economic growth with country governance as a moderating variable

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Abstract

This study examines the impact of Sukuk on economic growth with country governance (regulatory quality, the rule of law, and government effectiveness) as the moderating variable. Five countries, Indonesia, Malaysia, United Arab Emirates, Bahrain, and Saudi Arabia were taken as samples. Data taken were from 2006 to 2018. Moderating Regression Analysis (MRA) was used to test the effect of the variables in the country's governance in moderating the relationship between Sukuk and economic growth. The Generalized Least Square (GLS) was used to minimize the variance in the estimation model. The findings of this study indicate that the Sukuk development moderated by the regulatory quality has a significant positive effect on the country's economic growth. At the same time, the other two moderating variables (the rule of law and government effectiveness) did not show a significant moderation effect. The regulatory quality shows the policy's efficiency implemented by the government and Sukuk innovation.

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Introduction

Sukuk is a financial instrument that significantly contributes to the growth of the Islamic finance industry. It was estimated that in 2018-2019 the growth of the Islamic finance industry in the global market increased deliberately (S&P Global Ratings, 2018). This statement was based on

the 5% growth in 2017, whereas in the previous year, it was only about 2% ([S&P Global Ratings, 2018](#)). Hence, globally, Sukuk was considered the most significant contributor to the growth of Islamic financial assets in 2017. The biggest support comes from the Jumbo Sukuk issuance by the GCC (Gulf Cooperation Council) ([S&P Global Ratings, 2018](#)).

Based on data released by IIFM (International Islamic Financial Market), the number of Sukuk issuances from 2001 to 2017 reached USD 979.209 million ([Dadabhoy, 2018b](#)). Although the ratio of the assets of Sukuk to global Islamic financial assets is still relatively small, gradually, Sukuk has a potential value to be developed.

The issuance of both corporate Sukuk and sovereign Sukuk significantly contributes to economic development ([Smaoui et al., 2017](#)). Until recently, in terms of volume and number, the country's leading the Sukuk issuance are dominated by Saudi Arabia and Malaysia, while countries that rarely take advantage of Sukuk are from Africa. African countries took 2.2% of total global Sukuk issuance ([Dadabhoy, 2018b](#)). Product innovation in financial services is one of the potential strategies for triggering growth and strengthening the economic structure ([Melani, 2018](#)).

Infrastructure development is not an easy matter. Some challenges that hinder the development include the unavailability of long-term finance, a clear risk-sharing scheme, and the lack of support from banks and other companies involved in infrastructure finance ([Sanusi, 2012](#)). Using Sukuk through a financing scheme is a solution for infrastructure development in various countries.

Sukuk's scheme to support economic development appears significant in several countries, such as Malaysia ([IFSB, 2018](#)). In 2017, Malaysia took the Sukuk scheme to fund infrastructure development, real estate, transportation, telecommunications, financial services, education, and agriculture ([IFSB, 2018](#)). The same condition also occurred in Saudi Arabia; Musharakah Sukuk, worth \$ 550 million, was successfully used to develop engineering centres and buildings near Dubai airport. Then, the port was built in 2006 through the same scheme ([IFSB, 2018](#)).

Referring to the facts mentioned, it can be concluded that the financial sector has an essential role in stimulating economic growth. This idea was first stated by the neoclassical economist Schumpeter (1911) through his opinion that the financial sector has an essential role in developing the real sector. This hypothesis was tested by several economists afterwards and among them succeeded in identifying the relationship between the financial sectors and the real sectors (Levine, 1997; Wachtel, 2001; King and Levine, 1993a, 1993b, [Smaoui & Nechi, 2017](#)).

Studies that specifically examine the effect of Sukuk on economic growth were conducted by [Malikov \(2017\)](#) and [Smaoui et al. \(2017\)](#). Their studies revealed that there is a relationship between the development of Sukuk and economic growth. On the other hand, some studies showed no relationship between the development of Sukuk and economic growth ([Coşkun, Seven, Ertuğrul, & Ulussever, 2017](#)).

Notwithstanding the differences, Sukuk has significant roles and benefits for the country's development. Therefore, it is not only business actors to pay attention to the capital market but also the government in the form of policy interventions to create a conducive investment ecosystem. In line with this, a study conducted by [Anwar \(2018\)](#) shows a positive interaction between Sukuk and economic growth.

The development of the financial sector requires the role of the government in arranging rules, regulations, and policies to create sustainable development. The government's role in intervening in the development of the Sukuk can be in the form of implementing good governance, especially in financial sector development. In Indonesia, the Financial Services Authority (OJK), as the agency authorized to be the regulator of activities of financial institutions, keeps striving to formulate appropriate policies to strengthen the capital market.

This study is distinct from previous studies in terms of the issue raised. Research on the impact of financial market developments (Sukuk) on the real sector involving country

governance as a moderating variable has never been tested. The country governance variable is one of the important novelties in this study. Moreover, in terms of economic growth from an Islamic perspective, financial sector growth should reflect real sector growth. Thus, the growth in the financial sector must not exceed the growth of the real sector. Therefore, as one of the growing financing instruments in Islamic finance, Sukuk needs to be tested to determine its effectiveness and role in the country's economic growth.

This study developed a model from previous studies regarding the relationship between Sukuk development and economic growth by involving country governance variables (the rule of law, regulatory quality, and government effectiveness). The rule of law, regulatory quality, and government effectiveness that reflect the level of state stability is expected to moderate the relationship between the development of Sukuk and economic growth variables.

In addition, this study is expected to encourage countries that insufficiently use the Sukuk scheme to immediately pay attention to developing the Sukuk ecosystem to strengthen the country's economic structure.

Schumpeter (1911) first conceived the concept of the effect of financial market developments on economic growth. He realized the importance of innovating financing products to increase productivity. Then, an economist, Patrick (1969), also investigated and found a form of causality between financial sector development and economic growth, which consists of the demand following and supply lending hypotheses.

The demand following hypothesis states that the creation of modern financial services through assets and liabilities responds to the increasing demand for services by savers and investors from the real sector (Patrick, 1969). Meanwhile, the supply-lending hypothesis states that creating financial services, especially for business people, will encourage real sector growth. Another term for describing the two hypotheses is the feedback hypothesis. It is a hypothesis that explains the reciprocal relationship between financial sector development and economic growth. Then, the supporters of this model emphasize that if the financial sector has good development, it will encourage growth in the real sector through technological changes and product and service innovation (Pradhan et al., 2018).

Based on the finance growth nexus theory stating that financial market growth can positively impact economic growth, the Sukuk market development is one of the proxies for financial market development. In the concept of inclusive and sustainable growth, financial contract reform will positively impact economic development. Risk-sharing-based financial instruments are one of the potential financial products for boosting economic growth (Iqbal & Shafiq, 2015). A Further study by Herwartz et al. (2014) supports previous research that a strong relationship exists between the financial sector and economic growth. In 2018, Fufa et al. (2018) and Pardhan et al. (2018) also found that the financial sector's development positively affects economic growth.

Limited studies explicitly examine the relationship between Sukuk's development and economic growth. There have been only a few studies investigating the relationship between the two. Among them is Smaoui (2017), who sought to investigate the relationship between the Sukuk market and economic growth. In this research, he proved the relationship between the development of the Sukuk market and economic growth. The same study was conducted by Hassan et al. (2018) and Malikov (2017), which took Malaysia as the sample. The studies proved a difference in economic growth between before and after Sukuk issuance. Anwar (2018) conducted another study that revealed the relationship between Sukuk market development and economic growth in Malaysia and Indonesia. Referring to the theoretical description and previous studies, a hypothesis was developed:

H1: The development of the Sukuk market positively affects economic growth.

This study involved the development of country governance as a moderating variable as a research model. The country governance variable is a development strategy from previous research models that examine the relationship between country governance and economic growth, such as research by [Nistotskaya et al. \(2016\)](#), [Acharya et al. \(2016\)](#), [Liu et al. \(2015\)](#), [Kim et al. \(2018\)](#), [Alam \(2017\)](#), [Arora et al. \(2018\)](#), [Harper \(2016\)](#), and [Wilson \(2016\)](#). Country governance variables include regulatory quality, the rule of law, and government effectiveness. Regulatory quality is one of the components of country governance. This study describes regulatory quality as a perception of the government's ability to formulate and implement policies to encourage private sector development ([World Bank, 2019](#)). Studies examining the effect of Sukuk development on economic growth have resulted in different findings. Therefore, this study attempted to re-explore the relationship of Sukuk with economic growth by involving the regulatory quality variable.

This study is expected to yield new findings of a strong relationship between the development of Sukuk and economic growth by including regulatory quality as a moderating variable. The creation of state conditions through regulatory quality is expected to boost the productivity of the Sukuk.

The regulatory quality variable was involved based on several considerations previously mentioned, such that the existence of country governance can strengthen government productivity in triggering economic growth ([Nistotskaya et al., 2016](#); [Acharya et al., 2016](#); [Liu et al., 2015](#); [Kim, 2018](#)). However, country governance does not significantly impact other conditions ([Wilson, 2016](#); [Harper, 2016](#)). Referring to the previous findings, the following hypothesis is:

H2: Regulatory quality moderates the positive relationship between the Sukuk market development and economic growth

The following variable of country governance is the rule of law. The rule of law is defined as absolute legal superiority made by the state, not by individuals, which aims to regulate behaviour, including government officials ([Lembaga Administration Negara, 2000](#)). Referring to the Worldwide Governance Indicators, the number of confidence in agents to comply with community rules, including contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence ([World Bank, 2019](#)).

As previously mentioned, country governance is predicted to affect economic growth positively. A study with the same findings mentioned was conducted by [Kim et al. \(2018\)](#) that improvements in country governance can help the government increase productivity, which can trigger economic growth.

In contrast, [Harper \(2016\)](#) shows different results. In this study, there was no significant effect of government. The government's marginal impact is not the primary key driving the economy. In further investigations, it was stated that the role of regional governments had the most critical role in improving the economy. Based on the description, the hypothesis formulated is:

H3: The rule of law moderates the positive relationship between the Sukuk market development and economic growth

Another country governance variable is government effectiveness. Government effectiveness. It is defined as a description of the perception of the quality of public services, the quality of civil services, the level of independence from political pressure, the quality of policy formulation and implementation, and the government's credibility towards these policies.

Based on considerations regarding the development of the Sukuk market, according to research conducted by Smaoui (2017), Malikov (2017), and Anwar (2018), testing of the variable of government effectiveness in terms of economic growth was also carried out by several previous researchers. Among them is research by Arora et al. (2018). The research results show that a high level of government effectiveness induces an increase in public services. The government's effectiveness also moderates through its interaction with tax collection variables in encouraging economic growth.

Subsequently, Alam et al. (2017) also found that government effectiveness significantly affects economic growth. Based on the description of the finance growth-nexus theory that explains the nexus relationship between the growth of the financial sector and the real sector. It is also based on the government effectiveness variable in predicting economic growth. The hypothesis formulated is:

H4: Government effectiveness moderates the positive relationship between the Sukuk market development and economic growth

Methodology

The main objective of this study is to examine the impact of Sukuk moderated by the variable of variable country governance on economic growth. The finance growth nexus theory tested this research using the Moderation Regression Analysis (MRA) and the Generalized Least Square (GLS) method. The variable of country governance proposed in the research hypotheses is the reason for the use of MRA analysis. At the same time, the GLS method is an alternative method to OLS, which aims to minimize the variance of each research variable.

The population in this study are all countries issuing Sukuk. However, due to the limitations of the data mechanism, the sample in the study was taken through the purposive sampling method by considering several things, including the availability of data based on the research object and countries that had issued Sukuk for at least the last 10 years. This study used secondary data in the type of panel data, which is a combination of time series and cross-section data. Sources of data were websites of the World Development Indicator of the World Bank, Bloomberg, the Worldwide Governance Indicator of the World Bank, and the United Nations Development Program (Human Development Reports). This study used data from the last 13 years, from 2006 to 2018. Based on these considerations, this study sampled five countries from 2006 to 2018 (IFCI, 2017). The following five countries met specific requirements to be included as research samples:

Table 1. List of countries taken as research object

No.	Countries	Level
1	Saudi Arabia	<i>Exceptional</i>
2	Malaysia	<i>Highest</i>
3	United Arab Emirates	<i>Significant</i>
4	Bahrain	<i>Moderate</i>
5	Indonesia	<i>Moderate</i>

Testing the variable of Sukuk on economic growth is the main test in this study. The next stage involves the variable of country governance consisting of regulatory quality, the rule of law, and government effectiveness as the moderating variables. Control variables are also involved in the study to measure the accuracy of the independent variables in explaining the dependent variable. A detailed explanation of the variables and their measurements can be seen in Table 2:

Table 2. Research variables

Types of Variables	Variables	Proxy	Sources
Dependent	Economic growth	GDP per capita (constant US\$ 2010)	(Smoui, 2017; World Bank, 2019)
		This variable uses lagged GDP per capita (t+1) as a proxy for GDP in year t.	
Independent	Sukuk	Development of Sukuk capitalization	(Smoui, 2017; Anwar, 2018)
Moderation	Regulatory Quality	The estimated value of the regulatory quality score ranges from -2.5 to 2.5	(World Bank, 2019)
	The rule of law	The estimated value of the rule of law the score ranges from -2.5 to 2.5	(World Bank, 2019)
	Government effectiveness	The estimated value of the government effectiveness score ranges from - 2.5 to 2.5	(World Bank, 2019)
Control	Inflation	Consumer price (% of GDP)	(Smoui, 2017)
	Trade openness	Trade (% GDP)	(Smoui, 2017)
	Government expenditure	General government final consumption expenditure (% of GDP)	(Smoui, 2017)
	The development of the stock market	The development of stock capitalization	(Smoui, 2017)
	Human development index	HDI Index	

Model Development and Method

The data analysis was done using the moderated regression analysis (MRA). The equation in the moderated regression analysis includes a moderating variable for giving an effect on the relationship between variable X (independent) and variable Y (dependent). This effect can strengthen or weaken the relationship between the two or even be completely absent. If X is stated as the predictor variable, M as the moderating variable, and Y as the criterion variable, the Moderated Regression Analysis model can be expressed in the form of the following equations:

$$PE_{it} = \alpha + \beta_1 PS_{it} + e \quad (1)$$

$$PE_{it} = \alpha + \beta_1 PS_{it} + \beta_2 RQ_{it} + \beta_3 RL_{it} + \beta_4 GE_{it} + e \quad (2)$$

$$PE_{it} = \alpha + \beta_1 PS_{it} + \beta_2 RQ_{it} + \beta_3 RL_{it} + \beta_4 GE_{it} + \beta_5 PS.RQ_{it} + \beta_6 PS.RL_{it} + \beta_7 PS.GE_{it} + e \quad (3)$$

Which:

PE = Economic growth

PS = Sukuk market development

RQ = Regulatory quality

RL = Rule of law

GE = Government effectiveness

e = Error

i = Country

t = Year

Referring to the third equation, if the statistical test shows no significant value in the coefficients β_2 , β_3 , β_4 , but significant on the coefficients β_5 , β_6 , and β_7 , the moderating variable is classified as "pure moderator" or complete moderation. It means the moderating variable fully interacts with the predictor variable (X) without being an independent predictor variable. Suppose the coefficient values of β_2 , β_3 , and β_4 show significant numbers and the coefficient values of β_5 , β_6 , and β_7 also show significant numbers. In that case, the classification of the moderating variables is included in the "Quasi Moderator" or pseudo-moderation. Meanwhile, suppose the coefficient values of β_2 , β_3 , and β_4 show no significant value and the coefficient values of β_5 , β_6 , and β_7 show no significant value. In that case, the classification of the moderating variables is included in the "Homologiser Moderator", or potential moderation.

Next, if the coefficient values of β_2 , β_3 , and β_4 show a significant number, but the coefficient values of β_5 , β_6 , and β_7 show no significant numbers. The classification of the moderating variable is included in the "Predictor Moderator". The beta coefficient interpretation on the MRA model is essential to see the quality of the resulting moderation. In the regression model, the estimator is expected to meet the assumption of the pure moderator. Furthermore, this study's GLS (Generalized Least Square) estimates the beta value because GLS has several advantages over OLS, such as its linearity, unbiased, and minimum variance.

Results and Discussion

In the general description of the research object, this study provides some information, including the intensity of issuance and the total Sukuk volume issued. Not many countries consistently issue Sukuk causing difficult data processing for Sukuk issuance for research purposes (Bloomberg, 2019). On the other hand, the intensity of Sukuk issuance does not always indicate a large volume of issuance. For instance, in Bahrain, in terms of frequency of issuance, Bahrain leads among countries issuing Sukuk. However, the countries having the largest volume of issuance are the UAE and Saudi Arabia, as seen from the very high value of market capitalization (Bloomberg, 2019). The results of testing through Eviews 11.0 can be seen in the description in table 3.

Table 3. Generalized least squares regression method test result

Variables	Coefficient	t-Statistic	Prob.	Hypothesis Prediction	Results
C	-5362.010	-2.478362	0.0168		
Sukuk market	52.78825	1.392025	0.1703	+	Accepted
Regulatory quality	4292.722	4.505362	**0.0000	+	Accepted
The rule of law	-3225.816	-2.847881	0.0065	+	Rejected
Government effectiveness	-733.5766	-1.338179	0.1871	+	Rejected
Sukuk market *regulatory quality	343.4857	2.419630	**0.0194	+	Accepted
Sukuk market * the rule of law	28.78602	0.667030	0.5079	+	Accepted
Sukuk market *Government effectiveness	-288.1416	-1.863237	0.0686	+	Rejected
Gini Index	16.05632	0.532242	0.5970	-	Rejected
Human development index	29999.60	11.70361	0.0000	+	Accepted
Inflation	-43.80992	-1.314629	0.1949	-	Accepted
Trade openness	1.006194	0.196433	0.8451	+	Accepted
Stock market	431.6002	155.8154	0.0079	+	Accepted

Source: Data processed

Referring to Table 2, the regression equation in this research model can be formulated as follows:

$$Y = 5362.010 + 52.78825 + 4292.722 - 3225.816 - 733.5766 + 343.485 + 28.78602 - 288.1416 + 16.05632 + 29999.60 - 43.80992 + 1.006194 + 431.6002$$

Sukuk is a long-term investment. Usually, the issuance of Sukuk is mostly used for a big project that requires a large number of funds for long-term economic infrastructure. This research was conducted from 2006 to 2018 and was completed in 2019. Based on the results of data estimation through the MRA with the GLS model, the regression model chosen is the best, in this case, the fixed effect model. The difference in data panel regression estimation results between the expected effect and fixed-effect models was not very significant. Hence, it did not change the real nature of data processing results.

Analysis of the Moderated Regression Analysis (MRA) model with the generalized least square (GLS) Method

As a reference for measuring the variability of the model built in explaining the economic growth variable, the model's efficiency level is explained through the test results of the coefficient of determination (R^2). Based on the results of the coefficient of determination, it can be concluded that the variation of the model consists of the independent variable of Sukuk market development, the moderating variables of regulatory quality, the rule of law, and government effectiveness, as well as control variables of HDI, inflation, trade openness, government expenditure, can explain the economic growth variable by 99%. Other variables outside the model explain the remaining 1%. The results of statistical testing can be seen in Table 4:

Table 4. Cross-section fixed weighted statistic

R-squared	0.996629	Mean dependent var.	23486.24
Adjusted R-squared	0.995506	S.D. dependent var.	10356.10
S.E. of regression	1060.510	Sum squared resid.	53984750
F-statistic	887.0095	Durbin-Watson stat	0.941099
Prob. (F-statistic)	0.000000		

Source: Data processed

Based on the results of statistical tests and real analysis of research variables, the variable of Sukuk does not have a significant effect on economic growth as developed through hypothesis 1. From the findings, it can be predicted that developments in the financial market cannot directly control the rate of economic growth, in this case, the Sukuk market. Even if there is a role in the financial market, it takes a strong commitment from each country to strengthen the sustainability of financial products. The result of this study is in contrast with the findings of previous studies, in which the development of Sukuk influences economic growth (Anwar, 2018; Hassan et al., 2018; Malikov, 2017; Smaoui, 2017).

In another empirical test, it was found that regulatory quality was able to moderate the positive relationship between Sukuk development and economic growth. This result can be confirmed through hypothesis 2. Regulatory quality in this study is interpreted as the quality of government regulations on the private sector's development. The quality of this regulation deals specifically with the activities and development of the financial industry and the private sector. Thus, it can be concluded that regulatory quality is a crucial requirement the state must meet to create a conducive investment ecosystem.

For instance, in Malaysia, several studies show a significant role of the Sukuk development on economic growth (Anwar, 2018; Hassan et al., 2018; Malikov, 2017). This is inseparable from regulators' commitment to being serious in developing and strengthening the

Sukuk. This is seen in Malaysia's consistency in issuing Sukuk from 1995 to 2019 (Aziz & Zhang, 2019; Bloomberg, 2019). In addition, in order to create a conducive ecosystem for the development of the Islamic finance industry, the Malaysian government has made several policies, including making a roadmap for ecosystem development, creating good governance, the presence of a highly skilled Islamic finance workforce, raising awareness on ESG, as well as providing support through policy tools and incentives (Aziz & Zhang, 2019).

Furthermore, the lack of a rule of law that can support the sustainability of Sukuk is explicitly explained through the results of testing on hypothesis 3, which shows that rule of law cannot moderate the relationship between Sukuk and economic growth. As well as the government effectiveness variable in hypothesis 4, this section shows non-linear results, meaning that the Indonesian government needs to improve government effectiveness related to the investment ecosystem.

This study delineates that capital is important for the state to increase the contribution of Sukuk. Hence, it is necessary to develop policies that are friendly to the investment ecosystem. Product innovation, a conducive investment environment, and investment security must be continuously improved so that investors have high confidence in investing in these Sukuk products. With a conducive ecosystem, it is believed that it can significantly contribute to the development of Sukuk and improve Sukuk innovation.

Conclusion

This study has several scientific and managerial implications. The different findings can add to the scientific repertoire through model construction and approaches involving country governance as significant variables in the research model. In the managerial realm, this study also provides an overview of the extent to which regulatory quality is involved in strengthening the effect of Sukuk development on economic growth. This study also has many weaknesses and limitations, particularly regarding research data. The Sukuk data processing mechanism became an obstacle since each country does not have consistent Sukuk issuance data; instead, it is based on issuance units. The second weakness relates to the measurement of country governance variables. This study used a general proxy issued by the World Bank. It did not provide specific proxies regarding country governance in handling the Sukuk in the financial industry. Overall, this study suggests that further research can be developed through various models, adding variables, and increasing the amount of data for generalizations.

Author's Contribution

Irma Yuliani: The researcher, instrumentation and drafting of the article.

Ibnu Qizam: Data analysis, improving the quality of article content

Arif Nugroho: Translating and proofreading the article

Zul Ihsan Muarrif: Data collection

Declaration of Competing Interest

We declare that we have no conflict of interest.

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