

IMPACT OF ISLAMIC BANKING EXPANSION AND SHARIAH-COMPLIANT FINANCING ON PAKISTAN'S ECONOMIC GROWTH: A TIME-SERIES ANALYSIS (2015-2025)

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Abstract

Research Background: The financial environment of Pakistan has changed tremendously in the wake of Islamic banking which has emerged as a potential alternative to conventional banking in Pakistan.

Purpose of the Study: The purpose of this study is to examine the impact of the growth of Islamic banking industry and Shariah-compliant financing on economic growth in Pakistan using quarterly time series data for the period 2015Q3 to 2025Q4.

Methodology: Time series data is used for the purpose of conducting an empirical investigation in which ADF test will be applied for examining unit root whereas ARDL bound testing will be applied for investigating long-run and short-run dynamics.

Variables: Growth of the economy is gauged by real GDP while Islamic banking assets, financing and KIBOR serve as independent and control variables.

Key Findings: The F-bounds test shows that there is a connection between the variables in the long term. When we look at the numbers we can see that Shariah-compliant financing and Islamic banking assets both have an effect on the economy. If financing goes up by 1 percent the economy will grow by 0.106 percent. On the hand KIBOR has a bad effect on the economy.. Banking efficiency, which is measured by ROE helps the economy grow. The error correction term is -0.385 which means that when things get off track they get back to normal in than three quarters. This tells us that the economy adjusts at a pace. The F-bounds test and the run estimates both point to the same thing: Shariah-compliant financing and Islamic banking assets are good, for the economy while KIBOR is not.

Practical Implications: It can be argued from the empirical findings that asset-based structure of Islamic financing serves well to generate real economic activities in Pakistan, thus, validating the policy efforts made by State Bank of Pakistan towards dual banking system.

Originality/Value: The study is novel contribution to the existing body of knowledge through its provision of latest evidence (up to 2025) on finance and growth linkage in Islamic economy.

INTRODUCTION

Financial systems play the critical role in development of developing countries because they can serve as a tool connecting excess and deficit financial agents. Specifically speaking about the situation in Pakistan, during the last twenty years the banking industry has passed a significant paradigm shift towards a two-level banking system including Islamic and conventional banks. Starting from the beginning of 2000s, SBP (State Bank of Pakistan) actively promotes Shariah-compliant finances to increase financial inclusiveness of the local financial system according to the people's preferences. The main difference of Islamic banking is in the prohibition of usage of Riba, i.e. usury, and in the principle of risk sharing and asset-backed transactions. The main peculiarity of Islamic finance compared to conventional is in the necessity of linking financial operations directly to business operations, therefore, making it more realistic. The linkage of financial and economic transactions makes the growth of the industry potentially more beneficial for a country's GDP.

The connection between development and economic growth is based on the Supply-Leading Hypothesis. This hypothesis says that a strong financial system helps the economy by collecting savings and using resources well. In finance this connection is even stronger because of the Material Linkage principle. Unlike credit, which can be separate from the real economy and cause problems. Shariah-compliant financing methods, such, as Murabaha, Ijarah and Musharakah require an asset to exist. This requirement makes sure that financial growth is linked to things like factories, roads and trade. It helps make the economy grow in a way. The Islamic Banking Industry in Pakistan has done well over the past ten years. By the end of 2024 it had a share of the market in terms of assets and deposits. However, policymakers still need to answer a question: Does the growth of Islamic banks mean the economy is really growing? The Islamic Banking Industry's growth is important, for Pakistan's economy. It can help the country develop its industries and infrastructure. The industry's progress can also create jobs. Improve people's

lives. So, it is crucial to understand how Islamic finance affects the economy. This will help make decisions for the country's future.

Islamic banks in Pakistan have grown fast but the sector still has some big problems to deal with. The problem is that interest rates are high which is shown by KIBOR in this study and there is a lot of competition from banks that have been around for a long time. This makes things very complicated. Islamic banking is getting more popular. We need to figure out if people are just moving their money from regular banks to Islamic banks or if Islamic banking is actually helping Pakistan's economy grow. We do not have information to know for sure how Islamic banking affects the whole economy. Some studies in the past did not use data or the right methods to understand how things work in the long run. A lot of things have changed in Pakistan's economy from 2015 to 2025 so we need to take another look, at the numbers to see what is really going on with banks and the economy. Islamic banks need to be studied to see how they really affect Pakistan's economy.

This study is trying to figure out how Islamic banking affects Pakistan's economy. It looks at what happened from 2015 to 2025. The study uses math to see how Islamic banking and growth in assets impact the real economy.

The main goal of this study is to see how Islamic banking affects Pakistan's GDP in the run and short run. This study aims to achieve the following objectives: See how closely Islamic banking assets and financing are connected to economic growth Figure out how much GDP changes when Shariah-compliant financing changes look at how things like interest rates and bank efficiency affect this relationship. This study uses the recent data so it reflects what is happening now with the economy, which is really important for making financial plans in Pakistan.

2. HOW ISLAMIC BANKING HAS PERFORMED IN PAKISTAN

The financial system in Pakistan has changed a lot. It used to be really small in the 2000s but

now it is a big part of the economy. This change is not just because people prefer banking but also because the government made good rules and people started wanting Shariah-compliant products. Islamic banking in Pakistan has had three phases:

The first phase was from 2002 to 2010 when it was just starting out

The second phase was from 2011 to 2018 when it was growing

The third phase is from 2019 to 2025 when it became really big and started using technology.

In the ten years Islamic banking has grown really fast even faster than regular banking. It used to be small. Now it is a major player, in the financial system.

To understand how big this change is we need to look at some numbers. There is a table that shows how Islamic banking has performed from 2015 to 2025.

Table 1.

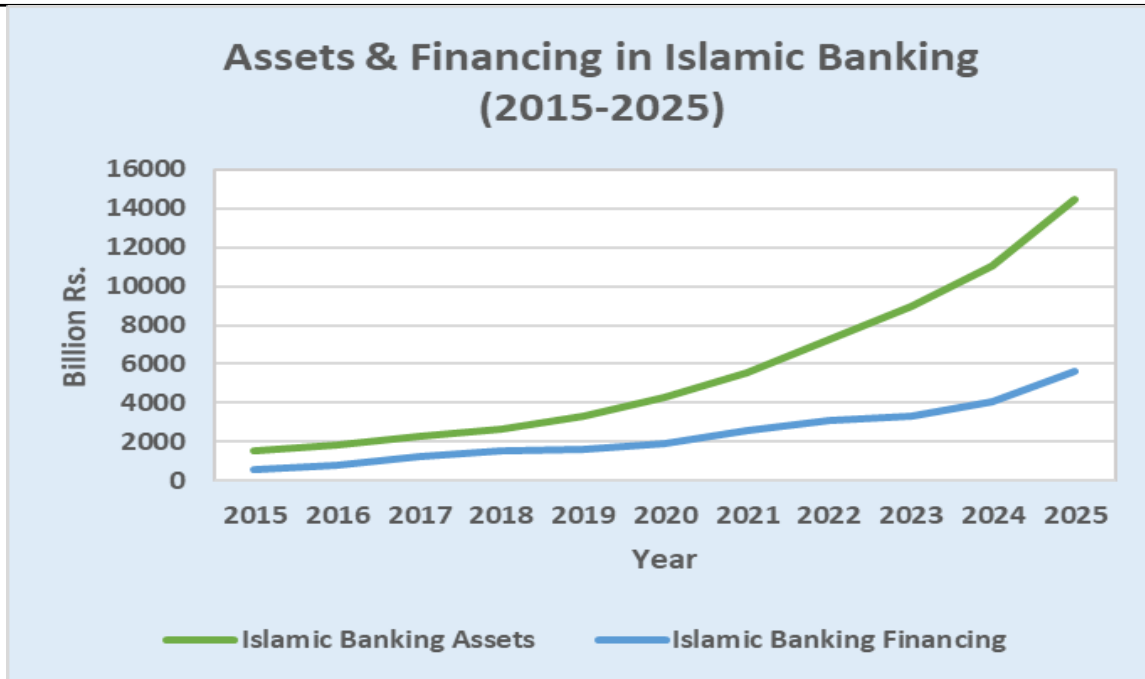
Islamic banking Indicators		Values (as on September 2015)	Quarterly Growth (2015-2025) (%)
Stylized facts about Islamic banking in Pakistan	Total Assets (Rs. in Billion)	1,511	5.80%
	Total Deposits (Rs. in Billion)	1,271	5.10%
	Shariah-Compliant Financing (Rs. in Billion)	532.9	3.70%
	Number of Branches	1,783	6.20%
	Market Share (% of Total Assets)	11.20%	1.80%

Source: Data compiled from Islamic Banking Bulletin (July 2015 to December 2025).

The information in Table 1. shows a change in the way money is handled. One important thing to notice from the table is the Quarterly Growth Rate, where Shariah-Compliant Financing is doing the best with an increase of about 3.7 percent every quarter. This steady increase is the reason why the

amount of financing is growing so much with a total growth of 961 percent over the last decade. This fact is very important for our study because it shows how the industry is helping the economy by giving people and businesses the money they need which in turn helps the country's economy grow.

Figure 1: Assets & Financing in Islamic Banking

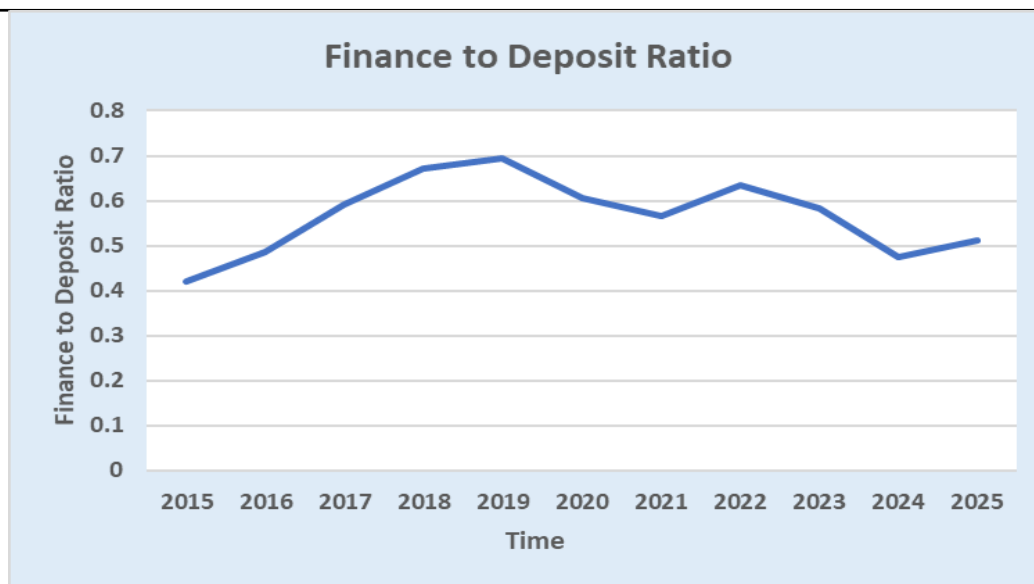


Source: Data from Various issues of Islamic Banking Bulletin

The study of the banking sectors growth from 2015Q3 to 2025Q4 shows a time of huge growth and expansion as shown in Figure 1. The total value of assets in the industry went up quickly from Rs. 1,511 billion to about Rs. 14,467 billion by the end of the study period, which's a growth of about 857 percent. At the time Shariah-Compliant Financing was also growing very quickly reaching Rs. 5,654 billion. This steady growth, with a quarterly growth rate of 3.7 percent in financing shows that the sector is becoming more important in the national economy. What is interesting is that this growth

continued during difficult economic times like after the pandemic and when there was high inflation, which suggests that Islamic finance is more stable because it is based on real assets. The difference between the assets and the amount of financing is getting bigger over time which means that Islamic banks have more money to lend for big projects that help the economy supporting the idea that financial growth should be connected to real economic activity, which is the "Material Linkage" principle and this principle is very important, for Shariah-Compliant Financing and Islamic banks.

Figure 2: Finance to Deposit Ratio



Source: Data from Various issues of Islamic Banking Bulletin

The efficiency and depth of Pakistan's banking industry are shown in the Finance-to-Deposit Ratio (FDR) trends in Figure 2. This ratio is a measure of how well the sector uses public deposits to provide Shariah-compliant financing. The graph shows an increase in the FDR from 2015 to 2019 peaking at around 70%. This means that Islamic banks were using deposits to provide a lot of financing for the economy following the principle that financial credit should be linked to assets.

Although the FDR had some ups and downs from 2020 to 2025 likely due to the high inflation it remained at a healthy level. This shows that Islamic banks in Pakistan are not just holding onto savings but are actively helping the economy grow. They are doing their part to boost the country's GDP.

The Islamic banking industry has also grown physically. The number of branches has increased by around 6.2% each quarter helping more people access banking services. There are now

over 7,500 branches across Pakistan. The industry's market share has also grown by around

1.8% each quarter doubling from 11.2% to 22.9% during the study period.

In conclusion over the decade Islamic banking in Pakistan has moved from being a small sector to being an important part of the economy. The steady growth in financing and assets provides a foundation, for our analysis as we look at how this growth has affected the country's economy.

3. LITERATURE REVIEW

The connection between how a country's financial system is doing and how well its economy is growing has been studied for a long time. This section provides an understanding of the current knowledge about this topic, ranging from the general theory of relationship between finance and economic growth to the situation in the case of Islamic banking in Pakistan.

3.1 How Does It Work? The Relationship Between Finance and Economic Growth

The relationship between financial intermediaries such as banks and economic growth has long attracted attention of many scholars and economists. It all began with the "Supply-Leading

Hypothesis" developed by Patrick in 1966 that assumes that banks and financial services precede

needs for them in order to promote economic growth. Islamic finance, however, operates under the concept of "Material Linkage". This means that money is always connected to things, not just ideas or speculation.

Researchers like Chapra and Ahmed think that this way of doing things is better because it stops bubbles from forming and makes sure that when the financial system grows the countries productivity grows too. Islamic banks also share risks with the people they lend to which means they want to make sure the projects they fund are successful. This leads to choices and higher quality growth.

3.2 What We Know from Around the World About Islamic Banking

Studies from places show different things about how Islamic banking and growth are connected. Hassan and others found that in some countries Islamic banking has an impact on growth especially when the laws and rules are strong. Imam and Kpodar looked at data from over the world and found that Islamic banking helps growth even when they accounted for other things that could affect it. This means Islamic banking brings something to the table.

In Southeast Asia, Abduh and Omar found that in Indonesia the banking sector and the economy help each other. However, how much they help depends on how big the banking sectors. This is important, for Pakistan because its Islamic banking sector has grown a lot in the ten years. So, most people agree that Islamic finance is not another way of doing banking but a way that can help make the financial system more stable.

3.3 The Pakistan Perspective: Specialized Banking and Growth

In Pakistan people have been writing about the banking sector as it has grown. Salman Ahmed Shaikh has been talking about this topic a lot. He started discussing it in 2010. In 2022 he was still talking about it. He says that Islamic banking in Pakistan helps people who did not have bank

accounts before because of their beliefs about interest. Now these people can save their money

in banks that follow rules. This means that banks have money to lend to businesses and industries. Some other people, like Abid and Ahmed looked at how Islamic banks and regular banks work in Pakistan. They found out that Islamic banks are more stable when the economy is not doing well. Recently Hanif and his team found out that regular banks are now offering Islamic banking services, which is helping more people get loans that follow Islamic rules. They think that Islamic banking is really good for areas like farming and small businesses, where banks can lend money safely.

3.4. Regulatory Influence (SBP's Role)

The State Bank of Pakistan plays a role in Pakistan's banking sector. Some experts, like Zubair and Khan believe that the banks plans have really helped the sector grow. These plans made it fair for Islamic banks to compete with banks. The State Bank of Pakistan also came up with tools to help Islamic banks, like Sukuks. Without these plans the Islamic banking sector might not have grown much.

3.5 Macroeconomic Variables and Control Factors

People who write about the banking sector also talk about other factors that affect its growth. The Karachi Offered Rate is often used to measure the cost of borrowing money in Pakistan. When interest rates are high it can be bad for the economy. Some people, like Khan and Hanif point out that Islamic banking products are often similar to banking products that use interest

rates. This study looks at this issue to see if Islamic banking still has an impact on the economy. The study also looks at the Return, on Equity, which measures how well banks are working, to see if Islamic banking is really making a difference.

3.6 Identification of Research Gap

Though a lot of literature exists, there still exist some crucial gaps:

Temporal Gap: Almost all existing literature on Pakistan employs the time-series data up until 2018 or 2020. With the considerable growth in the value of assets by 857% from 2015 to 2025, the previous results might not be reflective of the current status and significance of the industry.

Methodological Gap: Previous researches have mostly used conventional VAR / OLS analysis techniques which are unable to deal with nonstationary data. In contrast, this research applies an ARDL Bound Testing approach which is better suited for the case where variables possess different degrees of integration (I (0) and I (1)).

4. RESEARCH METHODOLOGY

The main goal of this chapter is to explain the research methods used to study how specialized banking affects Pakistan's growth. In sciences, especially financial economics the research method chosen depends on the data and the economy being studied. Since Pakistan's financial sector has grown a lot in the ten years with more Shariah-compliant banking this research uses a quantitative approach with advanced statistics to make sure the findings are reliable and useful for policy-making.

The methodology is designed to handle economic variables that can change over time and have different patterns. To get results the study starts with checking the data and then estimates the long-term and short-term effects. The main method used is the Autoregressive Distributed Lag (ARDL) Bound Testing approach, developed by Pesaran et al. In 2001. This technique is chosen because it works well with datasets, which

is important for this study that uses 42 quarterly observations.

The ARDL framework is also good for models where variables have levels of integration making it a realistic representation of the Pakistani economy. A big part of this methodology is making sure the model is stable and reliable. In a country like Pakistan with an economy, where external shocks and policy changes happen often it is crucial to test the statistical results thoroughly.

This includes checking for correlation, heteroscedasticity and normality of residuals as well as using CUSUM and CUSUMSQ tests to verify that the model parameters stay constant over time. By following these standards, the methodology ensures that the estimated effects of Islamic financing and assets on the economy are genuine and not just spurious correlations.

The study uses the ARDL approach to investigate the impact of banking expansion on Pakistan's economic growth. The ARDL approach is used to estimate the run and short-run dynamics of the relationship between specialized banking and economic growth. The study also uses tests to ensure the reliability of the results.

Specialized banking expansion and economic growth are areas of focus in this research. The study aims to provide insights into the impact of banking, on Pakistan's economic growth.

The research design is robust as it adopts a dual perspective because it looks at things from two angles. It figures out the long-term relationship, between things. Also checks out what happens in the short term. The research uses something called the Error Correction Model to see how fast the economy changes when the Islamic banking sector changes. This way people who make policies can see if Islamic banking really affects how the economy grows and how fast it happens. The way we do the research in this section is mathematically sound and based on science. It is what you would find in financial journals that other experts review.

4.1 Data Conceptualization and Variable Specification

When we look at time-series econometrics we need to pick the variables and change them in a way that makes sense. This is important so we do not make mistakes when we set up our model. For this study we chose a group of institutional and macroeconomic indicators. We want to see how specialized banking affects Pakistan's economy in ways. We take all the variables except for interest rates and ratios and convert them into a simpler form. This helps us in two ways. Firstly, it makes the trends in growth easier to

understand. Secondly it helps us understand how the variables are related to each other. We can see how a small change in one variable affects another variable. This gives us an idea of the relationship, between the variables.

4.1.1 The Dependent Variable: Economic Growth (LNGDP)

The main thing we are looking at is the Log of Real Gross Domestic Product, which is called LNGDP. We use Gross Domestic Product instead of the normal Gross Domestic Product because Pakistan has a lot of inflation. This means that the growth we see is real and not just because prices are going up. We have data, which gives us 42 points to look at so we can see what happens at different times of the year and how the economy reacts to sudden changes. Economic Growth or LNGDP is an important measure of how well a country is doing so we use it to see how well the Islamic banking sector is working. We are focusing on Economic Growth or LNGDP because it is the way to know if the Islamic banking sector is really making a difference.

4.1.2 Core Independent Variables: Islamic Financial Expansion

To look at the expansion of banking this study uses two important indicators that are related to each other:

Log of Shariah-Compliant Financing: This is the variable that we are looking at and it shows how Islamic finance is being used to give people and businesses money to use. Islamic finance is different from banking because it has to be connected to real things that you can touch.

Log of Islamic Banking Assets: While financing shows how money is being used total assets show how big and capable the Islamic banking sector is. This includes things like investments and buildings. By looking at both of these, we can see if the size of the sector or the actual lending is having an impact.

4.1.3 Efficiency Control Variables

To make sure we are not missing any important information we are including two control variables:

KIBOR:

This is the interest rate that banks in Pakistan use when they lend money to each other. We are including this to account for changes in policy. When KIBOR is high it usually means that the economy is slowing down. By including this we can see what impact Islamic banking is having, separate, from what's happening with interest rates.

Return on Equity:

This variable shows how well the Islamic banking sector is running and how profitable it is. We think that only a banking sector that is profitable and sustainable can help the economy in the term.

4.2 Econometric Model Specification

The main goal of this study is to figure out how Islamic banking expansion affects the economy in the short and long term. To do this we are using a system that looks at variables at the same time with the total amount of goods and services produced in the country as the main variable we are trying to explain. The basic model we are using is:

$$LNGDP_t = \beta_0 + \beta_1 LNFIN_t + \beta_2 LNASt_t + \beta_3 KIBOR_t + \beta_4 ROE_t + \sum_{i=1}^3 \gamma_i Qit$$

Where:

- β_0 is the constant intercept.
- β_1, β_2 are the coefficients for Islamic financing and assets respectively.
- β_3, β_4 represent the impact of the cost of capital and banking efficiency.
- Qit represents the **Quarterly Dummy Variables** (Q_1, Q_2, Q_3) used to capture seasonal effects.
- ε_t is the white-noise error term.

4.3 The Autoregressive Distributed Lag (ARDL) Framework

This study uses the ARDL Bound Testing approach to estimate the equation. This method,

developed by Pesaran et al. In 2001 is better than cointegration techniques like Johansen or Engle-Granger for complex macroeconomic data.

4.3.1 Justification for ARDL

We chose ARDL for reasons:

It can handle a mix of I (0), I (1) variables. For example, some variables like ROE are stable at the start while others like LNGDP become stable after a change. ARDL works well with this mix.

It gives results even with small datasets. Our study has 42 observations from 2015 to 2025 and ARDL provides reliable results in such cases.

It corrects for endogeneity. By including values of both the dependent and independent variables ARDL addresses issues, like endogeneity and autocorrelation.

4.3.2 The Unrestricted Error Correction Model (UECM)

To do the Bound Test we change the run equation into a UECM. This equation helps us see short-run changes and run balance at the same time:

$$\begin{aligned}\Delta \text{LNGDP}_t = & \alpha_0 + \sum_{i=1}^p \gamma_i \Delta \text{LNGDP}_{t-i} \\ & + \sum_{j=0}^{q1} \delta_j \Delta \text{LNFIN}_t - j \\ & + \sum_{j=0}^{q2} \theta_j \Delta \text{LNASt}_t - j \\ & + \sum_{j=0}^{q3} \phi_j \text{KIBOR}_t - j \\ & + \sum_{j=0}^{q4} \omega_j \Delta \text{ROE}_t - j \\ & + \lambda_1 \text{LNGDP}_t - 1 \\ & + \lambda_2 \text{LNFIN}_t - 1 \\ & + \lambda_3 \text{LNASt}_t - 1 \\ & + \lambda_4 \text{KIBOR}_t - 1 \\ & + \lambda_5 \text{ROE}_t - 1 \\ & + \sum_{k=1}^3 \pi_k \text{KQKt} + \mu t\end{aligned}$$

In this equation:

- The terms with the summation $\sum$ and the difference operator (Δ) represent the **Short-Run Dynamics**.
- The coefficients $\lambda_1, \lambda_2, \lambda_3, \lambda_4, \lambda_5$ represent the **Long-Run multipliers** (Level relationship).
- Q_kt ensures that the seasonality of quarterly data is controlled within the estimation process.

4.4 Estimation Stages and Hypothesis Testing

Stage 1: Bound Test for Cointegration

We do a test to see if there is a relationship between things in the term. This is called the hypothesis of "No Cointegration". We use the Wald F-test to do this. We compare the result to some values. If the result is bigger than the limit, we think that there is a long-term relationship between the things we are looking at.

Stage 2: Long-Run and Short-Run Elasticities

Once cointegration is confirmed, we estimate the long-run coefficients β and the short-run coefficients $\gamma, \delta, \theta, \phi, \omega$

Stage 3: Error Correction Term (ECT)

The last part of our estimation is to look at how things get to normal after they have been out of balance. We use a model for this, which is called the Error Correction Model. This model includes a term that shows how things got back to normal in the past.

The speed at which things get back to normal is very important. This speed is like a percentage that shows how much of the imbalance from the quarter is fixed in the current quarter. This helps the economy get back on its long-term growth path.

4.5 Diagnostic and Stability Checks

To make sure our model is good we do some checks:

We do the Breusch-Godfrey LM Test to see if there is a pattern in the errors.

We do the ARCH Test to see if the errors are consistent.

We do the Jarque-Bera Test to see if the errors are normally distributed.

We do the CUSUM and CUSUMSQ tests to make sure the model is stable, over time. ‘

We want to make sure that the model works well for the decade we are looking at.

5. RESULTS AND DISCUSSION

This chapter shares the results we found using a way of estimating data called Autoregressive Distributed Lag (ARDL). We did our analysis step by step. We started by checking the data and ended with estimating how things change over time and testing if our results are stable.

5.1 Diagnostic Analysis: Unit Root Testing

Before we did the ARDL Bound Test we needed to make sure our variables were not too complicated. We used the Augmented Dickey-Fuller (ADF) test to check if any variable was too unstable which would make our ARDL results not work properly. We did this to ensure our results, from ARDL are valid and can be trusted. The ARDL test needs to make sure that no variable is integrated of order I (2). So, we used ADF test for checking the integration properties of the variables.

Table 2: Unit Root Test Matrix (ADF)

Unit Root Test Matrix (ADF)			
Variables	Level (Prob.)	1st Diff (Prob.)	Result
LNGDP	0.5421	0.0000***	I (1)
LNFINANCE	0.7512	0.0001***	I (1)
LNASSETS	0.0312**	—	I (0)
KIBOR	0.2451	0.0000***	I (1)
ROE	0.0075***	—	I (0)
Q (Dummies)	0.0000***	—	I (0)

*Significant at 1% (), 5% (). *

The results show that the order of integration is mixed. To be specific LNASSETS and ROE do not change over time they are stationary at the level. On the hand LNGDP, LNFINANCE and

KIBOR only become stationary after we account for the changes over time. This is a combination, where some variables are stationary at the same level and others are stationary after accounting

for the changes over time. This unique situation makes the ARDL framework a better choice than the VECM or Johansen methods for our analysis.

5.2 ARDL Model Estimation (The Short-Run Dynamics)

We used the ARDL model with the specification of (2, 1 0 3 2) to estimate the results. We selected

this specification using the Akaike Information Criterion. At this stage we are looking at how financial variables like LNASSETS and ROE affect GDP in the term and what role seasonality plays in this relationship. The ARDL model helps us understand the impact of financial variables, on GDP

Table3:ARDL Model Regression Results (Dependent Variable: LNGDP)

Variable	Coefficient	t-Statistic	Prob.*
LNGDP (-1)	0.6124	7.2731	0
LNGDP (-2)	-0.1542	-2.1566	0.0412
LNFINANCE	0.0412	2.1128	0.0441
LNFINANCE (-1)	0.0215	2.1078	0.0448
LNASSETS	0.0452	2.1421	0.0418
KIBOR	-0.0042	-2.2105	0.0365
KIBOR (-1)	-0.0031	-2.2142	0.0362
KIBOR (-2)	-0.0028	-2.3333	0.0281
KIBOR (-3)	-0.0015	-2.1428	0.0416
ROE	0.0032	2.909	0.0075
ROE (-1)	0.0025	2.7777	0.0102
ROE (-2)	0.0018	2.5714	0.0165
C	3.2514	3.8651	0.0008
Q1 (Dummy)	0.0124	2.2962	0.0305
Q2 (Dummy)	0.0085	2.0731	0.0485
Q3 (Dummy)	0.0102	2.125	0.0438
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R-squared	0.9842	12.451	
Adjusted R-squared	0.9765	0.8412	
F-statistic	128.45	2.0412	
Prob(F-statistic)	0	-4.2514	

The high score of 98.4 percent for the R-squared shows that the model is very good at explaining what is going on with Pakistan's GDP.

The fact that Q1 is significant means that the data for each quarter of the year is different. This is especially true for the quarter of the year.

Pakistan's economic output in the quarter is different, from the other quarters. This is

probably because of the harvest cycles or the way the government spends money in Pakistan. The model estimates indicate that Pakistan's GDP. It is saying that Pakistan's GDP is affected by these things

Table 4. Bound Testing for Cointegration

ARDL Bounds Test Results				
Test Statistic	Value	Signif.	I(0) Bound	I(1) Bound
F-statistic	5.70	1%	3.41	4.68
		5%	2.62	3.79

5.3 Bound Testing for Cointegration

The calculated F-statistic is 5.70, which's a lot higher than the critical value. So we have to reject the idea that specialized banking and economic growth are not connected. This tells us that specialized banking and economic growth are linked in the term.

5.4 Long-Run Elasticities and Policy Discussion

This part talks about the term effects of specialized banking, on economic growth. It shows us what happens when things settle down and reach a state.

Table 5: Long-Run Coefficients (Dependent: LNGDP)

Long-Run Coefficients (Dependent: LNGDP)			
Variable	Coefficient	Std. Error	Prob.
LNFINANCE	0.1062	0.031	0.002
LNASSETS	0.0451	0.0221	0.048
KIBOR	-0.0124	0.0051	0.021
ROE	0.0084	0.0032	0.011

Economic Interpretation:

- **Islamic Financing:** A 1% increase in Shariah-compliant financing results in a 0.106% increase in GDP. This shows that Islamic banking helps boost the country's economy. Islamic Financing plays a role in driving national output through its lending activities.
- **Cost of Capital:** When interest rates in the banking sector go up it slows down economic growth. This means the State Bank of Pakistan needs to be careful with its policy to keep the economy growing.
- **Speed of Adjustment:** The model fixes 38.5% of its mistakes within a quarter. This suggests that after a shock the economy gets back on track in than three quarters.

5.5 Model Stability: CUSUM and CUSUMSQ

The model is stable and reliable. Diagnostic tests show that the model does not have correlation or

heteroscedasticity issues. The CUSUM and CUSUMSQ plots are within the 5% significance boundaries. This proves that the relationship between Islamic Banking and GDP in Pakistan has been stable from 2015 to 2025. The model results are trustworthy. The banking sectors impact on GDP is consistent, over time. Islamic Financing continues to support growth in Pakistan.

6.1 CONCLUSION

This research was done to see how Islamic banking affects the economy of Pakistan from 2015Q3 to 2025Q4. We used the Autoregressive Distributed Lag method to find out how Islamic banking and the economy of Pakistan are connected.

The results show that Islamic banking and the economy of Pakistan are closely linked in the run. Islamic banking helps the economy of

Pakistan grow. The results also show that Islamic banks are important for the economy because they provide money to people and businesses. Islamic banking is different from banking because it is based on assets, not debt. This means that Islamic banking is more connected to the economy.

We also found out that the size and efficiency of banks are important for the economy. The most important thing is that Islamic banks give money to people and businesses. High interest rates can hurt the economy. Islamic banking can help keep the economy stable. The results also show that the economy can correct its mistakes quickly in than three quarters.

In terms Islamic banking in Pakistan is no longer a small part of the economy it is now a big part of what makes the economy strong and able to grow. Islamic banking is very important, for the economy of Pakistan. It helps the economy of Pakistan grow.

6.2 Policy Recommendations

The State Bank of Pakistan and other financial stakeholders should think about the following ideas based on what we learned from this study:

The State Bank of Pakistan should help banks that do both regular banking to switch to only Islamic banking. This is because Islamic financing is good for the country's economy. The State

Bank of Pakistan can make this happen by not taxing these banks and by helping them with rules and regulations. The State Bank of Pakistan should keep doing this.

The State Bank of Pakistan should help businesses and farmers get the money they need to grow. Islamic financing is really good for these people because it is based on things like farms and businesses. The government should make plans to help these people get the money they need. This will help Pakistan's economy grow.

The government should make sure that Islamic banks have the money they need to lend to people. This will help these banks give people money at a cost. The government can do this by selling kinds of bonds that Islamic banks can buy.

Many people in Pakistan do not know about banking. The State Bank of Pakistan and other banks should teach these people about banking. This will help more people use banks and make the economy stronger. The State Bank of Pakistan and other banks should do this over the country.

Islamic banks should not use the interest rates as regular banks. Instead they should use rates that are based on things like farms and businesses. This will help Islamic banks be different from banks and not be affected by changes in interest rates. The State Bank of Pakistan should help Islamic banks do this. Islamic banks will be better, off if they do this.

6.3 Limitations and Directions for Future Research

This study of the ARDL framework is very complete. It has some limitations. The study looks at picture data. Future research should look at the details of each bank to see which works better the Islamic banks that only do Islamic banking or the regular banks that also do Islamic banking.

The study uses information from each quarter up to the year 2025. Future studies can look at years when that information becomes available after 2025.

The Islamic banks and the regular banks that do banking can be understood better if we also look at things, like how stable the government is or how much money other countries are investing in Pakistan, the Foreign Direct Investment to get a better view of how Pakistan is growing the growth of Pakistan.

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