

UNIVERSITI TEKNOLOGI MARA

**FINANCIAL INCLUSION AND
ISLAMIC FINANCIAL SYSTEM:
MEASUREMENT AND IMPACT
ASSESSMENT IN A CROSS-
COUNTRY ANALYSIS**

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ABSTRACT

Financial inclusion is an important development agenda, particularly in developing economies. Access and usage of financial services are critical in empowering people to capture economic opportunities and improve their livelihoods. Meanwhile, the fast-growing Islamic finance industry should be able to contribute toward financial inclusion as its underlying values promotes inclusion and social justice. While a robust measure of financial inclusion is crucial to further identify the determinants of financial inclusion, an established measurement does not exist until this date. Furthermore, the link between the components of Islamic finance and financial inclusion is an area yet to be established. Therefore, this study first aims to construct a multidimensional Financial Inclusion Index (FII) for a sample of 66 developing economies. Second, the study empirically analyses the effects of the Islamic financial system, institutional environment, socioeconomic factors and measures of technological infrastructure on financial inclusion in said sample. Third, the study further investigates the influence of the overall development of the Islamic financial system and its five key components (i.e., quantitative development, Islamic governance, CSR, knowledge and awareness) on financial inclusion in a smaller sample of 40 developing economies with significant presence of Islamic finance, while controlling for the level of economic development. The FII comprehensively includes five relevant indicators from two main dimensions. Annual data from 2013 to 2019 are obtained from the International Monetary Fund's (IMF) Financial Access Survey, World Bank's MIX Market, and World Council of Credit Unions Statistical Report. A two-stage factor analysis approach is employed for weight assignment. Panel data analysis using pooled OLS, fixed effects and random effects models are used, and model estimations are done separately for the full sample as well as sub-sample analyses based on income levels and geographical regions. In general, the study finds that financial inclusion in developing economies is categorized as low but with significant variation among countries. The findings of the first panel data analysis on the full sample reveal that the unemployment rate, economic freedom, mobile phone subscription and internet penetration have significant impacts on financial inclusion, but Islamic finance as a whole provides no significant influence. On the other hand, the second panel data analysis shows that GDP per capita, Islamic governance, and CSR have significant positive influences on financial inclusion. However, the influence of the explanatory variables is mixed in the sub-sample analyses. This study contributes to important policy implications for the government to use a standardized measure of financial inclusion to monitor the level of financial inclusion. The findings also provide a case for the regulators to establish comprehensive Islamic governance and regulatory framework, and encourages implementation of CSR activities using the Islamic social finance instruments, to improve the overall financial inclusion level.

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