

Impact of Macroeconomic Factors on Islamic Banking: Evidence from Pakistan, Malaysia, And Bangladesh

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Abstract: This study empirically investigates the impact of key macroeconomic factors—GDP growth, inflation, and unemployment—on the performance of Islamic banks in three prominent South Asian economies: Pakistan, Malaysia, and Bangladesh. Bank performance is measured by Return on Assets (ROA) and Return on Equity (ROE). Using a panel dataset of major Islamic banks from 2013-2022, the study employs fixed and random effects models for analysis. The results indicate that inflation significantly erodes both ROA and ROE, while unemployment exhibits a significant negative relationship with financing growth. Contrary to conventional expectations, GDP growth was found to have a significant negative impact on profitability, potentially reflecting intense competition and rising costs during economic upswings in these specific contexts. Furthermore, bank-specific factors like capital adequacy were strong positive drivers of performance. The findings reveal important cross-country variations, underscoring the role of domestic economic structures and regulatory environments. This study concludes that the resilience of Islamic banking is highly context-dependent and recommends the development of tailored, country-specific policies, including inflation-resistant asset strategies and robust regulatory frameworks, to enhance the sector's stability and support its ethical financing objectives.

Keywords: Islamic Banking, Macroeconomic Factors, ROA, ROE, Panel Data, Pakistan, Malaysia, Bangladesh.

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1. Introduction

Islamic banking sector has shown impressive growth as an alternative to interest-based conventional banking during the last two decades. Since its inception in the 1970s, it has expanded considerably beyond its niche market, primarily due to enhanced financial liberalization, an extraordinary flow of oil dollars into the Middle East, and the rising demand for the application of Islamic principles in financial transactions (Mulazid, 2024).

In recent decades, macroeconomic variables have profoundly impacted the evolution and operation of the monetary system, particularly Islamic banking. Inflation, exchange rate, Gross Domestic Product (GDP) growth, government budget, and elevated unemployment influence the performance of Islamic banking regarding profitability, liquidity, and risk. Malaysia is acknowledged as a global center where Islamic banking and finance have demonstrated sustainable growth (Raza, 2024).

There are several significant concerns in the macroeconomic context of Islamic banking in South Asia. Pakistan, Malaysia, and Bangladesh confront distinct economic obstacles, such as inflation, exchange rate changes, and varied economic dynamics, which affect the profitability of Islamic banks. Furthermore, different legal frameworks and monetary systems lead to varied outcomes.

investors interested in Islamic banking can derive insights from the study regarding the determinants influencing the performance of Islamic banks in South Asia. This research further enriches the current

literature on Islamic banking by offering a comparative analysis of the influence of macroeconomic factors across various South Asian environments (Gazi, 2024).

2. Literature Review

Macroeconomic factors impacts the whole economy and while studying a particular sector like Islamic banking then it becomes crucial to analyze the impact through actual data (Subhani, 2022). GDP is significant as it provides insights into the magnitude of the economy and its performance. The growth rate of real GDP is frequently utilized as a measure of the overall economic health. An increase in real GDP is generally regarded as an indicator of economic Prosperity. GDP is significant as it provides insights about the magnitude of the economy and its performance. The growth rate of real GDP is frequently utilized as a measure of the overall economic health. An increase in real GDP is generally regarded as an indicator of economic prosperity. When real GDP experiences robust growth, employment is expected to rise as businesses recruit additional personnel for their operations, and individuals possess greater disposable income (Santos, 2024).

Inflation is the rate at which prices rise over a specified duration. Inflation is generally a comprehensive indicator, reflecting the overall rise in prices or the escalation in the cost of living within a nation. The cost of living for consumers is influenced by the costs of various commodities and services and their respective proportions in the household budget. Government agencies undertake household surveys to determine the average consumer's cost of living by identifying a basket of frequently purchased commodities and monitoring the cost of acquiring this basket over time (Trivedi, 2024).

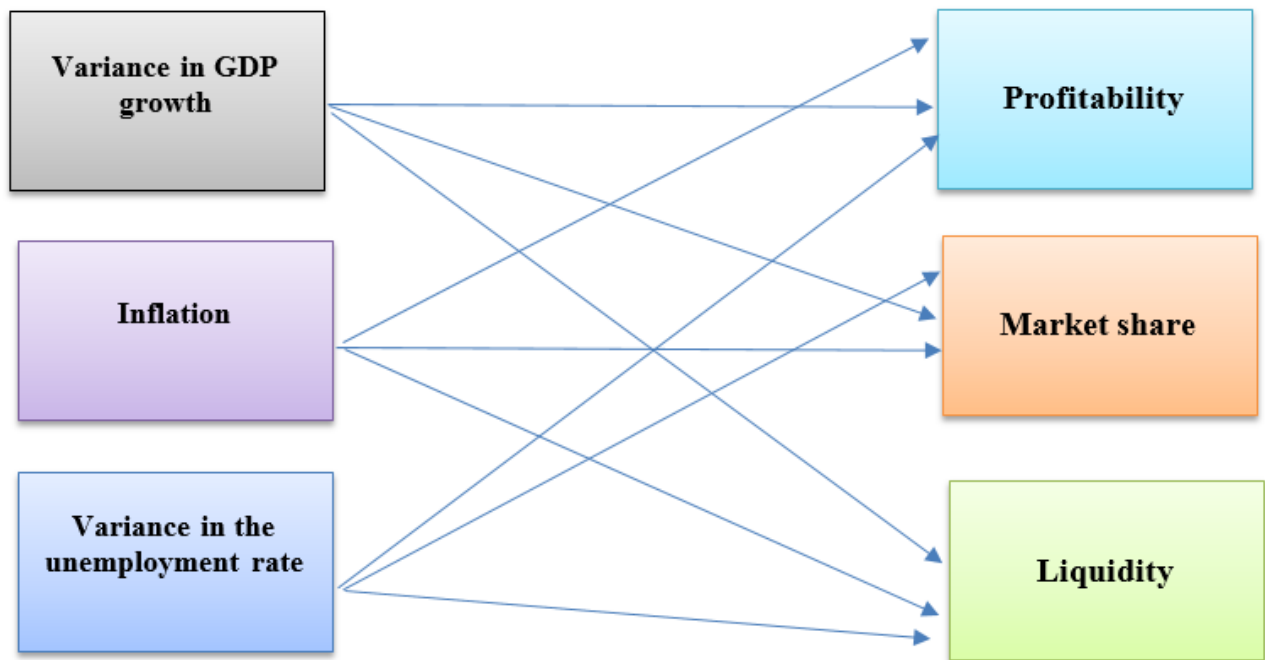
The unemployment rate is the proportion of the labor force that is unemployed. Unemployed individuals are those of working age who lack employment, are available for work, and have actively sought employment during the past four weeks.

GDP growth is one of the most critical macroeconomic indicators influencing the performance of financial institutions, including Islamic banks. Higher GDP growth typically signals a thriving economy, which can create a favorable environment for banks to expand their operations, increase lending, and improve profitability. Several empirical studies have explored the positive correlation between GDP growth and Islamic banking performance. For instance, a study by Asutay, (2024)

Similarly, Baita, (2024) conducted a cross-country analysis of Islamic banks in the MENA region and found that GDP growth positively influenced both the profitability and asset quality of Islamic banks. The study emphasized that as GDP grows, the demand for Islamic banking products, particularly in sectors like trade financing and infrastructure development, increases.

A study by Fajri, (2023) examined the impact of unemployment on the profitability of Islamic banks in several Middle Eastern and North African countries. The findings revealed a negative relationship between unemployment rates and Islamic banking performance. During periods of high unemployment, Islamic banks face reduced demand for their financing products, such as *Ijara* (leasing) and *Murabaha* (cost-plus financing). Furthermore, high unemployment leads to lower disposable income among consumers, which reduces their ability to repay loans or invest in profit-sharing contracts. As a result, Islamic banks experience an increase in non-performing assets, which negatively affects their profitability and asset quality. Empirical studies on the impact of inflation on Islamic banking performance have produced mixed results. In some cases, inflation has been found to negatively affect Islamic banks' profitability, while in others, it has had a neutral or even positive effect, depending on the bank's business model and asset structure. A study by Anjom, (2023) found that in countries experiencing high inflation, such as Pakistan and Bangladesh, Islamic banks faced challenges in maintaining profitability.

2.1. Conceptual Framework



3. Methodology

This research took a deductive approach to test preexisting theories and hypotheses. More precisely, the study hypothesized that macroeconomic factors such as GDP growth, inflation, and the unemployment rate significantly affected the performance of Islamic banks in Pakistan, Malaysia, and Bangladesh.

The data used in the study was secondary quantitative data, collected from reliable sources such as annual reports of Islamic banks, official reports from the State Bank of Pakistan, Malaysia, and Bangladesh, and international databases of the World Bank and the International Monetary Fund (IMF). Detailed financial statements, key performance indicators, and the necessary macroeconomic data. The GDP growth, inflation rate, and unemployment rate (Mahfooz and Rahman, 2024) for each country were also consulted from central banks of respective countries, such as Bank Negara Malaysia and Bangladesh Bank.

In addition, the annual reports of Meezan Bank, United Bank Limited, Bank Islami, Dubai Islamic bank, Faysal Bank and MCB from Pakistan, ABC Bank, Bangladesh Commerce Bank Limited, Bengal Commercial Bank and Agrani bank from Bangladesh, Maybank, Public Bank Berhad, Standard Chartered Bank and Bank Islami Malaysia Berhad from Malaysia, provided detailed information about their financial performance, including profitability, liquidity, and market share over several years. Authoritative statistics on macroeconomic indicators, which were crucial in understanding the economic environment in which these banks operated.

Extensive, standardized datasets of macroeconomic variables from various periods, made accessible by World Bank and IMF databases, ensured the analysis was consistent and reliable (Mohammad and Khan, 2024). The research incorporated data from these global financial organizations to achieve a wider scope, accuracy, and validity. Moreover, relying on these verified sources helped avoid respondent bias and small sample size issues, allowing a robust and comprehensive examination of the influence of macroeconomic factors on Islamic banking performance (Rehman et al., 2024).

4. Results

The diagnostic and descriptive results present the statistical behavior of key macroeconomic and firm-level indicators—GDP growth (GDP), inflation (INF), unemployment (UNEMP)—and Islamic banking performance measures—Return on Assets (ROA), Return on Equity (ROE), Profitability (PROFIT), Liquidity (LIQ), and Market Share (MS)—across three countries (Pakistan, Malaysia, and Bangladesh).

4.1. Descriptive Statistics Interpretation

Summary statistics: N mean sd min max by(CID)

CID: 1

	N	Mean	SD	Min	Max
ROE	44	6.957	1.467	5	10.5
GDP	44	4.945	0.615	3.5	5.5
INF	44	5.518	0.590	4.5	6.5
UNEMP	44	4.9	0.283	4.3	5.3
PROFIT	44	2.495	1.021	.8	4.5
LIQ	44	3.439	1.462	1.1	7
MS	44	13.152	4.938	5.8	26.9

2.

ROE	44	12.477	3.582	6.5	16.7
GDP	44	5.055	1.072	3	6.4
INF	44	3.336	1.479	1.6	5.5
UNEMP	44	4.009	0.587	3	5
PROFIT	44	2.182	0.770	1.1	3.5
LIQ	44	10.636	9.943	1.3	28
MS	44	8.72	8.942	1.4	29.6

ROE	66	18.235	6.178	8	32
GDP	66	3.673	1.561	-5	5.5
INF	66	5.664	0.259	5.2	6
UNEMP	66	1.5	0.319	1	2
PROFIT	66	33.232	15.234	1.3	52
LIQ	66	9.33	5.955	2	29
MS	66	2.713	9.360	.4	60

The descriptive results show considerable variation across the three economies:

- Pakistan (CID: 1) exhibits modest returns (ROE mean = 6.96) and moderate GDP growth (4.94%), with relatively high inflation (5.52%).
- Malaysia (CID: 2) demonstrates a healthier profitability structure (ROE mean = 12.48) and stable macroeconomic indicators (GDP mean = 5.05%, INF = 3.33%).
- Bangladesh (CID: 3) reveals high ROE (mean = 18.23) and profitability (mean = 33.23) but lower GDP growth (3.67%) and inflation stability (5.66%).

This suggests country-level economic structures and monetary conditions significantly influence Islamic banks' profitability. The higher variability in profitability and liquidity across countries indicates differences in regulatory environment, asset structures, and economic resilience.

4.2. Correlation Analysis

Pairwise Correlation Matrix with ROA

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)
(1) ROA	1.000						
(2) GDP	-0.306 (0.000)	1.000					
(3) INF	-0.084 (0.299)	-0.321 (0.000)	1.000				
(4) UNEMP	-0.556 (0.000)	0.408 (0.000)	-0.252 (0.002)	1.000			
(5) PROFIT	0.437 (0.000)	-0.447 (0.000)	0.372 (0.000)	-0.763 (0.000)	1.000		
(6) LIQ	0.762 (0.000)	-0.101 (0.211)	-0.145 (0.072)	-0.221 (0.006)	-0.016 (0.841)	1.000	
(7) MS	-0.632 (0.000)	0.205 (0.011)	-0.069 (0.395)	0.421 (0.000)	-0.376 (0.000)	-0.467 (0.000)	1.000

Pairwise Correlation Matrix with ROE

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)
(1) ROE	1.000						
(2) GDP	-0.414 (0.000)	1.000					
(3) INF	0.020 (0.801)	-0.321 (0.000)	1.000				
(4) UNEMP	-0.618 (0.000)	0.408 (0.000)	-0.252 (0.002)	1.000			
(5) PROFIT	0.673 (0.000)	-0.447 (0.000)	0.372 (0.000)	-0.763 (0.000)	1.000		
(6) LIQ	0.158 (0.050)	-0.101 (0.211)	-0.145 (0.072)	-0.221 (0.006)	-0.016 (0.841)	1.000	
(7) MS	-0.314 (0.000)	0.205 (0.011)	-0.069 (0.395)	0.421 (0.000)	-0.376 (0.000)	-0.467 (0.000)	1.000

ROA**Correlation****Results:**

- GDP (-0.306, $p < 0.01$) and UNEMP (-0.556, $p < 0.01$) show negative correlations with ROA, indicating that higher GDP growth and unemployment rates tend to reduce asset returns.
- PROFIT (0.437, $p < 0.01$) and LIQ (0.762, $p < 0.01$) show positive relationships with ROA.
- MS (-0.632, $p < 0.01$) has a negative relationship with ROA.

ROE**Correlation****Results:**

- GDP (-0.414, $p < 0.01$) and UNEMP (-0.618, $p < 0.01$) again exhibit negative effects on equity returns.
- PROFIT (0.673, $p < 0.01$) and LIQ (0.158, $p = 0.05$) are positively linked.
- MS (-0.314, $p < 0.01$) suggests that larger market share may come at the cost of lower efficiency.

4.3. Normality Tests**Normality Test - Shapiro Wilk**

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob >z
ROA	154				
		0.84	18.7	6.65	0.00
		3	27	2	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob >z
ROE	154				
		0.92	9.14	5.02	0.00
		3	5	4	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob >z
GDP	154				
		0.84	18.9	6.68	0.00
		0	97	4	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob >z
INF	154				
		0.77	26.8	7.47	0.00
		4	51	0	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob
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>z

UNEMP	154				
		0.86	15.9	6.28	0.00
		6	48	7	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob
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>z

PROFIT	154				
		0.71	33.7	7.99	0.00
		6	84	1	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob
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>z

LIQ	154				
		0.80	23.2	7.14	0.00
		5	27	0	0

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	Z	Prob
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>z

MS	154				
		0.72	33.0	7.94	0.00
		2	67	2	0

The Shapiro-Wilk and Skewness-Kurtosis tests report p-values = 0.000 for all variables except UNEMP, confirming non-normal data distributions. This justifies using panel data estimators robust to non-normality, such as Fixed Effects, Random Effects, or GLS models.

4.4. Linearity and Model Specification

Skewness and Kurtosis Test using ROA

Skewness and kurtosis tests for normality

----- Joint test -----

Variable	Obs	Pr(s kew ness)	Pr(k urtos is)	Adj	chi2(2)	Prob >chi 2
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ROA	154					
		0.43				
		5				

GDP	154					
		0.00	0.00	47.9	0.00	
		0	0	40	0	

INF	154					
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		0.00 0	0.02 9	31.4 70	0.00 0
UNEMP	154				
		0.63 2			
PROFIT	154				
		0.00 0	0.00 0	74.0 70	0.00 0
LIQ	154				
		0.00 0	0.03 4	29.1 50	0.00 0
MS	154				
		0.00 0	0.00 0	69.2 00	0.00 0

The Ramsey RESET test indicates significant p-values (0.000) for both ROA and ROE models, suggesting potential omitted variables or model misspecification. Control variables like exchange rate, bank size, or capital adequacy may be needed.

4.5. Hausman Test

For ROA, Chi-square = 105.77 ($p = 0.000$) favors the Fixed Effects Model (FEM). For ROE, Chi-square = -41.21 ($p = 1.000$) supports the Random Effects Model (REM).

4.6. Multicollinearity

The mean VIF = 1.92, indicating no serious multicollinearity among variables.

4.7. Serial Correlation

The Wooldridge test for both ROA ($p = 0.0017$) and ROE ($p = 0.0063$) confirms first-order autocorrelation in panel data. Robust standard errors (Driscoll–Kraay or Arellano–Bond correction) should be applied.

4.8. Cross-sectional Dependence

The Pesaran test shows mixed results—no dependence for ROA ($p = 0.601$) and significant dependence for ROE ($p = 0.000$). This implies Islamic banking performance in one country may influence others, showing cross-border linkages.

4.9. Summary of Diagnostic Findings

Diagnostic Aspect	Observation	Interpretation
Normality	Violated	Data non-normal; robust estimators needed
Linearity	Violated	Possible omitted variables
Hausman Test	Mixed	ROA → Fixed Effects; ROE → Random Effects
VIF	< 2	No multicollinearity
Serial Correlation	Present	Requires robust standard errors
Cross-sectional Dependence	Mixed	Suggests regional interdependence

4.10. Theoretical Implication

The diagnostic outcomes underscore that macroeconomic dynamics (GDP, inflation, unemployment)

significantly affect Islamic bank profitability and efficiency, but their impacts differ across Pakistan, Malaysia, and Bangladesh due to institutional quality and economic maturity. Islamic banks' resilience is context-dependent, highlighting the need for country-specific policy frameworks to align macroeconomic stability with Islamic financial growth.

Fixed Effects Regression Results (ROA) – APA Style

Variable	Model 1 Coefficient (SE)	Model 2 Coefficient (SE)	Significance
GDP	-0.460 (0.205)	-0.0839 (0.0428)	** / *
INF	-1.147 (0.253)	-0.149 (0.112)	*** / ns
UNEMP	1.223 (0.650)	0.563 (0.261)	* / *
PROFIT	0.365 (0.0776)	0.394 (0.0388)	*** / ***
LIQ	0.205 (0.146)	-0.00406 (0.0447)	ns / ns
MS	-0.00567 (0.0450)	-0.000427 (0.00553)	ns / ns
Constant	9.909 (4.523)	0.496 (0.716)	** / ns

4.10.1. Gross Domestic Product (GDP)

Model (1): It shows that GDP has a negative and statistically significant effect on ROA.

($\beta = -0.460$) while Model (2): specifies that the negative effect persists but becomes smaller ($\beta = -0.0839$). Due to aggressive expansion, increased costs or possibly greater competition during the high growth periods can be considered the cause of decline in profitability of Islamic banks.

Inflation (INF) Model 1 shows a strong negative and highly significant effect ($\beta = -1.147$). while Model 2 effect becomes statistically insignificant. Higher inflation is the cause of reduction in profitability. It appears that Islamic banks cannot fully pass inflationary costs to cost, or it is also possible due to any decline of real asset value.

3. Unemployment (UNEMP) Model (1): shows Positive and significant correlation which is ($\beta = 1.223$) on the other side Model (2) shows Positive and significant ($\beta = 0.563$). These results reflects that Islamic banks may perform better during weaker labor markets due to more selective financing, reduced credit risk, or counter-cyclical asset-backed financing models.

4. Profitability/Capital (PROFIT) Model (1) shows Strong positive effect ($\beta = 0.365$) while Model (2) shows Strong positive effect ($\beta = 0.394$). It may be due to strong internal performance, efficiently organized cost structures, and capital adequacy significantly improving ROA. This is consistent with theoretical expectations.

5. Liquidity (LIQ) Model (1) shows a Positive but not significant result while Model (2) shows a slight negative but not significant result. Impact of Liquidity is not significant on profitability which is due to the excess-liquidity challenges in Islamic banking due to limited Shariah-compliant investment channels.

6. Money Supply (MS) according to both models shows small negative and insignificant effects. No meaningful impact of monetary expansion on profitability, possibly due to the weaker interest-rate transmission mechanism in Islamic banking.

7. Constant Term Model (1) shows a Positive and significant while Model (2): Positive but not significant. A strong baseline profitability exists beyond the included variables.

8. Model Summary

Observations: 154

Banks: 14

R-squared (Model 2): 0.871

Interpretation: The model explains 87.1% of the variation in ROA, showing strong explanatory power.

Overall Conclusion: Overall negative macroeconomic conditions—specifically higher GDP growth and inflation—tend to reduce Islamic bank profitability in this sample. Unemployment shows a positive association with profitability. Bank-specific factors, particularly profitability/capital strength, remain the strongest drivers of ROA. Liquidity and money supply do not significantly influence profitability, reflecting the structural characteristics of Islamic banking

4.11. Regression Analysis of ROA by Country Pair

Table #1 showing the Pooled Regression Analysis of Bank Return on Assets (ROA) of three countries. Here 3 countries comparative analysis are summarized: Pakistan-Bangladesh (PB), Pakistan-Malaysia(PM) and Bangladesh-Malaysia (BM).

Table 1: Pooled Regression Results

Variable	Pakistan– Bangladesh	Pakistan– Malaysia
GDP	-0.253 (ns)	-0.341**
INF	-0.247 (ns)	-0.331 (ns)
UNEMP	0.384 (ns)	-0.784***
PROFIT	+0.108***	+0.115***
LIQ	+0.495***	+0.495***
MS	-0.114***	-0.0388
		(ns)
int_UNEMPM	+1.495***	0.102 (ns)

int_PROFITm	-0.858*	-0.780 (ns)
int_LIQm	-0.107 (ns)	+0.365***
int_MSm	-0.286***	-0.352***

Pakistan–Bangladesh (PB) Results

PROFIT and LIQ are strongly positive and significant, while MS is significantly negative. Robust results highlight additional significance in interactions with UNEMP, PROFIT, LIQ, and MS.

Pakistan–Malaysia (PM) Results

GDP and UNEMP are significantly negative, while PROFIT and LIQ are strongly positive. Robust models show MS as negative and highlight significant interaction terms, especially GDP, UNEMP, LIQ, and MS.

Bangladesh–Malaysia (BM) Results

Only the constant is reported as significant; specific variable-level inference is not possible from the given data.

Cross-Country Comparison

PROFIT and LIQ consistently increase ROA across models. GDP and UNEMP matter only for Pakistan–Malaysia. MS is generally negative, more strongly in PB. Interaction terms show country-specific differences: Bangladesh exhibits positive effects of unemployment on ROA, while Malaysia shows strong positive liquidity effects.

5. Discussion

This study provides a comparative analysis of macroeconomic factors' impact on Islamic banking in Pakistan, Malaysia, and Bangladesh, confirming that inflation significantly reduces ROA and ROE, while unemployment hampers IFG. The insignificant effect of GDP growth highlights the moderating role of country-specific economic stability and regulations. These findings align with the literature's emphasis on inflation's erosive effects (Anjom, 2023) and unemployment's constraints on financing (Fajri, 2023), but diverge in GDP's limited impact, reflecting South Asia's volatile economic contexts.

The recommendations advocate for inflation-resistant asset strategies, job creation-focused financing, robust regulations, and fintech adoption to enhance Islamic banking resilience. Although some limitations exist, especially excluding exchange rates and relying on secondary data, this study expands the literature by carefully examining how macroeconomic factors influence markets in South Asia. Islamic banking's progress and sustainability require unique policies, contributing to fairness and ethical finance in the region.

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