

**Bangor University**

## **DOCTOR OF PHILOSOPHY**

### **Islamic banking**

Chachi, Abdelkader

*Award date:*  
1989

*Awarding institution:*  
Bangor University

[Link to publication](#)

#### **General rights**

Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

- Users may download and print one copy of any publication from the public portal for the purpose of private study or research.
- You may not further distribute the material or use it for any profit-making activity or commercial gain
- You may freely distribute the URL identifying the publication in the public portal ?

#### **Take down policy**

If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

**I S L A M I C     B A N K I N G**

**By**

**ABDELKADER CHACHI**

**Licence Es-Sciences Commerciales et Financieres (Universite d'Alger)  
Diploma for Advanced Studies in Economic Development (Manchester University)**

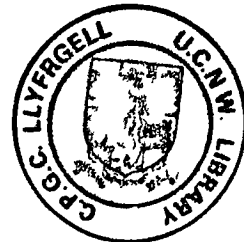
I'W DDEFNYDDIO YN Y  
LLYFRGELL YN UNIG  
—  
TO BE CONSULTED IN THE  
LIBRARY ONLY

**A Thesis Submitted in Candidature for the Degree of  
Philosophiae Doctor**

**SCHOOL OF ACCOUNTING, BANKING AND ECONOMICS  
UNIVERSITY COLLEGE OF NORTH WALES (UCNW), BANGOR**

**BANGOR  
NORTH WALES (GB)**

**1989**



IN THE NAME OF

ALLAH

MOST GRACIOUS MOST MERCIFUL

بِسْمِ اللّٰهِ الرَّحْمٰنِ الرَّحِیْمِ

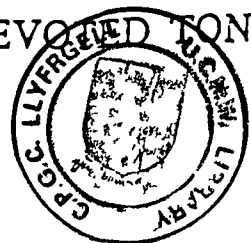
وَقُلِّدْ زِدْنِي عِلْمًا

Say: O Lord Advance me in Knowledge

THANKING

HIM

WITH A FULL HEART AND DEVOTED TONGUE



## ACKNOWLEDGEMENT

First and foremost, Praise be to Allah, The Most Gracious, The Most Merciful and Peace be upon his Messenger Mohammed (PBUH).

My thanks and gratitude are extended to Professor J.R.S. Revell for providing me with perceptive comments and constructive criticisms, and also for his long patience with my slow performance. I also would like to thank Professor E.P.M. Gardener, Professor L.A. Winters, Mrs C. Owen and all the staff of the School of Accounting, Banking and Economics, the Institute of European Finance, the library and the computing laboratory for any service they provided me with, during my long stay.

My thanks are also extended to the members of the Islamic Society of the U.C.N.W, Bangor, for providing me with the religious and friendly atmosphere that helped me fulfill my religious duties and meet and know a great number of Muslims from different countries of the world.

I am indebted to the Algerian M.E.S (Ministere de l'Enseignement Superieur) for providing me with the financial support during the normal period of this study (1982/83-1985/86), to the Islamic Banks which provided me with their financial reports and documentation and to Br. Osama Yasein for helping me with the printing of this thesis.

I am also indebted to my uncle Mohammed Chachi, who brought me up, educated me and lived in great hardship in order for me to reach this stage and to all the other members of my family who waited so long with patience for me to finish this work successfully.

Last but not least, my deepest gratitude is to my wife Fatiha Fodeili and my children Hocine, Abdallah, Abdelhamid and Sarah Chachi for accompanying me and providing me with the inspiring and conducive family atmosphere needed in this country (G.B).



## TABLE OF CONTENTS

Declaration	i
Acknowledgement	ii
Table of Contents	iii
List of Tables	vi
List of Figures	viii
Abbreviations	ix
Glossary	x
Abstract	xii
General Introduction	1
Outline and Methodology of the Study	4
PART ONE	
Chapter One: What is <u>Islam</u> and What it has to do with Economics	7
1.1 Introduction	7
1.2 Can Economics be Value-Free	7
1.3 What is <u>Islam</u> and what are its Main Sources	9
1.4 The Salient Features of the Islamic Economic System (IES) As Compared to the Capitalist and the Communist Systems	11
1.4.1 The Economic Philosophy	11
1.4.2 The Economic Problem	15
1.4.3 The Principle of Ownership	18
1.4.3 The Principle of Economic Freedom	20
1.4.5 The Principle of Social Justice	22
1.5 Conclusion	25
Chapter Two: The Importance of Saving and Financial Intermediation For Economic Development	26
2.1 Introduction	26
2.2 The Importance of Savings	26
2.3 The Importance of Intermediation	31
2.4 The Alternative Hypotheses about the Role of Banks	35
2.4.1 The Structuralist Hypothesis	36
2.4.2 The Financial Repression Hypothesis	37
2.4.3 The Islamic Hypothesis	40
2.5 The Relevance of These Hypotheses	43
2.6 Conclusion	60
Chapter Three: The Origin and Development of Banking Generally and of Islamic Banking in Particular	61
3.1 Introduction	61
3.2 Banking in Ancient Times	61
3.2.1 Banking in Prehistoric Times	61
3.2.2 Banking in Mesopotamia	62
3.2.3 Banking in Greece	64
3.2.4 Banking in Egypt	65
3.2.5 Banking in Rome	65
3.3 Banking in the Islamic World from the Rise of <u>Islam</u> Till the 12th Century	66
3.4 Banking in Europe from the Fall of the Roman Empire Till the 17th Century	70
3.5 Banking in the Muslim World from the Fall of the Islamic Empire and the Emergence of Islamic Banking	72
3.6 Conclusion	80

PART TWO

Chapter Four: The Bases of Islamic Banking: The Prohibition of Interest and the Permission of Profit and PLS	82
4.1 Introduction	82
4.2 Definitions	83
4.3 The Theories of Interest and their Criticism	84
4.3.1 The Colourless Theories	85
4.3.2 The Productivity Theories	85
4.3.3 The Use Theories	85
4.3.4 The Abstinence Theory	86
4.3.5 The Labour Theories	87
4.3.6 The Exploitation Theories	87
4.3.7 The Eclectics	88
4.3.8 The Time Preference Theory	89
4.3.9 The Loanable Fund Theory	90
4.3.10 The Liquidity Preference Theory	91
4.4 The Theories of Profits.	92
4.4.1 The Classical Theories	93
4.4.2 The Management Earnings Theory	93
4.4.3 The Business Ability Theory	94
4.4.4 The Dynamic Theory	95
4.4.5 The Risk Theory	96
4.4.6 The Uncertainty Theory	98
4.4.7 The Monopoly Theory	98
4.4.8 The Acquired Advantages Theory	99
4.5 The Islamic Solution to the Problem of Interest and Profit	100
4.5.1 Interest	100
4.5.2 Profit	105
4.5.3 Profit and Loss Sharing (PLS)	108
4.6 Conclusion	111
Chapter Five: Towards an Islamic Financial System	112
5.1 Introduction	112
5.2 The Islamic Financial Claims	113
5.3 The Islamic Financial Institutions	126
5.4 The Islamic Financial Markets	132
5.5 Conclusion	135
Chapter Six: The Islamic Banking System	136
6.1 Introduction	136
6.2 The Islamic Central Bank	137
6.2.1 The Bank of Issue and Custodian of The Nation's Reserves	137
6.2.2 The Government Banker, Agent and Adviser	137
6.2.3 The Custodian of the Financial Institutions' Cash Reserves	138
6.2.4 The Bankers' Bank and Clearing Bank	138
6.2.5 The Lender of Last Resort	139
6.2.6 Supervisor and Controller of Financial Institutions	139
6.2.7 Controller of Credit and Applicant of Monetary Policy	140
6.3 The Islamic Commercial Banks	150
6.4 Management of Islamic Banks	151
6.4.1 Planning the Activities of an Islamic Bank	152
6.4.2 The Structure and Organisation of an Islamic Bank	152
6.4.3 Profitability Management	155
6.4.4 Capital Adequacy Management	156
6.4.5 Liquidity and Balance Sheet Management	158
6.4.6 Risk Management in Islamic Banks	162
6.5 Conclusion	165

Chapter Seven: The Socio-Economic Implications of PLS and Interest Based Finance	166
7.1 Introduction	166
7.2 Mobilisation of Savings	167
7.3 Entrepreneurship, Investment and Employment	171
7.4 Financial Stability	175
7.5 Social Justice	
7.6 The LDCs' Debt Problem	
7.7 Conclusion	188
 PART THREE	
Chapter Eight : The Performance of The Islamic Development Bank	189
8.1 Introduction	189
8.2 The Economies of The Member-Countries: a Brief Overview	189
8.3 The Performance Analysis of the IDB	196
8.3.1 Establishment, Purpose and Operations of the IDB	196
8.3.2 The IDB Membership and Capital	197
8.3.3 The IDB Balance Sheets	200
8.4 The IDB Finance Operations	205
8.4.1 The IDB Ordinary Operations	208
8.4.2 The IDB Foreign Trade Operations	216
8.4.3 The IDB Special Assistance Operations	223
8.4 Conclusion	226
 Chapter Nine : The Performance of Kuwait Finance House	228
9.1 Introduction	228
9.2 The Kuwaiti Economy : an Overview	228
9.3 The Kuwaiti Banking System	233
9.4 The Performance Analysis of the KFH, NBK, OCB and KBS	237
9.4.1 The Establishment and Objectives of KFH	237
9.4.2 Performance in Terms of Capital and Reserves	239
9.4.3 Performance in Terms of Total Assets	243
9.4.4 Performance in Terms of Total Deposits	248
9.4.5 Performance in Terms of Total Finance	252
9.4.6 Performance in Terms of Other Proxies	257
9.5 Conclusion	261
 Chapter Ten : The Performance of Faisal Islamic Bank of Egypt	262
10.1 Introduction	262
10.2 The Egyptian Economy : an Overview	262
10.3 The Egyptian Banking System	265
10.4 The Performance Analysis of FIBE, NBE, OCB and EBS	275
10.4.1 The Establishment and Objectives of FIBE	275
10.4.2 Performance in Terms of Capital and Reserves	276
10.4.3 Performance in Terms of Total Assets	281
10.4.4 Performance in Terms of Total Deposits	285
10.4.5 Performance in Terms of Total Finance	291
10.4.6 Performance in Terms of Other Proxies	294
10.5 Conclusion	298
 Chapter Eleven : The Performance of Faisal Islamic Bank of Sudan	299
11.1 Introduction	299
11.2 The Sudanese Economy : an Overview	299
11.3 The Sudanese Banking System	303
11.4 The Performance Analysis of FIBS, BOK, OCB and SBS	308
11.4.1 The Establishment and Objectives of FIBS	308
11.4.2 Performance in Terms of Capital and Reserves	308
11.4.3 Performance in Terms of Total Assets	312
11.4.4 Performance in Terms of Total Deposits	316
11.4.5 Performance in Terms of Total Finance	319
11.4.6 Performance in Terms of Other Proxies	323
11.5 Conclusion	325
 General Conclusion	326
Bibliography	330

## LIST OF TABLES

Table 2.1	Criteria Used for Selecting the Countries	44
Table 2.2	The Averages of GDP/c and of Some Selected Ratios for the Selected Countries for the Period 1965-84;	46
Table 2.3	The Growth Rates of the Averages of the Selected Ratios	48
Table 2.4	Correlation and Regression Analysis to Test the Structuralist Hypothesis	50
Table 2.5	Correlation and Regression Analysis to Test the Relevance of the Repressionist and the Islamic Hypotheses	52
Table 2.6	Trend of the Selected Average Ratios for the Groups	54
Table 3.1	Comparative Analysis of the TLD in EBS and in MGISB	76
Table 3.2	The Number of Depositors and their Average Deposits	76
Table 3.3	Mit-Ghamr Islamic Saving Banks' Branches	77
Table 3.4	Percentage Share of Saving and Investment Deposits in the Total Deposits of Different Groups of Savers in MGISB	79
Table 3.5	The Top 15 Arab Islamic Financial Institutions in 1987	80
Table 3.6	Position of Some of the Islamic Arab Banks Among the Top 100 Arab Banks	81
Table 3.7	The Market Share of Some of the Oldest Islamic Banks	81
Table 8.1	IDB High Income Member Countries: Basic Economic Indicators	190
Table 8.2	External Trade Position of Oil Exporting IDB Member Countries	190
Table 8.3	IDB Middle Income Member Countries: Basic Economic Indicators	192
Table 8.4	IDB Middle Income Member Countries Public External Debt	193
Table 8.5	IDB Low Per Capita Income Member Countries: Basic Indicators	195
Table 8.6	Initial Subscription to the Authorised Capital of IDB	198
Table 8.7	IDB Member Countries Subscription as on 29.12.1405H	199
Table 8.8	The IDB Balance Sheets for the Years 1400-1405H	202
Table 8.9	The Breakdown of IDB Ordinary Finance 1400-1405H	202
Table 8.10	Growth Rates of the Most Important Items of the IDB Balance Sheets Between 1400-1405H	203
Table 8.11	IDB Total Finance Operations From 1396H till 1405H	206
Table 8.12	Growth Rates of IDB Total Finance Operations (1396-1405)	207
Table 8.13	The Evolution of the IDB Ordinary Operations (1396-1405)	209
Table 8.14	Sectoral Allocation of IDB Total Ordinary Finance	215
Table 8.15	Foreign Trade Structure of Some IDB Member Countries	217
Table 8.16	Total IDB Member Countries' Trade as Compared to Total World and LDCs' Trade (1978-84)	219
Table 8.17	IDB Foreign Trade Financing Operations (1395-1405H)	221
Table 8.18	Breakdown of IDB FTF Operations by Commodity	222
Table 8.19	The IDB Distribution of Sacrificial Meat (1403-1405)	225
Table 9.1	Kuwaiti Gross Domestic Product Between 1980 and 1984	232
Table 9.2	Consolidated Balance Sheets of Kuwaiti Banks	236
Table 9.3	Comparative Analysis of the K&R of KFH, NBK, OCB & KBS	240
Table 9.4	The Market Share of KFH, NBK and OCB in KBS's K&R	242
Table 9.5	Capital Ratios of KFH, NBK, OCB and KBS 1978-87	243
Table 9.6	Comparison of the ARG of the K&R, TLA, TLD and TLF of KFH, NBK, OCB and KBS	243
Table 9.7	Comparative Analysis of the TLA of KFH, NBK, OCB & KBS	245
Table 9.8	The Market Share of KFH, NBK and OCB in KBS's TLA	247
Table 9.9	Comparative Analysis of the TLD of KFH, NBK, OCB & KBS	249
Table 9.10	The Market Share of KFH, NBK and OCB in KBS's TLD	252
Table 9.11	Comparative Analysis of the TLF of KFH, NBK, OCB & KBS	254
Table 9.12	The Market Share of KFH, NBK and OCB in KBS's TLF	256
Table 9.13	Comparative Analysis of KFH, NBK and KBS Portfolio Investment Sectoral Distribution for 1985	257

Table 9.14	Comparative Analysis of KFH Performance in Terms of Intermediation, Liquidity, Efficiency and Profitability	258
Table 10.1	Contribution of Each of the Economic Sectors to the Egyptian GDP	264
Table 10.2	The Main Egyptian Exports and their Relative Importance	264
Table 10.3	Foreign Banks in Egypt Before 1900 AD	267
Table 10.4	Contribution of the EBS in the Promotion of Savings, Banking Habits and GDP (1953-73)	272
Table 10.5	Contribution of the EBS in the promotion of Savings, Banking Habits and GDP (1974-84)	273
Table 10.6	Comparative Analysis of the Performance of FIBE, NBE OCB and EBS in Terms of K&R	277
Table 10.7	The Market Shares of FIBE, NBE and OCB in the K&R of the EBS	278
Table 10.8	Comparative Analysis of the Performance of FIBE, NBE OCB and EBS in Terms of TLA	282
Table 10.9	The Market Shares of FIBE, NBE and OCB in the TLA of the EBS	284
Table 10.10	Comparative Analysis of the Performance of FIBE, NBE OCB and EBS in Terms of TLD	286
Table 10.11	The Market Shares of FIBE, NBE and OCB in the TLD of the EBS	289
Table 10.12	Comparative Analysis of the TSD and DD in FIBE, NBE, OCB and EBS's TLD	290
Table 10.13	Comparative Analysis of the Performance of FIBE, NBE OCB and EBS in Terms of TLF	292
Table 10.14	The Market Shares of FIBE, NBE and OCB in the TLF of the EBS	294
Table 10.15	Comparative Analysis of the Performance of FIBE, NBE OCB and EBS in Terms of Intermediation, Liquidity, Profitability and Efficiency	295
Table 11.1	The Sudanese GDP for 1983-86	302
Table 11.2	Sudan's Trade Balance Between 1981 and 1986	302
Table 11.3	The Expatriation of Profits Before Nationalisation	304
Table 11.4	Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of K&R	309
Table 11.5	The Market Share of FIBS, BOK and OCB in the K&R of SBS	312
Table 11.6	Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of TLA	313
Table 11.7	The Market Share of FIBS, BOK and OCB in the TLA of SBS	315
Table 11.8	Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of TLD	317
Table 11.9	The Market Share of FIBS, BOK and OCB in the TLD of SBS	319
Table 11.10	Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of TLF	320
Table 11.11	The Market Share of FIBS, BOK and OCB in the TLF of SBS	322
Table 11.12	Comparative Analysis of the Performance of FIBE, NBE, OCB and EBS in Terms of Intermediation, Liquidity, Profitability and Efficiency	324

Notes: Totals may not add up due to rounding  
- : Nil or Negligible  
ns: Not significant  
na: Not available

## LIST OF FIGURES

Figure 2.1	Comparison of the Ratios M2/M1 for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	55
Figure 2.2	Comparison of the Ratios QM/GDP for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	55
Figure 2.3	Comparison of the Ratios QM/M2 for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	56
Figure 2.4	Comparison of the Ratios TSD/GDP for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	56
Figure 2.5	Comparison of the Ratios TSD/BTA for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	57
Figure 2.6	Comparison of the Ratios TSD/TLD for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	57
Figure 2.7	Comparison of the Ratios M1/M2 for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	58
Figure 2.8	Comparison of the Ratios M1/GDP for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	58
Figure 2.9	Comparison of the Ratios DD/BTA for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	60
Figure 2.10	Comparison of the Ratios DD/TLD for the Selected Groups NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs	60
Figure 9.1	Performance of KFH, NBK, OCB and KBS in Terms of Capital and Reserves in Current and Constant Prices	241
Figure 9.2	Performance of KFH, NBK, OCB and KBS in Terms of Total Assets in Current and Constant Prices	246
Figure 9.3	Performance of KFH, NBK, OCB and KBS in Terms of Total Deposits in Current and Constant Prices	251
Figure 9.4	Performance of KFH, NBK, OCB and KBS in Terms of Total Finance in Current and Constant Prices	255
Figure 10.1	Performance of FIBE, NBE, OCB and EBS in Terms of Capital and Reserves in Current and Constant Prices	279
Figure 10.2	Performance of FIBE, NBE, OCB and EBS in Terms of Total Assets in Current and Constant Prices	283
Figure 10.3	Performance of FIBE, NBE, OCB and EBS in Terms of Total Deposits in Current and Constant Prices	287
Figure 10.4	Performance of FIBE, NBE, OCB and EBS in Terms of Total Finance in Current and Constant Prices	293
Figure 11.1	Performance of FIBS, BOK, OCB and SBS in Terms of Capital and Reserves in Current and Constant Prices	311
Figure 11.2	Performance of FIBS, BOK, OCB and SBS in Terms of Total Assets in Current and Constant Prices	314
Figure 11.3	Performance of FIBS, BOK, OCB and SBS in Terms of Total Deposits in Current and Constant Prices	318
Figure 11.4	Performance of FIBS, BOK, OCB and SBS in Terms of Total Finance in Current and Constant Prices	321

## LIST OF ABBREVIATIONS

AIB	Al-Barakah International Bank
ALLCs	All Countries
ALLDCs	ALL Less Developed Countries
ALLMCs	All Muslim Countries
ALLNMCs	All Non Muslim Countries
ARG	Average Rate of Growth
BIB	Bahrain Islamic Bank
BIIC	Bahrain Islamic Investment Company
bn	Billion
BOK	Bank of Khartoum
BOS	Bank of Sudan
CBE	Central Bank of Egypt
CBK	Central Bank of Kuwait
CCPI	Change in Consumer Price Index
CLCB	Committee of London Clearing Banks
CPI	Consumer Price Index
DCs	Developed Countries
DD	Demand Deposits
DEU	Deficit Economic Unit
DIB	Dubai Islamic Bank
DMI	<u>Dar el-Mal el-Islami</u> (Islamic Finance house)
FIBB	Faisal Islamic Bank of Bahrain
FIBE	Faisal Islamic Bank of Egypt
FIBK	Faisal Islamic Bank of Kibris (Cyprus)
FIBS	Faisal Islamic Bank of Sudan
FTF	Foreign Trade Finance
GDP	Gross Domestic Product
GNP	Gross National Product
GNP/c	Income per Capita
JIB	Jordan Islamic Bank
IAIB	International Association of Islamic Banks
IBBS	Interest Based Banking System
IBI	Islamic International Bank (Denmark)
IBID	Islamic Bank for Investment and Development
IBFI	<i>Interest Based Financial Institution</i>
IBFS	Interest Based Financial System
IBS	Islamic Banking System
ICB	Islamic Central Bank
ID	Islamic Dinar
IDB	Islamic Development Bank
IFIs	Islamic Financial Institutions
IFS	Islamic Financial System
IMF	International Monetary Fund
KFH	Kuwait Finance House
KBS	Kuwaiti Banking System
KD	Kuwaiti Dinar
K&R	Capital and Reserves
LDCs	Less Developed Countries
LE	Egyptian Pound
LS	Sudanese Pound
m	million
M1 ; M2	Money Supply
MCDs	<u>Mudharabah</u> Certificates of Deposits
MCWIBs	Muslim Countries With Islamic Banks
MCWNIBs	Muslim Countries With No Islamic Banks
MFIB	<u>Massraf Faisal EL-Islami</u> of Bahrain
MPFIs	Multi-Purpose Financial Institutions
na	Not Available
NBE	National Bank of Egypt
NBK	National Bank of Kuwait

nd	Not Dated
NDFIs	National Development Financial Institutions
NIR	Nominal Interest Rate
NOB	Number of Branches
NOS	Number of Staff
ns	Not Significant
OC	Operating Costs
OCB	Other Commercial Banks
OAPEC	Organisation of Arab Petroleum Exporting Countries
OECD	Organisation for economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
PBT	Profit Before Tax
PBUH	Peace Be Upon Him
PCB	People Co-operative Bank (in Sudan)
PLS	Profit and Loss Sharing
POSBs	Post Office Savings Banks
RIR	Real Interest Rate
SDR	Special Drawing Right
SEU	Surplus Economic Unit
SP	Sale Price
SR	Sale Residual
SRTP	Sale Residual Theory of Profits
TC	Total Costs
TLA	Total Assets
TLD	Total Deposits
TLF	Total Finance
TSD	Time and Saving Deposits
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nations
USA	United States of America

#### GLOSSARY OF ARABIC TERMS

<u>Adl</u>	Justice
<u>Allah</u>	God
<u>Amanah</u>	Trust, Safe Deposit
<u>Bai' Bittaqseet</u>	Sale by Instalments
<u>Bai' Muajjal</u>	Deferred Sale
<u>Bai' EL-Salam</u>	Future Sale
<u>Bayt El-Mal</u>	Treasury
<u>Dharib</u>	The manager in a Mudharabah contract
<u>Dhimmi</u>	Non Muslim living in an Islamic Society
<u>Diwan</u>	Organisation
<u>Diyah</u>	Blood Money
<u>Djahbadh</u>	Banker, Connoisseur
<u>El-Ameen</u>	The trustworthy
<u>El-Hisba</u>	Control, Inspection or Supervision
<u>El-Khatmah</u>	Balance Sheet
<u>El-Makhzen</u>	Storehouse
<u>Faddan</u>	Acre
<u>Fadh1</u>	Surplus
<u>Falah</u>	Prosperity
<u>Fardh</u>	Obligation
<u>Fatwah</u>	Legal Ruling
<u>Fi'l</u>	Deed
<u>Fiqh</u>	Jurisprudence
<u>Ghanimah</u>	Spoils of War
<u>Gharar</u>	Ambiguity, Deception
<u>Gharim</u>	A Debtor who is unable to pay back loans
<u>Hadith</u>	Saying of Prophet Mohammed (PBUH)
<u>Haji</u>	Pilgrimage
<u>Halal</u>	Lawful, Permitted
<u>Haqq</u>	Legal Right
<u>Haram</u>	Unlawful, Prohibited



<u>Hawala</u>	Credit transfer
<u>Hayat Tayibah</u>	Good life
<u>Hijra</u>	Emigration
<u>Ihsan</u>	Benevolence
<u>Ihtikar</u>	Speculation, monopoly
<u>Ihya'</u>	Soil Reclamation
<u>Ijarah</u>	Leasing
<u>Ijarah Waqtina'</u>	Hire-purchase
<u>Ijma'a</u>	Consensus of Muslim scholars
<u>Ijtihad</u>	Reasoning
<u>Iktinaz</u>	Hoarding
<u>Infag</u>	Spending in Charity
<u>Iqrar</u>	Consent
<u>Islam</u>	Submission, Peace
<u>Israf</u>	extravagance
<u>Istighlal</u>	Exploitation
<u>Jihad</u>	Struggle or effort
<u>Jizyah</u>	Poll tax
<u>Juala</u>	Commission or Fee
<u>Khalifah</u>	Caliph
<u>Khamassah</u>	Sharecropping (a sort of)
<u>Kharaj</u>	Land Tax
<u>Khusraan</u>	Failure
<u>Koran</u>	The revealed Book of Islam
<u>Mal Allah</u>	Allah's wealth
<u>Mal El-Muslimeen</u>	The wealth of the Muslims
<u>Masraf</u>	Bank
<u>Mudharabah</u>	Commenda
<u>Mudharib</u>	Capital Owner in a Mudharabah contract
<u>Muhaqalah</u>	Sale of immature or unharvested crop
<u>Murabahah</u>	Mark-up
<u>Musagat</u>	Sharecropping
<u>Musharakah</u>	Partnership
<u>Muzaraah</u>	Sharecropping
<u>Nas Saheeh Wa Sareeh</u>	Clear cut quotation
<u>Nissab</u>	Minimum amount liable to Zakat
<u>Qardh Hassan</u>	Interest Free-Credit
<u>Qaul</u>	Saying
<u>Qiradh</u>	Commenda
<u>Qiyas</u>	Analogy
<u>Riba</u>	Interest or Usury
<u>Riba El-Fadhli</u>	Usury on sales
<u>Riba El-Nassea</u>	Usury on loans
<u>Rikaz</u>	Treasure Trove
<u>Ruq'a</u>	Promissory note
<u>Sadaqat</u>	Alms
<u>Sakk</u>	Cheque
<u>Sayrafi</u>	Money exchanger or Banker
<u>Shariah</u>	Islamic Law
<u>Shirk</u>	Polytheism
<u>Souk</u>	Market
<u>Suftaja</u>	Bill of Exchange
<u>Sunnah</u>	Tradition of Prophet Mohammed (PBUH)
<u>Takafol</u>	Solidarity or taking care of each other
<u>Tawheed</u>	Oneness of God
<u>Tawliyah</u>	Break even sale
<u>Tayibat</u>	Good and pure things
<u>Tazkiyah</u>	Purification
<u>Ummah</u>	Nation
<u>Ushur</u>	Tyths
<u>Wadai'</u>	Deposits
<u>Wadhi'a</u>	Sale at a discount
<u>Waqf</u>	Dedicated property
<u>Wassat</u>	Middle way, Balance, Golden mean
<u>Zakat</u>	Compulsory poor due

## ABSTRACT

For most of this century, and despite the fact that there was no agreement among economists as to why interest should be paid, it was almost unanimously held by most if not all economists that interest is necessary for banking and consequently necessary for financial and economic development and that any religion, like Islam, that prohibits interest, is an obstacle to economic growth and development. This view was not exclusively held by Western economists who may not know much about Islam, but even by some Muslim thinkers who, repeating the controversial arguments justifying interest, claimed that there is no other way to develop except to leave the religion of Islam aside or at least its economic and political aspects because it stands in the way of progress and development. However, there were some other Muslim scholars who were not so convinced of the Western and pro-Western idea that interest is a necessary component of any financial and economic development and were convinced that if Allah has forbidden interest then there must be something wrong with it and when He allowed trade and PLS (Profit and Loss Sharing) system of finance as alternatives, then these must, perhaps, lead to the achievement of greater financial and economic development 'without tears' (Kahf 1978). They sought in the Koran and Sunnah a way of doing banking and encouraging development that is not only complying with Shariah but that may lead to a more just and more beneficial way of development. They dug into the historical practices of the Prophet Mohammed (PBUH), his companions and the early followers and found that the alternatives, to interest, that were acceptable to, maintained and encouraged by, Islam, are trade (profit) and the PLS system which were practiced long before the rise of Islam, so they just applied the principles to today's banking practices and called it 'Islamic Banking'.

This study aims to show that interest is not a necessary component of banking, as was widely held before, and that Islam, by prohibiting interest and permitting profit and Profit sharing as alternatives, is not an obstacle to, but a promoter of, economic growth and development with social justice.

This study also attempts to distill and refine the theoretical bases of Islamic Banking. It critically surveys and discusses the different theories that have been advanced to justify interest and profits and compares the functions and institutions of the Islamic Financial and Banking Systems with their Interest-Based counterparts. It also discusses the likely impact of the Profit and Loss Sharing (PLS) system, and empirically analyses the performance of some of the oldest Islamic Banks vis-a-vis the performance of the Interest-Based Banks of the same countries.

The empirical analyses undertaken showed that Islamic banking is more appropriate and more relevant to the economic growth and development of the Muslim World. Despite the fact that they are operating in hostile and non-Islamic environments, the existing Islamic Banks have managed to mobilise substantial amounts of deposits and contributed greatly to the finance of many economic sectors and projects of the countries they are working in.

## GENERAL INTRODUCTION

The question of economic development has assumed unprecedented importance and financial development has long been considered as a very important factor, if not the most important one in furthering and improving the economic development of any country. Consequently the efficient mobilisation of savings have been identified as crucial in achieving rapid and effective economic development (see chapter 2 below).

Banks are perhaps the most important and vital financial intermediaries in any economy. They mobilise savings and idle funds from the Surplus Economic Units (SEUs) and make them available to the Deficit Economic Units (DEUs) who can make better and fuller use of them. However, until the recent emergence of the so called 'Islamic Banks', 'Islamic Insurance Companies' and 'Islamic Investment Companies' based on Profit and Profit and Loss Sharing (PLS), instead of interest in the late 1970s and the 'Islamisation' of the banking systems of Pakistan, Iran and Sudan in the early 1980s, it was almost unanimously held by most, if not all, economists that no financial or banking system can develop very far or develop at all without recourse to interest and that any religion, like Islam, which categorically prohibits interest, is an obstacle to economic growth and development.

The last few years have witnessed a resurgence of calls for a re-examination or perhaps even a reform of the International Economic and Monetary Order. In contribution to this and in reconciling the need for an efficient banking system that mobilises savings for investment and brings about economic growth and development in Muslim countries with the Islamic Shariah (law) which prohibits interest, Muslim economists developed the concept of Islamic Banking that is not based on interest but on Profit and PLS system. And so, within the last thirty years or so, many Muslim economists have developed theoretical models of Islamic Banking in order to find, on one hand, a solution to the problem of mo-

bilising savings from devout Muslims who do not deal with interest based banks because of the Islamic injunctions against interest, and on the other, to find a solution to the world economy which has entered a phase of extraordinary instability and whose course is uncertain and to the International Financial System which is in a state of disarray. They showed that all the banking services could be carried out on the basis of PLS and other non interest based financial instruments which are compatible with Islamic Shariah (see survey by M.N. Siddiqi 1980).

These models have been put into practice by the recently emerged 'Islamic Banks', 'Islamic Insurance Companies' and 'Islamic Investment Companies'. Writing about these, R. Cooper (1981:44) contended that:

Perhaps the most remarkable phenomenon in the Middle East financial world in recent years, and one which has implications stretching far beyond the region, has been the growth of Islamic Financial Institutions. The central feature that differentiates such institutions from the conventional modern financial institutions, is the prohibition of Riba (interest) and the permission of Profit and Loss Sharing system.

Now despite the somewhat successful working and performance of these Islamic Financial Institutions (see Chapters 8-11 below), there are still those who, like Pryor (1985), think that interest is necessary for any banking system to work properly and mobilise savings efficiently and consequently consider any religion like Islam that prohibits interest as an obstacle to economic growth and development.

The purpose of this study is manifold:

Firstly, to show that, contrary to what most economists hold about interest as the necessary and the best way to mobilise savings for economic development and for doing banking, interest is neither necessary, nor is it the best way to mobilise savings for economic development, especially in Islamic countries, where devout Muslims are reluctant to give or take interest, because of the Islamic injunction against it;

Secondly, to show that Islam, by prohibiting interest, is not an obstacle to economic development but by allowing the principles of Profits and PLS as alternatives to interest, is a promoter to economic de-

velopment and perhaps to a greater extent and with greater justice than by allowing interest; not only that, but it has its own economic system that is different from all other economic systems;

Thirdly, to survey and critically discuss the different theories advanced to justify interest and profits and introduce 'The Islamic Solution' to the problem.

Fourthly to distil the different models of Islamic banking presented over the years with the view to refine and improve them and put them in the perspective of a pure Islamic economy where all aspects of the Islamic Shariah are applied because as Khurshid (1985:11) argued:

Any element of the Islamic system, however important, cannot produce the desired results, if it is allowed to operate in isolation. It must lead to other complementary changes to complete the process. Elimination of Riba is only one aspect of the Islamic economic programme. It must be accompanied by, and strengthened through, other motivational and structural changes. Islamic banking is only a part of the process, and not the be-all and end-all of the process.

Fifthly, to look at the likely economic implications of the interest and PLS based financing systems; and finally, to assess the performance of some of the oldest established Islamic banks and demonstrate how they have managed to mobilise savings and finance investments despite the fact that they are working in hostile environments with competition from interest based banks, with no lender of last resort and with no promise of a guaranteed return to their depositors (see case studies in Chapters 9-11), which prove the feasibility of the system and its success in mobilising savings for economic development.

The hypotheses of this study, therefore, are:

- 1) Is interest really necessary to do banking and to mobilise savings for economic development?
- 2) If not, is there any other alternative? And if there is, what is it? How does it work? And what are its likely implications on the economy as compared to interest? And what is wrong with interest?
- 3) Is Islam an obstacle to economic development? Why? and
- 4) What are the results obtained by the already established "Islamic Banks" and to what extent have they contributed to the saving-investment process in the countries, they are working in? How efficient are they?

## OUTLINE AND METHODOLOGY OF THE STUDY

In addition to the general introduction and the general conclusion of this thesis, this study is divided into three parts:

The first part, which is divided into three chapters, chapter one to chapter three is a background to the subject. Chapter one introduces the reader, who is assumed to know nothing about Islam, Islamic Economics or Islamic Banking, to what Islam is, what it stands for and what it has to do with economics and presents the salient features of the Islamic Economic System (IES) as compared to the salient features of the Capitalist and Communist systems. The methodology here is theoretical, comparative and descriptive. Chapter two reviews the relationship between financial and economic development and examines the different hypotheses advanced by different economists about the role of banks in the saving-investment process and examines the relevance of these hypotheses to a number of Islamic and non Islamic, Developed and Less developed countries. The methodology used is theoretical, statistical and analytical using cross-section and time-series data analysis.

Chapter three traces the origin of banking operations to earlier times than is held by most economists and shows that banking is not 'Italian by Birth' as many would think, but banking operations were known to Muslims, Romans, Greeks, Egyptians, and even to Babylonians and Sumerians long before 13th century Italy. This chapter also traces the origin and development of the newly emerged Islamic banking. The methodology here, is historical and descriptive.

The second Part is divided into four chapters: chapter four to chapter seven. Chapter four deals with the theoretical and juridical bases of Islamic Banking and Finance: The prohibition of interest and

the permission of profits and PLS system. It critically reviews the theories of interest and profit and introduces the 'Islamic Solution' to the problem. The methodology is obviously historical, theoretical, critical and analytical.

Chapter five is an attempt to describe, analyse and compare the financial claims, institutions and markets that may exist in an Islamic Financial System (IFS) and their functions vis-a-vis those of an Interest Based Financial System (IBFS). Because for the moment there is no fully fledged IFS anywhere in the world, the research procedure is therefore, theoretically descriptive and analytically comparative.

Chapter six deals with the working of a model of an Islamic Banking System (IBS) as compared to a model of a non Islamic one. It shows how the IBS could be applied, managed, controlled and supervised and how it would implement monetary policies without recourse to interest. The methodology followed here is also theoretically descriptive and analytically comparative.

Chapter seven, however, looks at some of the implications of PLS system vis-a-vis those of interest based finance and shows how the implementation of a PLS system in an Islamic economy could improve the economy in question. Once again, the methodology used is theoretical for the same reasons advanced earlier.

Part three, however, is an empirical study about the performance of some of the oldest Islamic banks where some data could be obtained. These are: the Islamic Development Bank (IDB), established in 1975 in Saudi Arabia and 3 Islamic commercial banks chosen from 3 different countries: (1) Kuwait Finance House (KFH), established in 1977, from a high per capita income country (Kuwait); (2) Faisal Islamic Bank of Egypt (FIBE) established in 1978, from a middle per capita income country (Egypt) and (3) Faisal Islamic Bank of Sudan (FIBS), established in 1978, from a very poor country (Sudan), with a low per capita income.

Since there is no agreement among economists as to what constitute a bank input or output or as to how measure its performance or efficiency (see Elhadef (1954), Gorman (1966), Bell and Murphy (1968), Powers (1969), Benston (1972), Revell (1980) and Heggstad (1980), to name but a few) and since most if not all banking researchers use items of the balance sheet like total assets, total deposits, total loans, etc., in their research in order to assess banking performance, the methodology followed in analysing the performance of IDB, KFH, FIBE and FIBS, in chapters eight to eleven respectively, is the use of proxies for bank input/output, such as capital and reserves (K&R), Total Assets (TLA), Total Deposits (TLD), Total Finance (TLF), and ratios, such as TLF/TLD, TLF/TLA, TLD/TLA, etc., in tabular and graphical analysis.

However, it is very important to note, at the outset of this study, that Islamic Banking and Finance has emerged only very recently in form of Islamic banks, insurance companies and investment companies here and there, and that the steps that have been taken towards the Islamisation of the financial systems of some of the Islamic countries such as those of Pakistan, Sudan and Iran, are doubtful or still in their early stages, it should be emphasised that conclusion based on such a study must of necessity be preliminary in nature because theoretical discussion of the issues involved is also at a relatively early stage among Muslim economists and beset by several methodological concepts.



## CHAPTER ONE

### WHAT IS ISLAM AND WHAT HAS IT TO DO WITH ECONOMICS?

#### 1.1 INTRODUCTION

As Khurshid (1980b:XV) noticed: "The world has suffered from the folly of the social sciences following almost unreservedly the model of the natural sciences, with the result that technocratic solutions are being imposed in the name of science, often legitimising the status quo to the neglect of all moral ideological and political options available for social policy". For instance, economics was often emphasised as a positive science that has nothing to do with religion and moral values which are normative par excellence. Recently, however, and as Hodgson (1983:237) reported: "Two disputes have continually frustrated attempts to provide a tenable method of enquiry for economic science: a) should theory construction in economics include a commitment to moral principles? or should economic theory remain value-free?; b) does the peculiar subject matter of economics demand a 'teleological' or a 'mechanistic' pattern of explanation?".

The purpose of this chapter is to investigate the relationship between Islam and economics by answering the following questions:

- 1-) Can economics be really value-free ?
- 2-) What is Islam and what are its main sources ?
- 3-) What has Islam to do with Economics and what are the salient features of the Islamic Economic System, if there is any, as compared to the salient features of Capitalism and Communism?.

#### 1.2 CAN ECONOMICS BE REALLY VALUE-FREE ?

This problem has troubled economists of all schools. Even the great neo-classical economist and mathematician, Alfred Marshall (cited by Gruchy 1987:XI), expressed his concern of the difficulties to be found in adopting too high a level of mathematical abstraction to economics as he wrote: "In my view every economic fact, whether or not it is of such a nature to be expressed in numbers, stands in relation as cause and effect to many other facts; and since it never happens that all of them can be expressed in numbers, the application of exact mathematical

methods to those that can, is nearly always a waste of time, while in the large majority of cases it is particularly misleading". Economics is only a tiny part of the all related social sciences and as is the view of Myrdal (1968), concrete problems are never simply economic, sociological, psychological or political. Even concerning the objectivity of research in social sciences, Myrdal (ibid:31-2) argued that:

The problem of objectivity in research cannot be solved simply by attempting to eradicate valuations. Every study of a social problem, however limited in scope, is and must be determined by valuations. A disinterested social science has never existed and never will exist. Research like every other rationally pursued activity, must have a direction. The viewpoint and the direction are determined by one's interest in a matter. Valuations enter into the choice of approach, the selection of problems, the definition of concepts, and the gathering of data, and are by no means confined to the practical or political inference drawn from theoretical findings. The value premises, that actually and of necessity, determine approaches in the social sciences can be hidden. In fact, most writings, particularly in economics, remain in large part simply ideological.

Nienhaus (1985b:1) noted that: "The strict separation of positive and normative economics and the neglect of the latter became the general practice not before the second or third decade of the 20th century. This separation lead to the development of a kind of economic theory which makes economics more a branch of applied mathematics than a science of human action".

"Muslim economists believe that the reorientation of approach and the reconstruction of the entire framework of economic analysis and policy are needed to harness economics once again to the service of humanity. The Muslim economist starts from the assumptions that economics, neither is, nor can be, totally value-free" (Khurshid ibid). Thus, they say that it is wrong to isolate the economic behaviour of Man from his moral, spiritual, social, psychological, political and cultural behaviour. Mawdudi (1984:9-10) argued that: "If economics is isolated and segregated from the whole of which it is a part and an attempt is made to solve all the problems of life by means of economic panaceas, as if man were no more than an economic animal and his moral and spiritual aspirations had no reality apart from his economic endeavours, we should not be surprised if chaos and confusion are the final result".

### 1.3 WHAT IS ISLAM? AND WHAT ARE ITS MAIN SOURCES?

Islam, literally means Submission, Surrender, Obedience and Peace. Technically it means complete submission and obedience to the Will of Allah and to his Shariah. This signifies that one can achieve real peace of body and mind only through submission to the will of Allah and obedience to his Shariah. Islam is the Last Message or the Last Testament revealed by Allah to all Mankind, through the last messenger Mohammed (PBUH) to urge them to submit themselves wholly to Him and surrender to His Divine Will in every detail of their every day life. This message, in essence, was the message revealed to every prophet throughout the history of Mankind to be delivered to his own people. For instance, Allah said in Koran 2:130-131 about Abraham (PBUH):

He, who turns away from the religion of Abraham is but a fool. We chose him and rendered him pure in this world, and in the hereafter he will be in the ranks of the righteous. His Lord said to him: "surrender to My Will (ie be a Muslim)". He said: "I surrender and bow myself to the will of the Lord and Cherisher of the universe". And this was the legacy that Abraham left to his sons, and so did Jacob: "O my sons! Allah has chosen the faith for you, then do not die except in a state of Islam (obedience, surrender and submission to Allah).

So Islam is not a new religion, but the culmination of the earlier monotheistic religions or the final version of the sak13H message which was being sent gradually to different peoples in different times and places to prepare them for the last version. Thus, it is one and the same faith and way of life consistently revealed by Allah to Mankind through messengers from the beginning. As Khurshid (ibid:IV) described:

Islam is not a religion in the limited sense of the word interested only in Man's salvation in the life to come or only a relationship between Allah and Man and has nothing to do with this life. Islam is a complete way and code of life and aims at instructing the entire fabric of human life and culture in the light of values and principles revealed by Allah for man's guidance. Human life is looked upon as an organic whole and its problems are approached not in a purely mechanistic way, but in the light of the moral values and social ideals that Islam expounds. Man is treated as a human being possessing a moral personality and not just a complex of molecules.

There are three main sources of Islam. These are:

1-) The Koran which is the last and complete version of Islam, revealed by Allah to His last messenger Mohammed (PBUH) to guide all humanity. Allah says in Koran 5:48: "To you (O Mohammed) we revealed the Book (Koran) in truth confirming the truth of whatever there still

remains of earlier revelations (eg the Torah and the Gospel) and determining what is true therein.

2-) The Sunnah, literally means a way, a rule, a manner of acting, etc.. The Sunnah of the Prophet (PBUH) takes 3 forms:

- a) Qawl or Hadith (saying of the prophet Mohammed (PBUH))
- b) Fi'l or Amal (an action or practice of his)
- c) Iqrar (silent approval about an action made in his presence)

The Koran deals with the broad principles or essentials of Islam going into detail in very rare cases. Details were generally provided by the prophet Mohammed (PBUH) in his Sunnah. Only authentic Sunnah is binding on every Muslim (male/female). Sahih El-Bukhari (the collection of El-Bukhari) and Sahih Muslim (the collection of Muslim) contain only authentic Hadiths but other collections may contain all sorts of Hadiths authentic and doubtful, though it is mentioned which is which.

3-) The Ijtihad: The word Ijtihad is derived from the Arabic verb Ijtahada meaning to exert efforts to one's best ability. It also means to persevere or to struggle. Technically it is applicable to a scholar exerting the faculty of reasoning to his utmost for the purpose of forming an opinion respecting a point on which there is little or nothing about in Koran or the Sunnah. Reasoning plays a very important part in Islam. The value of reason is expressly recognised in the Koran which appeals to reason again and again and is full of exhortations like "Do they not reflect?"; "Do they not understand?"; "Have you no sense?"; etc.. Ijtihad is also recognised by the Sunnah. For instance, appointing Muadh Ibn Jabal as governor to Yemen, the prophet Mohammed (PBUH) asked him: "How would you judge cases?". Muadh replied: "I will judge by the laws of the Koran". Then the prophet (PBUH) asked him: "What if you do not find any direction therein?". Muadh then answered "then I will act according to the Sunnah of the prophet (PBUH). The prophet (PBUH) asked him once again: "But if you do not find any direction therein, what would you do?" and Muadh replied: "Then I will exercise my judgement and act on that". The prophet (PBUH), then raised his hands and said: "Praise be to Allah who guides the messenger of his messenger as he pleases" (M.M. Ali nd:98).

This event also shows the priority of Koran over both Sunnah and Ijtihad and that the latter should only be applied in case there is no Nas Saheeh Wa Sareeh (clear cut quotation) neither in the Koran nor in the Sunnah. The highest form of Ijtihad and one that has priority over individual Ijtihad is Ijmaa (consensus: decision reached by a majority of Muslim scholars). Qiyas (analogy) is one way of making Ijtihad.

#### 1.4 THE SALIENT FEATURES OF THE ISLAMIC ECONOMIC SYSTEM (IES) AS COMPARED TO THE CAPITALIST AND THE COMMUNIST SYSTEMS

There are a number of economic systems and the choice of this or that system has far reaching implications on production, consumption, saving, investment, finance and distribution both at the micro and macro levels. This choice also affects the social and political structure of the country where that choice takes place. Thus, before studying the Islamic Banking System, it is very important to determine the Islamic Economic System (IES) or the framework where this is to be implemented.

Halm (1974:273) defined an economic system as: "the sum total of institutions and patterns of behaviour that organise economic activity in society". In this respect the IES differ from all other economic systems in its nature, form, purpose and means. Presley (1988a:67) says:

Islam possesses its own paradigm of economic relations within the context of an entire Islamic system based on injunctions and norms called the Shariah. The Shariah specifies, inter alia, rules that relate to the allocation of resources, property rights, production and consumption, the workings of markets and the distribution of income and wealth. Similarly, rules and requirements have been specified that define the framework within which the underlying monetary and banking system can be designed.

##### 1.4.1 The Economic Philosophy

Any economic system is founded on one ideology or another, or one philosophy or another, which provides it with its basis and objectives on one hand, and with its axioms and principles on the other. This is true even for the Marxian economics which claims to reject religious and moral principles and considers them as the 'opium of the people'. The process, followed by the set of axioms and principles in order to bring the economy closer to the objective of the system, represents the testable ground of the system (Kahf 1978:6). Gruchy (1987:1) pointed out that: "nothing distinguishes different types of economics from one

another more than the varying views on what is considered to be the proper subject matter of economics... What determines how an economist looks at the real social world around him and what he takes to be the proper subject matter of economics, is the philosophical position or intellectual orientation that underlines his work".

The validity of an economic system can be tested, as Kahf (1978:6) argued, by its internal consistency, its compatibility with the systems organising the other aspects of life and its provision for improvement and growth. Consequently a system for the Islamic economy must be formulated on the basis of the Islamic doctrine of life, because, as Abu-Saud (1980:59) argued: "It is dangerous to adopt an economic system that does not emanate from and correspond with the ideology, in fact such a trial is doomed to failure. Thus, there is no Islamic Economics (or Islamic Banking) per se unless there is an Islamic Ideology prevailing and applied in a Muslim community".

Capitalism, is a Man-made economic system based on the principle of laissez faire, laissez passer, the corner stone of capitalism, which indicates, at least theoretically, that Man can do whatever he likes, and that no one including God, State or Society should intervene in his business. As such, "the economic questions of human civilisation are", as Khurshid (1980b:xii) described: "grappled with, without reference to God and his guidance. God may be worshipped in one's personal life. Nonetheless the affairs of society and the economy are to be conducted according to Man's own discretion and sovereign wisdom".

Capitalism was boosted by, if not developed as a result of, different factors which preceded its appearance such as the rise of Calvinism, the Puritan Movement, the Industrial Revolution, the Reformation, the Repeal of Usury, the French Revolution, etc.. It is also called the private enterprise economy or the free market economy which is built upon the private ownership and control of the means of production, free choice of occupation and consumer sovereignty.

Despite rejecting all moral and religious norms, Communism, which is also a Man-made economic system, "has been accepted by millions as a

gospel truth and enhanced as a religion which promises paradise on this side of the grave" (Schumpeter 1950:5). It developed as a reaction to the inequality and injustice of capitalism which are believed to be the results of the private ownership of the means of production and not of the lack of religious or moral teachings that might regulate them. In fact communism denies the very existence of God and rejects all religious and moral beliefs and considers them as 'the opium of people' but at the same time, makes of 'Matter' a god in the sense that it attributes everything to it and assume that it had always been in existence, that it is imperishable, that it preceded 'Thought' and that 'Thought' and everything else are but its products. Marx (1911) argued:

In the social production which men carry on, they enter into definite relations that are independent of their will, these relations of production correspond to a definite state of development of their material powers of production. The sum total of these relations of production constitutes the economic structure of society, the real foundation on which rise legal and political superstructures and to which correspond definite forms of social consciousness. The mode of production in material life determines the general character of the social, political and spiritual processes of life. It is not the consciousness of men that determines their existence, but, on the contrary their social existence determines their consciousness

Islam, also, has its own philosophy, according to which, the nature and purpose of Man's life on earth and his relationship with Allah, the people and the universe are defined. According to the Islamic doctrine, Allah created Man and subjected to him all that is in the universe and endowed him with all the faculties he needs to fulfill the temporary purpose of Tawheed Ibadat Allah (worshiping Allah alone) and the mission of Khalifah (trustee) on earth as a test. The test is for Man to follow Allah's Shariah with full freedom of choice through Tazkiyah (Purification and growth) in order to achieve Saada (happiness) and Falah (prosperity), or not to follow it and bear the consequences of Shagawah (unhappiness) and Khusraan (failure) in this temporary life and in the eternal hereafter. "Life on earth, being a test and all the provision available to Man being in the nature of a trust, Man is accountable to Allah and his success in the life hereafter depends on his performance in this life on earth. This add a new dimension to the valuation of things and deeds in this life" (M.N. Siddiqi 1980:195).

Naqvi (1981:18) argued that: "In the climate of Islamic philosophy, it is ethics that dominates economics and not the other way round. Hence the Islamic system differs from all other economic systems by an ethical factor". This difference, according to him, is fundamental because "ethics epitomise the common values of a society and determine the preference structures of the members of that society. The key to a thorough understanding of the originality of the Islamic economic system lies, therefore, in its ethical value system. However, the predominance of ethics in the universe of Islamic thought does not exclude the possibility that economic conditions may in certain cases influence the ethical behaviour of human beings".

According to Khurshid (1980b:174): "The major contribution of Islam lies in making human life and effort purposive and value orientated. The transformation it seeks to bring about, in human attitudes and pari passu in that of the social sciences, is to move them from a stance of pseudo-value neutrality towards open and manifest value commitment and value fulfillment" because as Naqvi (1981:27) argued: "the dichotomy of man's life into mundane pursuit and his spiritual aspirations has contributed immensely to the schizophrenic confusion prevailing in the modern world. Dualistic cultures, riddled with inherent contradictions have sprung up, spreading social tensions. The Islamic solution is to destroy this artificial schism by providing a unitary philosophy of life, according to which no moral vacuum can exist on the plane of social existence. Accordingly, in the context of the immaculate Islamic vision of unity, the distinction between the secular and the spiritual becomes both meaningless and inconsequential". The Koran 2:201 advises Mankind to seek Allah's bounties in both this life and in the hereafter. Presley (1988a:14) acknowledged this fact when he wrote:

Islam is not a religion in the limited sense of the word but covers all aspects of human life and wants. It seeks to develop a new moral personality in man, an integrated social existence and a new socio-economic and political order. It has its own approach to economic concepts, objectives, methods, laws and instruments. The Islamic economic system is not directly related to either capitalism or any variants of socialism or communism. The fundamental difference is that the Islamic economy rests upon Divine guidance whereas capitalistic and socialist economics propose particular human action without reference to religion.



#### 1.4.2 The Economic Problem

"The economic problem of Man has", as Afzalur-Rahman (1974:1) pointed out: "always attracted great attention from individuals as well as communities. Various attempts have been made to solve this difficult but important problem". However, although nobody denies the existence of the economic problem, there is no agreement as to what this problem is, what causes it, or how to solve it. For instance in capitalism, the economic problem is the relative scarcity of the natural resources which are limited and insufficient to satisfy the endless succession of Man's wants. Robbins (1935:16) defined economics as: "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses". Man's insatiable 'wants' are Robbins's 'ends' which exist to be satisfied. The resources of the Earth are the 'scarce means' which are available to satisfy these ends. Since the utilities (goods and services) that can be produced are limited compared with the insatiable wants of Man, then some sort of choice as to what shall be produced and in what quantities is necessary. The choices of millions of people take effect through the free market.

According to Communism which developed as a reaction to the ills of Capitalism, the economic problem lies in the conflict between the form of production and the relations of production. In other words, there is economic problem when there is conflict between owners of means of production and workers who do not own the means of production. Joan Robinson (1947:1) pointed out that: "While orthodox economists argued in terms of harmony of interest, Marx conceives economic life in terms of conflict of interests between owners of property who do not work and workers who own no property". Individual or private ownership of the means of production is assumed to be inconsistent with basic human nature and that it is basically and solely the cause of all conflicts in human life. In order that human life be improved and human conflicts be wiped out from the earth, individual ownership should be abolished and replaced by collective or common ownership (see Nasseef nd:4).

In Islam, however, the economic problem is neither the scarcity of the natural resources nor the conflict between the forms and relations of production but lies with Man himself (ie his belief, his economic and social behaviour, etc.,). Allah says in Koran 14:32-34:

It is Allah who created the Heavens and the Earth and sent down rain from the sky, and with it brought out fruits where-with to feed you. It is He who has made the ships subject to you, that you may sail through the sea by His command and the rivers also has He made subject to you. He has made subject to you the Sun and the Moon both diligently pursuing their courses and the Night and the Day has He made subject to you. and He gave you all that you ask for. But if you count the favours of Allah, never will you be able to number them. Verily Man is unjust and ungrateful.

And said in Koran 15:19-21:

And He spread out the Earth for you set thereon firm mountains and produced therein all kinds of things in due proportion and we have provided therein means of subsistence for you and for whose sustenance you are not responsible. And there is not a living thing but its sources and treasures are with Us. But We only send down thereof in due and ascertainable measure.

And also said in Koran 11:6:

There is no moving creature on Earth but its provision is upon Allah. He knows the time and place of its definite abode and its temporary deposit: all is in a clear record.

And again said in Koran 30:4:

Mischief has appeared on Land and on Sea because of what the hands of Man have earned, so that Allah may give them a taste of some of their deeds in order that they may stop doing evil.

Last but not least Allah says in Koran 67:15:

It is He Who made the Earth manageable for you so walk through its tracts and eat of his sustenance (to you) and to Him is your resurrection.

From the above mentioned Koranic verses and others (see for example Koran 3:14, 6:151, 10:31, 17:31, 29:60, 65:3, 67:21, 72:16, etc.), we understand that Allah has created and subjected all that is in the Heavens and in the Earth to Man and gave Man the reason, the ability and the skills to benefit of these bounties and showed him the best way to reach Falah (prosperity and success) in this life and in the here-after through Tazkiyah (purification and growth). Now it is for Man to seek the satisfaction of his spiritual and material needs according to Allah's Shariah or according to his own desires, bearing, however, the consequences of his choice. These bounties, though they are like all the other creatures of Allah, limited by time and space, are countless

and more than sufficient to give a relatively balanced satisfaction to all the needs of human beings, if these are managed and distributed justly as recommended by Allah albeit some preferences may inevitably follow as it is said in Koran 16:71: "Allah has bestowed His gifts of sustenance more freely on some of you than on others, as a test". But this should never creates any deprivation whatsoever. If however, the management and the distribution of these material resources is contrary to the Shariah, then injustice, exploitation and oppression are likely to be present giving rise not only to economic problems such a inequality, the existence of different classes in the society with different standards of living, unemployment, inflation, etc., but also to political, social, psychological and judicial problems. And in this case, the human beings, themselves, are to be blamed because it is they who have thrown the fate of a part of their own society in jeopardy by means of an unjust distribution system. So, according to the Islamic teachings, the economic problem is not of scarcity of the natural resources which are provided by Allah in due proportion, since this is a fact of life, that everything is limited by space and time except Allah. So why should they be unlimited if Human Beings themselves for whom they are created, are limited?, nor is it the private ownership of the means of production, since this may be regulated by moral religious and legal means, but it is one of management and distribution.

Islam, in fact, does recognise the insatiability of Man's wants, for instance, the prophet Mohammed (PBUH) said: "If Man had a valley of gold, he would want a second one and if he had a second one he would want a third one, and nothing satisfies Man's wants except dust". But Allah wants Man to restrict his wants to Taybats (good and pure things) that He made Halal (lawful) and to avoid Khabayths (bad and impure things) that He has made Haram (unlawful) as a test for Man. Allah says in Koran 21:35: "We test you by good and evil by way of trial and to us must be your return". And says in Koran 7:157: "He commands them what is just and forbids them what is evil, He allows them what is good and pure and prohibits for them what is bad and impure".

Besides, Islam discourages Israf (extravagance) even in what is lawful and encourages moderation. Allah says: "Eat and drink but do not waste by excess for Allah does not like the extravagants" (Koran 2:31). The Islamic stress on moderation as pointed out by Mannan (1984:61) "makes the act of satisfying wants as a means to end rather than an end itself. By implication, acts of satisfying wants may not necessarily create new wave of wants... The moral and social responsibility imposed on a Muslim as part of his faith puts a limit to the emergence of more wants requiring satisfaction for himself". Thus, in Islamic society, wants are restricted because constraints are imposed not only by income but also by social and moral norms. So the real economic problem, from the Islamic point of view is, as Mawdudi (1984:13) contends:

If we look at the question in a plain straightforward manner, avoiding terminological and professional complications we find the economic problem... to be no more than this: with a view to sustaining and advancing human civilisation, how to arrange economic distribution so as to keep all men supplied with the necessities of existence and see that every individual in society is provided with opportunities adequate to the development of his personality and the attainment of the highest possible development according to his capacity and aptitude.

#### 1.4.3 The Principle of Ownership

Capitalism is characterised by the private ownership of the means of production, in other words the individual can, according to the principle of laissez faire, laissez passer, own, purchase, produce or sell any property he likes without any external intervention. The public or common ownership of some means of production in some capitalist countries is an exception recognised only under social pressure which led to the nationalisation of this or that sector.

The Communist economic system, on the other hand, is directly opposed to the capitalist system and is characterised by the common or collective ownership of the means of production. The right of the individual to own property of means of production is neither allowed nor recognised except in some very limited circumstances when there is no other way to raise the productivity or efficiency of this or that sector without allowing some sort of limited private ownership. But the general rule is that all means of production must be owned by the state or the collectivity and not privately.

Contrarily the Islamic economic system recognises and allows three distinct forms of ownership to prevail side by side at the same time, these are: private property, common property and state property, thus, allowing a triple nature of possession and defines and determines the field of each of these different forms of ownership, the detail of which is beyond the scope of this study but briefly we can say that:

1-) Islam recognises the individual's right to ownership of all types of property acquired by lawful means. It allows him to earn as much wealth as he can get by his knowledge, skill and labour. This includes all the rightly owned means of production and natural resources like arable land, land for building, firms that produce or offer Halal goods and services, machinery, crops, industrial products, livestock etc.. The norms of acquisition and disposal of private and business property and the purchase and sale of merchandise, are all discussed in great detail in the Koran, the Sunnah and the Ijtihad and so are the institution of Zakat (welfare due) and Mirath (inheritance) which would not have been done in such detail if the institution of private ownership of most productive resources had not been recognised by Islam. Allah says in Koran 4:29: "O you who believe! Devour not the property of each other wrongfully, except that it be trading or by your mutual consent. And says in Koran 4:2: And give to the orphans their property and substitute not worthless things for their good ones".

2-) The state or public ownership includes the properties that are not allowed to be owned by the private sector and not left to be used freely for the common use. These include the energy and mineral resources like oil, coal, iron, gold, copper etc.. No individual singly or in association with others should be given any right to own them or use them for his (their) own personal benefit because these are gifts from Allah to the whole society and every citizen of the Islamic state has an equal right in it. The Islamic Fiqh (jurisprudence) discussed in detail which properties should be private and which should be public.

3-) The common or collective ownership includes all the remaining natural resources that are not allowed to be owned by the private sec-

tor and that have not been explored by the government such as rivers, forests, pastures, etc.. These are to be used by anyone to the extent that is judged by the society as non detrimental to the property itself or to the society. Most Muslim scholars include these properties under the ownership of the state but others like Sadr (1980) separate them from the properties of the state because anyone can use them freely with no need of a permission, whereas no one is allowed to use the properties of the state, except the state itself by hiring labour from the private sector. The prophet Mohammed (PBUH) said: "People are to share three things: water, pasture and fire".

#### 1.4.4 The Principle of Economic Freedom

The Capitalist Economic System allows, at least theoretically, almost unlimited Economic Freedom to the individual to initiate, organise and establish any enterprise he likes and to purchase, produce or sell anything he likes according to the principle of 'laissez faire, laissez passer'. In other words the individual has freedom of choice with respect to consumption, occupation, saving and investment. For example, he can gamble, speculate or do whatever he likes to realise the maximum profit possible and the government should not intervene in his business.

In Communism, Economic Freedom is almost completely abolished, as is the right of ownership. Halm (1974:275) contended that: "The most thorough going form of 'the centrally planned economy', 'Authoritarian Socialism' or 'Common Economy' features the public ownership of a control over all productive resources, including labour, and the direction of the economy by command from the centre according to all inclusive plans. But this extreme form of central planning is not likely ever to exist in real life nor can it be assumed that any government would insist on distributing national income without allowing any choice on the part of the consumers". Under the pressure of the impossibility to achieve this goal, the Communist Economies were obliged to combine public ownership of the means of production and central planning, with as much personal freedom as this framework permits in terms of occupation and consumption but not in terms of ownership and production.

The Islamic Economic System, however, recognising that the market system cannot be relied upon in providing adequately for both private and social needs, does not give individuals almost total freedom as in Capitalism, nor does it abolish freedom almost completely as in Communism but allows Economic Freedom to the extent that it is within the Shariah and that it is not detrimental to the society. Individuals are, on one hand, allowed to engage in Halal transactions and contracts with full free choice in the sense that any contract or transaction lacking free mutual consent is considered to be void and invalid. But on the other hand, they are not allowed to engage in Haram transactions and contracts that are not permitted by Shariah and that are detrimental to the society such as gambling, speculation, monopoly, taking and giving interest, the production, distribution and consumption of pork, wine, intoxicants and all other unlawful things. Mannan (1984:25) pointed out that: "Islam allows private ownership of property but subjects the owner to restrictions preventing him from using the property as a tool of exploitation of the poor. His ownership of anything and everything is relative, not absolute... Under Islamic state, anybody who is using the private property as a tool of exploitation may be deprived of his ownership... therefore, violation of any of the principles justifies the intervention of the state to regulate and control private property to the advantage of the greatest number of the people in a community".

In Islam, and as pointed out by Chapra (1979:23), the market mechanism may also be considered to be an integral part of the Islamic economic system because, on the one hand, the institution of private property, that Islam allows, is not workable without it; and on the other, it offers the consumers a chance to express their desires for the production of Halal goods of their liking by their willingness to pay the price, and also gives resource owners an opportunity to sell their resources in accordance with their free will". This market however, is not left to itself but the government stands ready to intervene at any time to prevent Ihtikar (speculation and monopoly), Gharar (ambiguity and deception), Istighlal (exploitation), Riba (interest), etc...

El-Hisba is one of such institutions developed by the Muslims to help regulate the society and economy and ensure the full flowering of the Islamic norms of behaviour. The function of El-Hisba, as described by Khurshid (1982:7): "consists in maintaining public law and order and supervising the behaviour of the buyers and sellers in the market with a view to ensure right conduct, and protect people from dishonesty and malpractices. The purpose was to regulate public life in such a way that a high degree of public morality is attained and the society is protected from bad workmanship, fraud, extortion, exploitation, etc."

#### 1.4.5 The Principle of Social Justice

All schools of economics agree that the purpose of the economy is to meet human needs and realise optimum social justice, but disagree over how that meeting of needs and achieving of social justice does and should take place. In a general way, every society must decide what to produce, how to produce it and how to distribute it, a process that Gruchy (1987) refers to as 'social provisioning'. For instance, before Capitalism was compelled, under social pressure and fear of Communism spread, to introduce labour laws that include the right to trade union, insurance and social security, it was believed that economic justice is best achieved through individual activities in the market place where everybody is free to maximise his profit and utility, then and only then when every individual intending to maximise only his own gain that the interests of society achieve maximum utility because "every individual intending only his own gain is", as believed by Adam Smith (1936) "led by an 'invisible hand' to promote an end which was no part of his intention, the interest of society". In Practice this proved to be wrong because, in early Capitalism, and as Qardawi (1981:4) described:

Every man was responsible to earn what he likes and to spend to his wishes. They observe that there is no compulsion for the poor to live in poverty, nor there is any force to fling them far from striving hard to earn their livelihood. Society is not responsible for any person who lags behind intentionally sitting idle pinning his faith on mere hope from the heavens; that the rich are not bound to assist them and if they do it is due to sheer pleasure for reward in the hereafter and that is all. This system gave a fillip to greed, selfishness, egoism, cruelty and exploitation. This made the women and children to work in the factories and elsewhere (in very bad conditions and for very long times) on meagre wages.



Communists consider the private ownership of the means of production and the economic freedom as the causes of all economic ills and injustice and so they abolished the private ownership and replaced it with collective ownership of the means of production and suppressed the economic freedom of the individuals. "The bargain is very costly for the individual who has to sacrifice his individuality, his rights to freedom and private property to get two meals a day" (Afzalur-Rahman 1974).

In a true Islamic state, social and economic justice should neither be achieved by giving almost absolute liberty to individuals to do what they like so that the rich become richer and the poor poorer, nor by nationalising all means of production and curbing all human rights and freedom. S. Qutub (1980:127) pointed out that:

Islam affirms that just as encroachments upon society by the cupidity and ambition of the individual are a kind of social oppression which is inconsistent with justice. Similarly, encroachments upon the nature and ability of the individual by society are also a kind of injustice. It is an injustice, not only to the individual, but to the society also. For the evil effects of suppressing the activity of the individual by crushing his natural trends and propensities do not only result in the deprivation of that one individual of his due but also results in precluding the whole society from availing itself of his maximum abilities.

Thus an Islamic economy is neither a 'laissez faire' economy nor a 'centrally-controlled command economy'. In other words the Islamic economic system does not believe in the 'invisible hand' of capitalism nor does it believe in achieving social and economic justice by nationalising all means of production and curbing freedom. "Islam admits the right to private ownership but does not consider it to be an absolute and unconditional right which is bound to cause disorder on earth" (Shafi 1975:6). It regards social and individual welfare as complementary rather than competitive and antagonistic. It therefore encourages cooperation instead of competition and rivalry and develops an intimate relationship between individuals (see Afzalur-Rahman 1982:350).

Islam prescribes a number of instruments that must be applied if the society is to achieve real social and economic justice and reduce the disparity that might appear between the rich and the poor as a consequence of private ownership and of the difference in physical and intellectual ability of the members of the society. It curbs the accumu-

lation and concentration of wealth in few hands by positive and negative means. Among the negative means it prohibits, hoarding, interest, gambling, monopoly, speculation and extravagance and among the positive ones, it implements Allah's laws of Takafol (mutual help and solidarity), Waqf (dedication of private property for the general social use), Mirath (inheritance), Zakat (welfare due), Sadaqat (charity) and PLS finance. But first and foremost it enjoins on every individual to work in one way or another, in Halal occupations to earn his livelihood and the livelihood of his family and poor close relatives but if, for physical, social or economic handicap, he is unable to get much to satisfy his basic needs, then, he has a right in the wealth of the community, first in form of a pension from Bayt El-Mal (the Treasury) and second in form of Takafol (mutual help from close relatives and friends). Besides, the Islamic state must make sure that every capable citizen has a job. In other words anyone who needs a job, the government should either employ him in its public sector, or help him get a job in the private sector or help him to set up his own business by lending him capital on Qardh Hassan (interest free credit) basis. In the meantime he should get unemployment benefit from Bayt El-Mal. By the way, social benefits such as unemployment benefit, child benefit, old age benefit (pension), which have been implemented only recently in capitalist countries under social pressure, were all known and practiced in Islam, more than 1400 years ago. It is the duty of the Islamic government to collect Zakat (the welfare due) and distribute it to its beneficiaries, and collect any other necessary taxes to reduce social inequality.

Abu Zahra (1957) asserted that Muslim jurists have unanimously held that catering to the welfare and prosperity of the people and relieving them from hardship is the basic objective of the Shariah and hence of the Islamic state. Hassanu-Zamman (1981) indicated that the focal point of the economic function of the Islamic State is the institution of Bayt El-Mal whose very concept, as Doi (1984:387) remarked: "is the concept of trust: the wealth of Bayt El-Mal is to be treated as Mal-Allah (Allah's wealth) or Mal-El-Muslimeen (the Muslims' wealth), as

against the imperial treasury or the emperor's wealth as used to be known during the Medieval period. This concept implied that monies paid into the treasury were Allah's trust and the common property of all the Muslims" and that the Khalifah (Caliph) was only in the position of trustee whose duty was to expend them on the common concerns of all Muslims while allowing for himself nothing more than a salary, determined by Majlis El-Shurah (council of consultation) and which must not exceed the income of an average citizen. This way, and as Shafi (1975:9) put it: "The wealth instead of becoming concentrated in few hands would be allowed to circulate in the society as widely as possible, so that the distinction between the rich and the poor could be narrowed down, as far as is natural and practicable.

#### 1.5 CONCLUSION

From the above brief investigation of the relationship between Islam and economics and of the features of the IES as compared to Capitalism and Communism, it is quite clear that no economic system can be totally value-free, even Communism which claims to reject all moral and religious principles is based upon certain values and concepts that govern its institutions and working and that Islam has its own distinct economic system which has nothing to do with Capitalism or Communism. Thus, when Islam allows the private ownership of most of the means of production, it does not mean that it is a capitalist system and when it forces its welfare policies that narrow the gap between the have and the have-nots, it does not mean that it is a communist or socialist system but has its own distinct ideology, goals and means that are drawn from the divine Shariah of Islam.

## CHAPTER TWO

### THE IMPORTANCE OF SAVINGS AND FINANCIAL INTERMEDIATION FOR ECONOMIC DEVELOPMENT

#### 2.1 INTRODUCTION

Postwar literature on economic development has confirmed the central importance of domestic savings for capital accumulation and focused considerable attention on the process of financial intermediation and its impact on growth and development though with differing emphasis on the relative magnitudes of the impact attributed to financial institutions in the development process (see Porter 1966; Patrick 1966; Gurley and Shaw 1967; Goldsmith 1966, 1969; Adelman and Morris 1967; Cameron *et al.* 1972; McKinnon 1973; etc..).

The purpose of this chapter is: first, to stress the importance of saving and intermediation for economic growth and development; second, to examine the different hypotheses about the role of financial institutions in the saving investment-process and introduce what I call: 'The Islamic Hypothesis' as yet another alternative hypothesis; and finally to investigate the relevance of these alternative hypotheses to the financial and economic development of some Islamic and non Islamic countries by using cross-section and time series-data analysis.

#### 2.2 THE IMPORTANCE OF SAVINGS

Perhaps it is not an *exaggeration to say that most if not all of* the economic growth theories, whether Classical, Keynesian, Marxist, Neo-Classical or Islamic, agree on the fact that mobilisation of savings for investment is one of the most important pre-conditions for accelerated economic development albeit in varying degrees. The central importance of savings for capital accumulation and output growth was emphasised in almost all discussions of economic development. For instance Mathias (1973:122) summed the Classical view in the following:

A long intellectual tradition emphasised that capital was the critical factor of production and that shortage of savings and hence capital, was a critical constraint upon the growth of an economy. This certainly was the main emphasis of Classical

economists led by Adam Smith who emphasised that expansion was limited by the powers of 'accumulation' and that capital was created by parsimony sparing resources from consumption.

In the Keynesian theory capital plays a central role in determining the level of investment, production and employment and is considered to be the most volatile component of the aggregate effective demand of the economy. Keynes (1936) considers the investment of capital as an essential explanatory variable of economic progress, decline and stagnation. The Harrod-Dommar growth theory, which is an important extension of the Keynesian theory, relates the rate of income growth of a country to its marginal propensity to save and its marginal capital-output ratio.

According to Marxian economics, although capital accumulation leads to the ultimate destruction of the capitalist economy, the investment of capital, however, leads to positive growth. Marx (1911) attributes the positive growth to the reinvestment of the surplus expropriated by the capitalists from the workers, as a result of their desire for further accumulation of wealth.

According to Islamic economics, although the central key to economic dynamism and development depends on Man himself and on his Jihad (effort, strive, struggle) within the collective will of the society, the role of capital is neither denied nor neglected. In fact it is well recognised that capital is necessary to accelerate the changes though not sufficient to achieve the desired economic development that brings about not only an increase in the national product but realises social justice as well. To achieve this, other things are needed beside capital such as the Islamic education of people, the strong belief of the concerned people in Islam, the right economic and monetary policies that promote economic development and that comply with the Shariah, the good management and efficiency of the financial and non financial institutions, etc.. But because these are seldom possible without capital investment, Muslim economists, agree that savings are a necessary, though not a sufficient condition for more growth and development.

Postwar economic development literature also emphasised the importance of savings for capital accumulation and economic growth. For instance, A. Lewis (1954:155) contended that: "The central problem in the

theory of economic development is to understand the process by which a community, which was previously saving and investing 4 or 5% of its national income or less, converts itself into an economy where voluntary savings is running at about 12 to 15% of national income or more".

Rostow (1960), in analysing the stages of economic growth, adopted Lewis' view and defined the state of 'take-off' into self-sustaining growth as requiring, among other things, a rise in the rate of savings.

The United Nations (1980:8) report of the first group of experts on programming techniques for economic development reported that:

The general rate of development is always limited by shortage of productive factors. If any one scarce factor associated with underdevelopment should be singled out, it would be capital. The final goal of development programming is, therefore to find the best way of breaking the vicious circle between capital shortage and underdevelopment and to design the most efficient and optimum rate of capital accumulation. It would be an over-simplification of course, to regard economic development as a matter of capital accumulation alone. Other things are needed in addition, such as the entrepreneurship and training of workers and public administrations, technical and managerial skills, other natural resources and the existence of a political, social and institutional framework which exploits the impulses of expansion. Yet these are seldom possible without some increase in capital formation.

It is also argued that capital increases by investment, and more investment necessitates more savings or foreign assistance. Foreign assistance, if not in the form of grants, means some burden in the future. Domestic savings are therefore the more reliable source of investment to break the vicious circle of poverty and underdevelopment. How much capital will in fact be accumulated depends in the first place on how much, out of current income, is saved rather than consumed. Hence, the importance attached in discussions of economic development to the rate of savings as well as to the specific forms of investment such savings take (Taha 1976:1 and El-Zubair 1983:3).

As Meier (1976:267) pointed out: "The process of capital formation involves three essential steps:

- 1- An increase in the volume of real savings so that resources can be released for investment purposes;
- 2- The channeling of savings through a finance and credit mechanism, so that investible funds can be collected from a wide range of different sources and claimed by investors;
- 3- The act of investment itself, by which resources are used for increasing the capital stock".

To achieve the first step, there are many alternative but not mutually exclusive techniques which may be compressed into two main classes: internal and external sources (see Gurley and Shaw 1967:260; Meier 1976:268 and Ragazzi 1981:50).

From internal sources, an increase of savings may be generated, as Meier (1976:267-68) put it: "voluntarily through a reduction in consumption, involuntarily through additional taxation, compulsory lending to the government or inflation, or finally by the absorption of underemployed labour into productive work". And from external sources, "the financing of development may be met by the investment of foreign capital, restriction of consumption imports, or an improvement in the country's terms of trade" (ibid).

The policies relating to savings mobilisation depends on the political and economic structure of the society. Government's savings, that is the excess of current revenues over current expenditures, rarely exceeds 2 or 3% of GDP and often is negative in LDCs where the level of real income is very low and large areas are still in the subsistence economy, thus government revenues through taxation can hardly be increased because a country's taxation potential depends on a variety of conditions: the level of real per capita income, the degree of inequality in the distribution of income, the structure of the economy, the political leadership and administrative powers of the government (see Meier 1976, Taha 1976 and Ragazzi 1981). Kaldor (1963:9) noticed that:

Many LDCs suffer not only from lack of revenue but also from an international scale of priorities in the allocation of public funds. Too much may be spent on the (real or fancied) needs of defence or for ostentatious purposes of various kinds, such as public buildings and ornaments, lavish diplomatic missions, etc..

Fiscal policy as a means of mobilising resources by the government should, as Taha (1976:5) put it, be carefully manipulated so as not to adversely affect the savings potential of the other sectors because, as Meier (1976:268) argued: "The saving that is forced by additional taxation, is likely to be less than the additional tax revenue since there may be a reduction in private voluntary savings institutions or a fall in consumption by the amount of the tax". Besides, taxation is never

popular and especially in the LDCs. It is clumsy, costly, and sometimes involves bureaucracy, corruption, disputes, litigations, etc..

The government can also finance investment through compulsory lending or credit expansion. But in LDCs where there is little or no capital or money markets, there is only narrow scope for practicing compulsory lending through purchase of government bonds. Besides this may also result, if practiced in poor countries, in reducing private voluntary savings instead of a fall in consumption by the full amount of the compulsory lending. As for credit expansion, this method is inflationary and though the deliberate use of inflationary policies to promote economic development has been recommended on theoretical grounds by certain economists, inflation, as H. Johnson (1966:28) pointed out, is likely to reduce and impede growth by distorting the allocation of resources and wasting the inflation gathered development resources on consumption, by increasing uncertainty and reducing incentives for innovation and improvement, and through their balance of payments effects by fostering the inefficiencies of protectionism and exchange control.

Another internal source of savings is represented by the 'investible surplus' of underemployed labour. If this 'investible surplus' is utilised in productive activity, the national output would be increased, and the required savings might be generated from the additional output. It should also be noted that the direct formation of capital through the use of underemployed labour can be obtained by what is termed the 'unit multiplier' method. If labour does have zero productivity in agriculture, it can be withdrawn and put to work on investment projects (construction, irrigation works, and buildings etc..) without a drop in agricultural output. Most of the payment of the additional wages will be directed towards foodstuffs, and agricultural income will rise. The higher income may then be taxed, and the tax revenue can finance the investment projects... This method depends upon the ease with which labour can be attracted to investment projects, the degree to which labour can form capital without requiring additional investment expenditure, the absence of an adverse effect on agricultural output, and the capacity to offset the investment with taxation (Meier 1976:268).



Corporate savings too, as Ragazzi (1981:50) noticed, is limited in many LDCs because of the smallness of this sector. It is the savings of the non corporate (household) sector that is of crucial significance in most middle and low income LDCs, because this is the only surplus sector in the sense that its savings exceed its investment. Thus, the growth of the government and corporate sectors is critically related to the mobilisation of savings from this surplus sector.

But most LDCs are generally characterised by low levels of savings because of low per capita incomes and lack of sound financial institutions and instruments that are compatible with the beliefs and customs of the majority of the people. Nevertheless, however poor an economy may be, households save in one form or another. Thus, the need for the institutions which allow such savings to be collected and invested conveniently and safely and which ensure that these savings are channeled into the most useful purposes. Keynes (1936:107-08) lists eight main motives of a subjective character which lead individuals to save:

- 1-) To build up a reserve against unforeseen contingencies;
- 2-) To provide for an anticipated future relation between the income and the needs of the individual or his family, different from that which exists in the present as for example in relation to old age, family education, or the maintenance of dependents;
- 3-) To enjoy interest and appreciation, because a larger real consumption at a later date is preferred to a smaller immediate consumption
- 4-) To enjoy a gradually increasing expenditure since it gratifies a common instinct to look forward to a gradually improving standard of life rather than the contrary, even though the capacity for enjoyment may be diminishing;
- 5-) To enjoy a sense of independence and the power to do things, though without a clear idea or definite intention of specific action;
- 6-) To secure a masse de manoeuvre to carry out speculative or business projects;
- 7-) To bequeath a fortune;
- 8-) To satisfy pure miserliness, ie unreasonable but insistent inhibitions against acts of expenditure as such.

### 2.3 THE IMPORTANCE OF INTERMEDIATION

There are among economists those who attribute a positive role to financial institutions in the development process, and there are those who regard it as a passive factor. Among those who attribute a positive role, mention may be made about Adam Smith (1937:281) who once wrote: "I have heard it asserted that the trade of the City of Glasgow doubled

about 15 years after the first erection of the banks there and the trade of Scotland has more than quadrupled since the first erection of the two public banks in Edinburgh... that the banks have contributed to this increase cannot be doubted".

Schumpeter, who (1949) argued that two factors are essential for economic development: financial institutions and availability of entrepreneurs. Regarding the former he held that: "financing as a special act is fundamentally necessary in practice and in theory".

Porter (1966:347) who pointed out that: "the visible correlations in the world between financial and real development are indeed commanding whether one relates the development of the nation's financial system (however measured) to its per capita income across countries at a moment of time or across time for a particular country, the relationship between real and monetary variables, is undeniable".

Adelman and Morris (1967) who showed in their study of 74 LDCs for the years 1950-63 that financial development has been associated fairly closely to the capacity of these nations to develop, compared to other 39 economic and non-economic factors, with differences in the level and rate of growth of real national product per head. Out of 14 purely economic variables, they found that the level of financial development is the best indicator of a country's development potential.

Goldsmith (1969), who quantified, in his study of 35 DCs and LDCs, the association between the financial superstructure and the real economic infrastructure by what he called the 'financial interrelations ratio (FIR) which is equal to the value of outstanding financial instruments divided by the value of national wealth (physical assets plus the net foreign balances) for each of these countries. He found that the FIR is in the range of 1 and 1.5 for DCs and in the range of 2/3 to 1 for LDCs. He also found that the FIR increases over the course of industrialisation up to a certain level and then remains fairly stable, which indicates that the role of financial institutions is especially very important during the early stages of industrialisation and development. From these observations he concluded that, with the exception

of the centrally planned economies, there is only one major path of financial development associated with economic development. He contended that the financial superstructure in the form of both primary and secondary securities accelerates economic growth and improves economic performance to the extent that it facilitates the migration of funds to the best user". Thus, he considers the relationship between financial and real development as direct and visible and concludes that:

the evidence now available is more in favour of the hypothesis that there exists only one major path of financial development, a path marked by certain regulations in the course of financial interrelations ratio in the share of financial institutions in the total financial assets, and in the position of the banking system. From that path countries have deviated only to a minor extent.

Other proponents of the positive view of the role of financial institutions include: Gerschenkron (1962), Patrick (1966), Minsky (1972), Cameron et al. (1972), McKinnon (1973), and Shaw (1973) to name but a few. All of these are strong advocates of the efficiency of financial development in contributing significantly to the real growth of the LDCs, though in varying degrees.

The negative view of the contribution of financial institutions to economic development is particularly associated with Gurley (1967) who explicitly expressed skepticism and challenged the prominence of financial development in economic development. Unlike Goldsmith (1966) who emphasised the role of financial development towards economic development, Gurley, though not questioning the efficiency of the development of financial institutions per se, insisted on the existence of alternative techniques that may prove more feasible in a country's comprehensive aggregate planning approach, such as central planning, fiscal or tax subsidy techniques and transfer of foreign savings and pointed out that: "the actual choice among these techniques depends on the social cost and benefits of each". He argued that economic costing may prove secondary and the overriding criteria may be whether the chosen technique is generally compatible with the ideology of the country. He did not consider any of these techniques as best for all countries or for one country over its entire development path and admitted that he has not performed any systematic analysis of the costs and benefits of

these alternatives for a country over time or for a group of countries. He just contended that such choices are subject to change as the balance of benefits and costs is altered over time and concluded that: "recent experiences strongly suggest that banking systems as intermediaries are not highly essential to the growth process".

The passive contribution of financial institutions to economic development is also based on the experience of socialist countries where central planning is considered to be the central key to economic development and on the experience of some LDCs where financial institutions have played little or no role in promoting growth and development.

The controversy over the relationship between financial and real development is most thoroughly discussed by Patrick (1966) in his analysis of finance in developing economies in which he distinguishes the two opposing viewpoints by delineating them as 'demand-following' and 'supply-leading' finance. He defined the former as "the phenomenon in which the creation of modern financial institutions, their financial assets and liabilities and related financial services is in response to the demand for these services by investors and savers in the real economy" (p.174) and defined the latter as: "the creation of financial institutions and the supply of their financial assets, liabilities and related financial services in advance of demand for them" (p.175).

According to him, the 'demand-following' approach implies that finance is essentially passive and permissive in the growth process. Thus its contribution to economic development is minimal. He cites late 18th and early 19th century England as a historical example and those modelled after it, though as Abdi (1977:19) pointed out: "economics' historians differ in their assessment of the contributions of these banking systems to their respective economies" and "whether the English banking system contributed only minimally to the early industrialisation and economic growth of the country is disputed".

'The supply-leading' finance is, according to him, associated with positive growth inducing of developing economies through its allocative efficiency and encouragement of enterprise. It fulfills 2 functions:

- 1- transfer resources from traditional (non growth) sectors to modern sectors, and
- 2- promote and stimulate an entrepreneurial response in these modern sectors (pp.175-6).

He contended that: "New access to such supply-leading funds may in itself have substantial, favourable expectational and psychological effects on entrepreneurs. It opens new horizons as to possible alternatives, enabling the entrepreneur to 'think big'. This may be the most significant effect of all, particularly in countries where entrepreneurship is a major constraint on development" (p.176). 'Supply-leading' finance, however, may play a more direct role in the development of the entrepreneurial impulse by extending financial and non financial services to DEUs than 'demand-following' finance. Germany and Japan where enterprises receive both financial and non financial assistance from banks and where banks participate actively in the success of the enterprises operations, are associated with 'supply-leading' finance.

Patrick, however, realised that these phenomenon are not rigid to a country over time and that in actual practice, there is likely to be an interaction of 'supply-leading' and 'demand-following' phenomena with the former dominating at the early stages of the development, becoming less important as the process of growth progresses. He contended that: "this sequential process is also likely to occur within and among specific industries or sectors. One industry may, initially be encouraged financially on a 'supply-leading' basis and as it develops, have its financing shift to 'demand-following' while another industry remains in the 'supply-leading' phase".

#### 2.4 THE ALTERNATIVE HYPOTHESES ABOUT THE EFFECTIVE ROLE OF FINANCIAL INSTITUTIONS IN ECONOMIC DEVELOPMENT

According to Abdi (1977:26) and Gupta (1984:1), the hypotheses put forward on the role of commercial banks in the savings-investment process may be classified into two distinct hypotheses: the structuralist hypothesis and the financial repression hypothesis. But with the recent emergence of Islamic Economics and Islamic Banking one could add a third hypothesis which may be called 'The Islamic Hypothesis' and which I attempt to present and discuss after discussing the former ones.

#### 2.4.1 The Structuralist Hypothesis

According to this hypothesis, the positive role of banks in the saving-investment process, depends on how widespread is the network of these financial institutions and on the overall structure of the financial system which in turn depends on the relative backwardness of the country's economy in question.

This hypothesis is associated with Gerschenkron's analysis of the role of banking systems in the capital formation processes of early industrialisation of Western European countries and the Soviet Union. Using "the relative degree of backwardness" not only as an indicator of the potential of a country's industrialisation, but also as a determinant of the behaviour of its economic institutions, Gerschenkron (1962) classified European countries on the basis of their relative backwardness, with Britain coming first in the list as the most developed, Germany coming mid-way in the classification and Russia as the most backward economy coming last. Despite the questionable criteria he used and the lack of precision of the classification of relative states of backwardness, Gerschenkron concluded that: "As the relative backwardness of an economy increases, the role of the banks in industrial capital formation declines so that in the extreme case of backwardness where the need for capital is large and the confidence in the banking system is low, the structure of the economy is such that not even the banks could supply the necessary capital and entrepreneurship required for industrialisation and development citing Russia as an example of such a case he contends on p.22:

The scarcity of capital in Russia was such that no banking system could conceivably succeed attracting sufficient funds to finance a large scale industrialisation. The standard of honesty in business were so disastrously low, the general distrust of the public so great that no bank could have hoped to attract even such capital funds as were available, and no bank would have successfully engaged in long term credit policies in an economy where fraudulent bankruptcy had been almost elevated to the rank of a general business practice.

For this type of economy the structuralists holds that the mobilisation and allocation of savings would have to be accomplished through substitute institutions such as the state (Abdi 1977:16). Gerschenkron also found that in the more developed economies like Britain, the role

of the banks in financing development was minimal because of the availability of alternative sources of finance. Only in moderately balanced economies where the level of business trust increases and banks' risk aversion decreases, will the banks have an impact on the economic development. Citing Germany as the best example of such category where the banks, in essence, were the prime source of capital and entrepreneurship for this type of industrialisation he contended:

A German bank, as the saying went, accompanied an industrial enterprise from 'cradle to grave' from establishment to liquidation throughout all the vicissitudes of its existence through the device of formally short term but in reality long term current accounts credits... the banks acquired a formidable degree of ascendancy over industrial enterprises which extended far beyond the sphere of financial control into that of entrepreneurial and managerial decisions. According to this approach, the pattern of industrialisation in an economy and the contribution of institutions such as the state and the banks is determined by its relative backwardness.

Goldsmith (1966), who takes the structuralist view using a single equation model, argued that the size of a country's financial structure as proxied by the FIR (Financial Interrelations Ratio) which is equal to the ratio of total financial assets to total wealth, was determined by its per capita income, its rate of growth and the actual rate of inflation. He reached almost the same conclusions reached by Gerschenkron.

Bhatia and Khatkhate (1975), however, examined the relationship of financial development to economic development in 11 African countries, using a narrower definition of FIR because of lack of data, and using alternately currency, demand deposits, time and savings deposits and also their total, as a proportion of GDP, but they did not find any systematic pattern or definitive relationship discerned between financial intermediation and growth in many of the African countries.

#### 2.4.2 The Financial Repression Hypothesis

The financial repression hypothesis is associated with the works of Cameron *et al.* (1972), McKinnon (1973), Shaw (1973), Galbis (1976), Fry (1982) and others. These authors are strong advocates of the efficacy of financial development in contributing significantly to the real growth of LDCs. They emphasise that the financial sector of any economy is invariably growth inducing and that is only when it is

repressed, which, in their view, is often the case, that would it fail to make a positive contribution or acts as an obstacle to real growth. According to them, without distortions of interest rates, the banks will have the largest impact on developing economies. They suggest what they call 'financial liberalisation' or 'financial deepening' as the right solution to the problem (Abdi 1977:26).

The financial repression hypothesis explains the poor performance of banks and other financial institutions in LDCs as being related to the fragmentation of the financial markets caused by administrative constraints on interest rates that impede them to reflect the relative scarcity of resources, ceilings on deposits and loan rates which are in nominal terms and which result in low and often negative real rates of return on financial assets, lending policies which place exclusive emphasis on short term lending and on collateral security, inflation and attempted deflation which aggravates the situation and make it even worse. In such situation, "it is hardly surprising that savers respond to low real returns by reducing their holdings of money and near monies far below what might be considered socially optimum" (McKinnon 1973:69).

The proponents of this hypothesis advocate an increase in the efficiency of bank lending in the form of positive real interest rates policy, in the effective mobilisation of savings and their efficient allocation to alternative investment projects, which is, according to McKinnon (1973:26): "a necessary condition for enlarging the real size of the monetary system and for alleviating financial repression". Thus, according to them, free market forces and financial liberalisation would bring about an optimum financial structure and development which would eliminate the fragmentation of markets and realise the desired economic development. In other words, government should abandon intervention policies, particularly in the financial sphere, thereby creating the conditions for the emergence and growth of financial institutions and let the market forces free to guarantee maximum financial deepening and best efficiency in credit allocation.

Vogel and Buser (1976) tested the repressionist hypothesis for 16 Latin American countries using pooled time-series data for the period



1950-71 and using as proxies for financial deepening currency/GDP; demand deposits/GDP and time deposits/GDP. In one set of regressions, the independent variables were the current and one period lagged values of the actual rate of inflation and real GDP. In another set of regressions, a simple average of the two period values of the independent variables was used. They found in both cases that inflation has a consistently significant and negative effect and concluded that: "these high levels of significance confirm the contribution of inflation to financial repression while the low elasticities for currency and demand deposits strongly support Shaw's view that financial repression may proceed to the point where the willingness to hold those assets that are used for transaction purposes is no longer very responsive to inflation because of the high cost of reversion to barter". But their model and results were criticised of being suffering from serious limitations. It is argued that, although their estimating equations are derived from a portfolio selection model no effort is made to incorporate a variable measuring uncertainty which appears in the theoretical version. Further the real rates of interest were approximated by the actual rates of inflation, a highly questionable assumption (see Gupta 1984:10).

Williamson (1968) using cross-section data for 6 countries (Burma, India, Japan, Korea, Philippines and Taiwan) to examine the effect of real interest rates on savings, found the effect to be either negative or statistically insignificant. He found the effect to be significantly negative for half of the countries (Japan, Taiwan and the Philippines) and speculated that this was probably due to the interdependence between savings and investment decision making in the Asian households. If their saving decisions were dependent on their investment decisions, higher interest rates by discouraging investment would also reduce their savings. This assumed, as Snyder (1974:146) pointed out that: "capital markets are so important that the entrepreneur has no safe outlet for his savings other than in his own business or firm".

In a more elaborate study, Wai (1972) examining the effect of the real interest rates on savings in DCs and LDCs, found only 3 signifi-

cant cases among the LDCs (Tunisia, Brazil and Nicaragua) and all of these cases were negative, thus supporting Williamson's findings. Using two alternate interest rate variables for Latin America, bond yield and deposit rate, he found that both variables had significant and positive effects and that actual inflation had a significantly negative effect. As for the other 23 LDCs from Africa, Asia and the Middle-East neither real nor nominal interest rate and nor inflation rate were significant. For this group interest rate was proxied mostly with the discount rate. From his time-series regressions for both DCs and LDCs he concluded that: "for the overwhelming majority of both developed and developing countries, there were no significant results, either way for both real interest rates or prices. Therefore one cannot draw conclusions from the evidence of the country equations about the influence of prices and interest rates on real savings" (p.127).

In a recent study, Gupta (1984), estimating the real interest rate (ex-ante) and their relationship with the nominal interest rate in 11 Asian countries -to examine the validity of the repressinist's policy prescription that nominal deposits rates should be raised high, which, ceteris paribus, would lead to high real (ex-ante) rates-, found that for 8 of the 11 countries (Burma, India, Malaysia, Pakistan, Philip-pines, Singapore, Sri Lanka and Thailand) the correlation between the nominal interest rate and the real (ex-ante) rates, is negative and that only for Indonesia, Korea and Taiwan is the correlation positive and concluded by saying: "It is clear that for 8 of the 11 countries, increases in nominal deposit rates are no guarantee that the real rate (ex-ante) will also increases. In fact, our results suggest something even stronger, namely that high nominal rates may rather lead to lower or negative real rates (ex-ante). To the extent that financial deepening is a function of real rates, it follows that a policy of high nominal interest rates may not always lead to greater financial deepening".

#### 2.4.3 The Islamic Hypothesis

This hypothesis, about the role of banks in economic development can be inferred from the Koran, the Sunnah, the Ijtihad and the recent literature on Islamic economics and Islamic banking. As mentioned ear-

lier, all the sources of Islam prohibit Riba and allow profit because Allah says in Koran 2:275: Allah has allowed trade and prohibited interest. This led to the fact that the majority of Muslim populations are reluctant to give or take interest and thus, are unwilling to deposit their savings with Interest Based Banks (IBBs). Among those who deal with these banks, do so only in some very confined circumstances where it was not possible for them to avoid transacting with a bank and, even then, they tend to prefer interest-free transactions and interest-free accounts such as current account (Demand Deposit) rather than Time and Savings Deposit accounts which bear interest. And among those who do deposit their savings in time deposit accounts, some tend not to take the interest for themselves but leave it to the bank to dispose of it or draw it but give it to poor people as a charity without expecting a reward for it, hoping thus to escape the chastisement of taking Riba.

Chapra (1985:159) pointed out that: "In practically all Muslim countries the conventional banks have been unable to penetrate a predominant part of the rural as well as urban population because of a number of factors, an important one being the lack of faith of the Muslim masses in interest based banking institutions". For instance, despite the fact that Egypt was the first Islamic country where modern IBBs were introduced in 1856 (see 10.3 below), and despite the fact that many attempts were made to draw a distinction between Riba and interest, claiming that Islam prohibits only interest on consumption loans but not interest on productive loans or on bank deposits and loans thus trying to persuade uneducated people to deposit their savings in the banks and to take loans from the banks at interest (see 4.5 below), the majority of the Muslim Egyptian population, as in many other Islamic countries, has never had dealings with banks. Because of this, capital formation had been impaired. Tarbush (1981) pointed out that: "Until the 1970s only 4% of the Egyptians expected to use banks, do so". However, Traute and Nienhaus (1982:251) commenting on the first successful experiment of Islamic Banking in Egypt (see 3.5 below), wrote:

The basic idea behind the Islamic savings bank experiment was that the process of capital formation in countries like Egypt

cannot work adequately not because of a lack of saving motivation or ability in the population, but because of a lack of financial institutions which are within reach and trustworthy to a vast majority of the population, especially, in rural areas. The non-integration of the majority of the population into the (interest based) financial system may be indicated by the fact that 90% of the population of Islamic countries or even more, are said to have no accounts at all in any of the financial institutions (while in industrial countries this situation is rather reverse).

Arabia (No.42 1985) reported that: "Three quarters of a century of deliberate secularisation have hardly touched more than Turkey's periphery. 90% of Turks are said not to favour using interest based banks".

Parker (1984:17) wrote that: "Stories abound of wealthy Saudis with occasionally as much as £200 million to their names who consistently refuse interests on their bank deposits".

The reluctance of these people to deposit their savings with banks does not mean that these people do not save, on the contrary, they save substantial parts of their incomes, however small their incomes may be for social events, emergencies, and the like, such as building a house, circumcision of children, weddings, Haji (pilgrimage), Eids (religious feasts), etc.. However, these savings are made in real assets in form of jewellery, land, real estate etc., or hoarded in the pillows, under the mattresses or underground. It is true that Islam also prohibits Iktinaz (hoarding) but the prohibition of Riba (interest) is stronger. In fact, it is the most severely prohibited thing in Islam after Shirk (polytheism). It is the only thing that Allah declared war against (see Koran 2:279). As Traute (1983:79) pointed out: "a precondition, however for any change of behaviour from hoarding and 'real assets saving' to financial savings is the creation of financial institutions which would not violate the religious principles of large segments of the population. Only then could the vast majority of the population be integrated into the process of capital formation" .

Muslim economists are strong advocates of the efficacy of financial development in contributing significantly to the real growth of developing countries and they contend that only when it runs against the belief of the majority of the population of a country that it fails to make a positive contribution to its economic development. They argue

that the poor performance of IBBs in mobilising savings in Muslim countries is neither due to structural deficiencies nor to financial repression of interest rates, though both may exist, but is mainly due to the very existence of interest (be it small or large, real or nominal) since the majority of Muslims are insensitive or indifferent to changes in interest rates because of the Islamic injunctions against it. However, if Islamic Shariah is implemented, interest is abolished and banks were PLS based as Shariah prescribes, then the Islamic Banks should be more effective in mobilising the dormant resources that are hoarded.

Muslim economists suggest that if Islamic countries are to develop, they have to reconcile not only their banking system with Islam but all their institutions (political, cultural, social and economic) with the Shariah; for unless this is so, the efficiency of the partially implemented Shariah will be very much limited and/or may even lead to adverse results for Allah says in Koran 13:11: Allah will not change the situation of a people until they change themselves".

Among the earliest proponents of Islamic banking, to name but a few, are Mawdudi (nd); Uzair (1974); Quereshi (1974); El Naggar (1974); Muslehuddin (1974); Mannan (1974); Abdou (1976); Afzalur-Rahman (1979); Siddiqi (1983a, 1983b); and El-Sadr (nd). They all attack the institution of interest not only from the moral, social and religious point of views but from the economic point of view as well, and argue that since Allah has forbidden interest, then there must be something wrong with it, pointing out that interest is at the root of many economic ills such as inflation, unemployment, World debt crisis, etc..

## 2.5 THE RELEVANCE OF THE HYPOTHESES

In order to: (1) assess and test the relevance of the above mentioned hypotheses to Muslim and non Muslim countries, 18 countries have been selected in the following way:

- a- 5 Non Muslim Developed Countries (NMDCs): Austria, Canada, Finland, Japan and Spain
- b- 5 Non Muslim Less Developed Countries (NMLDCs): Guatemala, Guyana, India, Jamaica and Thailand
- c- 4 Muslim Countries With Islamic Banks (MCWIBs): Egypt, Jordan, Pakistan and Sudan.
- d- 4 Muslim Countries With No Islamic Banks (MCWNIIBs) before 1985: Algeria, Morocco, Syria and Turkey.

The selection of countries was based on 3 criteria: (1) The selection was made so as each group is made up of countries with high, middle and low per capita incomes within the same category. (2) Countries in each group were selected from as wide a geographical base as possible and (3) The availability of data (see Table 2.1).

Table 2.1 Criteria used for selecting the countries.

Country	Geographical position	1984 GNP/c in US\$	To represent	High GNP/c	Medium GNP/c	Low GNP/c
Austria	central Europe	9140	NMDCs		*	
Canada	Far West	13280	"	*		
Finland	Northern Eur.	10770	"		*	
Japan	Far East Asia	10630	"		*	
Spain	Southern Eur.	4440	"			*
Guatemala	Latin America	1160	NMLDCs	*		
Guyana	South America	590	"		*	
India	Asia	260	"			*
Jamaica	Central America	1150	"	*		
Thailand	Far East Asia	860	"		*	
Egypt	Middle East	720	MCWIBs		*	
Jordan	"	1570	"	*		
Pakistan	Far East Asia	380	"			*
Sudan	Sub-Sahara	360	"			*
Algeria	North Africa	2410	MCWNIBs	*		
Morocco	"	670	"			*
Syria	Middle East	1620	"		*	
Turkey	Europe	1160	"		*	

Source :The World Bank: World Development Report, 1986

Since there is no precise definition of financial development, financial deepening, economic structure or their measurement, proxies in the form of ratios were used in correlation, regression, tabular and graphical analyses for individual as well as for groups of countries for the period 1965-84, using cross section and time series data. The ratios used are: M2/M1; M2/GDP; QM/M2; M1/M2; TSD/TLD; BTA/GDP; BTF/GDP; TSD/GDP; DD/M1; NIR; CCPI and RIR Where:

GDP = Gross Domestic Product; DD = Demand Deposits;  
M1 = currency outside banks + DD; QM = Quasi Money;  
M2 = M1 + QM; BTA = Banks' Total Assets;  
TSD = Time and Savings Deposits; BTF = Banks' Total Finance;  
TLD = Total Deposits; NIR = Nominal Interest Rates;  
CCPI = Change in Consumer Price Index; RIR = Real interest Rates;

The averages of these ratios together with the averages of GDP/c of each of the selected countries and of their groupings were calculated for the whole period 1965-84 and for its breakdown into two sub-periods: 1965-74 and 1975-84, and presented in tables 2.2 below.

The percentage point changes of the ratios of the 1975-84 period over those of the 1965-74 period are presented in table 2.3 and the results of the correlation and regression analyses are presented in tables 2.4 and 2.5. The reason for dividing the period 1975-84 into two sub-divisions is to gauge the improvement made by every group and every country in the last decade over the previous one.

### Testing the Structuralist Hypothesis

The following ratios: M2/GDP, M1/M2, BTA/GDP and TSD/GDP have been used for the purpose of testing the structuralist hypothesis with the data of the selected countries. The results obtained are as follows:

1- When regressing GDP/c on M2/GDP and correlating between them for all the countries (ALLCs) taken together or for their sub-groups (NMDCs, NMLDCs, MCWIBs and MCWNIBs), it was found that for all groups except for MCWNIBs, there was a significant relationship, this is because, despite the fact that this latter recorded the highest growth in terms of GDP/c (265%) compared to other groups, their M2/GDP growth was the lowest (1.35%) (see Table 2.3). However the regression analysis for individual countries showed that one country of each group has no significant relationship. These countries are: Finland among the NMDCs, Guyana among the NMLDCs, Pakistan among the MCWIBs and Turkey among the MCWNIBs. Finland, because its M2/GDP remained stable around 42% whereas its GDP/c grew by more than 224% from an average of US\$2668 for the period 1965-74 to an average of US\$8655 for the period 1975-84. Guyana, because its M2/GDP grew much faster (ie more than 100%) than its GDP/c which grew by only 47% for the period 1975-84 over the period 1965-74. In fact Guyana recorded the lowest rate of growth in terms of GDP/c and the highest rates of growth in terms of M2/GDP, BTA/GDP, BTF/GDP compared to other countries. As for Pakistan and Turkey, their GDP/c grew at an ARG of 229% and 175% respectively in the decade 1975-84 over the previous one and their M2/GDP declined by -4% and -2.6% respectively

Table 2.2 The Averages of GDP/c and of some selected financial ratios for some selected countries for the periods:  
 (1) 1965-1984; (2) 1965-1974; (3) 1975-1984

Countries or Groupings	GNP/C	M2/M1	M2/GDP	M1/M2	QM/M2	TSD/TLD	BTA/GDP	BTF/GDP	TSD/GDP	DD/M1	DD/M2	NIR	CCPI		RIR
													US\$	%	
Austria	(1)	2300	314.5	56.5	32.0	68.0	81.9	67.2	56.1	38.5	47.2	15.0	4.88	4.96	-0.09
	(2)	8018	510.5	75.5	20.2	79.8	88.3	124.9	91.7	60.4	51.8	10.5	4.72	5.34	-0.62
	(3)	5159	412.5	66.0	26.1	73.9	85.1	96.1	73.9	49.4	49.5	12.8	4.80	5.15	-0.35
Canada	(1)	4185	214.3	38.6	47.6	52.4	58.8	44.3	34.8	20.3	76.6	36.6	8.71	6.78	1.93
	(2)	11903	389.2	46.5	26.5	73.5	79.5	61.3	48.2	34.3	71.4	19.0	11.21	8.79	2.42
	(3)	8044	301.8	42.6	37.1	63.0	69.1	52.8	41.5	27.3	74.0	27.8	9.96	7.79	2.17
Finland	(1)	2668	538.4	42.0	18.7	81.3	87.6	46.2	43.7	34.2	61.6	11.6	7.68	6.98	-0.70
	(2)	8655	523.2	42.4	19.2	80.8	85.2	55.9	48.6	34.3	72.8	14.0	8.85	10.86	-2.01
	(3)	5661	530.8	42.2	18.9	81.1	86.4	51.1	46.1	34.2	67.2	12.8	8.26	8.92	-0.66
Japan	(1)	2128	250.1	80.0	40.0	60.0	67.2	93.8	89.2	52.2	77.1	30.9	6.19	8.06	-1.87
	(2)	8155	285.1	89.5	35.4	64.6	70.6	109.5	102.9	58.0	75.8	26.9	5.52	5.61	-0.09
	(3)	5142	267.6	84.8	37.7	62.3	68.9	101.6	96.1	55.1	76.5	28.9	5.86	6.84	-0.98
Spain	(1)	1278	240.3	74.7	41.9	58.1	68.4	77.0	72.1	45.1	66.1	27.7	5.44	8.22	-2.78
	(2)	4145	300.3	82.0	33.8	66.3	73.7	97.1	83.5	54.3	69.5	23.6	7.80	16.01	-8.21
	(3)	2711	270.3	78.4	37.8	62.2	71.1	87.1	77.8	49.7	67.8	25.6	6.62	12.12	-5.50
NMDCs	(1)	2512	265.7	54.0	37.7	62.3	70.4	62.3	55.3	34.7	71.5	27.0	6.08	6.60	-0.52
	(2)	8175	359.9	61.6	28.2	71.8	78.0	81.6	69.2	44.3	71.8	20.3	7.62	9.32	-1.70
	(3)	5343	312.8	57.8	33.0	67.0	74.2	72.0	62.3	39.5	71.6	23.6	6.85	7.96	-1.11
Guatemala	(1)	360	194.5	19.0	52.2	47.8	67.5	16.4	12.9	9.2	43.6	22.7	4.10	3.71	0.39
	(2)	958	235.8	23.1	42.9	57.1	74.9	20.6	16.1	13.2	44.4	19.1	7.80	10.10	-2.30
	(3)	659	215.2	21.0	47.5	52.5	71.2	18.5	14.5	11.2	44.0	20.9	5.95	6.88	-0.93
Guyana	(1)	364	251.5	32.4	39.9	60.1	79.0	25.3	20.5	19.5	39.8	15.9	6.40	4.73	1.67
	(2)	535	252.3	64.9	40.3	59.7	75.6	70.9	54.3	39.8	47.3	19.1	10.35	14.75	-4.40
	(3)	449	251.9	48.7	40.1	59.9	77.3	48.1	37.4	29.6	43.5	17.5	8.38	9.75	-1.37
India	(1)	99	149.3	25.2	67.2	32.8	56.1	17.7	16.6	8.3	38.3	25.6	6.10	9.72	-3.62
	(2)	210	230.6	38.4	45.0	55.0	73.1	33.0	29.9	21.1	42.4	19.6	9.40	6.76	2.64
	(3)	155	190.0	31.8	56.1	43.9	64.6	25.3	23.3	14.7	40.4	22.6	7.75	8.24	-0.49
Jamaica	(1)	727	282.4	32.2	35.5	64.5	74.2	33.3	28.9	20.8	63.2	22.4	6.05	8.32	-2.27
	(2)	1276	267.3	38.9	38.3	61.7	71.5	42.4	35.6	24.4	63.9	24.5	10.40	18.84	-8.44
	(3)	1001	274.9	35.6	36.9	63.1	72.9	37.9	32.3	22.6	63.5	23.4	8.23	13.58	-5.35
Thailand	(1)	195	214.8	30.1	48.4	51.6	74.9	28.4	23.6	15.8	35.0	16.9	8.60	5.77	2.83
	(2)	599	393.2	40.6	26.8	73.2	88.7	45.3	38.7	30.0	33.7	9.2	11.85	7.71	4.14
	(3)	397	302.5	35.3	37.6	62.4	81.8	36.9	31.2	22.9	34.4	13.1	10.23	6.74	3.49
NMLDCs	(1)	349	200.4	28.4	50.7	49.3	71.9	25.6	21.6	14.2	37.5	19.0	6.25	6.45	-0.20
	(2)	716	333.7	39.0	31.2	68.8	84.7	41.6	35.5	27.1	38.9	12.3	9.96	11.62	-1.66
	(3)	532	267.1	33.7	41.0	59.1	78.3	33.6	28.6	20.6	38.2	15.6	8.11	9.04	-0.93



Table 2.2 (cont Inued)

Countries or Groupings	GDP/C US\$	M2/GDP		M1/M2		QM/M2		TSD/ILD		BIA/GDP		BTF/GDP		TSD/GDP		DD/MI		DD/M2		NIR		CCPI		RIR	
		%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Egypt	(1) 212 (2) 556 (3) 384	130.1 163.5 146.8	37.5 66.5 52.0	76.9 62.7 69.8	23.1 37.3 30.2	46.6 53.4 61.8	43.9 79.8 40.1	31.7 48.5 40.1	8.6 26.5 17.6	34.3 37.7 36.0	26.4 23.7 25.1	5.00 7.70 7.35	5.36 13.28 9.32	-0.36 -3.58 -1.97											
Jordan	(1) 252 (2) 1088 (3) 670	127.4 164.4 145.9	67.6 101.1 84.4	78.6 61.9 70.2	21.4 38.2 29.8	46.9 59.5 53.2	40.6 90.0 65.3	27.9 64.6 46.3	14.0 38.2 26.1	31.1 39.6 35.3	24.2 24.5 24.3	5.23 5.90 5.56	6.61 9.42 8.01	-1.38 -3.52 -2.45											
Pakistan	(1) 85 (2) 278 (3) 181	143.0 150.5 146.8	41.4 39.8 40.6	70.0 66.5 68.3	30.0 33.5 31.4	49.9 48.7 49.3	34.9 36.2 35.5	31.0 31.9 31.5	12.4 13.4 12.9	43.0 53.0 48.0	30.1 35.2 32.7	5.80 9.80 7.80	9.12 9.68 9.40	-3.30 0.12 -1.60											
Sudan*	(1) 125 (2) 315 (3) 220	114.3 118.8 116.6	18.7 30.3 24.5	87.6 84.3 85.9	12.5 15.7 14.1	24.8 29.2 27.0	13.7 25.0 19.4	12.5 15.1 13.8	2.2 4.9 3.5	39.2 45.2 42.2	34.3 38.0 36.2	5.00 7.25 6.13	5.09 22.50 13.82	-0.09 -15.30 -7.69											
MCWIBs	(1) 168 (2) 559 (3) 364	136.2 157.1 146.6	47.4 56.5 51.9	73.5 64.1 68.8	26.5 36.0 31.2	48.8 54.2 51.5	36.4 51.8 44.1	30.0 40.8 35.4	12.5 20.3 16.4	37.9 46.4 42.1	27.9 29.7 28.8	5.26 8.16 6.71	6.55 13.73 10.14	-1.29 -5.57 -3.43											
Algeria*	(1) 312 (2) 1636 (3) 974	106.9 107.3 107.1	52.2 61.2 56.7	93.6 92.2 92.9	6.4 6.6 6.5	10.8 13.4 12.1	35.3 57.5 46.4	31.5 53.5 42.5	3.6 4.8 4.2	54.3 55.0 54.6	50.6 51.3 51.0	3.50 5.45 4.48	4.00 9.88 6.94	-0.50 -4.43 -2.46											
Morocco	(1) 278 (2) 691 (3) 484	107.2 116.9 112.1	32.6 41.5 37.0	93.3 85.6 89.5	6.7 14.4 10.6	11.0 21.7 16.3	19.8 28.5 24.1	17.4 26.0 21.7	2.2 6.0 4.1	58.6 60.4 59.5	54.7 51.8 53.2	3.60 5.55 4.58	3.59 9.81 6.70	0.01 -4.26 -2.12											
Syria *	(1) 287 (2) 1258 (3) 773	107.2 110.9 109.0	33.1 43.5 38.3	93.3 90.2 91.8	6.7 9.8 8.2	26.5 22.9 24.7	24.7 39.8 32.2	21.9 33.9 27.9	2.2 4.3 3.3	19.9 36.5 28.2	18.6 32.9 25.7	5.00 5.00 5.00	4.51 11.75 8.13	0.49 -6.75 -3.13											
Turkey	(1) 424 (2) 1167 (3) 796	124.4 148.7 136.5	28.7 27.9 28.3	80.6 71.1 75.8	19.4 28.9 24.2	31.7 35.9 33.8	35.8 39.8 37.8	29.0 27.7 28.4	7.9 8.2 8.1	66.5 68.0 67.3	53.5 48.4 51.0	8.23 19.88 14.05	9.11 43.14 26.13	-0.88 -23.26 -12.08											
MCUNIBs	(1) 325 (2) 1188 (3) 757	110.2 126.8 118.5	37.7 38.3 38.0	90.8 80.2 85.5	9.2 19.6 14.4	17.3 28.2 22.8	29.2 41.7 35.4	25.2 33.3 29.2	4.1 7.3 5.5	54.5 58.7 56.6	49.4 47.2 48.3	5.08 8.97 7.03	5.30 18.65 11.97	-0.22 -9.68 -4.95											
ALLCs	(1) 904 (2) 2858 (3) 1881	197.6 232.9 215.3	42.1 47.8 45.0	50.7 43.0 46.9	49.3 56.8 53.1	64.9 70.2 67.6	42.3 55.0 48.6	36.8 45.9 41.3	21.3 27.2 24.3	53.7 55.9 54.8	27.2 24.1 25.7	5.72 8.69 7.21	6.25 13.01 9.64	-0.54 -4.32 -2.43											

Notes: \* For the periods (1):1964-1973 ; (2):1974-1983 and (3):1964-1983  
Source: IMF, International Financial Statistics, Various issues

Table 2.3 The Growth of the average GDP/c and of the financial ratios of the period 1975-1984 over those of the 1965-1974 period for the selected countries.

Countries or Groupings	GDP/C US\$	M2/M1	M2/GDP	M1/M2	GM/M2	TSD/TLD	BTA/GDP	BTF/GDP	TSD/GDP	DD/M1	DD/M2	NIR	CCPI	RIR
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Austria	248.7	62.3	33.6	-36.9	17.4	7.8	85.8	63.5	57.1	9.9	-30.0	-3.3	7.7	-588.9
Canada	184.4	81.6	20.4	-44.3	40.3	35.1	38.3	38.7	69.1	-6.8	-48.2	28.7	29.6	25.4
Finland	224.3	-2.8	1.0	2.7	-0.7	-2.7	21.0	11.3	0.3	18.1	21.0	15.2	55.6	-187.1
Japan	283.3	14.0	11.9	-11.5	7.7	5.0	16.8	15.4	11.0	-1.7	-12.9	-10.8	-30.4	95.2
Spain	224.4	25.0	9.8	-19.3	14.1	7.9	26.1	15.8	20.4	5.1	-14.8	43.4	94.8	-195.3
NMDCs	225.5	35.4	14.0	-25.2	15.3	10.7	31.0	25.2	27.4	0.4	-24.8	25.3	41.2	-226.9
Guatemala	166.3	21.2	21.5	-17.8	19.5	10.9	25.5	24.6	43.4	1.8	-15.9	90.2	172.2	-689.7
Guyana	47.2	0.3	100.6	1.0	-0.6	-4.3	180.6	164.4	103.5	18.6	20.1	61.7	211.8	-363.5
India	111.6	54.5	52.4	-32.8	67.6	30.5	86.6	79.5	153.4	10.8	-23.4	54.1	-30.5	172.9
Jamaica	75.4	-5.4	20.8	7.9	-4.3	-3.6	27.2	23.1	17.0	1.2	9.4	71.9	126.4	-271.8
Thailand	207.8	85.7	35.0	-44.6	41.9	18.5	59.5	63.8	90.1	-3.7	-45.6	37.8	33.6	46.3
NMLDCs	105.1	66.5	37.6	-38.5	39.7	17.8	62.7	64.4	91.1	3.6	-35.3	59.4	80.2	-730.0
Egypt	163.3	25.7	77.4	-18.5	61.5	29.4	81.6	52.8	206.6	9.8	-10.2	94.0	174.8	-894.4
Jordan	332.3	29.1	49.5	-21.2	78.4	26.9	121.8	131.1	173.1	27.3	1.2	12.8	42.5	-155.1
Pakistan	229.1	5.2	-4.0	-5.0	11.8	-2.3	3.7	2.8	7.4	23.2	16.9	69.0	6.1	103.6
Sudan	151.5	3.9	62.2	-3.8	26.0	17.5	81.9	21.0	127.0	15.2	10.8	45.0	342.0	-16900.0
MCWIBs	232.6	15.4	19.0	-12.8	35.5	11.2	42.3	36.3	62.0	22.4	6.7	55.1	109.6	-331.9
Algeria	424.1	0.3	17.3	-1.5	3.6	24.1	63.0	69.7	34.3	1.3	1.4	55.7	147.0	-786.0
Morocco	148.2	9.1	27.6	-8.3	113.5	98.3	44.3	49.3	170.9	3.0	-5.3	54.2	173.3	-427.0
Syria	338.2	3.5	31.4	-3.3	46.5	-13.8	61.5	54.8	93.7	83.1	77.0	00.0	160.5	-1477.5
Turkey	175.1	19.6	-2.6	-11.8	49.0	13.2	11.2	-4.6	4.0	2.3	-9.5	141.6	373.6	-2543.2
MCWIBs	265.0	15.1	1.4	-11.7	112.8	63.3	43.0	32.7	79.9	7.7	-4.5	76.6	251.9	-4300.0
ALLCs	216.0	17.9	13.6	-15.3	15.5	8.2	30.1	24.8	27.7	4.0	-11.4	51.9	108.2	-700.0

Source: table 2.2 above.

(see table 2.3). This is also reflected in their negative correlation ratios of -4% and -15% respectively (see table 2.4)

2- When regressing and correlating GDP/c and M1/M2, it was found that there are significant negative relationships for all the countries except for Finland, Guyana and Jamaica which recorded non significant positive relationships and Sudan which recorded a non significant negative relationship. The relationship is also significantly negative for all the groups. This means that the higher the income the lower the use of money and the higher the use of quasi-money. The negative relationships do not mean that the structuralist hypothesis is not valid here. On the contrary, this does give support to the structuralist hypothesis in the sense that with the development of financial and economic structure of the country, people switch from money to quasi-money (from currency and demand deposits to time and savings deposits) and this is to be expected. Concerning the countries Finland, Guyana and Jamaica, they recorded positive, albeit not significant relationship because their ratios of M1/M2 for 1975-84 were slightly greater than those of 1965-74, their rates of growth were 2.7%, 1% and 7.9% respectively.

3- When regressing GDP/c on BTA/GDP and correlating between them for the groups of countries, significant relationships were found to exist for every group. However, the correlation and regression analyses for individual countries revealed that there was no evidence of a strong relationship for Guyana, Pakistan and Turkey. Guyana because its BTA/GDP grew by a staggering 180.6% (the highest compared to those of other countries) in 1975-84 as compared to 1965-74 while its GDP/c grew by only 47% (the lowest compared to those of other countries). As for Pakistan and Turkey, the opposite case happened since their BTA/GDP ratios grew by only 3.7% and 11.2% respectively while their GDP/c grew by 229.1% and 175.1% respectively for the same period.

4- When regressing GDP/c on TSD/GDP and correlating between them for the groups of countries it was found that for all groups there was a significant relationship, however no significant relationship was found to exist for a number of countries when taken individually. For instance both Finland and Japan among the NMDCs recorded a non signifi-

Table 2.4 Correlation and Regression Analysis to Test the Relevance of the Structuralist Hypothesis

Countries or Groupings	GDP/c on M2/GDP			GDP/c on M1/M2			GDP/c on BTA/GDP			GDP/c on TSD/GDP										
	C.R	R.sq	F.V	SIG	P.V	C.R	R.sq	F.V	SIG	P.V	C.R	R.sq	F.V	SIG	P.V					
Austria	96	92	195	**	0.00	-97	94	279	**	0.00	95	91	179	**	0.00	96	93	224	**	0.00
Canada	88	78	64	**	0.00	-90	81	79	**	0.00	95	90	157	**	0.00	92	85	99	**	0.00
Finland	27	7	1	ns	0.25	8	1	0	ns	0.74	78	61	28	**	0.00	18	3	1	ns	0.44
Japan	83	70	41	**	0.00	-83	68	39	**	0.00	91	82	81	**	0.00	34	11	2	ns	0.15
Spain	55	31	8	*	0.01	-79	63	31	**	0.00	76	58	25	**	0.00	72	52	19	**	0.00
NMDCs	91	83	85	**	0.00	-98	96	381	**	0.00	97	95	310	**	0.00	93	86	106	**	0.00
Guatemala	75	56	23	**	0.00	-76	57	24	**	0.00	84	71	43	**	0.00	79	63	31	**	0.00
Guyana	37	14	3	ns	0.11	18	3	1	ns	0.44	31	10	2	ns	0.18	30	9	2	ns	0.19
India	96	92	210	**	0.00	-98	96	379	**	0.00	97	95	336	**	0.00	97	94	288	**	0.00
Jamaica	54	30	8	*	0.01	21	5	1	ns	0.37	59	35	10	**	0.01	38	14	3	ns	0.10
Thailand	84	71	44	**	0.00	-92	85	105	**	0.00	90	81	79	**	0.00	90	81	79	**	0.00
NMLDCs	87	75	54	**	0.00	-96	92	200	**	0.00	92	84	94	**	0.00	90	80	73	**	0.00
Egypt	94	88	131	**	0.00	-92	84	92	**	0.00	96	93	228	**	0.00	91	83	89	**	0.00
Jordan	82	67	36	**	0.00	-96	92	219	**	0.00	96	93	225	**	0.00	96	93	241	**	0.00
Pakistan	-4	0	0	ns	0.87	-66	44	14	**	0.00	39	15	3	ns	0.09	45	20	4	ns	0.05
Sudan	60	36	10	**	0.01	-39	15	3	ns	0.00	59	35	10	**	0.01	50	25	6	*	0.03
MCWIBs	81	65	33	**	0.00	-95	90	161	**	0.00	95	91	172	**	0.00	93	87	116	**	0.00
Algeria	50	25	6	*	0.03	-51	26	6	*	0.02	53	28	7	*	0.02	59	34	9	**	0.01
Morocco	87	76	56	**	0.00	-86	73	50	**	0.00	83	69	39	**	0.00	88	78	63	**	0.00
Syria	83	70	41	**	0.00	-93	86	108	**	0.00	96	92	195	**	0.00	93	87	120	**	0.00
Turkey	-15	-2	0	ns	0.54	-37	14	3	ns	0.10	39	15	3	ns	0.09	1	0	0	ns	1.00
MCWNIBs	0	0	0	ns	1.00	-82	67	36	**	0.00	71	50	18	**	0.00	73	53	20	**	0.00
ALLCs	77	60	26	**	0.00	-96	91	190	**	0.00	91	83	87	**	0.00	89	78	65	**	0.00

Notes: ns Not Significant; \* Significant at 5%; \*\* Significant at 1%  
Source: Table 2.2 above.

cant relationship because, whereas their GDP/c grew by 224% and 283% respectively for the period 1975-84 over the period 1965-74, their TSD/GDP ratios grew only by 0.29% and 10.95% respectively. This can also be seen from the low correlation ratios which were 18% and 34% respectively (see table 2.4). Guyana and Jamaica among the NMLDCs also experienced a non significant relationship. Guyana, because its TSD/GDP grew faster than its GDP/c (103% as against 47%) and Jamaica, because the opposite case happened since its TSD/GDP grew by only 16.99% compared to the growth of its GDP/c which reached 75.41%. The correlation ratios for both countries were 30% and 38% respectively. Turkey among the MCWNIBs also recorded a non significant relationship because its TSD/GDP did not grow as fast as its GDP/c. Its TSD/GDP grew by only 4.04% for the period 1975-84 over the period 1965-74 whereas its GDP/c grew by 175%. The very low correlation ratio of 1.4% confirms it.

#### **Testing the Repressionist and the Islamic hypotheses**

Because the Muslim economists hold a diametrically opposed theory to that of the Financial Repression theorists especially concerning the relationship between interest rates and financial development, the correlation and regression regression analyses of the following ratios were carried out in order to test both hypotheses: TSD/GDP on RIR; BTA/GDP on RIR; TSD/TLD on RIR and TSD/BTA on RIR (see Table 2.5). The results obtained were as follows:

1- When regressing TSD/GDP on RIR and correlating them, it was found that, with the exception of Finland which showed a significant positive relationship all the other countries whether taken individually or in groups, have either a negative or a non significant positive relationship. The lowest near significant negative relationships were those of the Islamic countries like Sudan, Algeria, Morocco and Syria. In fact Sudan and Morocco have significant negative relationships. This to some extent give support to the Islamic hypothesis and reject the repression hypothesis not only as far as the Islamic countries are concerned but also for non Islamic countries. Finland is the only country where there is a significant positive relationship suggesting that its people are sensitive to interest rates and since their RIR went down

Table 2.5 Correlation and Regression Analysis to Test the Relevance of the Reversionist and the Islamic hypotheses

Countries or Groupings	TSD/GDP ON RIR			BTA/GDP on RIR			TSD/TLD ON RIR			TSD/BTA ON RIR					
	C.R	R.sq	F.V	SIG	P.V	C.R	R.sq	F.V	SIG	P.V	C.R	R.sq	F.V	SIG	P.V
Austria	-12	1.4	0.3	ns	0.63	-13	1.6	0.3	ns	0.60	2	0.0	0.0	ns	0.95
Canada	20	3.8	0.7	ns	0.41	25	6.3	1.2	ns	0.29	15	2.3	0.4	ns	0.53
Finland	69	47.6	16.4	*	0.00	8	0.7	0.1	ns	0.73	71	49.8	17.9	**	0.00
Japan	39	15.0	3.2	ns	0.09	25	6.3	1.2	ns	0.29	51	25.8	6.3	**	0.02
Spain	-36	12.7	2.6	ns	0.12	-39	15.5	3.3	ns	0.09	-2	0.0	0.0	ns	0.94
NMDCs	-5	0.2	0.0	ns	0.85	-10	1.1	0.2	ns	0.66	4	0.1	0.0	ns	0.88
Guatemala	-30	8.7	1.7	ns	0.21	-27	7.2	1.4	ns	0.25	-20	4.1	0.8	ns	0.39
Guyana	-34	11.4	2.3	ns	0.15	-33	10.9	2.2	ns	0.15	32	10.4	2.1	ns	0.17
India	20	4.0	0.8	ns	0.40	26	6.6	1.3	ns	0.27	14	1.9	0.4	ns	0.56
Jamaica	25	6.3	1.2	ns	0.29	-9	0.8	0.1	ns	0.71	66	43.3	13.7	**	0.00
Thailand	17	2.9	0.5	ns	0.47	13	1.6	0.3	ns	0.60	-2	0.0	0.0	ns	0.95
NMLDCs	-16	2.6	0.5	ns	0.50	-22	5.0	1.0	ns	0.34	-29	8.3	1.6	ns	0.22
Egypt	-19	3.5	0.7	ns	0.43	-30	8.8	1.7	ns	0.21	-18	3.3	0.6	ns	0.45
Jordan	0	0.0	0.0	ns	0.99	-8	0.7	0.1	ns	0.73	17	2.7	0.5	ns	0.49
Pakistan	42	17.6	3.8	ns	0.07	17	2.9	0.5	ns	0.47	38	14.3	3.0	ns	0.10
Sudan	-58	33.6	9.1	**	0.01	-58	33.7	9.2	**	0.01	-47	22.0	5.1	*	0.04
MCWIBs	-22	4.7	0.9	ns	0.36	-32	10.5	2.1	ns	0.16	6	0.3	0.1	ns	0.80
Algeria	-36	12.6	2.6	ns	0.13	-41	17.0	3.7	ns	0.07	-43	18.7	4.1	ns	0.06
Morocco	-46	21.3	4.9	*	0.04	-43	18.2	4.0	ns	0.06	-44	19.7	4.4	ns	0.05
Syria	-42	18.0	3.9	ns	0.06	-43	18.7	4.1	ns	0.06	47	22.0	5.1	*	0.04
Turkey	26	6.9	1.3	ns	0.26	1	0.0	0.0	ns	0.98	21	4.4	0.8	ns	0.38
MCWNIBs	-13	1.7	0.3	ns	0.58	-59	36.6	9.43	**	0.01	-14	1.9	0.3	ns	0.57
ALLCs	-45	20.4	4.6	*	0.05	-54	29.5	7.52	**	0.01	-40	16.1	3.5	ns	0.08

Notes: ns Nbt Significant; \* Significant at 5%; \*\* Significant at 1%  
Source: Table 2.2 above.

from an average of -0.7% in 1965-74 to an average of -2% in 1975-84 at a highly negative rate of growth of -187% so did its rate of savings or in fact it merely grew by 0.3% during the same period.

2- When regressing BTA/GDP on RIR and correlating between them, it was found that for all groups of countries the relationship is a negative one and that it is more negative in the case of the Islamic countries than it is in the case of the non Islamic ones. In fact it is significantly negative in the case of the MCWNIBs (see the correlation ratios in table 2.5). Concerning individual countries, none of the countries except Sudan had a significant relationship. They all had either a very low positive relationship or a negative one. The significant relationship for Sudan is not a positive but a negative one, which suggests that when interest rates go up, BTA/GDP goes down significantly and vice versa. In fact as can be seen from table 2.3 the BTA/GDP ratio for Sudan grew from 13.7% in 1964-73 to 25% in 1974-83 by an ARG of 81.9% while its RIR went down from -0.09% to -15.3% by an unbelievable -16900% The next lowest and near significant negative relationships are those of the Islamic countries: -41% for Algeria, -43% for Morocco, -43% for Syria (see table 2.5).

3- When regressing TSD/TLD on RIR and correlating them, it was found that none of the groups have a significant relationship, however for individual countries, significant positive relationship were recorded by Finland and Japan among the NMDCs and by Jamaica among the NMLDCs. Among the countries which recorded negative relationships between TSD/TLD and RIR, the Islamic countries again: Algeria (-43%), Morocco (-44%), Syria (-47%) and Sudan (-47%), all have the lowest correlation ratios. In fact the relationship is significantly negative for Morocco, Syria and Sudan (see Table 2.5).

4- When regressing TSD/BTA on RIR and correlating between them, it was found that none of the groups has a significant relationship. As for individual countries, only Guyana and Jamaica among the NMLDCs and Pakistan among the MCWIBs, recorded significant positive relationships. Other countries either have non significant positive relationships or have negative ones. The lowest negative relationships were recorded on-

ce again by The Islamic countries (-18% for Egypt, -40% for Syria, -54% for Morocco, and -60% for Sudan). In fact it was significantly negative for Syria, Morocco and Sudan (see Table 2.5) which give support, to some extent, once more to the Islamic hypothesis which affirms that most Muslims, though, may be not all of them, are reluctant to deal in interest based transactions and that the solution to such a situation is to offer them the Islamic financial institutions that do not conflict with their belief in Islam and its Shariah which prohibits Riba and permits trade (in other words profits) and PLS system.

Extra support for the Islamic hypothesis may also be seen in Table 2.6 and in Figures 2.1-2.10 below, showing the trend of these ratios for the groups of countries (NMDCs, NMLDCs, MCWIBs, MCWNIBs and ALLCs). It is quite clear that the ratios: M2/M1, QM/GDP, QM/M2, TSD/GDP, TSD/BTA and TSD/TLD involving interest, are the lowest for the Islamic countries (MCWIBs and MCWNIBs) and highest for the non Islamic countries (NMDCs and NMLDCs) and the ratios: M1/M2, M1/GDP, DD/BTA and DD/TLD, not involving interest, show the opposite, thus, confirming the Muslim economists' claim that the majority of Muslims do not deal with Interest based banks and when they do, they do so through interest free instruments such as depositing their savings in current accounts rather than in interest bearing time and savings accounts.

Table 2.6 Trend of the selected average ratios for the different groups

Ratios	NMDCs	NMLDCs	MCWIBs	MCWNIBs	ALLCs
Ratios Involving Interest					
M2/M1	312.8	267.1	146.6	118.5	215.3
QM/GDP	39.0	20.7	16.6	5.5	24.1
QM/M2	67.0	59.1	31.2	14.4	53.1
TSD/GDP	39.5	20.6	16.4	5.5	24.3
TSD/BTA	55.1	59.7	36.6	15.8	50.0
TSD/TLD	74.2	78.3	51.5	22.8	67.6
Ratios Not Involving Interest					
M1/M2	33.0	41.0	68.8	85.5	46.9
M1/GDP	18.8	13.4	35.4	32.5	20.9
DD/BTA	19.5	16.2	34.4	54.4	24.1
DD/TLD	25.8	21.7	48.5	77.2	32.4

Source: IMF International Financial Statistics, various issues.



Figure 2.1 Comparison of the Ratios M2/M1 for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

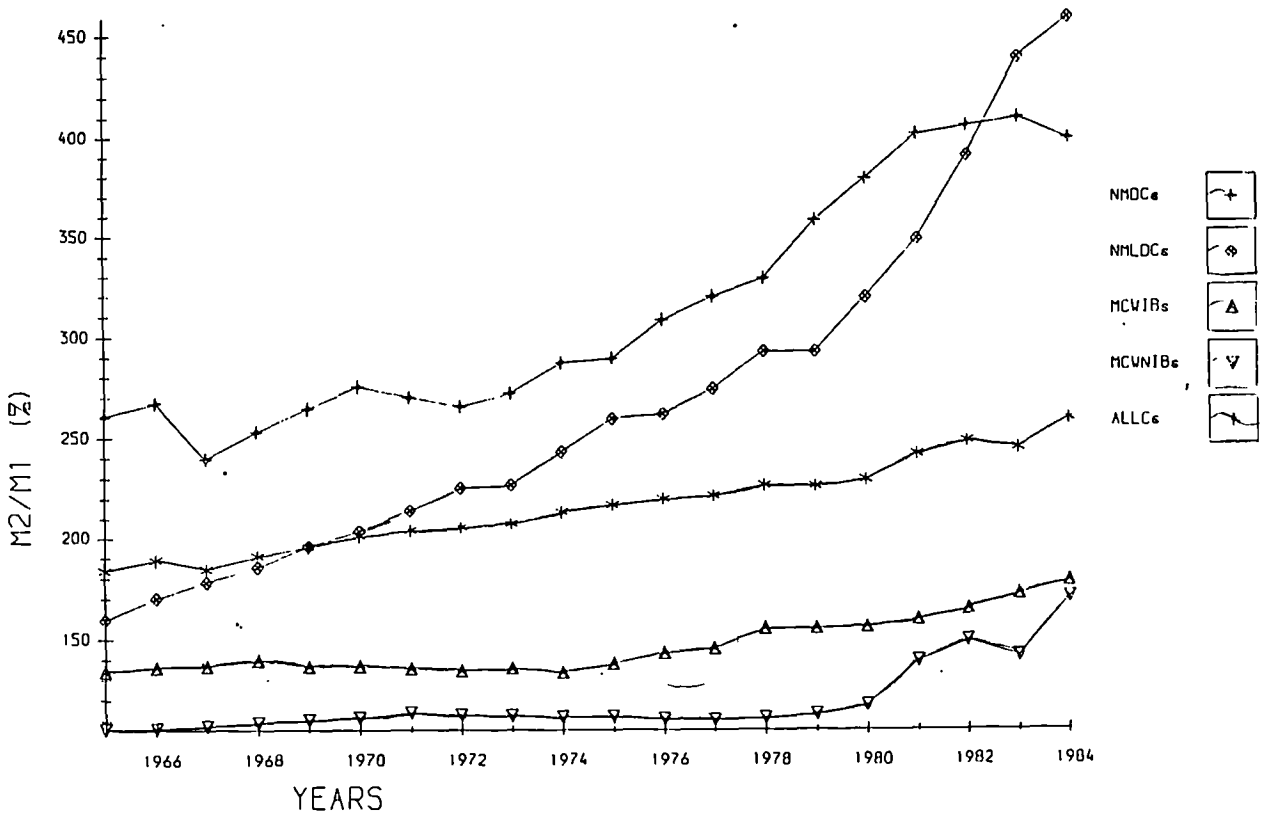


Figure 2.2 Comparison of the Ratios QM/GDP for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

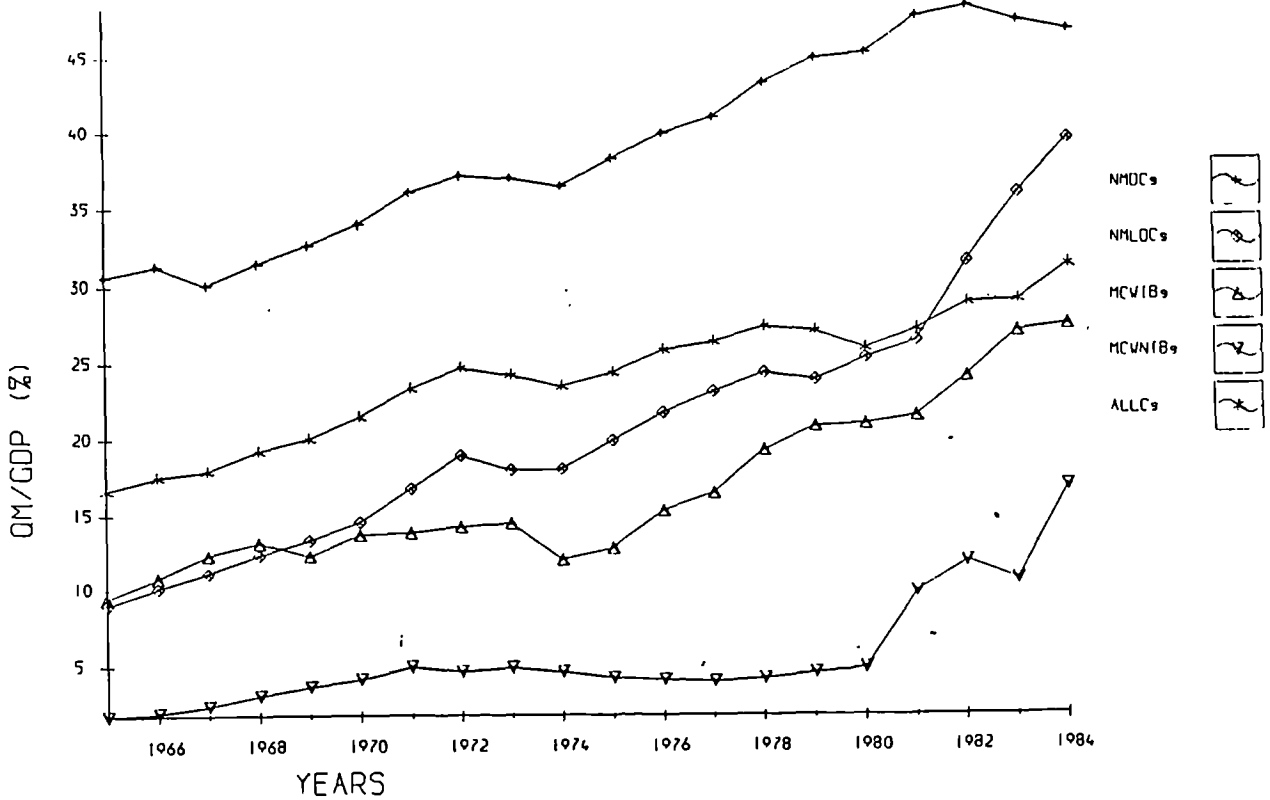


Figure 2.3 Comparison of the Ratios QM/M2 for NNDCs, NMLDCs, MCWIBs, MCVNIBs & ALLCs

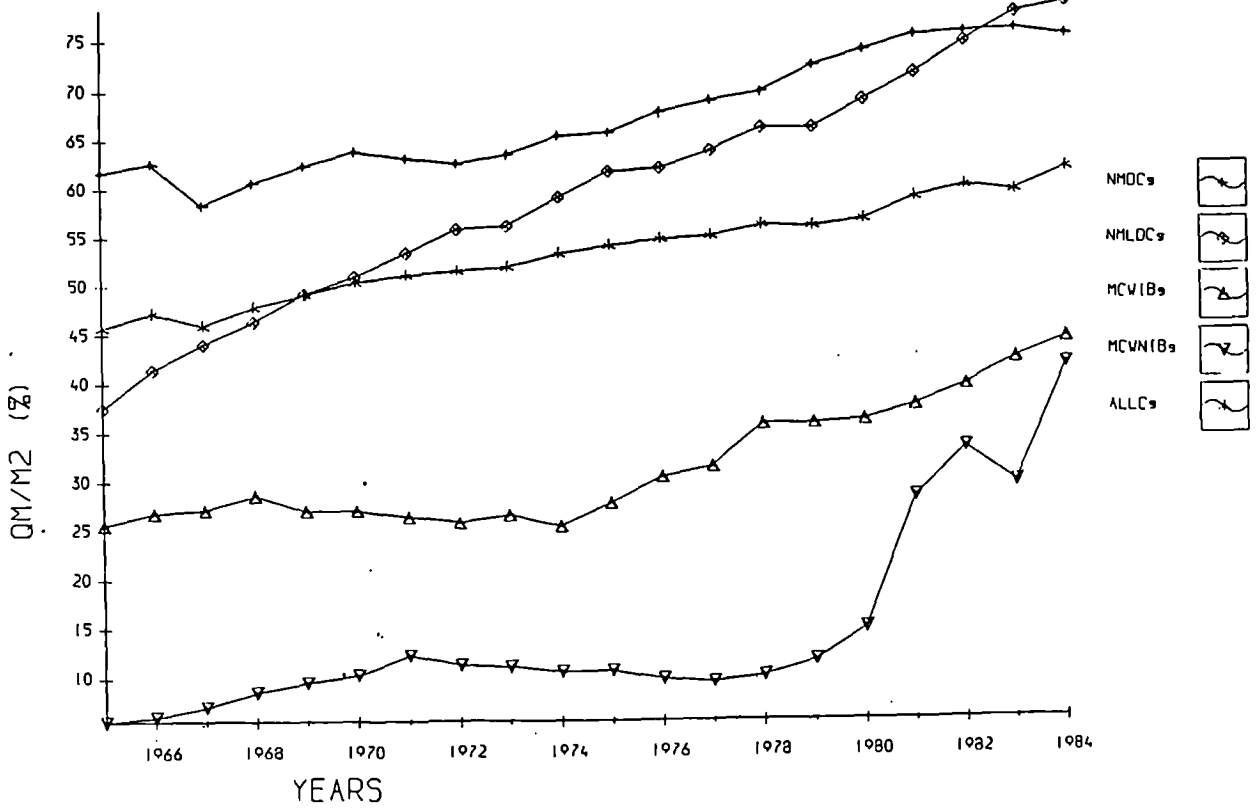


Figure 2.4 Comparison of the Ratios TSD/GDP for NNDCs, NMLDCs, MCWIBs, MCVNIBs & ALLCs

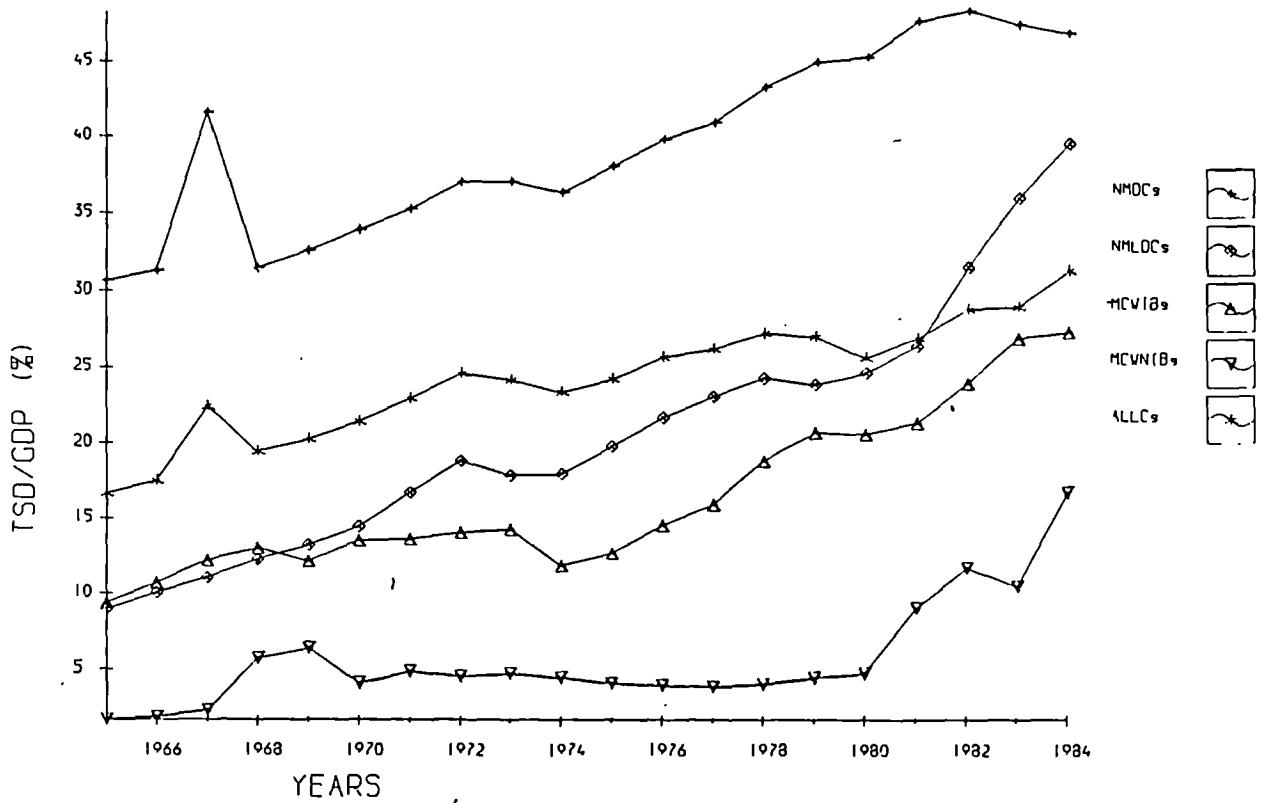


Figure 2.5 Comparison of the Ratios TSD/BTA for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

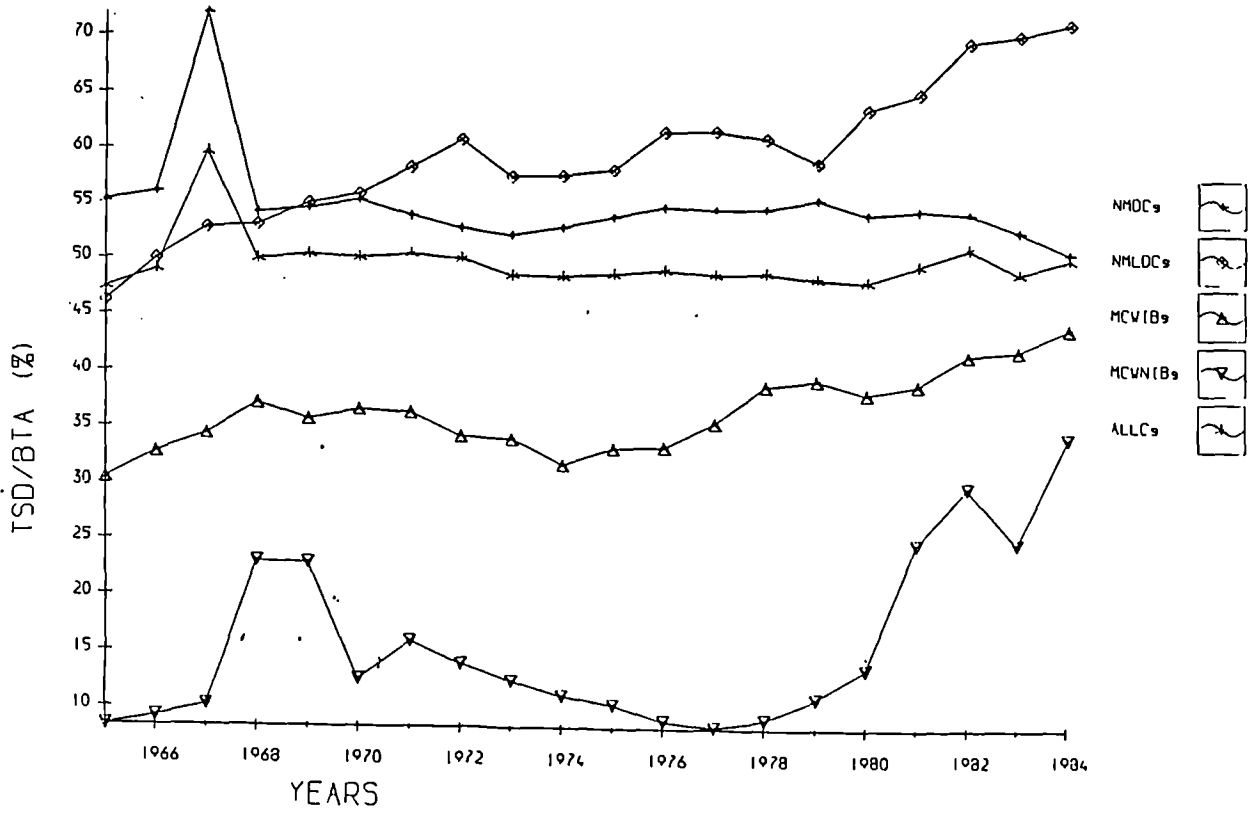


Figure 2.6 Comparison of the Ratios TSD/TLD for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

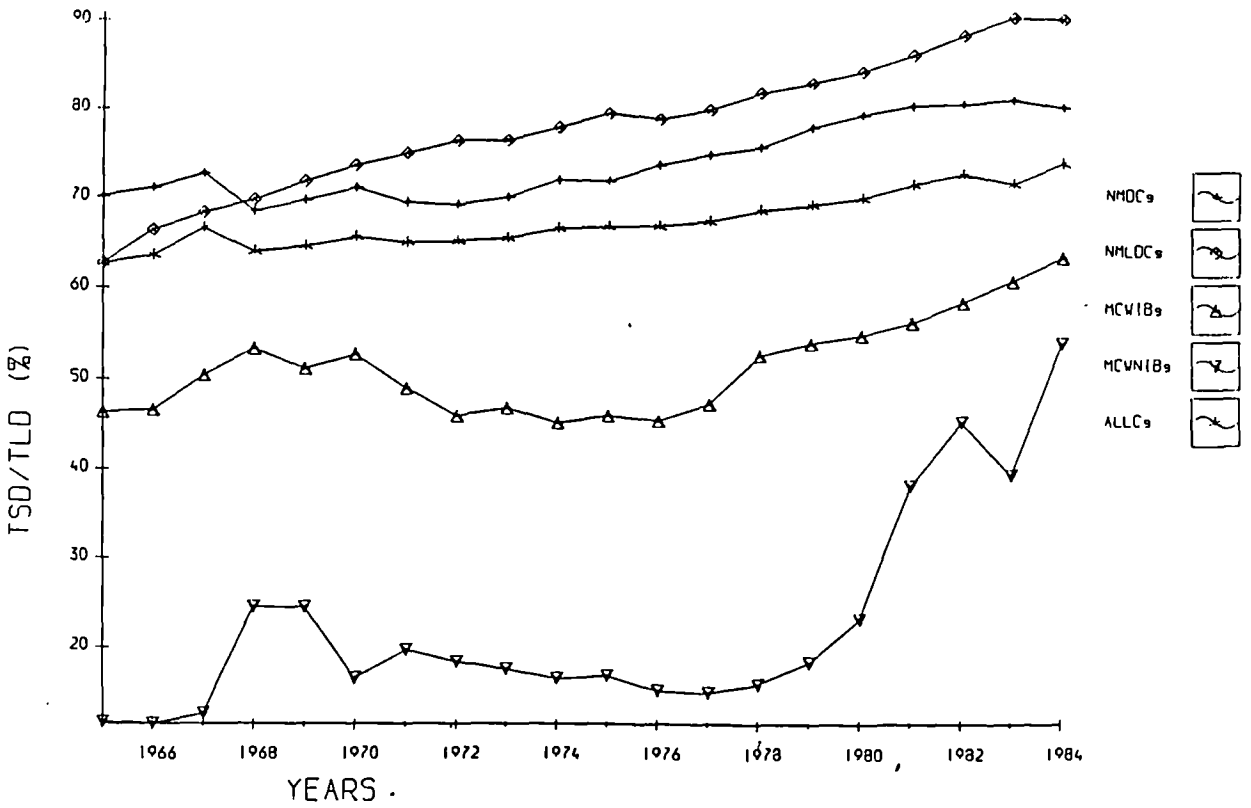


Figure 2.7 Comparison of the Ratios M1/M2 for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

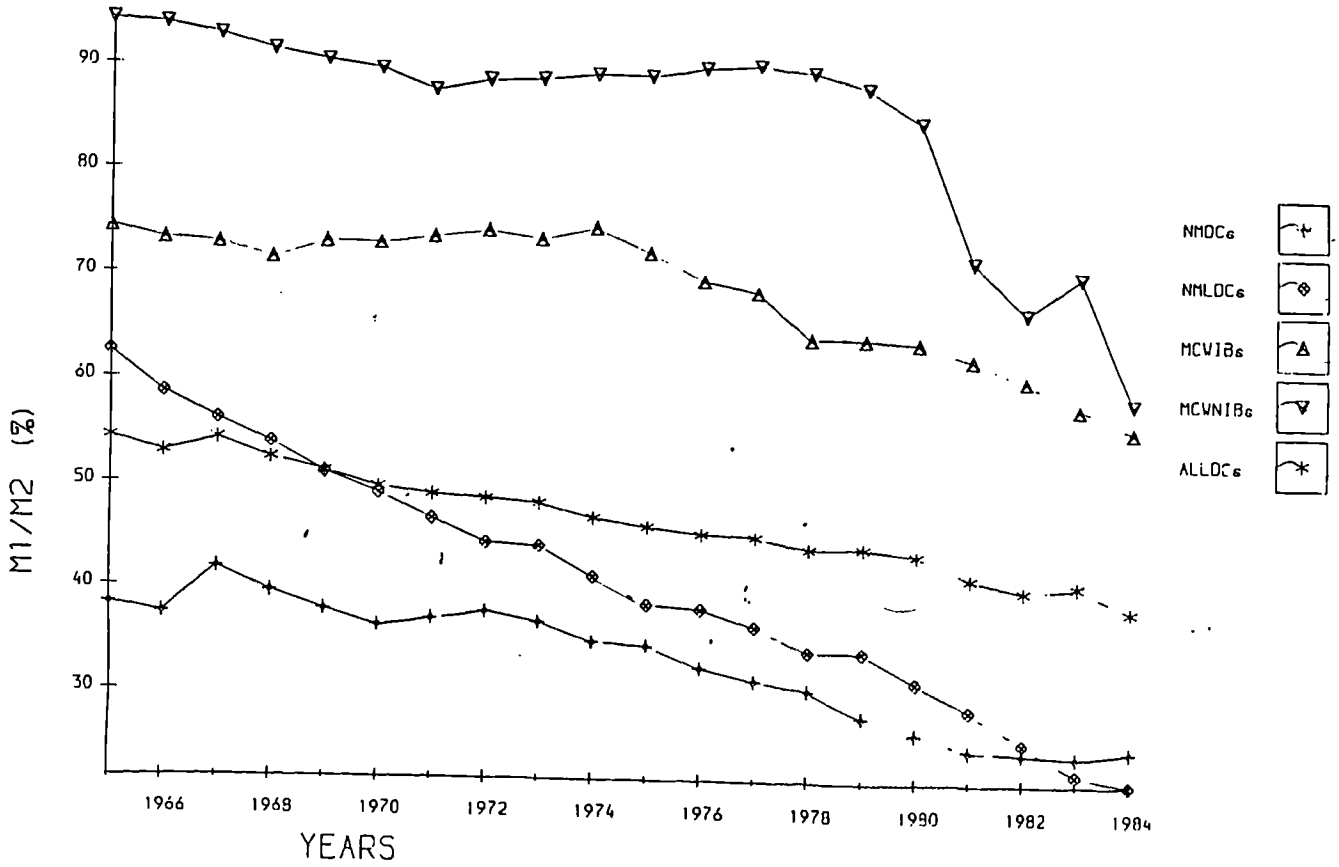


Figure 2.8 Comparison of the Ratios M1/GDP for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

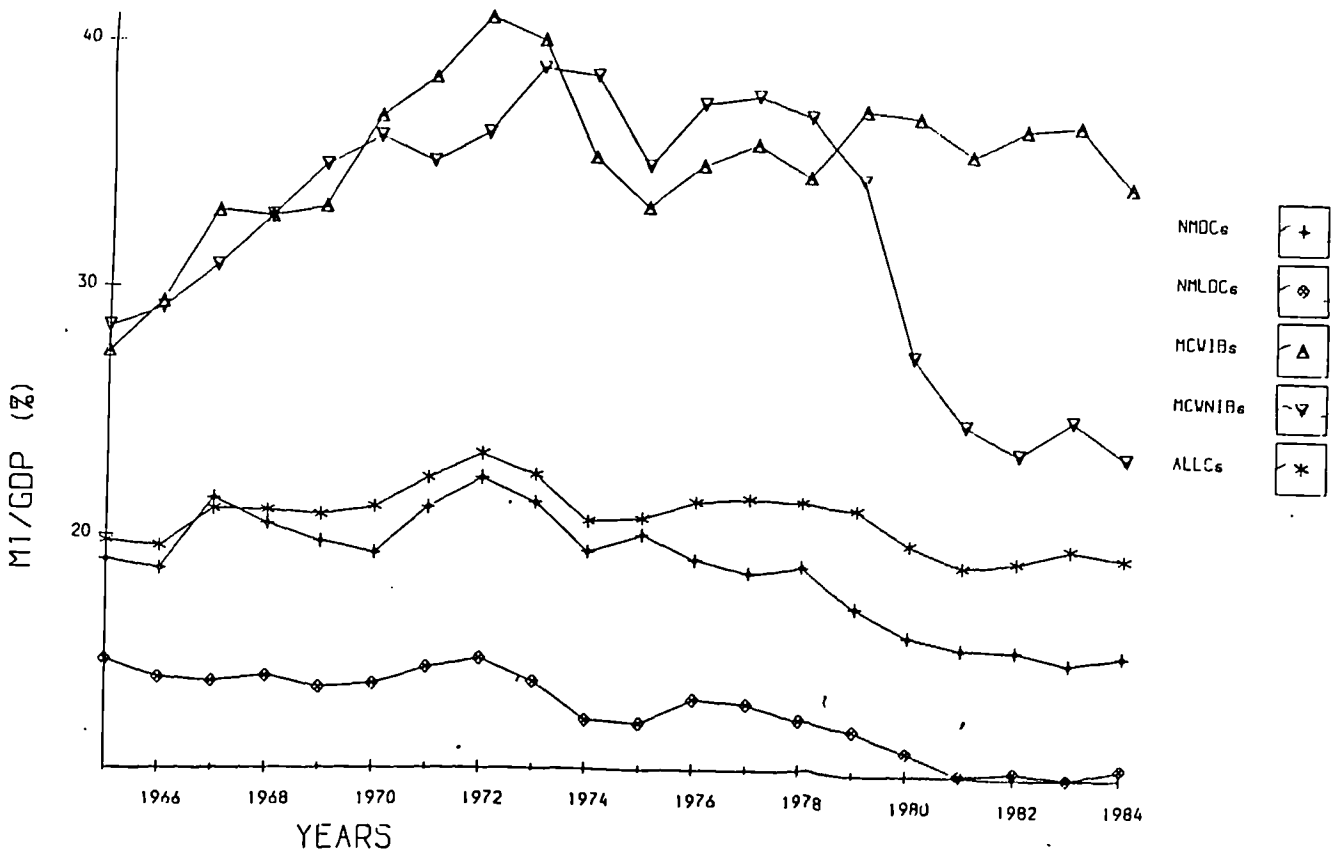


Figure 2.9 Comparison of the Ratios DD/BTA for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs

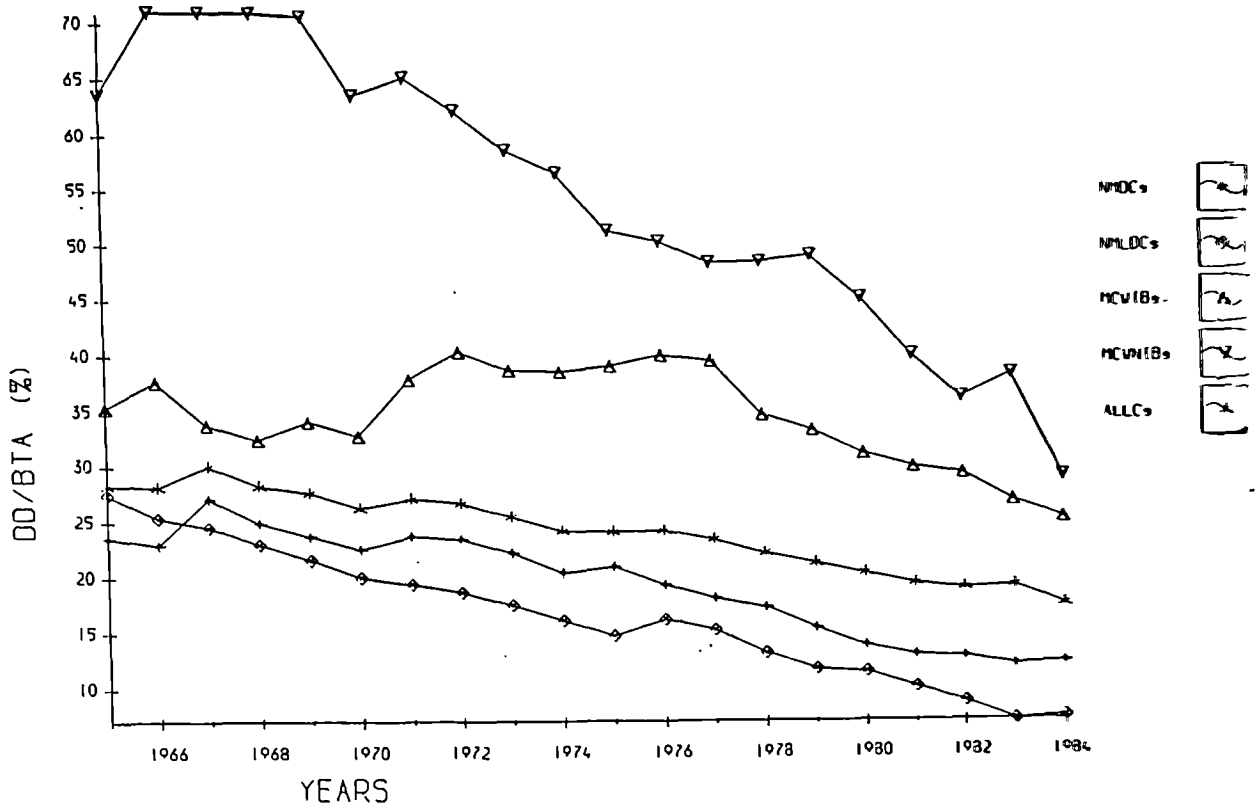
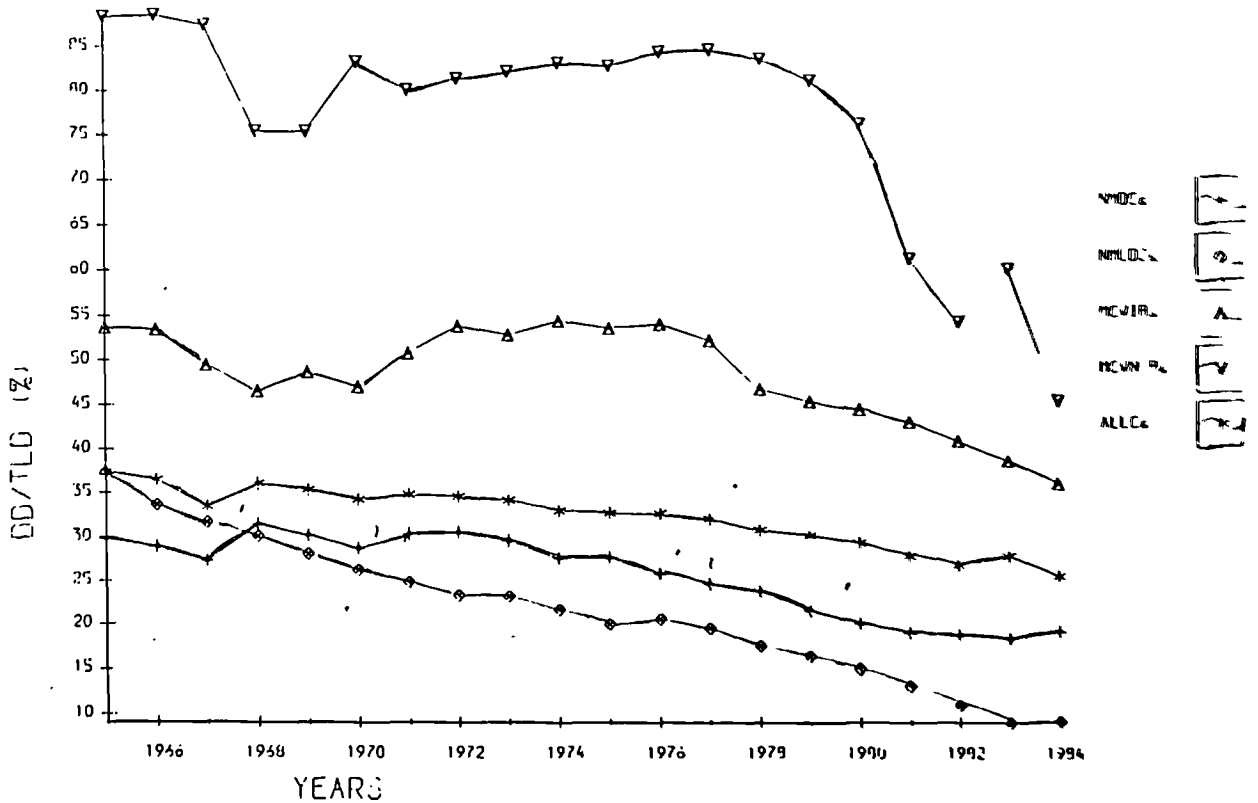


Figure 2.10 Comparison of the Ratios DD/TLD for NMDCs, NMLDCs, MCWIBs, MCWNIBs & ALLCs



## 2.6 CONCLUSION

From the review of economics literature, concerning the importance of savings and intermediation for economic development, it appears that there is an almost unanimous agreement among economists of all schools that both savings and intermediation are very important for boosting economic development. However, there is much disagreement on what makes people save less, why some of them do not put their savings in financial institutions, how best to encourage people to save and how to mobilise savings efficiently, thus the different hypotheses (Structuralist, Repressionist and Islamic) put forward.

The regression and correlation analyses carried out in this chapter in order to test these hypotheses for the 18 selected Islamic and non Islamic, Developed and Less Developed countries revealed that although the Islamic countries have high FIRs in terms of the ratios not involving interest, they have at the same time very low FIRs proxied by ratios involving interest. Generally speaking, the available data give some support and only to some extent to both the Structuralist and the Islamic hypotheses but no support for the Repressionist hypothesis was found, not only as far as Islamic countries are concerned but for almost all countries whether being Islamic or not or whether taken in groups or individually. This confirms the results obtained by Williamson (1968), Wai (1972) and Gupta (1984) mentioned above.

## CHAPTER THREE

### ORIGIN AND DEVELOPMENT OF BANKING GENERALLY AND OF ISLAMIC BANKING IN PARTICULAR

#### 3.1 INTRODUCTION

Jacob Burchard (cited by Lopez 1979:1) said: "History is the one field of study that does not begin at the beginning". Banking, as one of the most specialized forms of commerce, appeared as did the latter in conjunction with the civilisations of the past and was nearly always at the basis of their prosperity, but as Orsingher (1967:1) put it: "It is impossible with the documents discovered so far, whatever their kind, to determine when banking operations first took place or to give a continuous uninterrupted account of their evolution".

Most economists maintain, as Bergier (1979:105) claims that: "Banking was Italian by birth", first because the technical word 'bank' is derived from the Italian word 'banco' which means a table or a bench on which Italian money changers and bankers used to display their moneys and records and conduct their transactions. Second, because they consider that the first banks worthy of the name were those established in Venice, Florence, Genoa and Lucca in Italy, during the 12th century AD (see Usher 1943 and De Roover 1954). Thus, banking is often considered as a modern device or even a modern vice but a glance through the pages of financial history will dispel the notion of novelty.

Banking, as Homoud (1985) pointed out: "was known in various forms and guises in a number of cultures which flourished in various parts of the world before they lapsed into oblivion". The purpose of this chapter is to show that banking was known long before Italy 12th Century AD and to trace the origin and follow the development of Islamic banking.

#### 3.2 BANKING IN ANCIENT TIMES

##### 3.2.1 Banking in Prehistoric Times

As mentioned above and as Lopez (1979:1) put it: "Nobody knows when credit was first used as a lubricant of business probably in prehistory but banks of a sort existed in ancient Mesopotamia, Greece and Rome".

According to Homer (1963:17), credit probably antedated industry, banking, coinage and even primitive forms of money. He contended: "when we consider credit in its broadest meaning we can infer something of its earliest forms. Primitive credit need only have consisted of a loan of seed to a son or brother or neighbour until harvest time or a loan of an animal or of a tool or of a food. Such transfers are called gifts if no repayment is expected, loans if repayment is expected and loans at interest if the repayment of a certain amount, more than was loaned is expected. These transactions in kind required no money, no exchange and no barter". Unfortunately, there is no historical evidence available about these or other banking operations in these prehistoric times.

### 3.2.2 Banking in Mesopotamia

Although it is impossible to establish when or where banking operations first started, it is clear, as Homoud (1985:17) argued that: "the need for it emerged and developed with the use of money as a means of exchange at the beginning of organised agriculture, industry and trade". The first civilisations for which there is available historical evidence on banking operations are the Sumerians and Babylonians who lived about 34 centuries BC in Mesopotamia. Orsingher (1967:1) reported that:

Historical excavations have uncovered the temple of Uruk and Chaldea, a relic of the Babylonian Empire, and have shown that the foundation of the -now known- oldest banking building in the world took place more than 3,300 years before our era.

From the examination of the -up to now discovered- historical evidence in Mesopotamia it would be inferred that in those days banking was characterised by being related with sacred temples and that it attained a relatively high degree of progress. The translation of a text of one of the scripts found there shows that a farmer had borrowed from the priestess of the temple a quantity of silver to finance his purchase of sesame and he undertook to pay for the equivalent of this silver in sesame at the price current at the harvest time to the holder of the credit document made payable to the bearer (Homoud 1985:17-18).

At least four observations can be made about this document: First, it shows that the temples used to act as, or play the role of banks, which may be explained by the fact that people used to have more confi-



dence in their religious temples and priests than in others, because of the glory of sanctification of these temples and the belief that these would render accurate and complete account of deposit and that they are more secure than any other place since nobody would dare to steal from the sacred temple. Second, the customer is a producer, in other words the loan was for production purposes and not for consumption. Third, a credit document equivalent to a bill of exchange was given by the borrower as a credit evidence not only that but was made payable to bearer which means that it was transferable. And fourth, there was no interest involved in the operation since the customer is required to pay only the equivalent of the silver he borrowed in sesame at the current price of the harvest time; which may be smaller, equal or greater than its price at the time of the borrowing but even if it is greater this would not be interest since interest is the amount paid over and above the capital lent and from the same kind such as silver on silver or sesame on sesame but not silver on sesame or sesame on silver (see 4.2 below).

According to Levy (1964:9): "Kings and private individuals were also among the large scale capitalist bankers at that time". Investments took the form of loans of money or seed, the rate of interest was 20% for money and 33% for barley and the borrower as well as his family risked slavery for non payment of debt if he defaulted. The limited partnership (Commenda) was also a Babylonian invention (ibid:11).

Bank operations by temples and great landowners had become so numerous and so important that the Babylonian King Hammurabi (1728-1686 BC) thought it was necessary to lay down standard rules of procedures which deal with nearly all cases arising from the terms of ownership of land, the employment of agricultural labour, civil obligations, loans, interest, pledges, guarantees, the presence or absence of evidence, natural accidents, loss, theft, etc., (Homer 1963:26 and Orsingher 1967:viii)

After the Persian conquest around 539 BC, Mesopotamia lost her independence. Babylonia was no longer a great capital city, interest rate reached the level of 40% and became the common prevailing rate. Her old civilisation had all but vanished and the centre of economic progress and activity shifted to Greece (Ibid:31).

### 3.2.3 Banking in Greece

According to Orsingher (1967:3), the development of banking in early Greece was hampered by the level of local economic activity, the severity of local laws and the precarious state of trade and exchange until the invention of coin money. The question, which arises here, is who invented coin money and when?. Orsingher (1967:viii) answered that: "Perhaps the Chinese, but no certainty exists on this point". However, the official coinage of money, as Einzig (1948:225); Homer (1963:33); Levy (1964:18-19); and Orsingher (1967:viii-ix) pointed out, is supposed to have originated in Lydia in the 7th Century BC. The first coins were attributed to King Gyges (687 BC) of Lydia. They were of electrum (a mixture of gold and silver). King Croesus of Lydia (560-546 BC) is credited with providing the first ingots of pure gold when Lydia was then a leading producer of gold. This must have encouraged the emergence and practice of banking operations in Greece because certain traders soon began to specialise in the evaluation and exchange of coinage made from precious metals in various countries (Orsingher 1967:3).

The Greek bankers or Trapezites as they were called -from the Greek word, Trapeza, a table or a bench on which they used to display moneys and conduct their transactions- changed money, received deposits, made loans to individuals and states, issued letters of credit, honoured cheques and kept complete books, so, "in next to no time the commercial genius of the Greek rose to the point of speculation. Capital accumulated was only an investment with a view to accumulating more" (Homer *ibid*:69). Perhaps under the influence of earlier civilisations, temples were also used as deposit takers in Greece. The Shrine of Delphi, is sometimes described as the great banker of the Greek world (*ibid*:38).

But after the conquest of Alexandria (circa 325 BC), and as Homer (1963:39) reported: "Athens was no longer in a position to dominate Mediterranean Commerce. She had lost her empire... During the ensuing centuries, however, Rome, not Greece dominated the history of the Mediterranean world... Athens never regained her position as the great commercial and financial centre. As a consequence of Roman policy, trade shifted to Rhodes, Antioch, Selencia and especially to Alexandria".

#### 3.2.4 Banking in Egypt

According to Orsingher (1967:4) "Until the Alexandrian conquest, a primitive economic system persisted in Egypt, but the Ptolemies introduced coinage into Egypt and the same evolution which has been observed in Greece took place here also. Indeed, Trapezites are to be found here as in Greece, but they are, in some sort, official agents; many of them have Greek names and the earliest of them came from Greece".

During the 1st and 2nd centuries AD, Egypt attained the highest stages of development in the art of banking and was rich and prosperous (Homoud 1985:18). But in the third century AD the disorder of the Roman Empire broke through the barriers of Egypt's economic isolation deliberately caused by a fiat currency that circulated for some time only in Egypt (Homer 1963:51). Famine, plague and inflation devastated the land and banditry became widespread (A. Johnson 1933:vol II:353).

#### 3.2.5 Banking in Rome

The Romans, as described by Homer (1963:44), were a nation of farmers and soldiers. They left manufacture, commerce and banking mainly to foreigners. Most of the earliest bankers in Rome had Greek names and were called Trapezites. Orsingher (1967:5-6) reported that: "There were no banking monopolies during the Roman period, and this liberty allowed banking operations to develop and flourish". By the first century BC, Rome was the banking centre of the Republic and of the Empire and probably of the world at the time. Perhaps bankers became so numerous that in addition to the name Trapezites, they were later designated by names like Mensularii, Argentarii, Mummularii, Fenoeratores (Homer 1963:47).

After 90 BC, banking experienced ups and downs depending on the political and military conditions of the republic. In time of wars and disorder, inflation, financial stagnation and bankruptcy prevail and in times of peace and prosperity, financial stability is restored and banking operations and trade improved. "In the third century AD monetary inflation on a grand scale accompanied a succession of revolutions and civil wars" and the chaotic fifty years before Diocletian, 284-305 AD, were in the opinion of T. Frank (1933:300) "the period when Rome fell.

There were anarchy and looting. Provincials lost faith in Rome. Industry and trade disintegrated and even the Latin speech decayed".

### 3.3 BANKING IN THE ISLAMIC EMPIRE FROM THE RISE OF ISLAM TILL THE 12TH CENTURY

According to Homoud (1985:19): "the period lasting from the fall of Rome until the dawn of Islam was the darkest, most corrupt and unsettled period in the known history of Man.. The dawn of Islam removed darkness from the face of life and brought an environment of security and stability to the areas which came under its influence". The rise of Islam brought about a tremendous change in all economic, political, social and judicial spheres and brought about a new civilization that is based on the total and complete submission to Allah and his Shariah.

Wilson (1950:40-53) describing the impact of Islam, wrote:

The sudden eruption of the Arab (Muslim) people in the 7th Century is something unique in history. In three generations a collection of scattered tribes, some settled, some nomadic, living by trade and subsistence farming, had transformed itself into a rich and powerful empire dominating the whole of southern Mediterranean and the Near-East from Afghanistan to Spain... They had succeeded in welding together peoples of divers beliefs and languages into a unified society based on a common religion, a common language and common institutions.

Lieber (1968:230) also contends that "From the seventh century AD onwards, Muslims succeeded in developing long distance trade and international commerce on a scale which surpassed anything known before. This is, perhaps, because Islam is one great religion which affords the merchant a highly honoured place in society". And, perhaps, that is why many learned men had, at some stage of their careers, earned a living as merchants (see Weit 1955). Lieber (ibid) pointed out that: "Among Muslims, international trade was particularly stimulated by the pilgrimage to the holy places of Arabia, in which a great body of men converged each year from all over the world. Many of these pilgrims fulfilled their religious obligations and at the same time, marketed their local products along the route, returning home with foreign goods on which they hoped to make a handsome profit". And with the development of trade, comes the development of banking operations though not necessarily. Commenting on De Roover (1954:43) statement which says "There can be no banking where there are no banks", Udovitch (1979:255) argued:

This proposition may hold true for the development of banking in Medieval Europe but it certainly does not describe the Medieval Islamic world. In the sporadic information on this subject from Medieval literary or documentary sources, we encounter bankers and we encounter extensive and ramified banking activities but we do not encounter banks. That is we cannot identify any autonomous or semi-autonomous institutions whose primary concern was dealing in money as specialised if not exclusive pursuit.

But the historical writings of El-Qalqashandi (1913), El-Djahshiyari (1938) and Pellat and Schacht (1965), show that there were indeed banks called Dawaween El-Djahabidhah. Pellat and Schacht (ibid) reported that from the end of the 8th century the term Djahbadh (pl. Djahabidhah) was used in the sense of a financial clerk, expert in matters of coins, skilled money examiner, treasury receiver, government cashier, money changer or collector to designate the well known licensed merchant banker in the time of the Abbasid caliphs. In 913 AD the state established what is called Diwan El-Djahabidhah (pl. Dawaween El-Djahabidhah) with branches in the main trade cities conducting almost all modern banking functions albeit without recourse to interest. In the time of the caliph El-Muqtadir (980-1032 AD) El-Djahbadh assumed an ever increasing important role and emerged as a modern banker, who in addition to his functions as administrator of deposits and a remitter of funds from place to place via the medium of the Sakk and especially of the Suftajah, was called upon to grant huge loans to the caliphs, the viziers and other court officials. (see El-Qalqashandi 1913; El-Djahshiyari 1938 and Pellat and Schacht 1965).

The Chief or Governor of Diwan El-Djahabidhah was required by the state to prepare a monthly and a yearly accounting statement called El-Khatmah (the final account or the balance sheet) of all the items of income and expenditure (See Mettwalli and Shahata 1983:113-17).

Historical sources, also, show that many of the Djahabidhah were Christians or Jews despite their status as Dhimmi (non Muslims living in Muslim society). Among the Djahabidhah listed in the sources were: Ibrahim Ben Yuhanna, Zakariyah Ben Yuhanna, Sulayman Bin Wahb, Ibrahim Ben Ahmed, Israel Ben Salih and above all two Jewish merchants and bankers: Yusuf Ben Finkhas and Harun Ben Imran of Baghdad who were appoin-

ted to the office of Djahbadh of the Persian province Ahwaz and later became Djahabidhat El-Hadhra (the Court bankers) of the caliph El-Muqtadir and his viziers (see Mez 1937; Goiten 1967, 1973; Udovitch 1970, 1979 and El-Sayed 1984).

El-Djahabidhah used to advance loans to the state secured by the government tax revenues, which they used to collect. When they collect the tax revenues, they get their principal and an amount above it which some historians consider as interest (see Pellat and Schacht 1965:383). But if we take into consideration the efforts of collecting and administering the taxes, we can infer that the amount above the principal was not interest but a fee for the administration of the taxes because on one hand, interest is forbidden and fees are allowed in Islam, and on the other hand, interest depend on the amount and period of loans, while fees or commissions are allowed to be paid for rendering services. Udovitch (1979:267) affirmed that: "whereas it was customary for merchants and others to keep at least a portion of their money on deposit with merchant bankers and whereas the merchant banks themselves kept deposits of various size with several other merchant banks, there is no evidence whatsoever that any interest or other type of premium was paid to depositors". This is so because Allah prohibits Riba (interest) in many verses of the Koran and provides several means such as Musharakah (partnership), Mudharabah (Commanda), Muzaraah (share cropping), etc., whereby the Riba prohibition could be avoided.

In the early Middle-Ages, the Islamic empire played a great role in establishing the foundation of an economic golden age of which the players in the field of trade and banking were Arabs, Persians, Berbers, Jews, Christians and Armenians. Islamic trade reached from El-Andalus (Spain) to the sea of China. Pirenne (1939:49) contended:

In consequence of their worldwide trade relations, they (the Muslims) brought sugar cane from India, cotton to Sicily and Africa and rice to Sicily and Spain. They learned from the Chinese how to produce silk and paper and took this knowledge with them into all parts of their empire.

Lieber (1968:230) also observed that:

The merchants of Italy and other European countries obtained their first education in the use of sophisticated business methods from their counterparts on the opposite side of the

Mediterranean, most of whom were Muslims, although a few were Jews or Christians. One obvious result is the large number of words of Eastern origin mainly Aramaic, Arabic or Persian, which were introduced into the commercial terminology of medieval Europe. Some examples of the terms (whose European usage was not necessarily identical with their original connotation) are douane, arsenal, magazine, traffic, tariff, risk, fondaco, sensali, galeya, aval and maona.

To quote just a few others words one might mention the very word cheque, which is originally from the Arabic word Sakk; credit from Qard risk from Rizk; the French words Acheter from Ishtara (to buy), Le Magasin from El-Makhzen (warehouse), aval from Hawala and the Spanish words Almacen from El-Makhzen, Zoko from Souk (market) and many others. (see Doi 1984:399; Vives 1969:119-20; Terrey 1892 and Steigher 1963).

As Labib (1969:80) pointed out: "Everywhere that Islam entered, it activated business life, fostered an increasing exchange of goods and played an important part in the development of credit".

According to Udovitch (1979:263): "The Suftaja (Bill of Exchange) always and the Hawala (credit guarantee or credit transfer) usually occurred as a written obligation, and were thus the first and most important forms of commercial credit papers in the Medieval Near East". That is so, perhaps because of Allah's order to Muslims in the longest verse of the Koran 2:282-3 to write down all future obligations. Allah says:

O you who believe, when you deal with each other in transactions involving future obligations in a period of time, reduce them to writing. Let a scribe write down faithfully as between the parties, let not the scribe refuse to write as Allah has taught him, so let him write. Let him who incurs the liability dictate but let him fear his Lord Allah, and diminish aught of what he owes. If the party liable is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully and get two witnesses out of your men and if there are not two men, then a man and two women such as you choose for witnesses so that if one of them errs the other can remind her. The witnesses must not refuse when they are called on for evidence. Disdain not to reduce to writing your contracts for future commitments, whether it be small or big: It is juster in the sight of Allah, more suitable as evidence and more convenient to prevent doubt among yourselves but if it be a transaction, which you carry out on the spot among yourselves, then, there is no blame on you if you reduce it not to writing but take witnesses whenever you make a commercial contract and let neither scribe nor witness suffer harm. If you do harm, it would be wickedness in you. So fear Allah for it is Allah that teaches you and Allah is well acquainted with all things. If you are on a journey and cannot find a scribe, a pledge with possession may serve the purpose and if one of you deposits a thing on trust with another let the trustee faithfully discharge his trust and let him fear Allah, his Lord. Conceal not evidence for whoever conceals it, his heart is tainted with sin and Allah knows all that you do.

After the 13th Century the Djahbadh lost his control significantly as a court banker, his function was reduced to that of Sayrafi (money changer) as a result of the slow but prolonged decline of the Islamic Empire from about the 12th Century BC, due mainly to the following internal and external factors:

- 1 The gradual but continuous deviations from Islam and Islamic Shariah especially in the political sphere.
- 2 The extravagance and lavish expenditure of the courts.
- 3 The lack of organisation and the inflated bureaucracy.
- 4 The political break down, involving the loss of authority of the central government in the remote provinces and the emergence of petty dynasties and quasi-independent governors resulting in the degradation of the caliphs to the status of mere puppets of their ministers and military commanders.
- 5 The rise and development of different and antagonistic sects, all claiming to be the real Muslims such as the Suffis, the Shi'ites, the Ismaelites, the Druzes, etc..
- 6 The prolonged warfare with the crusaders, Mongols and Tartars, which caused much destruction in Iraq and Syria.
- 7 The Turco-Persian wars, which dragged on for nearly three centuries and which impeded the economic recovery of Iraq. (see Issawi 1966:4 and B. Lewis 1970:102).

#### 3.4 BANKING IN EUROPE FROM THE FALL OF THE ROMAN EMPIRE TILL THE 12th CENTURY AD

From about 300 AD time of the fall of the Roman Empire till about 1300 AD, Western Europe with the exception of Spain and Italy lived in dismal and bleak centuries called the 'Dark-Ages'. Spain, because it was part of the Islamic Empire under the name of El-Andalus which was known by its great civilisation between the 8th and 15th Centuries AD and Italy because of its strategic commercial position in the Mediterranean and its regular contact with Muslim, Christian, and Jewish merchants of the Islamic Empire, in fact Sicily and Venice were also part of the Islamic Empire for some time.

Following the fall of the Roman Empire, barbaric kingdoms prevailed throughout Western Europe. Commerce became profoundly depressed in Western Europe, which was, as Homer (1963:84) put it: "sinking back into a largely agricultural economy". This led the famous historian Pirenne (1933:20) to say that in Western Europe: "La terre etait tout et le commerce rien" which means that the land (or agriculture) was everything and the commerce was nothing. This is not to suggest that there was no trade in Western Europe, but just to say that it was very limited as a



consequence of political instability, uncertainty, high cost of transportation, heavy taxes and customs duties, piracy, bribery and illiteracy. Thus, if trade is limited, so must be banking operations.

During these so called 'Dark Ages', as reported by Homer (1963:84): "the Latin tongue was forgotten, culture vanished and superstition throve. However, money was used regularly throughout the darkest of the Dark-Ages but the lack of commerce reduced its circulation". Orsingher (1967:11) pointed out that: "during all the period which extends from the fall of the Roman Empire till the end of the 11th Century the banking industry in Western Europe was represented by the money changer. The age of the crusaders was the starting point for the development of monetary and credit operations during the 2nd part of the Middle Ages".

The 10th Century was called the century of transition in which the crusaders managed, on one hand, to weaken the Islamic Empire -which had already shown weakness after the destructive raids of the Mongols and Tartars and after the rise of divergent petty dynasties within it- and on the other, to transfer the know-how from the Islamic civilisation to Western Europe, especially on how to promote irrigation, handicrafts, partnerships, trade and banking so that by the end of the 11th Century, political and economic revival in Western Europe generally and in Italy in particular became general. Thus, as Lopez, (1952:273) described:

Italy at last began to exploit the advantage of her central position in regard to both continental Europe and the Mediterranean basin. A nation of moderately successful peasants and farmers who in Roman times were dependent upon Easterners for their trade and who did not produce enough food for their overgrown capital, now was on its way to becoming the first commercial and industrial nation in the world.

Venice, was perhaps the most prosperous town in Italy at that time where there was no serfdom and where the majority of its population was engaged in maritime trade especially with the Muslim world in spite of opposition from the Papacy. Coiners and money changers rose steadily in power and prestige; and commercial contracts, such as the 'Commenda' equivalent to the Islamic partnership contract of Mudharabah which involved sleeping partnership, became a very popular device in Mediterranean Commerce (see Homer 1963:86-88 and Miskimin 1969:118). This probably explains the observation of Lieber (1968:230) that:

The merchants of Italy obtained their first education in the use of sophisticated business methods from their counterparts on the opposite side of the Mediterranean most of whom were Muslims, although a few were Jews or Christians.

This also may explain as Homoud (1985:24) pointed out, the origin of the concept that the first bank worthy of this nomenclature was that which was established in Venice in the year 1157 AD, and what became common knowledge about dating the origin of banking operations back to the money changers in Lombardia who used to sit behind their wooden desks, known as banco. Thus, as Lopez (1952:291) remarked: "Italy was to the Medieval economic process what England was to the modern. Even as the industrial revolution first transformed economy and society in some English areas and spread later to the rest of the world, the commercial revolution (trade and banking) first affected a few Italian cities and then made its way slowly through the rest of Europe".

### 3.5 BANKING IN THE ISLAMIC WORLD SINCE THE FALL OF THE ISLAMIC EMPIRE AND THE EMERGENCE OF ISLAMIC BANKING SINCE THE 1940s

From the 11th Century AD, time when the Islamic Empire started declining till about the mid-20th Century AD the Muslim World underwent long centuries of prolonged decay and deterioration, known as 'Usur-El-Inhitat' or 'The Ages of Decline' just as Western Europe underwent the 'Dark Ages' from the fall of the Roman Empire till the end of the 12th Century. A deterioration which affected all aspects of life: political, economic, social and cultural. Many factors helped bring about this deterioration (see 3.3 above). The damaging consequences were disastrous.

- The once united caliphate became divided into hundreds of petty dynasties fighting each other. Despotism, tyranny and injustice became widespread. This made it easy for the Mongols, the Tartars, the Crusaders and others to invade, dominate and colonise the Muslim world.

- The once just and balanced Islamic society, based on the principles of the Shariah, was transformed into militaristic feudal societies that were much less conducive to economic and social development. Bayt El-Mal, which used to care about the poor, the destitute, the old and the young became the monopoly of the governors, ministers, military commanders and tax farmers. As a result the general public lost confi-

dence and withdrew from urban prosperous centres to hills in the countryside and to deserts to escape oppression, injustice, execution and confiscation. Ignorance, illiteracy, superstition, mysticism, idolatry, etc., all became widespread (see Issawi 1966:4).

- Agriculture shrank to a minute fraction of what it had been in the 10th Century and the population had correspondingly diminished. Land was granted or taken by officers. Farm techniques remained almost unchanged. Perhaps until the 1960s most farmers used only wooden ploughs instead of iron ones. As a result, yields were very low and both crops and livestock continued to be affected by droughts, pests and diseases. (see B. Lewis 1970:105, 113 and Issawi 1966:3, 21, 65).

- The strict regulation of craftsmen by the guilds and the subordination of many of them to merchants who supplied them with credit and raw materials and bought their output, diminished the formers' incentive to improve and modernise. The flood of European machine-made consumer goods brought by settlers dealt a severe blow to local handicrafts, many of which were wiped out in the following decades. One has only to compare the industrial products of the 18th Century with those made a few hundred years earlier to realise that the handicrafts had not only stagnated but had actually retrogressed (Issawi 1966:4, 18 and 46).

- From the 11th Century, trade was transferred from the Muslims to the Europeans who soon became the main carriers and traders in that sea. The 1498 discovery of the new trade route by the Portuguese Vasco de Gama, between Europe and India, around the Cape of Good Hope, came as a crowning catastrophe dealing a mortal blow to the Egyptian route which remained until then perhaps the only major trade route between East and West (Issawi 1966:7; and B. Lewis 1970:114).

With the achievement of independence, the nationalisation of foreign banks and the development of national banking, the overseas colonisation of the banks disappeared, but it has been replaced, however, by a very similar 'neo-colonial' banking system. It is true that by nationalising foreign banks and by establishing new indigenous banks, these banks became national banks looking after the national interests but their ope-

rating system was the same as the foreign ones in that they continued to operate and deal in interest which is alien to the belief of the Muslim population. Thus, arose the idea of establishing 'Islamic banks' which would not only offer all banking services but which would not break or violate the religious beliefs of the people.

The idea of creating 'Islamic Banks' or 'Interest-Free Banks' as they are also called, came as a result of the Islamic revival which can be traced back to the late 1940s and early 1950s, when some of the colonised Islamic countries became independent. The first attempt to establish an Islamic Bank was made, as Traute (1983) and R. Wilson (1983) pointed out, in the late 1950s in a rural area in Pakistan, though this had no lasting impact. A small experimental Interest-Free Bank was founded by a small number of pious landowners who were prepared to deposit funds without interest rewards. The credit was advanced to other poorer landowners for agricultural improvements. No interest was charged for the credit, but a small fixed administrative fee was levied to cover the operating costs of the bank. However, as R. Wilson (1983:75) put it: "although there was no shortage of borrowers, the depositors tended to view their payments in the institution as a once and for all effort, and the institution soon ran short of funds. In addition, the depositors took a considerable interest in how their deposits were loaned out and the bank officials enjoyed little autonomy with no new deposits forthcoming, and problems over recruitment of bank staff, who were unwilling to give up lucrative and secure careers in city commercial banking for an uncertain venture in the countryside, the institution soon foundered.. but just as the Pakistan venture was being ended a new experiment was being tried in Egypt"

On 25/07/1963 a pioneering experiment, the MGISB (Mit-Ghamr Islamic Savings Bank), started in the county of Mit-Ghamr in the Nile Delta of Egypt. The main instigator of this Islamic financial institution was Dr El-Naggar who later became secretary general of the International Association of Islamic Banks (IAIB). The model was the German savings banks adapted to the rural environment of an Islamic developing country. The purpose was to mobilise the idle savings of the majority of the Muslim

Egyptian population without transgressing the laws of the Shariah and to provide them with Halal returns on their savings as well.

Although Dr El-Naggar, was primarily an academic himself, he managed the bank and carefully selected the bank's staff from enthusiast Muslims, who had some banking experience with commercial institutions. "The staff soon gained the confidence of the conservative county community who saw they were devout Muslims like themselves, as they worshipped locally with their potential customers. The region's peasants were suspicious of outsiders and few had ever used commercial banks, which were seen as alien institutions belonging to the cities, and mainly to serve westernised Egyptians. These new bankers were viewed as different.. as they shared the same views and moral values as the peasants themselves, despite their education" (R. Wilson 1983:76).

The role of this bank, according to El-Naggar (1974:246-47), the pioneer and manager of this bank, was threefold: first, to act as an efficient intermediary between the supply and demand of capital, or in other words between surplus and deficit economic units; second, to act as an educational centre for economic efficiency, saving education and banking habit; and third, to set a dynamic factor in mobilising the idle capital for investment, thus, reducing hoarding and the problems of capital formation. R. Wilson (1983:76) reported that:

The bank's loans were used for a variety of purposes including house building and repairs, the purchase of simple machinery for handicraft industries, such as hand looms for weaving textiles or... sewing machines. Some loans helped finance the purchase of farm animals and basic improvement to the irrigation systems as efficient water provision was essential in a community based on agriculture.

MGISB soon prospered, and within three and a half years, the first depositors were joined by more than 251,000 and the deposits grew at unprecedented higher rates than expected (see Table 3.1 and figure 3.1 which compare the growth of its total deposits to that of the Egyptian Banking System (EBS) as a whole in current and constant prices during the same period and tables 2.2-2.4 which show the number of depositors, the size of the average deposit, the number of branches and the kinds of depositors who were banking with this Islamic bank). It is quite

clear from the comparative analysis of the little data, that this experiment proved quite successful and the savings mobilisation impressive. Its success in winning the support of a large number of students, farmers and villagers who regarded the bank as their own, is discussed by Ready (1967); Harvey (1981); Traute (1983) and R. Wilson (1983).

El-Naggar (ibid) commented:

In spite of the short period during which the bank has been in operation, it has rendered vital services to the economic development of the local community, especially in the development and the establishment of small industries and in providing new opportunities of work for unemployed workers in Mit-Ghamr and its 53 affiliated villages".

**Table 3.1 Comparative Analysis of the Total Deposits in the EBS and in the Mit-Ghamr Islamic Savings Bank for the period 1964-1967**

Years	EBS's TLD in EL	Index in %	Growth in %	MGISB's TLD in EL	Index in %	Growth in %
In Current Prices						
1964	378,000,000	100	-	40,944	100	-
1965	396,000,000	105	5	191,235	467	367
1966	415,000,000	110	5	879,570	2148	360
1967	445,000,000	118	7	1828,375	4466	108
Averages			6	278		
In Constant Prices						
1964	364,513,010	100	-	39,483	100	-
1965	332,214,760	91	-9	160,432	406	306
1966	319,722,650	88	-4	677,635	1716	322
1967	340,474,360	93	7	1,398,910	3543	106
Averages			-2	245		

Sources: IMF International Financial Statistics and El-Naggar (1974)

**Table 3.2 The Number of Depositors and their Average Deposits in Mit-Ghamr Islamic Savings Banks**

Years	No of Depositors	Growth in %	Average Deposit Per Saver	Growth in %
1964	17,560	-	2.33	-
1965	30,404	73	6.29	170
1966	151,998	400	5.79	-1
1967	251,152	65	7.28	26

Source: El-Naggar (1974:271)

**Table 3.3 Mit-Ghamr Islamic Savings Bank's branches Between 1963-1967**

Branch Name	Opening Date	Branch Name	Opening Date
1 Mit Ghamr	05-07-1963	6 Zefti	09-02-1966
2 Sharbine	14-08-1965	7 Al Mahallah	24-07-1966
3 Al Mansoura	11-09-1965	8 Misr El-Jadidah	23-07-1966
4 Dakerous	09-10-1965	9 Belqaa	01-10-1966
5 Kasr Al Ayni	14-10-1965		

Source: El-Naggar (ibid)

**Table 3.4 Percentage Share of Savings and Investment Deposits in Total Deposits of Different Groupings of Savers in MGISB**

Savings Deposits	Investment Deposits	Depositors
53.5	38.0	Students
14.0	12.0	Workers
2.3	12.8	Pensioners
10.2	22.0	Civil Servants
5.1	6.4	Housewives
10.9	15.9	Peasants
2.0	2.4	Merchants
2.0	2.0	Others

Source: El-Naggar (1974:272)

It is said that this bank was so successful that it would have covered the whole of Egypt by now, if it has not been stopped for political reasons outside its control. It came to an end in February 1967 after only three and a half years during which problems of rural indebtedness were reduced in the areas where this bank and its branches were operating. Borrowers, no longer, had to depend neither on the few local moneylenders, many of whom charged high interest rates, nor on the non Islamic banks which consider them as a 'non-bankable class' and which, they themselves would not deal with, as these banks base their operations on Riba (interest) which is Haram according to their Islam.

El-Naggar (1978:230-232) reported that:

Paradoxically, yet not surprisingly, it has been its success, rather than the reverse, which has created problems for the bank. As soon as the social role of the bank began to make itself evident in the successful development of the local area, conflicts started with the local social authorities who saw it as interfering in their own area of authority and regarded it as simply reduplicating their own efforts unnecessarily. In the meantime, because the bank introduced a new concept of banking more expressive of Islamic belief and practice and firmly rooted in a popular Muslim base the size of savings and number of savers was increasing rapidly either by the addition

of new savers, or by savers who transferred their money from the commercial banks to the Islamic one. Inevitably this aroused the traditional banks against their new popular based and progressive competitor... Thus, in furthering such changes, the functions and role of the bank could, from a narrow viewpoint, be regarded as conflicting with existing institutions such as the social authorities, the commercial banks and some of the central holding organisations: industrial or commercial which were mainly under government control, so it was stopped.

Nevertheless, the venture laid the seeds of modern Islamic banking and pointed the way for subsequent undertakings. Soon afterwards many Islamic social, developmental and commercial banks started doing business following the example of Mit-Ghamr Islamic savings bank with some improvements. The first of such banks is the Nasser Social Bank established in 1971 in Egypt, not as profit oriented institution but as a social bank to serve the previously 'unbankable' low income group; followed by the Islamic International Development Bank (IDB), an Inter-governmental institution established in 1975 in Jeddah (Saudi Arabia), with the purpose to foster the economic and social development of its member countries, and by the Dubai Islamic Bank (DIB) in Dubai (UAE) in 1975, the first major project of Islamic commercial bank, the success of which led to the establishment of a series of such banks elsewhere.

At present, in addition to the Islamisation of the Iranian, Pakistani and Sudanese banking systems, there are according to Euromoney of July 1988, about 100 Islamic financial institutions operating worldwide with total assets of some US\$16bn. Most of them were established in late 1970s and early 1980s in such countries as Egypt, Kuwait, Jordan, Bahrain, Qatar, Malaysia, Bangladesh, Senegal, Tunis, Turkey, etc., and most of them have been able to mobilise substantial amounts of deposits, acquire a notable share in the national market and generate sizable profits from their first year of operation, in spite of the shortness of the period, the competition from the interest-based banks and the problems related to the non-Islamic environments in which they operate. In fact there are Islamic Banks and Islamic Investment Companies in the West as well, as in Switzerland, Denmark, Luxembourg, England, etc..

These Islamic banks differ widely in size, the largest bank, KFH, has a total assets of about US\$4bn (see Table 3.5 showing only the top 15 Arab Islamic Financial Institutions; this does not include larger



Islamic banks of non Arab countries such as the Islamic Banks of Pakistan and Iran) and the smallest FIBK (Faisal Islamic Bank of Kibris) in Northern Cyprus had less than US\$10m. "Such absolute figures, however, are", as Nienhaus (1988:90) argued: "not sufficient for an assessment of the quantitative importance of a bank in its national context. Internationally small banks can have large market share nationally".

**Table 3.5 The Top 15 Arab Islamic Financial Institutions (in 1987)**

Rank	Name and Head Office	TLA US\$m	K&R US\$m	PBT US\$m	PBT/TLA %	PBT/K&R %	K&R/TLA %
1	KFH (Kuwait)	3,916 22.6	159 13.2	90.9 19.3	2.56 2.57	60.57 55.57	4.07 4.41
2	FIBE (Egypt)	1,905 -4.5	98 1.0	10.0 3.1	0.51 na	10.26 na	5.14 4.86
3	JIB (Jordan)	599 21.6	30 0.0	2.5 6.5	0.46 na	8.20 na	5.08 6.17
4	DIB (UAE)	470 13.1	25 28.2	na na	na na	na na	5.27 4.65
5	QIB (Qatar)	355 46.4	20 13.8	3.7 58.8	1.23 1.13	19.28 13.40	5.72 7.36
6	DMI (Switzerland)	344 4.2	283 0.7	8.7 4.2	2.59 na	3.09 na	82.27 85.15
7	AIIB (Bahrain)	233 -7.5	52 2.0	2.3 0.4	0.94 0.87	4.43 4.37	22.32 19.70
8	BIB (Bahrain)	187 10.7	19 0.0	8.4 12.0	4.72 4.45	44.21 42.85	10.16 11.24
9	FIBS (Sudan)	136 17.8	30 0.8	0.5 -64.5	0.39 1.24	1.65 4.66	21.97 25.68
10	AIB (England)	107 32.6	19 0.0	-0.1 -108.3	-0.06 na	-0.30 na	17.54 23.26
11	TIB (Sudan)	99 37.0	10 8.7	1.8 -16.7	2.10 na	18.75 na	10.08 12.71
12	FIBB (Bahrain)	70 52.2	39 11.4	3.0 15.8	5.43 na	8.51 na	55.71 76.09
13	IFH (Luxembourg)	45 -2.2	20 -20.0	-0.1 99.3	-0.11 na	-0.22 na	44.44 54.35
14	IBI (Denmark)	44 11.1	10 0.0	0.0 0.0	na na	na na	22.96 25.51
15	BIIC (Bahrain)	21 0.0	13 0.0	0.4 433.3	na na	na na	62.50 62.50

Source: The Banker, December 1988 P.73

The primary objective of these Islamic Financial Institutions is to mobilise dormant resources of devout Muslims who are reluctant to deal with Interest Based Banks because of Riba. And as pointed out by Tarbush (1981:6): "they apparently have no problem in achieving this goal. It is claimed that on its first day of opening to the public the Kuwait Fiance House (the Islamic Kuwaiti bank) received KD50m (US\$140m) transferred from deposits of the commercial banks".

The available data, on some of the existing Islamic Banks, reveal that many of them have even been able to acquire considerable amounts of assets that they qualify for ranking among the top 100 Arab largest banks and that they are improving (See table 3.6 showing the position of some Islamic Banks, in some Arab countries, among the top 100 Arab Banks. This does not include larger Islamic banks of non Arab countries such as the Islamic Banks of Pakistan and Iran).

**Table 3.6 Position of some Islamic Banks among the top 100 Arab Banks**

Year	KFH	FIBE	IBID	DIB	JIB	MFIB
1980	94					
1981	68					
1982	51	77				
1983	42	66				
1984	34	47				
1985	39	45	74	97	-	78
1986	36	43	na	87	87	76
1987	28	48	na	93	85	na

Note: See List of abbreviations for Banks' acronyms  
Source: Nienhaus (1988:90) and The Banker, various issues.

This shows, as Nienhaus (ibid) remarked that: "these Islamic Banks have grown to financial institutions of a respectable size within a relatively short period of time". Some of them like KFH, FIBE, FIBS, JIB and MFIB have become among the seven largest banks in their respective countries and despite a slow down in their rates of growth their market shares in the mobilisation of deposits and the allocation of funds have grown considerably (See Tables 3.6; 3.7 and chapters 9-11 below).

**Table 3.7 The Market Shares of some of the Oldest Islamic Banks (in %)**

Name	Est.	1980	1981	1982	1983	1984	1985	1986
DIB	1976	1.30	1.28	1.35	2.03	2.35	3.06	3.27
KFH	1978	5.70	8.21	12.32	17.33	17.13	17.64	18.03
FIBS	1978	6.86	10.87	15.00	13.34	12.68	7.74	7.08
FIBE	1979	1.61	4.43	5.62	6.89	7.06	9.83	7.43
JIB	1979	1.90	3.35	3.90	5.40	6.82	7.72	8.60
BIB	1979	1.03	1.42	2.86	3.45	3.91	6.42	6.68

Source: Nienhaus (1988:94)

### 3.6 CONCLUSION

Historical evidence on the development of banking, shows that banking operations have been known long before the 12th Century Italy which is considered by most economists as the 'birth place of banking'. Banking has been known to and practiced in earlier civilisations, such as the Islamic, the Roman, the Greek, the Egyptian and even the Babylonian and the Sumerian. In fact, there is available historical evidence which dates as early as 34 centuries BC (ie about 5,400 years ago) and which shows that a very advanced banking system was carried out by the religious temples which used to take care of the savings of their depositors and give loans to those who need finance, thus acting as banks.

We also saw how modern banking was developed in Europe and later transferred to the Muslim World, and how Islamic banking came about to fill the gap that modern interest-based banks could not fill in the Muslim World, because of the reluctance of the Muslims to deposit their savings with interest-based banks, due to their Islamic belief that interest is Riba and Riba is the most strictly prohibited thing in Islam after Shirk (polytheism).

## CHAPTER FOUR

### **THE BASIS OF ISLAMIC BANKING: THE PROHIBITION OF INTEREST AND THE PERMISSION OF PROFIT**

#### **4.1 INTRODUCTION**

Islamic banking is said to be based on two principles: a negative principle: the prohibition of interest; and a positive one: the permission of profit. The real difference between an Islamic bank and a non-Islamic bank is that: while the latter deals in interest in most of its transactions with its customers, the former rejects interest completely and instead, bases its transactions with its customers on the basis of profit and PLS system. However, although interest is perhaps no longer deemed to be synonymous with profit, there are still those who confuse the two concepts or at least do not see any difference in their economic impact. In fact, there are even those who, not only confuse interest with profit, but interest with rent and profit with wages, etc..

The purpose of this chapter is to enquire into the cause and nature of interest and profit by defining rent, wages, interest and profit; by critically reviewing and discussing the most important theories of interest and profit and by introducing 'the Islamic solution', to the problem, which was until recently, either not known to, or ignored by most economists. But it is very important to point out at the outset that: "the field is an extensive one and bristles with difficulties for in no other field of economics, perhaps, has so much been written and with such divergent results" (Divine 1959) .

Concerning the theory of interest, Harberler (1958:195) contended:

The theory of interest has for a long time been a weak spot in the science of economics and the explanation and determination of the interest rate still give rise to more disagreement among economists than any other branch of general economic theory.

And concerning the theory of profit, Maurice Dobb (1937:62) wrote:

The theory of profits is still perhaps the darkest part of the whole subject of economic distribution and though a voluminous controversy has been waged on the matter in America... a body of agreed opinion is still lacking and little has been done to erect a synthesis from the various partial explanations of a perplexed and perplexing subject.

In view of the vastness of the subject, and in view of the limited space for this chapter, the brief survey of the different theories of interest and profit and the discussion of their theories are confined only to the most important and well known ones, bearing in mind, as Knight (1957:30) pointed out that: "It is of course impossible to take up even the (most) important theories in all countries and summarise their views, while any brief treatment by schools or groups would be misleading rather than helpful". But before critically surveying and discussing these theories, it is very important to note that by looking at the historical development of the concepts of interest and profit one finds out that, until the repeal of the prohibition of interest in Europe in late Middle-Ages and the emergence of the various and conflicting theories to justify it, interest and usury were regarded by almost all religious leaders, canonists, philosophers and economists as a charge over and above loan capital. The two terms were interchangeable. They were both condemned not only by the monotheistic religions like Judaism, Christianity and Islam but also by all religious leaders, great philosophers and all honest men. It was only after the repeal of the prohibition of interest and the establishment of the so called 'legal rate' that usury received its present meaning of exorbitant charge for a money loan or a charge that exceeds the 'legal rate'.

As for trade and consequently profit, though regarded with dislike and suspicion by people like the Indian Brahmins, the ancient Greeks and Romans, and some Christian scholastics, it was not as much condemned as interest. Though regarded as legitimate, it was considered that it must be carried out only for the public benefit and must not yield more than the wages of the labour involved, due allowance being made for the skill and risk involved (see Tawney 1926:32 and Beddy 1940:11).

#### 4.2 DEFINITIONS

**Rent:** Rent may be defined as the predetermined market positive return paid periodically by a lessee to a lessor for the temporary use of the latter's property which must be a durable good but may not be money or a perishable consumer good, following a leasing contract. The

ownership of the property remains with the lessor and the lessee has only the right of use over it at the risk of the owner except when a damage is caused by the wilful act of the lessor.

**Wages:** Wages may be defined as the predetermined positive market returns paid by employers to employees in return for their work following an employment contract to do a certain job.

**Interest:** Interest may be defined as any predetermined return required by a lender from a borrower over and above the principal lent, following a lending contract. The ownership of the principal, once handed over to the borrower, becomes his own and at his own risk. Usually the lender secures his loan by taking a pledge from the borrower.

**Profit:** Profit is one of 3 forms of a sale residual following a Sale contract: 1) Profit; 2) Loss; and 3) No Profit and no Loss. Any of these three forms (ie one at any one time) may occur to the owner of the good sold and/or to the entrepreneur, who instead of getting wages for his management of the good sold accepts to share the sale residual.

#### 4.3 THE THEORIES OF INTEREST AND THEIR CRITICISMS

"After the repeal of the prohibition of interest, a perfect flood of writings broke out in which interest was defended with the utmost vigour, as if the barriers of long restraint had all been torn down in one day" (Boehm-Bawerk 1890:35). And just as before the repeal, nobody could, openly, defend the taking of interest, nobody, after the repeal could dare writing against it, this time not because of fear of punishment but of fear that he might be ridiculed or accused of fanaticism or reactionary thinking. This remained so until perhaps the mid 20th century when interest became a corner stone in the western theories of income distribution and when economists admitted its legitimacy without questioning its morality. The result was a great number of conflicting theories. This led Vera and Friederick Lutz (1951:237) to remark that: "the theory of interest is at present in a state of confusion".

Before presenting his own theory of interest in his book The Positive Theory of Capital to justify interest, Boehm-Bawerk critically surveyed all the important theories before him in his book Capital and

Interest. In the following sub-sections, the review and criticism of these theories and those of Boehm-Bawerk and Keynes will be dealt with.

#### 4.3.1 The Colourless Theories of Interest

Boehm-Bawerk (1890) included in this category along with other economists the theories of Adam Smith, Ricardo, Torrens and McCulloch. The title 'colourless' is used because these writers based their ideas on those of Adam Smith without adding much or enough to make definite theories of interest and because Adam Smith himself "has not laid down any distinct theory of interest (though) the germs of almost all the latter and conflicting theories are to be found with more or less distinctions in his scattered observations" (ibid 1890:70-71).

Some of these writers, like Sartorius, Lueder and Kraus, who followed Adam Smith, copied his vague idea about interest almost literally particularly his remark that: "if there were no interest the capitalist would have no inducement to spend his capital productively". Others, such as Politz and Murhad assumed that interest requires no explanation and said nothing about it. Others again gave reasons for it that though peculiar were superficial and trifling that they can scarcely lay claim to the honourable name of theories (ibid:80-81).

#### 4.3.2 The Productivity Theories

The theories that explain interest by the productivity of capital include those of J.B. Say, Malthus and Landerdale. Although the concept of productivity envisaged by these writers is not always clear and is not the same for each, the fundamental notion of all is that capital goods are in some sense productive and hence must receive a functional share in the distribution of income (Conard 1959:28). Although no-one denies the productivity of capital, since by its assistance more goods can be produced than otherwise, it should be self-evident that by creating goods one does not necessarily produce value. In fact, "The very fact that tomorrow's output can be larger than today's might indeed, cause the value of that output to be less than today's" (ibid:29).

#### 4.3.3 The Use Theories

Of the writers who hold this theories, Boehm-Bawerk gives special attention to J.B. Say who first suggested it, Hermann who worked out

its nature and essence and Menger who gave it the most complete form. These theories imply that, besides the substance of capital, the use of capital is an object of independent nature and of independent value. They argue that to obtain a return for capital it is not enough to sacrifice the substance of capital alone but the 'use' of it must also be sacrificed during the period of production; and since the value of the product is theoretically equal to the sum of the values of the means of production spent in making it, and since the substance of capital and the use of capital, taken together, are equal to the value of the product, this product naturally must be greater than the value of the substance of capital by itself. In other words and as Conard (1959:30) put it: "he who buys the product of capital must pay both for the substance of the capital and for the use of it. This latter payment provides the surplus which is interest".

In criticising these theories Boehm-Bawerk (1890:214) said that: "There is no independent use of capital such as is postulated by the use theorists. There can therefore be no independent value of the kind asserted and the phenomenon of surplus value cannot thus be accounted for. The assumption is nothing but the product of a fiction which is in contradiction of actual fact". He argued that all value of all goods always arise from their use, and that therefore it is meaningless to try to separate use value from the value of the substance".

#### 4.3.4 The Abstinence Theory

Senior is considered to be the founder of this theory. He distinguished between 2 primary instruments of production: labour and natural agents but these cannot attain complete efficiency if they are not supported by a third element, 'abstinence', which means: "the conduct of a person who either abstains from the unproductive use of what he can command or designedly prefers the production of remote to that of immediate results" (Boehm-Bawerk 1890:272). Thus, according to Senior, the sacrifice, which lies in the renunciation or the postponement of gratification demands compensation. Among the followers of Senior who hold this theory, Boehm-Bawerk (ibid) mentioned J.S. Mill, Jevons, Rossi,



Garnier, Cairness, etc., and concluded that "none of these writers have added any essential new feature to Senior's abstinence theory".

The ultimate and irrefutable objection to this theory in Boehm-Bawerk's view is that abstinence simply cannot be regarded as an independent factor of production (see Boehm-Bawerk 1890:278).

#### 4.3.5 Labour Theories

Under the title of the labour theories Boehm-Bawerk (1890) grouped together a number of theories advanced by theorists like Mill, Schaffle and Wagner, Courcelle Seneil and Rodbertus, who allege that interest is a payment legitimately earned by the capitalist, through the stored up labour and/or the labour of saving and accumulation.

As Afzalur-Rahman (1976:25) pointed out: "There is no doubt that foresight and saving do require some effort but the mere fact that the performance of labour in a certain set of circumstances is accompanied by the receipt of income is not by any means a justification for maintaining that the income is the wage of that labour. In order to advance such an argument one would have to be able to prove that the income is actually given in return for the labour and only in order to procure that labour". Besides, even if we admit that interest is the remuneration of the labour of saving as they claim, why then there is a difference in the remuneration of a rich man, who saves say: £10,000 and a poor man who saves only £500 in a year. They both experienced the 'labour' of saving from consumption and resisted the temptation for the same period. In fact the poor man with a higher propensity to consume must have experienced more pain and temptation to consume his savings, then why should the rich saving 'labourer' get more than the poor one.

#### 4.3.6 The Exploitation Theory

The exploitation theory was pronounced by socialist and communist writers, such as Sismondi, Proudhon, Rodbertus, Lassalle and Marx, who expounded the doctrine of Adam Smith and Ricardo that the source of all value is labour. The essence of this theory is:

All goods that have value are the product of human labour, and indeed, economically considered as exclusively the product of human labour. The labourers, however, do not retain the whole product which they alone have produced, for the capitalists take advantage of their command over the indispensable means

of production as secured by them by the institution of private property, to secure to themselves a part of the labourers' product. The means of doing so are supplied by the wage contract in which the labourers are compelled by hunger to sell their labour power to the capitalists for a part of what they, the labourers produce, while the remainder of the product falls as profit into the hands of the capitalists without any exertion on their part. Interest is thus a portion of the product of other people's labour, obtained by exploiting the necessary conditions of the labourer (Boehm-Bawerk (1890:315)).

Thus, according to them rent, interest and profit are illegitimate plunder from the product of other people's labour and the workers are defrauded (ie exploited) of the surplus value which they themselves have produced. This theory, according to Boehm-Bawerk (1890:390) is not only incorrect but in theoretical value, even takes one of the lowest places among interest theories. He wrote: "However the fallacies we may meet among the representatives of some of the other theories I scarcely think that anywhere else are to be found so great a number of the worst fallacies: wanton, unproved assumptions, self-contradiction and blindness of fact". He (ibid) demonstrated that labour does not create all value but besides labour there are other factors such as the demand and supply of the good and the passage of time on the good which affect its value and make it fluctuate sometimes below, sometimes above the amount of labour incorporated in it and contended:

The asserted law that the value of goods is regulated by the amount of the labour incorporated in them, does not hold at all, in the case of a very considerable proportion of goods; in the case of the others, does not hold always; and never holds exactly. These are the facts of experience with which the value theorists have to reckon.

#### 4.3.7 The Eclectics

After the repeal of the prohibition of interest and since the 1830s when the problem of interest had become a common subject of scientific discussion, it was no longer possible for economists to remain undecided about it. Boehm-Bawerk (1890:395) reported that:

Economists were obliged to own to an opinion and those who could not come to a decision of their own became eclectics. Interest theories were put forward in abundance. Writers who neither could, nor would, make one for themselves, nor decide exclusively on one of the already made, would choose from two or three or more heterogeneous theories the part that suited them, and weave them into what generally proved a rather badly connected whole, or without even trying to obtain the appearance of a whole, they would in the course of their writings employ sometimes one, sometimes another theory, as suited best for the purposes they might happen to have in view.

The least that can be said about such theories is that they are plagued with hesitation and inconsistency which give rise to all sorts of contradictions and confusion and thus are no better than the previous original theories of which, none is free from criticism.

#### 4.3.8 Time Preference Theory

At the end of his book Capital and Interest, where he surveyed and criticised all earlier known theories, Boehm-Bawerk (1890:428) wrote:

On the foundation thus laid I shall try to find for the vexed problem a solution which invents nothing and assumes nothing, but simply and truly attempts to deduce the phenomenon of the formation of interest from the simplest natural and psychological principal of our science.

And in his book Positive Theory of Capital (1891), he expounded his theory of interest according to which interest arises from the difference in value between present and future goods claiming that his theory "does not contain one single feature which is not based on true empirical principles". He contended:

Present goods are, as a rule, worth more than future goods of like kind and number. This proportion is the kernel and centre of the interest theory which I have to present. All the lines of explanation, by which I hope to elucidate the phenomenon of interest, run through this fact, and round it, both essentially and superficially, is grouped the whole of the theoretical work we have to do. Once this fact is established, then the willingness of persons to pay interest for the loans of funds becomes obvious.

Although this theory is one of the most accepted ones, it is not free from criticism. Cassel (1903:61) argued: "this formula of undervaluation of future goods in relation to present is however ambiguous and has, in fact, two different meanings even with Boehm-Bawerk himself". Besides he does not distinguish between the future change in the value of real goods and that of money. The future value of any real good cannot be accurately known at present because it is uncertain and depends on its demand and supply at that future. It may go up as well as down and it may remain unchanged. As for money, this is not the case because "if a man hoards his savings in cash he earns no interest though he saves as much as before" (Keynes 1936:167).

Mawdudi (1984:176), in criticising this theory, argued:

Does human nature really consider the present as more important and more valuable than the future?. If this is so why do the majority of people not consider it wise to exhaust all

their earnings today, and prefer to save a portion of their wealth for the future?. Perhaps you will not come across even 1% of people who have abandoned all care for the future and prefer to spend all their wealth on present pleasures and enjoyment... You will hardly find a man foolish enough to choose a better present at the cost of a worse fortune. It is a different matter if a man does so out of ignorance, stupidity or under the influence of monetary lust, but none would deliberately accept this choice as correct and reasonable.

S. Ahmed (1952:33) also contended that:

In all countries and climes, wherever the men have capacity to save, they do so in (almost) total disregard of the premium or otherwise on savings and when men cannot save, have barely enough to live on, no rate of interest can persuade them to starve. Here, of course, present goods are of much more value than future goods. But the men in this situation have no capacity to give loan and should as little enter the theories of interest as they do the money market. Those who can save, as a rule do sacrifice present comforts to future necessity.

#### 4.3.9 The Loanable Fund Theory

The loanable fund theory of interest, as proclaimed by its supporters such as Ohlin, Robertson, Hicks, Harberler, etc., regards interest as essentially a monetary problem. "These theorists are", as Qureshi (1983:28) pointed out: "less concerned with the cause of the existence of interest and more with the determination of the rate of interest". In other words, and as Afzalur-Rahman (1976:46) put it: "they do not attempt to answer the question why should interest be paid or why interest is paid?. They have simply ignored this question and have sought refuge in the theory of value. They say like all other things the price of capital is determined by the demand and supply of money".

In their effort to define interest, these theorists treat 'money capital' as equivalent to capital goods, a subtle mistake which, as Abu Saud (1980:64) put it: "helps them find a warrant for charging interest on borrowed money. Money per se cannot be considered equivalent to fully fledged goods mainly because all goods embody a utility which satisfies some human economic demand. This innate natural property is artificial in money, as demand for it -as a means of exchange- is a derived one imputed to the original need for the exchange of products. If money ceases to function as such means ie if no exchange of real products takes place through the mediation of money its raison d'etre disappears". Besides when exchanging goods, we do not exchange them against the like goods (in quantity and quality) but against other goods. Thus the ana-

logy of the interest with prices of other goods is totally wrong and does not answer the question why should interest be paid?.

#### 4.3.10 The Liquidity Preference Theory

Keynes' theory is built upon a rejection of the Classical assumption which regards the rate of interest as the factor which brings the demand for investment and the willingness to save into equilibrium with one another. In his explanation of the problem of interest, Keynes lays stress on what he called 'the liquidity preference' and the quantity of money giving four motives for this liquidity preference, two of which are insensitive to the rate of interest (the transactions motive and the precautionary motive) and two of which are interest-elastic (the speculation motive and the finance motive). Keynes (1936:167-8) argued:

The rate of interest is not the price which brings into equilibrium the demand for resources to invest with the readiness to abstain from present consumption. It is the price which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash... The mere definition of the rate of interest tells us in so many words that the rate of interest is the reward for parting with liquidity for a specified period. For the rate of interest is, in itself, nothing more than inverse proportion between a sum of money and what can be obtained for parting with control over the money in exchange for a debt for a stated period of time... the quantity of money is the other factor, which in connection with liquidity preference, determines the actual rate of interest in given circumstances... It is obvious that up to a (certain) point it is worthwhile to sacrifice a certain amount of interest for the convenience of liquidity. But, given that the rate of interest is never negative why should anyone prefer to hold his wealth in a form which yields little or no interest to holding it in a form which yields interest.

Although he did not agree with the classicals on the explanation of interest, Keynes agreed with them in not questioning its necessity or legitimacy. As Robertson (quoted by Afzalur-Rahman 1976:44) put it: "they leave interest suspended so to speak in a void, there being interest because there is interest". On the other hand he (ibid:235) wrote:

The money rate of interest, by setting the pace for all the other commodity rates of interest holds back investment in the production of these other commodities without being capable of stimulating investment for the production of money, which by hypothesis cannot be produced.

And he also argued on page 184 that:

It seems then that the rate of interest on money plays a peculiar part in setting a limit to the level of employment, since it sets a standard to which the marginal efficiency of a capital asset must attain if it is to be newly produced.

The trade cycles also result, according to Keynes, from the brakes put on the wheels of the economic machine by the rate of interest. Thus although Keynes diagnosed interest as the main cause of unemployment and trade cycles, and considered it as the chief obstacle in the way of the full utilisation of the productive resources available, he missed the remedy of abolishing it completely and suggested that "it is to our best advantage to reduce the rate of interest to that point, relatively to the schedule of the marginal efficiency of capital at which there is full employment" (p.375). But that point cannot be other than zero.

#### 4.4 THEORIES OF PROFIT

Beddy (1940) critically surveyed the most important and well-known theories of profits in the west then gave his own theory. Here, I shall briefly review and criticise these theories. But before that it is very important to point out that, unlike in the Muslim World where merchants and traders were honoured and consequently their profits approved, commerce and trade were very much despised in the West during the Middle-Ages and their profits were seen as illegitimate. Beddy reported that:

It was not until the advent of mercantilism, that the position of the merchants completely changed. Instead of being the despised members of the community they became the chief instrument by which the mercantilist policy could be carried out. On their ability depended the success of the effort to make as much profit as possible out of foreigners by exchanging home produced commodities for the much more highly prized precious metals, thus, those who engaged in this activity rose from their lowly social position to one of much higher standing in which they enjoyed no inconsiderable measure of respect. (p.12)

However, by the mid 18th Century the Physiocrats, led by Quesney, held that agriculture is the only source of the Produit net and that other sectors like industry and commerce are sterile since they give no real wealth surplus. Then came the Classicals starting with Adam Smith, who on one hand seems to dislike profit-seeking since he described profit seekers as: "an order of men whose interest is never exactly the same with that of the public who have generally an interest to deceive and even oppress the public and who, accordingly have, upon many occasions, both deceived and oppressed it" and on the the other realises at the same time that: "It is the stock that is employed for the sake of

profit which puts into motion the greater part of the useful labour of every society" (see Beddy 1940:15). Since then a number of theories have been advanced to explain profit, the most important of which are:

#### 4.4.1 The Classical Theories

The Classics recognised 3 forms of income: rent, wages and profits. But these forms of rewards were often too difficult to distinguish from each other because they sometimes arose in the composite form of the income of one person. Knight (1951:534) pointed out that:

The Classical writers, recognised at least three elements in the income of the capitalist entrepreneur: one payment for the bare use of the capital (equal to interest), a second element representing payment for the entrepreneur's activities as manager, and a third connected in a rather vague way with the carrying of the risks of hazards of the enterprise.

"The chief blemish of these theories", as Beddy (1940:20) remarked: "lies in the confusion between interest and profit". Although almost three quarters of a century separated Adam Smith from Mill, yet as Beddy (1940:36) noticed: "it was only at the very end of this period that fresh ideas began to emerge on the subject of profits. The classical economists failed to give a consistent and a clear theory of profit. Their treatment, as a whole, was superficial and inconsistent. At times they compare it to interest, others to rent, etc.". From Mill onwards economists began to distinguish profit from other forms of income but many were the theories they advanced to explain it.

#### 4.4.2 Management Earning Theory

This is one of the most accepted theories of profit which continue to be held by some economists up to the present day. The proponents of this theory believe that profits represent the reward for the work of management and superintendence. This theory is held by so many economists that Beddy (1940:47) said: "it would be a formidable and useless task to attempt to name them and to set forth their views in any detail". According to this theory, and as Beddy (1940:43) pointed out: "when the employer pays himself his own wages, he is left with neither a profit nor a loss on his business". Marshall's leaning towards this view is clear from his statement that "putting aside the gains of speculation... it remains true that competition tends to secure, to each

ordinary employer, earnings of management equal to what his work adds to the efficiency of production so much and no more". But Hawley (1892) argued: "why when all managerial functions are delegated do we not say that those to whom they are delegated receive profits and not wages".

Beddy (ibid:51) contended that: "if as is now quite clear, the management of the very large enterprises rests in the hands of salaried individuals who do not share in the net profits remaining after payment of all salaries and other expenses, there can be no doubt that the profits of such enterprises are not wages of management. This is the common sense and generally accepted view of modern economists".

#### 4.4.3 The Business Ability Theory

This theory is associated with Walker (1887) who, like many others, revolted against the emphasis placed on capital in explaining profits. He distinguished between the businessman (entrepreneur) and the capitalist. Excluding from profit the wages for the work of superintending and directing the business affairs as these could be delegated he found the explanation and justification for profits in the exceptional abilities of the businessman, to furnish the technical skill and commercial knowledge to administer the business, to assume its responsibilities and to provide against contingencies.

Comparing the businessmen who may be called the non-profit class (who make only a bare living by receiving only wages of superintendence that are not profits in his view) with the businessmen, in the same walks of life, who, because of their exceptional abilities and exceptional opportunities, make successful varying amounts of profits over and above their wages of superintendence, he spoke of the 'exceptional ability' which made men millionaires and the lack of it which caused long established business concerns of high prestige to collapse through inefficient management and arrived at the conclusion that: "just as rent was a reward for the superior productivity of certain soils, so also profits rewarded the superior personal abilities of certain employers or entrepreneurs" (see Beddy 1940:55).

This theory was criticised by Macvane (1887) who pointed to the failure of Walker to indicate clearly who was the gainless entrepreneur



and expressed his doubts that price was determined by the least efficient employer. Macvane's soundest objection to Walker's views was that they represented only a theory of differences in profit (ie he explained only why one entrepreneur got more than the other but he did not explain why the other got anything at all). This theory is today, as Beddy (1940:64) put it: "largely discredited though there still remain some who seeing the entrepreneur as the guiding spirit in all phases of business activity, continue to believe that all net gains result from acts of his, in which his superior skill and ability are displayed".

#### 4.4.4 The Dynamic Theory

This theory is upheld by Clark (1899) and his followers. Assuming that, all real knowledge of the laws of movement depends upon an adequate knowledge of the laws of rest, Clark started his treatment of the theory of profit by distinguishing between the static and dynamic economies and concluded that profits are exclusively the results of dynamic change. Clark's concept of dynamic theory is different from that of Schumpeter, which is governed largely by his views of a static state in which conditions are static but not stationary, that is to say in which the economic system adapts itself to changes in land or labour but does not itself develop from given conditions.

Although this theory received and perhaps continues to receive wide and unqualified acceptance, there are many, however who have challenged both the method and the conclusion of Clark. Beddy (1940:71) reported that: "Carver wrote of the doubtful utility of so heroic an assumption as that of the static state and Marshall was not among those who welcomed so abstract a concept which differed so greatly from that of the representative firm". Although, Knight (1957:37) admitted that without changes there would be no profits in the theoretical sense, he argued that: "it is not dynamic change, nor any change, as such, which causes profits, but the divergence of actual conditions from those which have been expected and on the basis of which business arrangements have been made which brings about a special entrepreneurial income".

Furthermore, as Beddy (1940:77) pointed out: "Clark's conception of

the entrepreneur is not sufficiently definite... Taussing could not accept the sharp distinction it draws between wages of management and profits. Clark's definition was therefore a matter of phraseology and no clear line could be drawn to show the functions which wages of management would remunerate and those which were remunerated by profits. Indeed Clark's entrepreneur is so shadowy a being that it is difficult to believe that it is the explanation of profit. His functions are too vague to leave unsatisfied that they are real".

#### 4.4.5 The Risk Theory

As Beddy (1940:82) pointed out: "It is probable that no theory of profits has attracted so much attention and given rise to much discussion as the risk theory which ranks today as one of the most widely accepted views of profit". Many Muslim scholars adhere to this theory in distinguishing between interest and profit and consequently reject some Halal sale contracts like Murabahah (mark-up) and Bai' Muajjal (sale at higher deferred price) as non risky and as similar to interest, which is Haram (See 5.2 below). But as we will see this theory is tenuous.

This idea of explaining profit in relation to risk was known from very early times by those who recognised in all business ventures an element of risk, but who did not believe that risk is the only explanation of the whole profits (see 4.4.1 above). However, the doctrine that profit is to be explained exclusively in terms of risk has been associated with the name of Hawley in the USA and Mangoldt in Germany.

Hawley (1893) regarded risk-taking as the inevitable accompaniment of dynamic production and the essential function of the entrepreneur. According to him: "Profit is simply the price paid by society for the assumption of business risks". Strictly speaking, he regards the entrepreneur as the only really productive factor, land, labour and capital being relegated to the position of 'means' of production. The class of risks rewarded by profits were, in his view, the uninsured business and industrial risks which are the results of the uncertainty of how the selling price of unsold product will compare with the cost or how the cost of unfinished product will compare with its selling price. This uncertainty would fall on the shoulders of the entrepreneur since, the

ownership of the product of industry was the distinguishing characteristic of the entrepreneur. He assumes that every businessman's subjective valuation of a risk is always greater than his actuarial valuation of the same risk because according to him: "the assumption of risk is irksome, it gives rise to trouble, anxiety and disutilities of various kinds and these must be rewarded by a payment over and above the actuarial value of the risk". Profit, therefore, consisted of two parts: one representing compensation for the actuarial or average loss incidental to the various classes of risks necessarily assumed by the entrepreneur and the remaining part represented an inducement to suffer the irksomeness of being exposed to the risk" (see Beddy 1940:84-85).

However, as Beddy (*ibid*) criticised this theory, it does not offer a full explanation of all the gains arising from business activities. It is evident that the very substantial gains of many monopolistic or semi-monopolistic business concerns could not be attributed to the risks which were undertaken, since in many cases the gains arose from the very fact of not taking any risks at all. When Hawley was conscious of and recognised that monopolistic profits fell outside his theory, he placed these gains in a distinct category and regarded distribution as consisting of rent, wages, interest, profits and monopoly gains.

This theory is defective for at least 4 reasons: First, Hawley was unable to maintain successfully that these gains were really a distinctive form of economic reward as to justify their inclusion in the theory of distribution as a fourth independent reward. Secondly, though he stated that there were four industrial forces: land, labour, capital and enterprise, he could not say that enterprise alone had two independent rewards: profits and monopoly gains. The third objection to this theory is that, it is well known that greater risk does not necessarily generate greater profits. Clark (1892) pointed out that "not only do profits not correspond with risks but often vary inversely as risks". Fourthly, this theory may also be challenged on the grounds that it is not always the entrepreneur who assumes risks, especially where entrepreneurs get wages and where losses are assumed by shareholders.

#### 4.4.6 The Uncertainty Theory

Knight (1921) criticised risk theorists for confusing risk and uncertainty. He believed that profit is not the reward of risk which can be measured and reduced by combinations and insurance but of uncertainty which cannot be measured or insured against. According to him a businessman must guess future demand and selling prices and pay amounts based on his guess in advance to his factors of production. This theory in turn could not escape criticism. Uncertainty is a subjective concept and the willingness to bear it differs from one person to another. Furthermore it has no direct relationship with the amount of profits realised. Besides like the risk theory it fails to explain profits that can be obtained by mark-up sales, where the prices include extra pre-agreed percentages over costs. Beddy (1940:125) argued that: "the real importance of uncertainty lies in its influence on supply. So far from being one of the factors of production it is simply one of the influences which affect the extent to which those factors will be utilised. In this respect it somewhat resembles pain which influences the supply of labour and abstinence which influences the supply of capital. Like them it is incidental rather than essential... Even if uncertainty bearing was connected only with business enterprise, we can no more say that profits are the reward for uncertainty-bearing than we can say that wages are the reward for pain".

#### 4.4.7 Monopoly Gains Theory

Among those, who hold the view that profits are wholly or in large part unearned and attribute its origin and size to the existence of advantageous monopolistic positions in the institutional structure which are possessed and exploited by a favourite minority and consider them mainly or wholly due to spoliation, Rodbertus, Lassalle and Marx may be mentioned. An immediate objection to this theory is that while such gains may be described as profit, the converse is not the case, since substantial profits may arise under competitive and not under monopolistic conditions. "Even in the same case of complete control by one person or group of persons of the production of a particular commodity, there is usually only a partial monopoly, on account of substitute com-

modities" (Beddy 1940:148). In fact, in most if not all of today's economies, neither monopoly nor competition regulate the economic activity structure, rather, it is the conditions of imperfect competition.

Thus this theory, like the risk theory which left monopoly gains out, does not explain or cover all profits and hence does not give a complete satisfactory explanation of all profits.

#### 4.5.8 The Acquired Advantage Theory

After reviewing and criticising all the previous theories of profits with a greater detail, Beddy (1940) presented his own theory: 'the acquired advantages theory'. According to him: "Profits do not arise from anything but acquired advantages and a study of profits must be a study of such advantages" (p.265). Hence, he went into a detailed study of a number of advantages, from which, he believed profits arise. But before that, he distinguished between two types of advantage by saying: "though there are so many different kinds of advantage as to make it virtually impossible to describe them fully, they all fall under two main headings, natural advantages and those which for want of a more apt description, may be referred to as acquired advantages (p.254). He attributed rent to the first which he considered to "arise from natural ability, natural fertility or more correctly from superiority of natural resources" (p.267) and profits to the latter which he considered to "arise from advantages which owe nothing to the bounty of nature".

In his analysis of the latter type of advantages, he argued that:

It is primarily the right to private property which enables the benefits of economic advantages to be reaped... and without such right, the same endeavours would not be made to secure advantages which had to be shared with the community at large and on this account, many advantages would not be sought at all... When the right to private property is enjoyed by all sections of the community it does not give rise to advantages. It ensures that those who possess advantages are permitted to benefit from them and in many cases, the right to private property is strengthened so that it becomes a specific right which is not shared by all, and obviously those advantages which can be enjoyed by virtue of such rights become the source of great profits. (p.269).

Among the advantages, he described in detail (between pp.270-340), the following ones may be mentioned:

- 1-) The protective duties and other restrictions on imports which have proved to be of great advantage to those whose products have been safeguarded from foreign competition;

- 2-) The machinery of politics which could be used to further the interest of "big business" where the ruling classes are the wealthy classes, and where the latter derive their wealth from profits which rest upon acquired advantages;
- 3-) The use of government legislation or patronage to favour specific individuals or groups who may be qualified in a particular respect;
- 4-) The circumstances in which, owing to inequality of opportunity it is impossible for many even to qualify for the possession of profitable advantages while others enjoy the profits that arise from advantages like business secrecy, location, size, sufficient wealth, machinery, diversification, education, monopoly, etc.;
- 5-) The marketing advantages through the possession of some exclusive advantages in the purchase of raw materials, in the methods and processes of manufacture, in accountability to cheap and efficient labour, in transport, in general organisation, in credit facilities and in anything connected with business in which advantage is possible;
- 6-) The unfair advantages which, though are of much more questionable type, give rise to profits. They arise from methods of doing business which are ruthless, unscrupulous or deceptive or arise from misapplied or distorted power or ability such as adulteration, deceptive advertising, over-charging, bribery and corruption of all kinds;
- 7-) The accidental or fortuitous advantages which are in some instances the most important element in profits, namely the reward for good fortune, luck and audacity.

This theory fails, like its predecessors, to answer what the direct cause of profit is or why profit should be paid to those who receive it. This theory may be accepted in explaining the causes of differences in business profits but not in explaining the whole of profits or their real cause. Hence, it can be said that this theory is open to the same objections which render the existing theories unacceptable.

#### 4.6 THE ISLAMIC SOLUTION TO THE PROBLEM OF INTEREST AND PROFIT

Before discussing the Islamic solution to the problem of interest and profit, it is very important to first know about the Islamic attitude towards them from the sources of Islam. But at the outset of this task it is worth remembering that in case the Ijtihad of a scholar or a group of scholars contradicts the Koran or the Sunnah, then this is considered as void and as non-Islamic whosoever its author(s) may be.

##### 4.6.1 Interest

Like the prohibition of intoxicants, the Koranic prohibition of interest was gradual. It came in four stages. The first Koranic verse to be revealed concerning interest is in Koran:30:39:

Whatever you lend at interest, so that it may increase your net worth at the expense of others, in reality it does not increase with Allah, but what you give in Zakat (poor due, charity, etc.) seeking Allah's pleasure, increases manifold.

Although this verse does not explicitly prohibit Riba, it suggests that lending at interest is an injustice since it is at the expense of others (borrowers). It also points out to the paradox that those, who think that by taking interest on loans, they increase their net worth, are wrong for in reality they do not. As for paying Zakat, though it appears as if it decreases the wealth of the individual, it in fact increases it. The Koran does not show us how this could be explained.

The second and third Koranic sets of verses about interest are to be found in Koran 4:160-162 and Koran 3:120-136. The former set of verses warn Muslims indirectly not to transgress Allah's laws and not to take interest as did some of the Jews who took interest despite its prohibition, but to be like the believers among them who believe in all the revelations from Allah, establish regular prayers, practise regular Zakat and believe in Allah and in the last day. The latter set of verses forbids the Muslim to take compound interest and states that the real prosperity cannot be obtained through the taking of high interest rates as many would think but on the contrary it can be obtained by spending freely in charity. Here again the Koran does not tell how this could be so, and leaves it to the scholars to exert their effort to find out how.

The last set of Koranic verses about Riba is in Koran 2:261-283, prohibits it categorically with the most severe condemnation by declaring war against those who take it, and clearly defines it as any gain over and above the principal lent, be it small or large. A distinction is made between interest from loan which is prohibited and sale which is permitted and a contrast is, once again, made between acts of Infaq (charity) and acts of Riba suggesting that it is the former rather than the latter which causes prosperity. Again how this could be achieved is left to the scholars to ponder about or discover. The longest verse of the Koran is also among this latter set of verses. It deals with the rules of writing down the contracts involving future obligations in order to prevent litigations and conflicts (see 3.4 above).

As for Riba in Sunnah, there are tens of Hadiths about it, some of those translated by Robson (1975:603-606) are as follows:

- 1- Jabir reported that: "Allah's messenger cursed the one who accepts Riba, the one who pays it, the one who records its contract and the witnesses to it, saying that: they are all alike.
- 2- Abdullah son of Hanzala reported Allah's messenger as saying: "A dirham which a man knowingly receives as interest is more serious than thirty six acts of fornication".
- 3- Abu Huraira reported Allah's messenger as saying: "Riba may take seventy forms, the least important being equal in its severity to a man committing incest with his own mother".
- 4- Abu Saeed El-Khudri reported Allah's messenger as saying: "Do not barter gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt except in equal quantities and with the condition that payment and delivery are made on the spot."
- 5- Abu Saeed El-Khudri reported that: "One day Bilal brought some good quality dates to the prophet (PBUH) who asked him: "Where did you get this from?". Bilal answered: "I had some dates of inferior quality which I exchanged against these: two measures against one". The prophet then said: "Ah! the very essence of Riba, the very essence of Riba. Do not do so, but when you wish to buy, sell your dates in a separate transaction with money, then buy what you like with what you get".

From the above mentioned Koranic verses and Hadiths all the Muslim scholars, from the rise of Islam till the present day, distinguish between two forms of Riba: Riba El-Nasseea and Riba El-Fadh1. The first is concerned with interest on money loans and the second emanating from the barter of some goods if these are of the same kind even if they differ in quality (see Hadith nos.4 and 5 above). With the exception of very few Muslims who appeared in the first half of the 20th century and who -under political and economic pressures or under western educational influence- thought that no rapid economic development is possible without modern banking and no banking is possible to work without interest, distinguished between interest transactions among individuals and interest to or from banks, sanctioning the first as the one prohibited by Islam and declaring the second as permissible, all other Muslim scholars agree that Riba El-Nasseea is any predetermined increase over and above the principal of a debt, whether this is between individuals or institutions. However, there is some disagreement among Muslim scholars concerning Riba El-Fadh1 which arises from the barter of commodities of the same kind (see Hadith nos.4 and 5 above) whether it arises only from the six commodities mentioned in the hadith or from all commodities of the same kind. Because what is of importance to us here is



the banking interest and this one falls, in my opinion, under Riba El-Nasseea, I shall limit my discussion only to this latter one.

The problem of interest has received quite a considerable attention by Muslim scholars this century. First, between 1916 and 1920 when the idea of establishing an indigenous bank in Egypt was in the air a number of lectures were given in Nadi Dar El-Ulum to discuss the legitimacy of banking interest (Banna 1986:7). Despite the fact that there was no agreement about the exclusion of banking interest from Riba, the result, however, was the establishment of the interest based: Banque Misr in 1920 followed by others. The second occasion was perhaps in the late 1940s and beginning of the 1950s when some Pakistani Muslim scholars, like Mawdudi, Qureshi, Uzair and M.N. Siddiqi, tried to find an alternative to interest based banking for the newly established Muslim country Pakistan. The third occasion was in 1965 during the second conference of the Islamic Research Congress in Cairo, in which the, then present scholars reached the consensus that all forms of interest including those from banks -whether they are for consumption or production purposes- are Riba and hence prohibited. The fourth occasion is connected with the emergence of the Islamic banks, which started in the 1970s and has been continuing in the 1980s. Now there seems to be a general consensus among contemporary Muslim scholars that all forms of predetermined interest on loans and deposits are Riba and so are prohibited.

Among those who excluded banking interest on deposits from Riba and considered it as permissible, Shaltout, Yusuf Ali, Khallaf, Dawalibi, Sanhuri and El-Fanjari (see Lachine 1983:498 and Banna 1986:35-66) may be mentioned. They argued that interest from bank on deposits is not Riba because the bank did not go to the depositors to borrow from them but it is the depositors who went to the bank and deposited their savings with it, in other words they deny that deposits constitute a debt on the bank. They further argued that the interest given to depositors is not predetermined by the latter, as the lenders do in the case of Riba, but by the bank and so it represents the profit share of depositors in the bank's profit and is just like Mudharabah profit.

The reply to these arguments is that no matter how the deposits came to reach the bank, they no doubt represent a debt on the bank towards the depositors (the bank owes these deposits in full to the depositors). If the bank pays any predetermined return on these deposits, then this return fall without any doubt under the definition of Riba El-Nasseea, no matter who decided on the rate of interest. Besides, these returns do not resemble profits from Mudharabah because a predetermined return on capital in a Mudharabah makes it not valid and not permissible.

Others like Dawalibi, distinguished between interest on consumption loans and interest on production loans and argued that Riba is concerned only with the former because in this case there is an exploitation of the need of the poor who need to be helped rather than oppressed. As for the interest on productive loans, they saw no objection in charging a so called 'fair and moderate rate'. The answer to this argument is: first, the Koran and the Sunnah, when referring to Riba, did not make such difference but affirmed that any addition over and above the principal of a loan is Riba; second, the historical evidences show that the Riba that used to be in existence in Arabia, prior to Islam, was mainly on productive loans (see 3.4 above); third, though exploitation is more apparent in interest on consumption loans, it is also present in productive loans not necessarily in detriment of the borrower but sometimes in detriment of the lender, especially in case where the borrower realises considerable profits by using the lender's money and gives only a tiny amount of it to the latter.

Some others, like Sanhuri argued that what Islam prohibits is excessive compound interest and not moderate simple interest. They allow interest because they think it is the only way necessary for mobilising savings for development. Again Islam is clear when prohibiting interest that no more than the principal of a loan is allowed. Besides, interest is neither necessary nor the only way to mobilise savings. Last but not least, what is a 'fair and moderate' rate of interest?.

As for the majority of Muslim scholars like Mawdudi (nd), S. Ahmed (1952), Afzalur-Rahman (1976), M.N. Siddiqi (1980), and Qureshi (1983) who adhere to the strict prohibition of interest on deposits and loans,

argue that the main reason why Islam abolishes interest is that it is Dhulm (injustice and exploitation). In the case of consumption loans, it violates the basic function for which Allah has created wealth which envisages that the needy be supported by those who have surplus wealth. In the case of productive loans, predetermined and guaranteed return to capital is unjust in view of the uncertainty surrounding the business.

A second reason advanced by Muslim scholars as to why all sorts of interest on loans must be prohibited is that it transfers wealth from the poor to the rich, increasing thus, inequality by making the rich richer and the poor poorer. This is against social interest and contrary to the will of Allah who ordains Adl (justice) and Ihsan (benevolence) and forbids Dhulm (injustice and oppression).

A third reason why interest is to be abolished is that it creates an idle class of people who neither work nor participate in bearing the risk of losses that might occur to the borrowers. If, instead of lending their surpluses, they had themselves invested them directly, they would not be certain of getting profits, they even might suffer losses, so why should they get predetermined returns on their lent capital?.

Another reason for the prohibition of interest is that, perhaps it is one of the main causes, if not the main cause, of inflation, unemployment, social injustice, Third World Debt Crisis, etc..

#### 4.6.2 Profit

Concerning profit, however, all Muslim scholars with no exception, agree that profits and PLS from legal trade of lawful goods, services and rights (eg shares in companies) are legitimate but they give different explanations as to what causes profits to arise or to what justifies the taking of profit. Some, like S. Ahmed (1952:25) explain profit as: "the result of initiative, enterprise and efficiency". Others, like Afzalur-Rahman (1976:90) consider it as: "the uncertain reward for the labour of trade and for the bearing of risk of loss of the principal". And others still, consider profits as the result of the productivity of capital. Since these arguments fall under one or another of the above criticised theories of profit, they are subject to the same criticisms.

In my view, if we look at profits in a plain straightforward manner, we find that profits are only one of three outcomes that emanate from sale and only from sale, for unless there were sale there would be no profits, no matter how much initiative, organisation, coordination, management or superintendence were involved and no matter how much risk and uncertainty may be borne and even no matter how much monopoly or other advantages the profit seekers might have acquired. It may be true that good management, organisation, monopoly or advantages like good location, advertising, use of computers, etc., may help selling more efficiently thus, indirectly affecting the size of profits, but this is not necessarily so in all cases. It may also be true that some sales involve bearing greater risks and uncertainty than others but this does not necessarily mean that those sales involving greater risk or uncertainty are more profitable than the others. Thus, in my view, profit is primarily and simply a part of what I call the 'Theory of Sale Residual' which is concerned not only with profit (the positive return on sales) but with losses (the negative return) and with the case of making neither profits nor losses. Perhaps that is why Allah mentioned sale and not profit in the Koran 2:274 when he said: "They say sale is just like interest but Allah has permitted sale and prohibited interest", to tell us that not only profits are permitted but all the outcomes of legal sales are permitted whether they are profits, losses or no profits and no losses. As for interest, he mentioned Riba, which is any positive return on loans to tell us that what is prohibited is not the act of lending itself but only the return on loans. This theory covers all returns on sales whether these latter are risky or not, certain or uncertain, carried out under monopoly or under competition, etc..

However, Islam does not allow all sorts of sales. It prohibits monopoly, speculation (storage of goods during periods of abundance to create shortages that lead to dramatic rises in prices), forward sales of money and of unripe agricultural products in their fields. It also prohibits the cut-throat competition and encourages fair business that is carried out in a spirit of humanitarianism and justice. Islam also prohibits all sales of harmful and prohibited products like the meat of

pork and of dead animals, blood, intoxicants, and all sales involving deception, fraud, chance and other crooked ways. In fact Islam has set some rules and conditions for the validity of sale contracts. Some of these conditions apply to the contractants and some others apply to the commodity. These conditions may be summarised as follows:

1-) **Conditions applying to the contractants:** the contractant must be sane, sensible, conscious, honest and under no obligation at the time of the agreement, otherwise the contract becomes void.

2-) **Conditions applying to the commodity:** the commodity must not be lawful, of some beneficial use, belong to the profit-seeker, obtainable, transferable and free from all defects. In case the commodity is defective in any way the buyer must be told beforehand.

The sale residual may be positive (profit), negative (loss) or equal to zero (no profit and no loss) depending on the sale price and on the cost of the commodity. This can be represented in the following simple equations:

$$SR = SP - TC \quad (1)$$

where: SR = Sale Residual; SP = Sale Price; TC = Total Cost

A profit arises only when SR is positive:  $SR > 0$  (2)

This happens only when:  $SP > TC$  (3)

A loss occurs when SR is negative:  $SR < 0$  (4)

which implies that the  $SP < TC$  (5)

And no profit and no loss arises when  $SR = 0$  (6)

That is to say when  $SP = TC$  (7)

Unlike the orthodox theory of income distribution which considers distribution purely from the functional standpoint by distinguishing separately the functions of land, labour, capital and enterprise and by regarding those functions as being rewarded by rent, wages, interest and profit respectively, the Islamic approach to the distribution of income is, in my view, a non functional one. The Islamic approach to the distribution of income is not so much concerned with the factors of production as it is concerned with the owners of these factors of production. It looks at the legal contracts determining the socio-economic relations between the owners of the factors of production and distribu-

tes the income according to these contracts. Thus, we can say that the Islamic approach to the distribution of income is a contractual one.

For example, the entrepreneur receives wages for his work if he agrees to be employed and to receive wages that have no relation to the SR of the company he works for. If however, he accepts that his reward be related to the SR of the company, he receives profits in case  $SR > 0$  and receives nothing in case the  $SR < 0$  or  $SR = 0$ , as in Mudharabah. If on the other hand, he agrees to receive part of his reward from the SR and the other part with no relation to the SR then he receives part of his reward in profit and part of it in wages. Likewise if the capital owner invests his money capital in a company accepting to be rewarded a share in the SR, he receives profits in case  $SR > 0$ , bears a share in the losses in case of  $SR < 0$  and gets nothing if the  $SR = 0$ . However, if he does not accept to be rewarded in relation to the SR he is not entitled to any interest but he is entitled to claim back his principal in full. If the capital provided by the capital owner is not money but a capital good that can be leased, its owner can either receive rent for its lease provided that he bears the costs of its repair and damage or receives profits on it, if it is valued at the time of signing the contract and committed to be used for a reward that depends on the SR, or receive nothing for it if he lends it. In this case the borrower bears the cost of any damage or repair while in his possession.

#### 4.6.3 Profit and Loss Sharing (PLS)

PLS is a financial mechanism taking one of the following forms:

1- Musharakah or Sharikat (partnership) which is divided in the Islamic Fiqh (jurisprudence) into Sharikat Al-Amlak (proprietary partnerships) and Sharikat Al-Uqud (contractual partnerships)

A- Sharikat Al-Amlak is concerned exclusively with joint ownership of property that may arise from situations like inheritance. It occurs when two or more persons become partners in the possession of a property with or without their consent. The one with their consent occurs when they are presented with a property gift and they agree and accept to own it jointly or when they buy something jointly. The one without their consent occurs when they inherit a house for example.

B- Sharikat El-Uqud or contractual partnerships, as their name indicates occur when two or more persons agree among themselves and contract to participate in a joint partnership and/or exploitation of a business and to share its profits and losses. Sharikat El-Uqud can take the form of one or a combination of the following types: Sharikat Inan, Sharikat Mufawadhah, Sharikat Abdan and Sharikat Woujouh.

a- Sharikat Inan is a limited partnership contract, whereby two or more persons provide capital and agree to share profits according to pre-agreed ratios (not necessarily proportional to their share capital) and losses according to the share of each in the capital. This partnership is said to be one with limited powers (Inan). The term Inan used in this sense is derived from the reins of a pack animal which serves to restrain the animal (Udovitch 1970:122). As the responsibility of the partners is limited to the extent of their joint capital only, this type of partnership is according to Afzalur-Rahman (1974) valid between men, women and children (through their guardians) and between Muslims and non-Muslims. Probably this type of partnership is the base on which modern joint stock companies were developed.

b- Sharikat Mufawadhah is an unlimited partnership whereby each partner confers upon his colleague(s) full authority to dispose of their joint capital in any acceptable manner intended to benefit their association. Each partner is the agent of his partner(s) and can act in all commercial matters with respect to his own and his colleague's property without the latter's prior approval. "The liability of the Mufawadhah partners is", as reported by Udovitch (1970:144), "both joint and several, any obligation incurred on behalf of the partnership towards third parties by one of the associates can be claimed in full from any of the other parties". This type of partnership requires mutual confidence, mutual agency and mutual surety. Because of its unlimited liability, this type of partnership is perhaps more risky than the Inan.

c- Sharikat Abdan, Sanai or A'amal is a service partnership whereby two or more persons provide their labour instead of capital and agree to share their remunerations. This partnership may join not only

labourers of the same occupation but may join any combination of labourers who agree to share the costs and proceeds of their work .

d- Sharikat Woujoh is a partnership whereby two or more persons agree to do business together using their creditworthiness and reputation to acquire the capital they need on Qard Hassan (interest-free credit) or on Mudharabah basis (as explained below) and share the residual profit they may make according to pre-agreed ratios.

2- Mudharabah (Commenda): This is a partnership between a Mudharib (capital owner) and a Dharib (manager) who prefer to share whatever residual is left from the business they establish with the combination of their capital and labour. They share any profits on the basis of pre-agreed ratios. If the SR = 0, both the Mudharib and the Dharib go unrewarded. Any loss resulting from the exigencies of travel or from an unsuccessful business venture is born exclusively by the Mudharib. The Dharib is in no way liable for a loss of this nature, losing only his expended time and effort (see Udovitch 1970:170).

3- Muzaraah (Share cropping): This is a partnership between a landowner who provides agricultural land, seeds and equipment and a tenant who provides his labour, agreeing to share either the output (in kind) or the sale proceeds (in money) of the crop, according to a pre-agreed ratios such as one-half each or one-third and two-thirds respectively, etc.. In the case of an orchard which only need to be watered and looked after then this contract is called Musagat. The share of the tenant in the Muzaraah or Musagat contract must be at least one-half of the crop. Qaradawi (1985:287-8) pointed out that: "In all the reports which have reached us from the time of the prophet (PBUH) and his companions, we find that the cultivator's share was never less than one-half and in some cases it was more". Hence a Muzaraah contract which gives less than one-half of the crop to the tenant should be declared void and the Islamic state should intervene to prevent such exploitation. An example of such an exploitative Muzaraah contract is what was known in Algeria before 1971 by the name of Khammassah whereby the cultivator gets the Khums (one-fifth) only and the landowner gets the remaining four-fifths of the crop (see Amirech 1987:84).



#### 4.7 CONCLUSION

Despite the great number of theories that have been advanced in order to justify and explain interest and profit none is free from flaws and criticism. Concerning interest none of the existing theories is valid or acceptable as a justification for a predetermined return on loans and no theory would succeed in future to justify a certain predetermined return from an uncertain income. As for profit, though the existing theories failed to explain its cause and missed the simple and direct cause of it: sale there is no question about its justification because it is a natural part of the exchange that is necessary for any economy to invest, grow, employ, produce and develop. Profit is only one of three outcomes of sale: profits, losses, and no profits and no losses. Profit is justifiable because the profit seeker accepts to bear losses if they happen to occur while in an interest based contract the lender requires a predetermined guaranteed return, bearing little or no risk, he goes even as to secure his loans by requiring from the borrower securities whose values are greater than the loans he grants.

Besides the profit-seeker participates in bearing the consequences of providing real goods and services needed by the society. An economy where no interest on loans is allowed may grow and develop and perhaps to a greater extent than an interest based economy. But an economy where no sale is allowed, can never go far beyond a subsistence economy and can hardly grow or develop. Thus one can say that interest is not a necessary condition for development whereas profit from sale is necessary. Perhaps that is why Allah the all-knowing permitted sale and prohibited interest. Beddy (1940:2) pointed out that: "it is unquestionable that the present day distribution of political power would be a different basis if the search for profit had not taken place. Nor would the social structure of today be as it is if there had been no desire for profit on the parts of individuals. Society would not have moved away so rapidly from the feudal stage".

**CHAPTER FIVE**  
**TOWARDS AN ISLAMIC FINANCIAL SYSTEM**

**5.1 INTRODUCTION**

The financial system of any economy encompasses financial instruments, financial markets and financial institutions. The primary role of the financial system is to facilitate the movement of funds from savers to investors because these are rarely the same economic units. Moreover, as Kidwell and Peterson (1981:6) pointed out: "The allocation of funds is necessary for the efficient production of goods and services which are vital to the well-being of society. The more efficiently savings are allocated to the best investment opportunities, the higher the standard of living achieved in an economy". "The essential features of any financial system", as described by Revell (1973:3), "consist of a number of financial interrelationships between the persons and bodies that make up an economy, and the basic structure of a financial system has three features: (1) the extent of these interrelationships; (2) the forms of the financial claims in which the interrelationships are expressed and (3) the pattern of relationship between persons and bodies of different kinds between economic units".

Because for the moment there is not a single country applying Islam in all its aspects, as it should be, and therefore there is no fully fledged Islamic Financial System (IFS), anywhere in the world, it would be difficult if not impossible to analyse the financial interrelationships between the persons and bodies that make up an economy that is non-existent. However, it is possible to conceive and compare the financial claims, markets and institutions that may exist in an IFS and their functions vis-a-vis those of an Interest Based Financial System (IBFS), the subject matter of this chapter. But before doing this it is very important to point out, at the outset, that an IFS is not a system that allows Islamic Financial Institutions (IFIs) based on PLS to operate side by side with Interest Based Financial Institutions (IBFIs),

nor is it a system that is completely based on the PLS system but in a non Islamic environment (ie a society that is not ruled according to the Islamic Shariah in all spheres of life: politically, economically, socially, culturally, etc.). The true Islamic financial or banking system that can be expected to achieve its objectives, and that may be acceptable to Allah, is the one that is not only based on Islamic Shariah but is also implemented in an Islamic society that believes in Islam and practises it with the intention of pleasing Allah. M.S. Khan (1986:2) pointed out that: "Although the elimination of interest is certainly a central tenet of the Islamic Economic System, it should be stressed that it is by no means an adequate description of the system as a whole or, for that matter even of Islamic Banking".

Nowhere in the Koran or in the Sunnah, the two fundamental and most important sources of Islam, can one find a detailed description of the Islamic Financial or Banking system, their necessity, establishment, structure or operation. All that the Koran and Sunnah have to say in this matter is that: all financial transactions involving interest, fraud, deception, gambling, speculation and all other crooked ways of doing business must be avoided and prohibited and that all other transactions such as PLS contracts, leasing, trade, and interest-free credits not involving the transgression of the Shariah, are allowed, encouraged and considered as Islamic if these are undertaken with the intention of pleasing Allah. Thus, there is no restriction in Islam on any Islamic society to organise its financial system the way it thinks best as long as it does so with the genuine action and intention to apply and not transgress Allah's Shariah. Therefore the establishment, the structure, the organisation, and the management of an IFS, are all a question of Ijtihad, subject, of course, to the Shariah.

## 5.2 THE ISLAMIC FINANCIAL CLAIMS

Revell (1973:30) defined a financial claim as "a claim to the payment of a future sum of money and/or a periodic payment of money" and commented: "the 'and/or' in this definition implies that either one of the payments will be sufficient condition but that both may be promi-

sed". "Financial claims, financial instruments or financial assets as they are also called provide the economy, as Campbell (1982:3) wrote, with two services -1) they provide a means by which funds can be transferred from those who have a surplus to those who have profitable investments for those funds; -2) they provide the means to transfer risk from those who seek to undertake investments to those who provide funds for the investments. Therefore, financial assets are the record of the claim which facilitates an exchange of funds and a shift of risk".

Describing the characteristics of financial claims in an IBFS, Revell (1973:30) also notes that: "Typically... a financial claim carries an obligation on the issuer to pay interest periodically and to redeem the claim at a stated value in one of three ways: -1) on demand; -2) after the giving of a stated period of notice; or -3) on a definite date or within a range of dates". In a true IFS, however no financial claim carries the obligation on the issuer to pay any predetermined interest, but depending on the contract which joins the beneficiary and the issuer of a claim and which determines their relationship as buyer/seller, as lessor/lessee, as debtor/creditor, or as partners, a return may or may not be promised to the issuer of the claim.

In case the claim represents a debt on the issuer, then the issuer (debtor) is obliged to pay back only the principal in full and the creditor is obliged not to take more than that. If the contract, between the two parties, is a PLS contract, then the issuer is obliged to pay a pre-agreed percentage share of the actual profit (Sale Residual) made by using the fund in question, only in case of realising a profit. The beneficiary (capital owner), in this case, is obliged to bear a proportional share in any loss if this might occur beyond the control of the issuer. Thus one can say that the IFS is an equity based system whereas the IBFS is a debt based one. Consequently no interest based deposits, bills, bonds, debentures etc., are allowed to exist in an IFS. Instead, these can either be interest-free or PLS based such as: demand deposits and Qardh-Hassan which are interest-free or investment deposits, Musharakah, Mudharabah, MCDs and ordinary shares which may or may not be

rewarded depending on the actual and effective results obtained by using their funds. There are however, 5 contracts on which a promise of a predetermined return is allowed in Islam, and which are considered by some contemporary Muslim economists, as similar to interest, these are:

- 1) Ijarah (leasing contract)
- 2) Ijarah waqtina' (hire-purchase agreement)
- 3) Murabahah (mark up sale)
- 4) Bai' Muajjal (sale at a deferred higher price) and
- 5) Bai' Bit-Tagseet (sale by instalments)

Arguing perhaps from their strong concern about the implementation of Shariah and their good intention of not "opening a back door for dealing on the basis of interest", some Muslim economists, like M.N. Siddiqi (1983b:137-139), think of the incomes emanating from these contracts or at least from the Murabahah and the Bai' Muajjal contracts as similar to or "bear close proximity to the present interest based arrangements in effect, though they may be different in formal legal details". They argue that there is no real risk to the seller in these contracts and that their economic effects are just like those of interest. For example M.N. Siddiqi (1983b:139) suggesting the removal of Bai' Muajjal from the list of permitted methods, says:

I would prefer that Bai' Muajjal is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form we have the overriding legal maxim that anything leading to something prohibited stands prohibited. It will be advisable to apply this maxim to Bai' Muajjal in order to save interest free banking from being sabotaged from within.

These Muslim economists forget that the higher prices agreed upon in these contracts are not of the same kind as the merchandise sold or the machine leased and that these enter under the permitted sale and leasing contracts. Allah says in Koran 2:285: Allah has permitted trade and prohibited interest. They are suspicious about these contracts and compare their incomes to interest because they differentiate between the concepts of profit and interest by the degree of risk involved in the contracts and not as I argued in the previous chapter in terms of sales and loans. Income from sale contracts are permitted whether there is risk involved in the transaction or not, because there is a Sale (an exchange of a commodity against money) whereas interest is prohibited because it is on Loan (an exchange of a present amount of money or of a

commodity against a greater amount of future money or of a commodity of the same kind) which is unjustifiable as we saw above. However, I agree with those Muslim economists that Islamic Banking and Finance should be PLS based if it is going to achieve any real change in the economic situation of the country concerned and that these methods should be used only as second best substitutes where PLS arrangements are not feasible but no-one has the right to pronounce Halal things as Haram except Allah. Nevertheless, if it is proven that the harm coming from them is greater than their benefits, which I doubt, then the ICB may -under the Shariah rule which stipulates: "Dar Ul-Mafassid Awla Min-Jalb El-Manafi" (warding off harm must be prior to gaining benefits) and under its regulatory and supervisory rights on the financial institutions-prescribe that these methods must not for example be applied in banking or that finance through them must not exceed 20% of the total finance they give, etc., but it cannot declare them as Haram.

Among the financial instruments, money is perhaps the most important and most difficult to define. As Kidwell and Peterson (1981:5-6) pointed out: "it is the key player in the financial system and one of the most important variables: Too much money leads to inflation and too little money leads to recession. All of this directly affects financial institutions and markets and, ultimately, the individual". So, It is a pre-requisite for establishing a highly developed financial system.

As Revell (1973:33) pointed out: "Much ink has been spilt on controversies over the most useful definition of money". Usually money is defined as anything used and accepted as a means of making payment for goods and services and of settling debt obligations. However, economists generally identify three basic properties of money:

1- Medium of exchange; 2- Unit of account; and 3- a store of value.

Theoretically, as Kidwell and Peterson (1981:10) contended: "money should possess the three properties.. Unfortunately no single substance perfectly satisfies our three functions. Furthermore there is no agreement among economists over which property is the most important. Some economists emphasize the medium of exchange property and define money as coins and currency in circulation and chequable accounts at finan-

cial institutions. Still others view money as the group of financial assets most closely related to aggregate levels of economic activity. As a result of these sharp differences of opinion, a number of definitions of money are currently used by economists and government officials".

Among the Muslim economists who paid special attention to money and its role Sadr (1968) and Abu-Saud (1980) criticised the use of money as a store of value and considered it as a source of many ills. While Sadr regards Zakat which discourages idle cash balances, and the abolition of interest which frustrates the desire to earn guaranteed returns by using such money as sufficient remedies for these ills in the Islamic system, Abu-Saud does not stop at that and suggests the issuing of a new kind of money that is subject to a tax other than Zakat to check hoarding and ensure its continuous circulation and stop all usurious earnings arising from it. As a practical measure, he suggested the idea of stamped money suggested earlier by Gessel and briefly tried in the municipality of Woergel, Switzerland in 1922 (M.N. Siddiqi 1980:218).

Savers in the IFS would have a number of alternative financial instruments to choose from. Concerning the collection of deposits or what is called the depository function, the Islamic bank or IFI offers its customers the choice between a number of different deposit accounts which are either interest free or PLS based depending on the purpose and commitment of the depositor and depending also on the security or risk involved with each of these types of deposits. Deposits may be classified by ownership, security or form of withdrawal. When classified by ownership deposits may be private, public or interbank: private deposits are those belonging to individuals, private companies or other private institutions; public deposits are those belonging to local and national governmental institutions; interbank deposits are those that banks deposit with other banks. When classified by security deposits may be secured or unsecured: secured if they are deposited as demand deposits not sharing in the fortune or misfortune of the bank and unsecured if they are deposited with the intention of sharing in the profits and losses of the bank. And when classified by form of withdrawal,

deposits may be classified as demand or current, savings, or investment deposits. Perhaps, the best way, to examine the depository function of the IFI is to look at the purposes for which money is deposited with it.

### 1- Demand Deposits

The primary purpose of those people who deposit their funds under this category is the 'liquidity preference' for transaction and contingency motives. They prefer keeping the extra liquidity readily available in a convenient form for spending and making payment to others. The aim of these depositors is not to earn a return on their deposits but only to keep them safe and readily available for use. The Islamic banks would not pay any return on these deposits and may charge fees, if necessary, for running and maintaining these accounts.

### 2- Saving Deposits

The primary motive of the depositors in the savings accounts is the 'precautionary motive'. Depositors in this category usually belong to the middle class. They resort to saving chiefly because of precaution wishing to earn a little income and at the same time have easy access to their deposits when needed. Under IBFS the IBFIs give interest on such deposits albeit at lower rate than on time deposits to encourage saving. However, under the IFS, the IFIs are not allowed to give interest but are allowed to share with depositors the profits they realise. Because savings deposits are not subject to a specific term period and can be withdrawn when needed though not as easily as demand deposits, the IFI may give choice to the depositor whether he would like to share with it the profits as well as the loss of using the funds or not. If he agrees to bear a share in the misfortunes of the institution then he has the right to get a return on his savings. This return could be calculated on the minimum saving deposit of each month or on the average outstanding savings deposit at a sharing rate lower of course than the sharing rate of investment deposits which are committed for a certain period and share in the losses of the IFI at par.

### 3- Investment Deposits

Depositors in this category are more concerned with earning a return on their surplus savings than with 'transaction' and 'precaution'



motives. They are mainly wealthy people who can afford to deposit their surplus funds with the banks for a certain period of time with no real hardship or problem and who cannot invest their surpluses by themselves because they lack information about investment opportunities and/or because they lack the initiative to directly take risk themselves. Thus the primary motive of these depositors is 'investment' or 'profit'. In an IBFS, the IBFIs give higher interest rates to these depositors than they give depositors with savings deposits. However in an IFS, depositors of this sort are not promised a pre-agreed rate of return but would share in the profits and losses of the IFI. The IFI will invest the deposits on the basis of PLS system and the aggregate profit would be distributed among shareholders and depositors according to the pre-agreed ratios. In case the IFI incurs a loss, this would be shared between shareholders and depositors in proportion of their funds.

#### 4- Mudharabah Certificates of Deposits (MCDs)

The IFIs may also offer negotiable MCDs to their depositors. This would allow the investors to deposit their surplus funds with the institution for quite a medium or long term and share with it the profits and losses on these deposits and also allow them the possibility to sell their MCDs in the secondary market in case they need liquidity. No predetermined interest is allowed on these certificates but the holder has the right to share their profits with the IFI and bear a proportion of any loss that might occur before these certificates mature. The Muslim saver may also invest in other forms of PLS negotiable securities, in non-interest bearing stocks like ordinary shares and become shareholders in the company they invest in or in unit trusts that invest only in non interest bearing stocks but may not invest in what is known in the IBFS as preferred stocks, bonds, debentures, options, etc..

Concerning the allocation of finance, the IFIs may use the following interest free or PLS based methods of finance:

1- Musharakah which means a profit-sharing joint venture designed for a certain operation within an agreed-upon period of time. The IFI and the customer contribute capital assets as well as technical and ma-

nagerial expertise in varying proportions, and they share the realised profits according to ratios agreed upon in advance. The sharing ratios are not uniform in all cases. However, it is important to realise that not only are profits shared but so are losses. If the venture results in a loss arising from natural or market forces then these will be shared by the bank and the other party in accordance with their capital participations. If however, the loss arose from negligence or breach of contract then the party responsible would be expected to bear the whole loss or as much as the Islamic court would decide. The relationship between the IFI and the customer is of partnership rather than that of creditor and debtor, which governs most transactions in interest based banks. Where medium or long term operations are undertaken, the IFI may agree with the customer upon a self-liquidating form of participation whereby the customer can through marginal repayments, gradually buy out the IFI's share in order to obtain the full ownership of the project, the equipment, the land or the property object of the operation. The success of this method of operation depends on the ability of the IFI to choose appropriate clients; make realistic feasibility studies of the projects and follow them up through audit and periodic control techniques (see Wood 1984, El-Sarraf 1984 and Abdeen & Shook 1984).

2- Mudharabah: which differs from the above described Musharakah contract in that the customer has the freedom to use the funds in the way he considers best and is not tied to investments in a predetermined venture. The other difference is that the customer does not need to have a capital of his own. He participates with his management only and does not bear any loss that occurs from the normal market forces, instead he goes unrewarded for the time and expertise he offered.

3- Murabahah: This method of financing is a mark-up sale whereby a client requests his IFI to buy a certain commodity or asset for him promising to buy it at a pre-set profit As such, and as Attia (1985:18) argued: "the passing of title of commodity or goods to Islamic banks (IFIs) when dealing on the basis of Murabahah, is necessary and this, of course, is in contradiction to the conventional banking system, where banks are dealing in money and not in commodities or goods".

4- Bai' Muajjal: This form of finance is the same as Murabahah described above, however, the payment is deferred. The payment may be made either in a lump sum or by instalment depending on the agreement between the IFI and the customer. According to the majority of the Muslim Jurists, the selling price in case of Bai' Muajjal may be set higher than the cash price but with the strict proviso that both the seller and the buyer agree on that fixed price at the time of the sale contract which must not be raised in case the buyer cannot pay in time.

5- Ijarah (Leasing): There are two types of lease arrangements allowed by the Shariah: Ijarah (simple leasing) and Ijarah Wa Iqtina' (hire-purchase). In the Ijarah form, the IFI purchases a capital asset and leases it to a customer (the lessee) in return for an agreed upon regular rent for a long or medium term depending on the need of the customer, the life of the capital asset, and the agreement between the IFI and its customer. The IFI would retain the ownership of the asset but the customer would have the exclusive right to the use of the asset on payment of the pre-agreed rental payments. At the end of the agreement, the asset reverts to the bank. "The rentals would be sufficient to amortise not only the capital outlay but also to yield, after taking into account the 'salvage' value of the asset, an adequate amount of profit for the bank" (Chapra 1985:167). In the Ijarah Wa Iqtina' form, the customer may agree with his IFI to share the proceeds of the assets by dividing the proceeds into three parts (not necessarily equal), one part for the bank as part repayment of the original finance, another part for the bank as its profit and the third part for the customer as his profit. After the finance given by the bank is totally repaid, the asset in question becomes the property of the customer (Hamdi 1981:13). Alternatively the bank and the customer may agree that a specified rent must be paid monthly no matter how much profits realised by the customer and that at the termination of the lease, the customer would keep the asset in question for a certain price they agree upon at that time. The risk related with these two forms of finance lies in the fact that the bank has to buy the asset in question and deliver it to the

customer and keep the ownership of the asset during the full period of lease at its own risk of damage, obsolescence and repair.

It is very important to draw attention here to the fact that leasing has become very popular in recent years and one of the fastest growing financing methods of interest based banks. "The reasons for the fast rate of growth in finance leasing are", as Reed et al. (1980:300) pointed out: "to be found in the advantages it affords, in certain circumstances, over buying assets with money borrowed under a conventional loan". The advantages claimed for finance leasing include the following:

- a. Provides financing at a lower cost
- b. Gives greater flexibility
- c. Requires a lower down payment - provides more financing
- d. Requires no capital expenditure authorization or bond issue
- e. Releases funds for more profitable investment in other assets
- f. Offers a tax advantage".

6- **Equity Investment:** The IFI may invest in ordinary shares of successful corporations. Chapra (1985:166) contended: "investment in the stocks and shares of joint-stock companies, whether public or private, should be an attractive avenue for the employment of the bank's funds. In fact, the stocks of well-established and high-dividend yielding companies, may serve as an alternative for interest-bearing government securities and bonds of private companies. With the presence of a well-organised and properly regulated stock market, the banks may be able to dispose of such stocks whenever they desire". The owner of the share is part owner of the assets and earnings of the corporation. A share has no maturity date, nor does it have any fixed claim on the assets or earnings. A share is a claim on the assets of the company after all other creditors have been paid off. Ordinary shares entitles the holder to some rights such as the rights to name the board of directors, the right to vote on any major changes in the enterprise such as dissolution, consolidation, or amendments to the charter or bylaws. The other basic right is to a dividend, if one is declared.

7- **Preferred Stock,** like common stock, is an equity or a share in the earnings and assets of the corporation, but there are several differences. The preferred stockholder has priority over the common stockholder for dividends. And, in general, in liquidation, preferred stocks

rank ahead of common stock. On the other hand, the dividend or rather the interest paid to the preferred stockholder is predetermined whereas the dividends paid to the common stockholder can rise or fall with the performance of a company. A preferred stockholder, however has no right to vote nor any voice in the management of the company. Preferred stock has seen a good deal of innovation in recent years. In many ways it has become much more debt-like. The major innovation in the US market has been floating-rate preferred stock. Preferred shares have also been combined with other instruments and made convertible into equity or exchangeable into debt (Walmsley 1988:61). This feature of getting a predetermined return on preferred stock makes them unacceptable from the Islamic point of view and so they would not exist in an IFS.

8- **Bonds:** The classical bond bears a fixed rate of interest and matures on a date fixed at the time of issue. So from the time of issue all the cash flows on the bond -except investment income- are known in advance. This relative certainty has made it an attractive investment instrument for those who need funds at some future date such as pension funds or life insurance companies. Another important feature of a bond is its relative volatility. This is affected by three main factors: the bond's coupon, the bond's yield and its maturity.

While equities and preferred stock tend to be of a fairly standard legal form, bonds have been issued in a wide variety of types. One variable is the type of security they offer. Government bonds are unsecured, they are backed only by the government promise to pay. Because bonds are interest-bearing, they are also not to exist in an IFS, they would be replaced by the MCDs or other PLS securities whose return is decided only after the real result of their use is known.

9- **Convertible bonds:** Convertibles and preferred stocks are, as Walmsley (ibid) pointed out, the oldest hybrid securities. Preferred is debt like equity, a convertible is equity like-debt. The holder of a convertible bond can exchange the security, at his option, for the common stock of the issuer in accordance with the terms of the bond indenture. Usually the indenture will say that the bond is convertible into common stock at a specified price. For example, a US\$1,000 bond

might be convertible into common stock at US\$50 per share, that is, it is worth 20 shares. If the price of the stock went to US\$75 the convertible would be worth US\$1,500. The actual fixing of the conversion price is set by the issuer, normally 15 to 20% above the price of the outstanding shares. As there would be no interest based claims in an IFS, there would be no convertibles as described.

10- **Options:** An option for ordinary shares is a right to buy or sell a certain number of shares at a certain price within a specific period. There are two sorts of options: call and put options. A call option is the right to buy shares while a put option is a right to sell shares. The writer of the option receives a premium from the other party who does not need to have large amounts of money, at the time of accepting the option or to tie up large amount of money in the stock without knowing the future direction of the market. By paying the premium, he gains control over the number of shares under his option and he can, exercise his option at any time within the time limits of the option if the prices of the stock in question go up, or not to exercise his option when the prices of the stock involved go down, thus losing only the premiums instead of losing on unwanted shares had he bought them.

11- **Warrants:** A warrant is a kind of option. It gives the holder the privilege of buying a specified number of shares of the underlying common stock at a specified exercise price. The purchase can be at any time on or before an expiry date. Bonds with warrants resemble convertibles except that the warrant can be traded separately. Another difference is that when the warrants are exercised new money is used to subscribe for the shares, and the total capital of the borrower increases. This is unlike the conversion of a convertible bond which merely shifts debts capital into equity capital. Until the warrant is exercised the holder has no rights to vote at a shareholder meetings nor to participate in dividend distributions. Recently, there has been the introduction of warrants on fixed interest instruments. Development here have taken two main forms. First there have been warrants attached to bonds which allow the investor to buy another bond at some prefixed level.

These allow the investor to gamble on the possibility of a further decline in interest rates. Second there have been a number of 'naked' warrant issues -warrants unaccompanied by other funding. Mostly these have been issued by investment banks, which can hedge the risks entailed.

From the description above of options and warrants, it becomes very clear that both options and warrants involve gambling and speculation and injustice which are prohibited by the Islamic Shariah and so there would be no options or warrants in an IFS, thus reducing the amount of speculation and fluctuation in the markets.

12- **Futures:** Futures are standardized agreements to buy or sell a specific commodity at a specific time and a place in the future, at a price established through open outcry in a central, regulated marketplace. The two key components of a future contract are that the agreement is standardized and that price is the only variable. Primary uses of futures are speculation and hedging. Because of the Islamic prohibition of forward exchange of currencies, and of speculation there would be no futures in the IFS as practised in the IBFS. However, it is permissible under the Shariah to agree to future contracts such as is the case of Bai' Muajjal which "requires the transfer of the goods to the possession of the buyer while payment will be due in the future and would be higher than its cash sale" (Presley 1988a:36) or Bai' El-Salam which "requires cash payment in consideration for goods that will be delivered in the future" (ibid). But in these contracts, the deferred price or the price paid in advance must be agreed upon at the time of the contract and must not change.

13- **Zero coupon:** Zero coupon has only one cash flow and that is at maturity, its reinvestment risk does not arise. This is particularly so since for all practical purposes a zero coupon bond is fully protected against early call. Its duration is always longer than that of a conventional bond of comparable maturity. Therefore a zero coupon is much more volatile. When rates fall, it becomes very attractive investment. Since it is an interest related claim it would not exist in an IFS.

14- **Perpetuals:** Perpetuals have no final maturity but also because they are interest based bonds they have no place in an IFS.

### 5.3 THE ISLAMIC FINANCIAL INSTITUTIONS

Most economic units, at one time or another fulfil an intermediary role but what we are interested in here is the specialised bodies whose main function is that of financial intermediation. Financial Institutions or Financial Intermediaries, as they are also known, are specialised institutions that come between SEUs and DEUs by taking up the direct claims issued by the latter and issuing secondary or indirect claims which, in one way or another, are better suited than direct claims to the needs of the former (see Revell 1973:73).

In the world of interest based financial systems, a great number of different financial institutions may co-exist specialising in one or more distinct types of intermediation: (1) denomination intermediation, (2) risk intermediation, (3) maturity intermediation or (4) liquidity intermediation. Though distinctly different they all have one function in common: they all purchase financial claims of one set of characteristics from DEUs and sell financial claims with a different set of characteristics to SEUs (Kidwell and Peterson 1983:34).

The advantages of intermediation arise almost entirely from economies of scale. Other advantages include: (1) Convenience; (2) Professional management; (3) Diversification; (4) Innovation; (5) Liquidity; and (6) Income. Without intermediation lenders would have to seek creditworthy borrowers, and borrowers seek lenders willing to borrow or lend on mutually acceptable terms for mutually convenient periods of time. The flow of credit would, clearly be seriously hampered by the time, inconvenience and cost involved (Struthers and Speight 1986:26).

An advanced financial system may consist of:

1- A Central Bank which would, have the right of note issue, the right to regulate and supervise commercial banks and other financial institutions, the right to control and apply monetary policies, and play the role of the government bank, the custodian of the nation's reserves, the bankers' bank, etc., (see chapter six below).

2- Commercial Banks which operate the payment mechanism through cheque current accounts, receive short term deposits from SEUs and make



short to medium term loans, through their branches, to DEUs. They are the largest and most important financial intermediaries and the most regulated financial institutions in any country this is perhaps because of their vital role in the payment mechanism and their effect on the monetary system of the country (See chapter six below).

3- **Savings Banks** which accept interest-bearing deposits of small accounts. The Post Office Savings Banks (POSBs) are the best example of these kind of financial institutions. In most countries the POSBs are government owned and their deposits used by the treasury. They do not give loans to other economic units. They benefit from the large number of post office branches which are situated almost everywhere not only in urban centres but in the rural areas as well. These institutions are very useful -especially in the LDCs- for the small investors who may not be welcomed by the commercial banks because of the cost of running such small accounts. These could well work in an Islamic economy but investors are not to be given predetermined interest. A question that arises here is how could they attract the small saver and encourage him to save?. One solution which I could think of, runs as follows:

The customer may open an account with the POSBs with as little as the equivalent of say £10.00, with the conditions that this minimum be kept at all times to assure the continuity of the account, that no more than say half of the deposits -that is over the minimum- could be withdrawn at any one time or one day, if the customer is to share in the profits of the POSBs. In return, the POSBs may invest 50% ± 5% of every monthly outstanding deposit in profitable public companies so as to get some income to share with the depositors at say 50-50 after the deduction of the operating costs, keep say 10% for liquidity purposes and pass the rest to the treasury as Qardh Hassan (interest-free).

4- **Mutual Credit Unions** are small nonprofit cooperative consumer-organised institutions owned entirely by their member-customers. Their liabilities are savings accounts (called share accounts), and their investments are almost entirely short term instalment consumer loans (see Kidwell and Peterson 1981:38). These could also exist in an IFS but in that case, instead of giving consumer loans to its members, the credit

union buys the consumer good required by the customer and then sell it to him at a Murabahah or on Bai' Bittaqseet bases.

5- Insurance Companies obtain funds by selling insurance policies that protect the policy holder against certain risks. There are life insurance companies and casualty insurance companies. Because they have a somewhat predictable cash flow, they are able to invest primarily in higher yielding long term assets. Insurance is considered as the most effective and economic way of dealing with risk and reducing its effect by spreading the loss that might cripple an individual or a business over a large number of policy holders. Otherwise individuals and businesses would have to set aside some of their capital resources against possible losses that might occur. As such insurance plays a very important economic function and thus, in certain respect, "it is even more important than banking" (M.N. Siddiqi 1985:11).

There are conflicting views amongst Muslim scholars about the desirability and permissibility of insurance. Those who object to modern insurance, and especially to the life form of it, argue that there is no justification for a person to get as much as he gets in case of an accident nor for losing his premiums in case nothing happen to him as in the case of casualty insurance and compare this to the act of gambling. They further argue that modern insurance companies are interest based and that life insurance pays for something which cannot be valued or indemnified. As for those who argue for the desirability and the necessity of insurance, they say that insurance like banking can be run and organised according Islamically. Secondly, Insurance is a form of Takafol (mutual solidarity) that Islam encourages and is beneficial to both the individual and the society. Besides, there is no harm in getting indemnification from the group. Thirdly, there are precedence in the Islamic tradition and history of compensating accidental killing by way of paying Diyah 'blood money' collected from the relatives and friends of the killer and paid to the heirs of the deceased. Besides, The prophet Mohammed (PBUH) also, once said: The Ash'aris are from me and I am from the Ash'aris, because when they have food shortage, they

gather all what they got and distribute it among themselves equally. And finally insurance is fundamentally different from gambling because as M.N. Siddiqi (1985:27-28) contended:

The evil of gambling lies in the fact that the gambler wilfully seeks out, through betting and wagering, risk which was not there earlier, or which, even if it did exist, did not personally concern him. Buying lottery tickets, betting and staking on horse races, football matches, games of cards or chess are examples. All possible forms of gambling and its current practices have one thing in common -the risk of financial loss- that the gambler courts by betting or wagering could have been avoided if he wanted to do so. The case of insurance is fundamentally different. The occurrence of peril against which and the effect of which the insured seeks protection does not depend on whether he is insured or not. Most of the normal pursuits of life, and normal economic activities are fraught with risks that cannot be adequately managed by any other method.

Thus, although there is no unanimous opinion about insurance, the arguments of those who reject insurance outright are in my view weaker. They confuse gambling (ie running a risk that is avoidable, the risk of loss with the covetousness to get a bigger gain in games of chance) with insurance or Takafol which is a means of collectively helping each other in reducing the effects of unavoidable risks. The risk of financial loss emanating from the normal businesses of life or of death, is always there irrespective of whether one arranges for protective insurance or not. It is true that the conventional insurance in its present form does not conform to Islam, yet this could easily be transformed to make it acceptable from the Islamic point of view, as is already done in some countries like Sudan.

Under the Islamic system of Takafol (mutual solidarity or insurance), the policyholders may join by contributing to a common fund which is invested for the benefit of the members. Profits out of these investments are added to the individual accounts according to the contribution made. The losses, if any, are also borne by the members. A reserve is built up from the profits earned for payment against death and disability of the members as agreed.

6- Pension Funds obtain their funds from the contributions made by employers and employees during the employees working years and provide monthly payment upon retirement. In an Islamic society this must be the duty of the Islamic government to assure every old person of a

pension from Bayt El-Mal that would help him lead a decent life and keep his social position in the society. So the Bayt El-Mal with the aid of its branches could do the job of pension funds by collecting funds from employees and employers proportionally to the salaries and wages paid and provide pension payments upon retirement not only to those who contributed to the funds but also to those who could not have contributed because of disability or unemployment.

7- Finance Houses are engaged in the provision of hire purchase and other forms of instalment credits, unlike the commercial banks they do not accept savings deposits from consumers. They obtain the majority of their funds from bank loans, commercial paper sales, and issues of both long term and short term debt in the capital and money markets in large quantities and lend those funds in small amounts to individuals and business enterprises that cannot obtain credit as cheaply or easily elsewhere (Kidwell and Peterson 1981:318), thus, doing the reverse of the other financial institutions. As there is no possibility of borrowing or lending at interest in an IFS, it would not be possible for finance companies to raise funds through debt issues. However, they may raise fund through the issue of PLS certificates which do not promise any predetermined returns but give right to a share in their profits if there is any, and reduce the value of the certificate by its share in the loss that may occur. In allocating their funds they could easily do so on the PLS basis with business firms. As for individuals they can either offer them consumer goods on Murabahah, Bai' Muajjal, Bai' Bit-Tagseet, Ijarah, Ijarah Waqtina' bases.

8- Merchant Banks: The term merchant bank, is applied to such a wide variety of institutions that it is impossible to define precisely. The title implies that they are both merchants and banks. The traditional function of the merchant banks is to accept bills of exchange on behalf of the drawee. Their own reputations were sound, and bills drawn on and accepted by them were freely negotiated. Their reputations and connections also made them the natural agents for issuing bonds for foreign governments and municipalities and debentures and shares for companies wishing to raise money. They engage in wholesale intermediation.

In fact most of them virtually provide every financial service except perhaps retail banking, though some are now accepting small deposits (see Struthers and Speight 1986:69). In an IFS no financial institution is allowed to issue interest bearing claims but the issue of shares and of PLS instruments is allowed so there would be no objection to merchant banks which avoid prohibited claims and transactions.

9- **Mortgage Finance Companies** or building societies as they are called in the UK, they collect interest bearing deposit from the public and offer long term mortgage loans at interest to their customers for house purchase secured by the pledge of real property as collateral. In the IFS, the mortgage finance companies would collect PLS deposits from the public and would not offer mortgage loans but may buy the houses in their names and on their own risk and sell them to their customer on the basis of Ijarah Waqtina', or Bai' Bittaqseet.

10- **Investment and Unit Trusts** are also called portfolio institutions because they raise money from the public by issuing their own shares or units and use them to buy securities, mostly shares and debentures in industrial and commercial public companies. The Islamic investment and unit trusts can do the same except that they do not deal in debentures or any other interest bearing instruments. They can issue shares or PLS units and buy shares and other PLS securities.

In an IFS, the same specialised institutions could exist with the difference that instead of dealing in interest based claims, the IFIs deal in profit and PLS based claims. Recently, however, as a result of deregulation and rapid institutional change in the major financial systems of the world, the distinction has become blurred and financial institutions are getting away from specialisation and are becoming more of diversified businesses rather than specialised ones. Perhaps it would be better if all financial institutions could be like department stores, where the customer can find all the financial services he needs under the same roof. They could all be given the opportunity to offer all the financial services they can with the condition that they all be required to operate under the central bank regulation and supervision

so as to get rid of the discriminatory treatment that exist in the financial world of today and to let the financial institutions compete at equal footing and opportunities. They do not need to be called banks or building societies or savings banks or whatever, they could simply be called Multi-purpose Financial Institutions (MPFIs) and that is all. What matters is not the name but the services they offer.

#### 5.4 THE ISLAMIC FINANCIAL MARKETS

Campbell (1982:4) pointed out that: "financial assets can be created and exchanged between suppliers and users of funds without ever utilising an organised financial market. But in a developed economy, this is more the exception than the norm. Most assets are exchanged through some kind of financial markets. "A market in its general economic sense is", as defined by Seldon and Pennance (1965:271): "a group of buyers and sellers who are in sufficiently close contact for the transaction between any pair of them to affect the terms on which the others buy and sell". In other words, a market exist when, as Bannock et al (1978:297) pointed out: "buyers wishing to exchange money for goods or services are in contact with sellers wishing to exchange goods and services for money. Thus a market is defined in terms of the fundamental forces of supply and demand, and is not necessarily confined to any particular geographical location".

"Financial markets" as pointed out by Revell (1973:49): "play an important part in the development and evolution of a financial system" by facilitating the collection of savings and by channeling funds to investors. Their basic roles, as described by Mettwally (1984:21), are:

- (a) to allow savers to participate fully in the fortunes of business enterprise;
- (b) to enable holders of shares and debts to obtain liquidity by selling their shares and bonds to business enterprises on the stock market;
- (c) to allow business enterprises to raise external finance in order to expand the economic activities of their enterprise;
- (d) to allow business enterprises to separate business and economic operations from financial activities.

As Revell (1973:50) remarked: "The word market is used somewhat loosely in discussion of the financial system, and the normal operations of financial institutions are sometimes brought within the term.

Thus, one hears talk of the market for deposits with banks or building societies or for house mortgages. We shall limit ourselves to cases in which there is an organised apparatus of dealers or brokers acting as intermediary between buyer and seller... The degree of organisation varies considerably between markets". The distinction between one market and another depends on the type of financial asset exchanged, whether it is short or long term, local or foreign, newly issued and sold directly by the issuer or previously issued and bought through brokers, sold over the counter or in auction. Thus, financial markets may be divided into primary and secondary markets or into money markets, capital markets and foreign exchange market, etc..

The difference between the primary and secondary markets is that the activity of the former is to conduct the sale/purchase of newly issued securities. It is by this activity that these markets help entrepreneurs acquire funds from those who have funds but may not have the time or the ability to use their funds productively. The first issue of securities by a public company may either be directly placed (direct placement) by the issuer or sold at a discount and/or for a commission or fees (underwriting) to an issuing house, a stockbroker or a bank which brings the firm to the market either by inviting the public to buy the shares or by placing them in bulk with financial institutions or stock exchange jobbers, who sell them piecemeal to the public. The direct placement is cheaper than underwriting for both the issuer and the investor because the issuer would not have to pay intermediaries to sell the securities to the investor and the investor would not have to pay any commission or fees to the intermediary to get the securities. However, direct placement often is not always feasible. Securities bought from the primary markets contribute directly to the expansion of economic activities because the receivers of the funds are the ultimate producers of goods and services (Zaman 1986:127).

The activity of the secondary markets is the exchange of money for existing securities. They provide a solution to those investors who may have bought some securities from the primary markets but needed liquidity at a certain stage. The existence of an active and an efficient

secondary market provides investors with a high degree of liquidity for their investments. The secondary market for negotiable securities is the stock exchange. Unlike in the primary sector, securities bought and sold in the secondary markets do not participate directly to the economic activities of, nor do they have a direct impact on, the original issuers. Both sellers and buyers in the secondary markets are investors who may gain or lose depending on the situation of the market.

The difference between the money markets and the capital markets lies in the maturity of the claims traded in them. Money markets for short term claims and capital markets for long term claims. As for the foreign exchange market, it differs from the others in being entirely international and is concerned with the exchange of foreign currencies.

Of recent origin is what is known as the parallel markets. They are parallel in the sense that they offer to lenders alternative facilities to those obtainable in the traditional markets. Both borrowers and lenders have a wider choice than in the traditional market and the terms allowed in the parallel markets are more flexible and more adaptable to changing requirements (Einzig 1966:2). There are at least six parallel markets, differentiated from each other by the credit instrument traded. These are the markets in interbank, inter-company, local authority, finance house, and eurocurrency deposits, and the market in certificates of deposits. One distinguishing feature of the parallel money markets is that they do not benefit from the central bank function of lender of last resort (Walmsley 1988:57-60).

As in an IBFS, The IFS would have all the types of markets through which Islamic financial claims could be bought and sold, however, their operations and their financial instruments would differ. Savers in an Islamic Society, as in any society, also have some degree or another of liquidity preference, but this does not justify the payment of interest as we saw in 4.3.10 above. "To the extent that savers can, if necessary sell securities quickly and at low cost, they will be more willing to devote a higher portion of their savings to long term instruments than they would otherwise... And since primary securities in the Islamic



system are normally tied to particular projects and enterprises, these are various risks that must enter into the portfolio decisions of the investor. Therefore, creation of a secondary market will stimulate investment in such securities by giving investors the option to buy or sell at any time" (Iqbal and Mirakhor 1987:5). Thus an IFS where interest bearing claims are prohibited and where direct PLS participation in business enterprise is encouraged well functioning financial markets are very important, provided that they comply with Islamic Shariah. In other words, no interest based instruments are allowed, nor are other illegal transactions, such as speculation, which make the prices of shares and other PLS financial assets fluctuate beyond the economic performance of the enterprises and the forward selling and buying of gold, silver and currencies, are involved.

### 5.5 Conclusion

From the above description of the financial instruments, institutions and markets of an advanced IBFS and the discussion of how these could be adapted or transformed so as to comply with the Shariah and create an advanced IFS, it became clear that from the structural or organisational point of view, there would be little or no difference between an advanced IFS and an advanced IBBS, however, the real difference between the two, lies in the financial instruments which are mostly interest based debts in the IBBS while in the IFS these must be either mostly PLS based equities or interest-free credits.

The lack of preferred stocks, bonds, options, futures, convertibles, etc., in the IFS would not be an obstacle to its development because on one hand, the funds that would have been invested under these instruments would be invested in the instruments available and on the other hand, this would reduce speculation and fluctuation in the markets that might be caused by the manipulation of these instruments, had they been available.

CHAPTER SIX  
THE ISLAMIC BANKING SYSTEM (IBS)

**6.1 INTRODUCTION**

In every modern society, the banking system is the main and vital institution that mobilises the society's savings and channels them to economic and social uses. In an Interest Based Banking System (IBBS), banks borrow funds at interest from the depositors and extend credits at interest to creditworthy borrowers, thus acting to induce investment, increase employment and production, and presumably achieve greater growth and economic development. In addition to this vital function banks also provide other important financial services of which the most important is perhaps the provision of current deposit accounts facilities or what is also called the payment mechanism (a convenient device to make payments through cheques). Indeed this service is, as Cooper (1984:49) pointed out: "one of the banking services which must be provided by an institution in order for it to become a recognised 'bank' and thus entitled among other things, to use the word bank".

Other services provided by interest based banks include the supply of foreign exchange, purchase and sale of securities, acceptance and collection of promissory notes and commercial bills, discounting, safe-keeping, etc.. Their main goal is to maximise their profits from interest rate differences and various fees and commissions, subject of course to a reasonable level of liquidity, safety and soundness.

As Sayers (1967:15) pointed out: "the banking systems of different countries vary substantially from one another but there has been during the present century a universal tendency for each nation to develop a wide network of banks centred upon the chief trading centre of the country with the largest banks themselves established in that centre and grouped round a quite different institution referred to as the central bank". The purpose of this chapter is to theoretically compare and analyse the structure, functions and management of an advanced Islamic Banking System (IBS) vis-a-vis those of an advanced IBBS.

## 6.2 THE ISLAMIC CENTRAL BANK (ICB)

The central bank is a special institution entrusted with the management of the money supply and of government finance together with the supervision and control of banks and other financial institutions. "The central bank" as Z. Ahmed (nd:1) described: "holds the key position in the financial system of a country. It is expected to act as a guardian of the country's monetary and banking system. It is the primary institution responsible for implementing monetary policy suited to the achievement of a country's socio-economic objectives". The ICB is no exception. However, in fulfilling its functions, it would not use or permit the use of interest or other prohibited financial instruments. As any other central bank, the ICB would be:

- 1-) The Bank of Issue and Custodian of the Nation's Reserves;
- 2-) The Bank of the Government;
- 3-) The Custodian of the Financial Institutions' Cash Reserves;
- 4-) The Bankers' Bank and Clearing Bank;
- 5-) The Lender of Last Resort;
- 6-) The Supervisor and Controller of Financial Institutions; and
- 7-) The Controller of Credit and Applicant of Monetary Policy.

### 6.2.1 The Bank of Issue and Custodian of the Nation's Reserves

The ICB may assume this function with little or no difference to other central banks. For the general interest of the Ummah (nation) the ICB should have the sole right of issue of the nation's currency so as to attain not only uniformity in the state note circulation but effective elasticity to meet the legitimate currency requirements of business and the general public and the effective supervision over a credit instrument which had for the sake of convenience to be declared legal tender money (De Kock 1974:22).

### 6.2.2 The Government Banker, Agent and Adviser

The ICB may also act as the government banker, adviser and agent. It would manage the banking accounts of government departments, boards, and enterprises, not only because it is more convenient and economical but also "because of the intimate connection between public finance and monetary affairs. The state is, in every country the largest receiver of revenue and its expenditure has come to play an increasingly important part in the economic life of the nation" (ibid:36). The turnover is huge and "because transfers of this magnitude might be embaras-

sing to a commercial bank, it is a recognised principle of central banking that the central bank should manage the government's accounts" (Hanson 1978:52), so as to cushion the commercial banks against the impact of large movements of cash originating in this way. However, the ICB is not to lend money to the government at interest nor float interest bearing bonds, it can lend interest free or float PLS securities. In providing the government with foreign exchange requirements, the ICB would not deal or allow dealings 'on the forward' market. It would deal and allow dealings only 'on the spot' market.

In its role as adviser to the government, the ICB should advise the government with the best ways of achieving economic development, avoiding inflation, establishing proper financial institutions that provide finance that can finance not only the large sized industries but also the small and medium enterprises in urban and rural areas.

#### **6.2.3 The Custodian of the Financial Institutions' Cash Reserves**

"The concentration of cash reserves in the central bank is", as De Kock (1974:58) contended: "a source of great strength to the financial system at any time. Centralised cash reserves can at least, serve as the basis of a larger and more elastic credit structure than if the same amounts were scattered among the individual banks. It is obvious that, when bank reserves are pooled in one institution which is moreover, charged with the responsibility of safeguarding the national economic interests, such reserves can be employed to the fullest extent possible and in the most effective manner during periods of seasonal strain and in financial crises or general emergencies". The obligation imposed on IFIs to keep minimum cash reserves with the ICB gives the latter a strong means with which it could operate and which, not only strengthens its financial position, but also gives it some means of control over the banking and credit situation.

#### **6.2.4 The Bankers' Bank and Clearing Bank**

It is more convenient and more advantageous for the financial institutions to entrust their surplus cash to the central bank just as it is convenient and advantageous for individuals and companies to entrust their surpluses to commercial banks and other financial institutions.

This should be in addition to the minimum reserve requirements that each financial institution must maintain with the central bank in order to protect the interests of their depositors and the interests of the nation. Likewise, the ICB would provide the IFIs with similar banking facilities and act therefore as the bankers' bank.

#### 6.2.5 The Lender of Last Resort

It is the responsibility of the central bank to protect banks that have been honestly and competently managed from the consequences of a sudden and unexpected demand for cash. In other words the central bank should but rather must act as a lender of last resort to banks so as to maintain the public confidence in the banking system and prevent its collapse. To do this effectively it is necessary that the central bank be permitted either to buy the assets of commercial banks or to make advances against them (Encyclopedia Britannica 1974:Vol2:708). "In a more recognisable terms the central bank must, as Sayers (1967:101) put it: "lend without a stint in times of financial crises". The ICB should be ready at any time to help any financial institution which might fail temporarily to match its liabilities so as to give confidence not only to depositors in current accounts but to investors as well. However in doing so it must not charge any interest but may either give very short interest free credits, buy some of the PLS securities held by the bank concerned at a slightly lower price than their market price or requires from it, after one or two warnings, to keep with it a larger future reserve for a certain time, as a penalty, until this latter settles or until the ICB decides to waive the penalty.

#### 6.2.6 Supervisor and Controller of Financial Institutions

"Given the importance of banks in modern financial systems and recent experiences in the banking sector, therefore, effective supervision is clearly, as Gardener (1981:63) put it: "an attractive economic good. Experience has shown that there are always a few operators who, given the opportunity, will cross the barriers of prudent banking if the rewards appear to be high enough. There has to be a higher authority responsible for ensuring that such banks are kept in line to

preserve the stability and safety of the entire system. That higher authority must be the supervisory authorities (the central bank)".

The regulation of financial institutions is necessary and very essential to ensure that banks are not only safe but seen as safe to help preserve the overall financial stability of the economy and to provide adequate 'consumer protection' to depositors; control the monetary system; and finally, protect financial markets from being inherently uncompetitive (see Gardener and Molyneux 1989:35).

In order to minimise the risks of banks and other financial institutions' failures due to mismanagement or unscrupulous practices, the ICB, like the other central banks all over the world, should have regular contact with the financial institutions by way of examination and close supervision of their operations and have the power to inspect, audit, control, advise, guide and impose penalties. Through regular inspection and contact, the ICB can acquaint itself with the finance and investment practices of the financial institutions and provide them with advice and guidance on such matters as staffing, branch expansion, investment, etc. and issue to them directives on all matters concerning liquidity, capital adequacy, monetary policy, etc.. It will usually consult them in all such matters, but if necessary such instructions can be issued in the form of rules and regulations for their guidance.

#### 6.2.7 Controller of Credit and Applicant of Monetary Policy

In view of its rather special position as the only bank with the right of issue, the custodian of the nation's reserves and the holder of the government and all financial institutions balances and reserve requirements, the ICB should, with the cooperation of the government, the treasury and the financial institutions be the principal controller of credit and applicant of the monetary policy in the Islamic state. To be in position to control credit, it must have an unchallengeable voice in deciding the volume of credits to be available from time to time.

The ICB, like any other conventional central bank, should, as De Kock (ibid:143-144) pointed out, aim at being able to assess approximately the extent to which bank credit is reasonable for a given economic situation at any time as compared with the operations of non

monetary factors since the relation between the two is very important for the purpose of formulating the correct credit policy. Secondly, it should aim at being able to determine the particular stage of the business cycle at any time, with a view to deciding not only when to act but what to do, how to do it and how far to go. Thirdly, it should try to secure the active and continuous cooperation of all the financial institutions for the more effective execution of its monetary policy... Fourthly, owing to the much wider sphere of government operations under modern conditions and the increased economic importance of the public sector generally, the ICB would need the cooperation and support of the government, because monetary policy has proved elsewhere to have only limited scope as an instrument for the maintenance of general economic stability and growth which has come to be widely accepted as the principal objective of national economic policies. It needs to be supplemented by, and coordinated with fiscal measures designed to secure appropriate adjustments in the level of public investment and current expenditures as well as in the incidence of taxation on private investment and consumption. In short, it is no longer a question of what monetary policy can achieve by itself but what it can do in conjunction with fiscal policy. Fifthly, the ICB must always keep watchful eye on the state of the country's balance of payment and monetary reserves, in view of their internal and external implications. Finally, in line with the objective of general economic stability, monetary and fiscal policies should not only be directed towards the maintenance of stable exchange rate, but also to the extent that these obligations can be reconciled with each other, towards the minimisation of fluctuations in business activity and the general price level (ibid).

The principal methods or instruments, which have been devised and employed, separately or collectively, by conventional central banks for the control or adjustment of credit include, among others:

- (1) The Discount Rate or Bank Rate Policy (BRP);
- (2) The Variable Reserve Requirements (VRR);
- (3) The Open Market Operations (OMO);
- (4) The Credit Rationing Policy (CRP);
- (5) The Selective Credit Control (SCC);
- (6) The Moral Suasion Policy (MSP)

The foregoing methods of credit control have come to be employed in different combinations instead of one at a time, and have varied in relative importance not only from time to time; but from country to country depending on the prevailing international or internal conditions and the current trend of monetary policy (De Kock (1974:126-127). Some of these are in force continuously, others are imposed and withdrawn at various times; some are mainly imposed to control the size of the money supply; some are concerned with the allocation of credit between different sectors of the economy. Although, the need for such control is almost universally accepted, they should not be allowed to impede competition or suppress innovation (CLCB 1978:67).

The choice of policy tools in an IFS would depend greatly on their compatibility with Islamic Shariah, on the economic situation of the country and on the policy objectives to be pursued. Five main objectives seems to have gained wide recognition among Muslim economists. These are: (1) Internal Stability, (2) Distributive justice, (3) External Equilibrium, (4) Allocative Efficiency and (5) Economic Growth.

#### **The Discount Rate or Bank Rate Policy**

The Discount Rate or Bank Rate Policy (BRP) represents one of the oldest instruments of credit control. "The basic approach of using this policy is", as Hawtrey (1962:273-274) pointed out: "not the level of rate of interest but the degree of rise or fall in Bank Rate which matters. It is a change in Bank Rate, rather than continuance either of a high rate or of a low rate which produces an effect. But the effect produced may be either strictly limited, a temporary retardation or modification of whatever movement in progress at the time, or it may be encouraged. The starting point of a big new movement amplified by the inherent instability of credit, the vicious circle of expansion or contraction, whether the effect is to be large or small, depends often on a psychological response. The rise or fall of Bank Rate is required to counteract expectations". Uzair (1982:215, 216) commented that: "The trouble with this approach is that it requires a constant and continuous manipulation of Bank Rate. This may create problems of instabili-



ty in the economic conditions of the country... The question about the effectiveness of Bank Rate has occupied the attention of experts in banking. Even in Britain where Bank Rate has been given a high importance opinion is divided... In certain situations a rise in Bank Rate may not check the demand for credit but may affect the cost of production, thus causing or aggravating 'cost push inflation'".

It is very important to note here, from the beginning, the absence of this instrument in the IBS because Bank Rate or Discount Rate is the rate of interest at which non Islamic central banks are prepared to discount or more accurately rediscount first class bills to the non Islamic banks in fulfilling their function of lender of last resort; and because, as we have seen in chapter five above, all interest based instruments are prohibited in Islam. M.N. Siddiqi (1983b:60) argued that: "the ICB would continue to perform its conventional functions even though it would lack the 'Bank Rate' as an instruments of policy", and suggested the use of two complementary instruments as alternatives. These, he called 'The Refinance Ratio' and 'The Lending Ratio'. The refinance ratio refers to the offer of the ICB to provide additional cash to the financial institutions to the extent of a certain percentage of the interest free loans granted by them. Raising or lowering this ratio will have the effect of expanding or contracting the supply by the commercial banks of short term credit. Prescribing different ratios in respect of credit extended to different sectors of the economy can be a means of channeling credit into desired directions... The Lending Ratio refers to the percentage of demand deposits which the commercial banks will be obliged to lend out as Interest Free loans. This instrument too according to him, can be manipulated to affect the supply of credit.

Uzair (1978) suggested the control of the PLS ratios, between the depositors and the bank and between the latter and the entrepreneurs as instruments of monetary policy. Saqr (1978) thinks that these are a matter between the bank and its customers and that it is not Islamic for the ICB to intervene and unilaterally change contractually determined Profit-Sharing Ratios which must not be altered after acceptance except by mutual consent of the parties to the contracts in question.

Chapra (1978) also advises against interference in this regard as the ICB can control credit in other ways. He prefers leaving the determination of these ratios to the market forces, on the ground of efficiency and competition. I agree with Saqr and Chapra and I think, the ICB can, instead, purchase equity securities, it chooses from the equity portfolio of the bank needing cash, at a discount (say 1 or 2% or more or less under their market prices) and pays in cash. This latter discount is not similar to the discount rate used by IBCBs on bills because bills are interest bearing securities and are not allowed in the IFS and the purchase and sale of equities and PLS securities is allowed whether their prices go up or down. Lowering or raising this discount rate on PLS securities may in some way encourage or hinder the IFIs to approach the ICB for funds and to expand or contract credit.

Uzair (1982:214-5) also suggested that the ICB should hold 25% or any other stipulated percentage of the capital stock of all the commercial banks operating in the country. This will, according to him, have several advantages: "(1) Since the central bank by virtue of its equity share, will automatically get a part of the profits of the commercial banks in the form of dividends, the need for interest payments to the central bank from the commercial bank on the latter's borrowings from the former will be obviated; (2) It will provide an additional lever to the central bank in controlling and regulating the activities of the commercial banks in the overall national interest. The nominees of the central bank of the boards of directors of the commercial banks regardless of whether they are privately-owned or state-owned, will ensure that the instructions of the central bank are complied with; (3) It will give the central bank a stake in the success and healthy development of the commercial banks. Such a close link between the central bank and the commercial banks will prove to be all the more important in fostering a healthy growth of the interest-free banking system as a whole. If the commercial banks face any problem in the transition period because of the new experiment it will be as concern of the central bank as that of commercial banks themselves". The danger,

however, is that such equity participation may lead to the creation of vested interests which may prevent the ICB from acting judiciously.

### Open Market Operations

"In its wider sense, Open Market Operations (OMO) may be held" as De Kock (1974:179) described: "to cover the purchase or sale by the central bank in the market of any kind of (financial) paper in which it deals, whether government securities or bankers' acceptances of foreign bills". In an Islamic economy, where no interest and no interest bearing securities are allowed, the ICB can also use OMO but by selling and purchasing ordinary shares and PLS securities of government and of first class financial, industrial and commercial institutions to control and stabilise their prices on one hand and to use them as monetary policy weaponry weapons in the right time at the other. The ICB should case have an adequate supply of 'ammunition' in form of highly diversified marketable securities so as not to affect tremendously the prices of the securities it involves in any one day. "Lack of ammunition as, Basu (1974:100) pointed out: "obviously stands in the way of the central bank's pursuing open market operations to their logical extent".

Basu (ibid) contended that: "The success of open market operations depends primarily upon first, the existence of broad and well organised money and capital markets and secondly, on the maintenance by financial institutions of a relatively stable cash ratio. The absence of a wide and active market for securities and the maintenance by the commercial banks of an elastic cash ratio in several countries have caused such operations to be practically of limited significance".

OMO have two impacts on the financial system. First, the immediate effect of a purchase or sale of securities is to increase or decrease the reserve base. However, there is always some questions as to whether the central bank can buy or sell the amount of securities it desires. But according to Cargill (1979:288) this is no problem because "the central bank does not conduct open market operations to make profits and will simply bid up the price on securities to a high enough level to purchase the securities from either banks, stockholders or individuals by simply creating the funds to purchase the securities, by inc-

raising the reserve accounts of the banks involved in the transactions. Likewise the central bank can sell any amount of securities it possesses because it will continue to lower the price until the securities are purchased. Second the effect of the central bank as a net purchaser or seller of securities shifts the demand or supply function of securities in the open market and immediately affects security prices".

This is the normal tendency in the direction of the foregoing assumptions but deviation from it cannot be excluded. Firstly because the quantity of money and the banks' cash reserves do not always increase or decrease in proportion to the purchase or sale of securities by the central bank as one or more counter forces might be operating simultaneously. Secondly, banks do not always increase or decrease their loans and investments in proportion to the increase or decrease in their cash reserves. There are various circumstances of monetary, economic or political nature which might deter banks from employing increased cash reserves fully if at all or from contracting credit when their reserves were reduced. Thirdly, it is not just a case of banks refraining at times from the full employment of their increased reserves but also one of a lack of willing or deserving borrowers (De Kock *ibid*:183-184).

OMO, though a major instruments of monetary control in the hands of central banks in the more mature and more sophisticated markets, are not the kind of weapon that can be readily and quickly adapted to LDCs where money and capital markets are immature or non-existent and where savings are very small or negotiable securities are lacking. Besides, even in some well DCs with very sophisticated money and capital markets the scope of OMO might be limited at times by the simultaneous operations of various counterforces in respect, not only of the supply of money and bank credit but also the demand therefrom. The question, as De Kock (*ibid*) put it: "is whether and to what extent the central bank could offset the effects of the counterforces concerned at any time by suitably adjusting its open market operations, by purchasing or selling securities in a greater or lesser measure than would otherwise have been considered necessary. The primary problem of course, would be that

of gauging accurately the extent and duration of all the actual or potential disturbing factors, and this in turn would depend not only on the experience and skill of the central bank in this field but also the degree of complexity of the prevailing economic conditions and trends".

#### Variable Reserve Requirements (VRR)

The use, by central banks, of the VRR is perhaps the most powerful tool, a central bank possess, because changes in VRR affect not only excess reserves but also the deposit money creation multiplier of the banking system (Binhammer 1968:125). This monetary instrument came to be adopted by all DCs and LDCs. However, "the range of variation is", as noticed by De Kock (1974:234-235): "not uniform but differ from one country to another. In many countries this instrument was employed only in the form of changes in cash reserve requirements and in some only in respect of commercial banks, and both these factors tended to limit its effectiveness as a restrictive measure". *The primary purpose of the VRR is to enable the central bank to exercise some degree of control over banks especially when these have a volume of reserves far in excess of legal requirements, which makes the other instruments ineffective. This is a method of quantitative credit control that affects their reserves directly as opposed to bank rate or OMO which affect them indirectly.*

This instrument of VRR can also be used by the ICB in an Islamic Economy so long as these reserves are kept with it on interest free or PLS bases. The ICB may impose a certain minimum cash and liquid reserve requirements equal to a certain percent of their deposits and designated non deposit liabilities and change it from time to time. The percent requirements should vary with the kind of financial institution, the deposits size and the type of deposit or source of funds. However, this must be taken with great caution because as Horvitz (1969:298) argued: "the large impact of VRR has some serious adverse side effects. Many banks may find it difficult to adjust promptly to increased reserve requirements. The bank that is fully loaned up will find it necessary to sell sizeable amounts of securities in what are probably depressed market. this can mean large capital losses and can put many banks in a severe liquidity bind".

Three more major criticisms have been levelled against the use of VRR. It is clumsy; it is discriminatory in its effects; and it is inflexible (Basu 1974:120). Perhaps that is why, as Horvitz (1969:299) pointed out: "there are few situations in which use of this weapon is called for. One such circumstances might be during wartime or other national emergencies which require large government expenditures during a period of full employment. An increase in reserves requirements could immobilise the excess reserves that would otherwise be created by deficit spending. The treasury could then borrow the needed funds from the central bank, thus avoiding the dangers of postwar inflation that could result from banks and others selling government bonds purchased during the emergency". There is also a substantial measure of agreement that the VRR can, as Basu (1974:119) noticed: "be appropriately pressed into service when a country is experiencing large and sudden movements in its gold and foreign exchange assets, especially as a result of speculative international capital movements. The effects of large inflows and outflows of foreign capital, it has been believed, can be counteracted more smoothly and effectively by changes in the required reserve ratio rather than by other monetary measures".

### **Credit Rationing**

Credit rationing is a direct control over the level of bank advances by requesting them from time to time to observe credit ceilings. This may be used by the ICB, as an alternative or as a supplement to other methods of credit controls. It consists of allocation of credit quotas to the financial institutions, not arbitrarily but in relation to their capital and reserves or to their proportionate share in the resources of the central bank to curb excessive inflationary pressures especially when other methods prove to be inadequate. It should be discontinued in normal times and to be used only in times of war, real crises or abnormal conditions, for it is a pernicious form of control, incompatible with the function of Lender of Last Resort and rigid.

### **Selective credit controls (SCC)**

The directional or selective control on bank advances in the shape of restrictions of credit to 'low priority' sectors of the economy and

its diversion to 'high priority' ones is sometimes used to encourage neglected sectors of the economy like agriculture and industry and to discourage sectors like trade and personal sector. SCC may take different forms. It may take the form of portfolio ceiling devices which involve the setting of ceiling on loans to be made for specified purposes or to certain specific sectors. The ceiling may be specified either in the form of percentages of loans and advances to be extended to different sectors or they may be stated in terms of the maximum aggregate amount of loans allocable to the specified sectors. Another type of portfolio-ceiling device, is the setting of incremental ceiling specifying the maximum increases allowed for loans for various purposes.

Alternatively these may be put in the form of a requirement for prior approval to be obtained from the central bank for loans to be extended above specified levels or specified percentages to the different sectors. The central bank may also tie this policies to the discount mechanism by charging preferential rates in rediscounting paper originating from the sectors earmarked 'high priority' in order to provide an added incentive for the banks to increase lending to these favoured activities, and higher rates to 'low priority' areas. A third way of imposing SCC is to link differential reserve requirements to the composition of the financial institutions portfolios. Banks whose portfolios conform to the requirement of certain prescribed percentages of loans to the 'high priority' areas are allowed to maintain lower cash or liquidity ratios than the normal ratio, which, of course will continue to be applied to the other financial institutions which do not meet the credit requirements. The prescribed percentages and/or the associated cash or liquidity ratio may be changed as Central Bank's emphasis shifts from one 'high priority' area to another. These instruments are to be distinguished from the quantitative instruments in that their impact is not on the total amount of credit but on the amount that is put to use in a particular sector of the economy (O.E. Johnson 1974).

There is nothing to prevent the ICB from using this instrument when necessary, except where interest is involved. The use of SCC in an IFS would assign a distributive or allocative role to the central bank in

cases where certain sectors that are vital for the overall national interest do not receive due attention of the IFIs either because they are more difficult to handle or because they are less lucrative than others (Uzair 1982:218). The ICB may also use it to curb the IFIs from extensive use of Murabahah, Ijarah or Bai Muajjal and to encourage them use PLS methods of finance such as Musharakah, Mudharabah, Muzaraah, etc..

### **Moral Suasion Policy**

Moral Suasion Policy is a qualitative instrument of monetary policy that consists of persuading the financial institutions that it is in their interest and in the interest of the nation as whole, that they should follow the issued instructions and directives. In an IFS moral suasion would play a significant role. The ICB would try to secure the active and continuous cooperation of all IFIs for the more effective execution of its monetary policy by developing closer relationships with them in order to persuade them that all financial institutions ultimately have a common interest in the maintenance of sound credit conditions and thereby increase its potential power of moral suasion over them whenever the occasion demands corrective action since experience of central banking elsewhere shows that it cannot rely on its legal powers and weapons at all times (De Kock 1974:143).

### **6.3 THE ISLAMIC COMMERCIAL BANKS**

The Islamic commercial banks, in fulfilling their services towards their customers, are faced with four categories of services as follows:

- A-) Services used by IBBs and prohibited by the Islamic Shariah;
- B-) Services developed by IFIs to replace the prohibited ones;
- C-) Services used by IBBs but doubtful or subject to controversy;
- D-) Services used by IBBs but which are Islamically permissible.

A-) The banking services that are provided by the IBBs and which are unacceptable from the Islamic point of view include:

1. All interest based financial claims;
2. Syndication, management or underwriting them;
3. Forward foreign exchange;
4. Discounting of interest based commercial papers;
5. Finance of interest based documentary credits;
6. factoring (buying of trade debt at discounts).

B-) The banking services that have been somewhat developed by Muslim economists to comply with Islamic Shariah are concerned with the



main banking services: collection of deposits and allocation of finance or in other words with the intermediary function (see 5.2 above).

C-) The banking services provided by IBBs but which are doubtful or controversial to Muslim scholars are, as reported by Attia (1985):

1. **Fees for letters of guarantee:** There is no controversy among Muslim Jurists as to the permissibility of the issuing of letters of guarantee or to the issuing charges that are not related to the amount of the letter to cover the expenses to the banks. However, the question arises as to the fees and commissions related to the amount of the letter of Guarantee. The legal aspect behind this controversy is not that the Letter of Guarantee is considered as finance and that these fees are considered as interest, but the point is that according to traditional Islamic Jurisprudence, the guarantee is classified under the non lucrative contracts, and as such it is assumed to be rendered as 'human service', free of charge.

2. **Bonus on current and savings accounts:** The predetermined yield on any deposit or loan is pure interest, and prohibited by Islamic law, whether it is on fixed term deposits, saving deposits or demand deposits.. meanwhile it is allowed that the debtor, when paying back his debt, gives the creditor a bonus whether expressed in increasing the amount of the loan or any other privileges or services and this is even recommended and expected from a pious debtor, provided that there is no previous condition or undertaking in this respect. Such a decision, if repeated and taken the form of a settled custom and is taken into consideration by the depositors when depositing their funds will amount to a prefixed condition or engagement considered as prohibited interest. There is even a question of whether the services rendered by banks to depositors of current accounts are to be considered as a kind of remuneration, and thus not allowed.

D-) Finally, the fourth category includes almost all the other banking services not involving interest. These are, as Attia (1985:4) pointed out: "in general, permissible under Islamic law, being pure services for which a fee or commission is allowed".

## 6.4 MANAGEMENT OF ISLAMIC FINANCIAL INSTITUTIONS

An efficient management of a financial institution not only improves the mobilisation of savings but also allocates them to the production needs of the society and realises good profits for the shareholders and depositors without falling in the pitfalls of liquidity or solvency. Management of IFIs requires that the operations of the IFIs are carried out Islamically (ie complying with Shariah) and effectively through the use of management techniques such as: planning, organising, coordinating, communicating, negotiating, controlling and decision making so as to attain maximum operating efficiency and profitability.

### 6.4.1 Planning the activities of an Islamic bank

Planning is perhaps the first very important thing to do in a process of good management. It is, as described by Hayes (1980:76): "deciding where we would like to be in the future and what and who may be involved in our getting there. It involves setting a plan with long and short range objectives, determining how to allocate resources in relation to the objectives, setting priorities, and assuring their fulfilment by making available the necessary people, plant and materials". Hayes (ibid:77) contends that: "planning is more complex than getting from here to there. It is the basis for cost control, budgetary administration, morale and productivity. In effect, any deficiency in these areas points to a defect in planning."

There is no objection from the Islamic point of view concerning the methods and techniques of planning so long that, in formulating the objectives and determining the tools, the management would not be involved in any prohibited transaction or injustice.

### 6.4.2 The Structure and Organisation of an Islamic Bank

Organising follows and supports planning. When the objectives have been agreed upon and the policies determined, organisation must follow to get things going on smoothly, efficiently and properly. Crosse and Hempel (1980:36) contended that: "a commercial bank is much more than a building. It is an organisation that combines human effort and financial resources to perform the banking function required by the community it serves, and to earn an adequate return on its owners' investments".

As Searle (1980:26) pointed out: "the particular organisational structure which a commercial banking organisation adopts depends upon a number of factors. Among these are the financial aspects of the decision opportunities in the market place, competitive considerations, and legal constraints related to the structure of the commercial banking system as they apply to that particular banking organisation".

Hayes (ibid:78) says that: "Organising is bringing people together in a way that most effectively and efficiently will achieve the objectives". It involves the definition of jobs and determination of responsibilities in writing. Far more importantly, however, as Hayes (ibid) put it: "organising is bringing people with relationships where each individual can find satisfaction in the job and yet all are united in a common accomplishment.. The objective is the responsibility of the team and to bring this about, participation is required". The organisation of any institution aims at achieving the objectives and policies of that institution. There is no objection in the Islamic Shariah as to the organisation of a bank or any other institution.

As Mudawi (1984:3) contends: "there is no prototype organisational set-up for an Islamic bank. Each Islamic bank should have the organisational shape and body which suits its environment, the laws of its country, the type of activity which dominates the economic scene and the level of advancement it has attained. An Islamic bank could be established, subject to regulatory approval, as a private company or a government owned institution or it could even be a mixture of both". It may take the form of a unit, branch or group bank, joint-holding company, or merge with another bank, etc.. It may also be involved in international banking through various organisational units such as representative offices, agencies, branches, subsidiaries, affiliates, etc.. Whatever form an Islamic bank takes, it has to have certain traditional organs. These organs may comprise a General Assembly in which the powers of ownership are vested, and a Board of Directors who are finally responsible to the supreme organisation of its owners. As such the organisational characteristics of an Islamic bank are:

**Shareholders:** The shareholders of any institution are the real owners of that company. It is they who choose the Board of Directors and agree or reject the overall policies of the institution. And it is they who bear the fortunes and misfortunes of the institutions. Crosse and Hempel (1980:49) pointed out that: "part of a bank's special character is related to the distribution of its stocks. A bank's stock may be closely held by a single individual or a relatively small group, or it can be widely distributed in the community".

**Investment Deposits Holders:** Unlike in conventional banks where depositors have a debtor/creditor relationship, receive predetermined interest returns that have no relation whatsoever with the profits and losses of the bank and have precedence over shareholders in case of a liquidation, the holders of investment deposits and PLS certificates in Islamic banks are like shareholders, share in the fortune and misfortune of the Islamic bank in proportion to their investment deposits and have no precedence over the shareholders in case of liquidation. In other words they also have the right of ownership in the bank. The only difference perhaps is that their deposits have maturities while those of shareholders have not. Thus, I think depositors of this sort with investment deposits maturing say after a year or more from the time of the the annual general meetings of shareholders should have the right to be represented albeit with less powers than the shareholders, of course in view of the difference in commitment.

**Board of Directors:** As Reed et al. (1980:64) pointed out: "Stockholders, depositors, and regulatory authorities look to directors for policy decisions and management ability that will result in the safety of funds and profitable operations". Depending on the banking act of the country and on the size of the institution, the Board of Directors of an Islamic Bank may be determined by the stockholders' general meeting. Each director may be required to directly own some shares in the institution he is involved with. The Board of Directors plays the role of agent towards the shareholders and represents the top echelon of authority. It should be responsible for the performance of the institution by selecting competent executive officers, effectively

supervising the bank's affairs, adopting and following sound policies and objectives and avoiding self-serving practices (ibid).

Probably the most important functions of the Board of Directors of an Islamic Bank, are the establishment of its objectives, the determination of policies and the supervision of the activities. The powers, duties, responsibilities and liabilities of the Board of Directors are determined by a combination of statutory law, common law, articles of association, bylaws and custom, subject of course to Islamic Shariah. The objectives can and should be set with respect to public relations, personnel training and development, and community progress and the development of policies is necessary in planning a course of action.

**Religious Supervisory Board:** Because for the present time Muslim bankers have little or no knowledge about the Shariah laws there are nowadays religious supervisory boards supervising and controlling the activities of the Islamic banks to make sure that the contracts agreed upon between the bank and its customers comply with the Shariah. However, in the future when Muslim bankers would be educated not only in the conventional banking studies but also in Shariah, this exclusive feature of religious supervisory boards should disappear.

**Different Departments:** For an effective and efficient management of an Islamic bank, it is perhaps very important that the tasks and responsibilities of the personnel are well defined and coordinated. A Typical Islamic bank could have an Investment Department, a follow up Department, A Legal department, A Recruitment and Training Department, A social Department, etc. (see Presley 1988a:64-5).

#### 6.4.3 Profitability Management

Islamic commercial banks, like other commercial banks, are profit-maximizing businesses subject of course to the Shariah and other constraints. They can increase their profits by investing more of their asset portfolio in higher yielding but more risky investments. However higher bank profits must not be achieved at the expense of bank safety. Thus, the central problem for bank management is reconciling the conflicting bank goals of solvency and liquidity, on one hand, and profita-

bility on the other or what is known as the 'banking dilemma' because the trade-off between profitability and safety is more acute for banks than for most other businesses (see Kidwell and Peterson 1980:188).

Bank earnings, as Crosse and Hempel (1980:102) pointed out: "are the foundation upon which rest the two main pillars of banking strength adequacy of capital and competence of management... Thus, earning power proved to be the first line of defence against the risks inherent in banking". In an IBBS, bank earnings, as Crosse and Hempel (ibid) put it: "provide the return on capital investment in banks. It is for the sake of this return on his or her investment that the stockholder is willing to supply the capital that enables a bank to engage in the risky business of creating credit, and it is by retaining assets generated by earnings that the major portion of bank capital has been accumulated". Gross income of IBBS is determined by the rate of return on loans and investments, by the level of various fees and charges imposed for the performance of services, and by the size and composition of assets. Although service fees have increased and will probably do so in the future, interest on earnings assets, from loans and investments provides almost 90% of IBBS's income (Reed et al. 1980:184).

The profitability of IFIs depends greatly on the realised profits and losses of their project investments which they finance, the rotation of their financial resources and the termination or completion of the operations. A large part of an IFI income would be in form of Juala (fees or commissions) and profits from Murabahah, Bai Muajjal, Bai Bit-Tagseet, Ijarah and Ijarah Waqtina' but not from interest. With a good capable management, IFI would be very much profitable except, perhaps in times of recession or mismanagement. The existing Islamic banks have proved this since most if not all of them realised substantial profits from their first year of business (see chapters 8-11 below) despite the fact that, like any other corporation, they had substantial amounts of establishment and overheads costs in their first years of business.

One of the principle byproducts of an analysis of revenue and expense is a budget that involves forecasting revenues, expenses and the resulting profits on savings. The IFI should follow this practice and

look for ways of increasing the earnings of the bank because the earning of an IFI do not go only to its shareholders but investment depositors also have their share in them. Unless an Islamic bank makes good profits, depositors will not approach it because their return depend directly on the profits realised by it.

#### 6.4.4 Capital Adequacy Management

As Crosse and Hempel (1980:67) contended: "the ultimate strength of a bank lies in its capital funds. Such is the consensus of writers on banking and bank supervisors. But the problem of bank capital is not quite that simple. It is not merely a question of the more capital the better; rather, it is how much capital for what reasons or purposes". Reed et al. (1980:158) pointed out that: "the effective management of capital funds may enhance the profitability of a bank while maintaining the traditional and necessary function of safety for depositors".

Capital adequacy is so important for banks because banks normally have a very high degree of financial leverage than do most other businesses, which means that the majority of their assets (around 90%) are financed by debt (the funds of the depositors). This state of affairs demands that capital must be adequate to maintain the confidence of the depositors who otherwise would be worried over the safety of their deposits and would withdraw them in fear that the bank may not be able to meet its obligations. Capital adequacy is also important for a bank to meet the regulations drawn by bank supervisors who decide how much capital is adequate and who have to make sure that the public confidence is maintained not only as far as a certain bank is concerned but for the banking system as a whole. Perhaps, that is why, banks are the most strictly supervised and regulated businesses all over the world. As Lachab (1987:8) pointed out: "This function of capital depends on its ability to maintain confidence in the banking system rather than its ability to pay off bank creditors under crisis situation. After all, no level of capital is sufficient, except 100 percent to absorb all bank losses. The emphasis on the capital ratios by the regulatory authorities can also be seen as a mean of controlling bank's rapid growth".

As in the case of IBBS the ultimate strength of an Islamic bank lies in its capital funds and so it must maintain the level of capital adequacy required by the supervisory authorities. But it is very important to note here as Reed et al. (1980:172) pointed out that: "although a ratio may be helpful as a starting point in analysing the capital adequacy of an individual bank, it should not be considered an end in itself. A bank does not have adequate capital just because it meets some statistical average, nor it is beyond criticism just because it meets some ratio... The inquiry must go beyond the ratio to an examination of the bank's operations and the risks it assumes in its loan and investment portfolio". Thus a number of factors such as the liquidity of assets, the volatility of deposits, the structure of deposits, the history of earnings, the quality of management, etc., must be taken into consideration when assessing the adequacy of capital of a bank.

It is perhaps also very important to note that an Islamic bank can raise its capital only through ordinary shares, retained profits and reserves. No preferred stock or subordinated capital debt involving interest are allowed in Islam or used by Islamic banks. However, investment deposits and other PLS instruments should not be considered as debts when calculating the capital adequacy ratios of Islamic banks but as part of the cover of debt because their holders are not debtors towards the Islamic banks but, as argued above, partners who have temporary ownership in the assets of the banks. Investment depositors, like the shareholders, share in the profits and losses of the bank and in times of crisis they should help the bank maintain the confidence of other depositors rather than withdraw their deposits if they are not to lose, because withdrawing their deposits does not exempt them from the liabilities of the banks since they have to bear part of the ultimate loss in case a loss occurs in proportion of their deposits in the total funds (capital and reserves plus investment deposits) and that, what makes them different from time depositors in IBBS. Furthermore, the Islamic bank should not allow investment depositors to withdraw their deposits before maturity, first because they have a contract to fulfil and secondly, it is in their own interest. However, current and saving



account depositors who do not share in the bank's result have the priority over investment depositors and their deposits must be guaranteed not only by the capital and reserves of the bank but with investment deposits as well. This means that the real leverage of Islamic banks is very low and their capital ratios are very high especially if investment deposits are considered as part of the capital and not as part of the debts as in the following formula:

$$\text{Capital Ratio} = \frac{\text{K\&R} + \text{ID}}{\text{DD} + \text{SD}}$$

Where: K&R = Capital and Reserves; ID = Investment Deposits;  
 DD = Demand Deposits; SD = Savings Deposits.

#### 6.4.5 Liquidity and Balance Sheet Management

The problem of liquidity for commercial banks is essentially that of having available at all times sufficient funds to meet demands for deposit withdrawals and contingencies. "Throughout the history of banking", as Revell (1975:13) noticed: "there have been many changes in the sources of liquidity, and these changes have been associated with the growth and adaptation of money markets and the forms of bank lending... The theory of liquidity has therefore been an operational one.. The theory has thus changed as practice has changed".

(1) **The commercial loan theory** or the Real Bills Doctrine, as it was also called is perhaps the oldest theory of solving the liquidity problem. It states that commercial banks should grant only short-term, 'self-liquidating' loans. There is, of course, no such thing as 'self-liquidating' loan especially when there is a slump in trade (Revell 1975:13-4). Banks used to adopt this method because there were not many ways of finding liquidity as are available today. The Islamic banks, in their present situation where they cannot use the interbank market and where they have no lender of last resort or a secondary market for their assets, could use this method but not in its original form because an Islamic bank does not give commercial loans, it provide finance on Murabahah which is somewhat a self-liquidating or on PLS basis where they share in the fortunes and misfortunes of the business-

ses financed after they make sure that they are viable or say 'self-liquidating' to some extent. However, when things improve, they do not need to stick to this method, they could follow one or more of the other ways of solving the 'dilemma'.

(2) **The shiftability theory** emerged in the 1930s as a new theory replacing the old commercial loan theory. It states that banking liquidity depends upon the ability of the bank to sell or shift its assets to others at a predictable price. "The doctrine of shiftability is", as Revell (ibid) argued: "subject to the same fallacy as 'the real bill' doctrine, that of assuming that liquidity for individual banks and for the banking system are identical. The fact is that no assets are liquid when all banks are simultaneously trying to 'shift' them". Individual Islamic Banks may also use this method when not all banks are doing the same, if they have a portfolio of negotiable PLS financial instruments and there is quite a good secondary market for them.

(3) **The anticipated income theory** emerged in the 1940s as a new way of assuring liquidity for banks. It expanded the menu of bank loans from short term loans to longer term loans and non business loans. It reasons that bank loans are paid off out of the future earnings of the borrower, from anticipated income and so it focuses on the borrower's ability to successfully repay a loan in stages over a period of time. The critical factor in the decision to grant a loan is the borrower's ability to repay the loan out of his future earnings. (Kidwell and Peterson 1980:192,193). When Islamic banks offer finance on the basis of the PLS system which relates their returns to the anticipated income of the customer, one can say that they use this technique.

(4) **Asset Management:** Asset Management is the term used to describe the allocation of funds among cash, security investment, loans and other assets so as to achieve the highest rate of return for the level of risk assumed within the liquidity and regulatory constraints. According to Reed et al. (1980:96), three different approaches to asset management have been espoused in attempts to resolve the liquidity-profitability dilemma. Each differs in its emphasis on the form of the management process and in the degree to which quantitative analysis is

employed in evaluating the alternatives available. No one approach can be considered a panacea for bank management because problems and deficiencies are associated with each. These are:

(a) **The Pool-of Fund Approach** which is the simplest to administer and whose basic idea is that all funds should be pooled together and then allocated to whatever asset investment is appropriate.

(b) **The Asset Allocation Approach or Conversion of Funds Approach** which was developed to meet the deficiency of The Pool of-Fund Approach which failed to distinguish among the different liquidity requirements of demand deposits, savings deposits, time deposits and capital funds. Under this method and as Baker (1978) described: "liabilities are categorised according to their volatility and then allocated to assets that share the same volatility characteristics. Volatility is assumed to be a function of deposit size as well as type... Determination of deposit volatility by category may be made either intuitively or through the use of statistical inference techniques".

(c) **The Management-Science Approach** which involves the application of computer-aided analysis and use sophisticated models and advanced mathematical techniques such as linear programming to analyse the complex interrelationships among various components of the balance sheet and income statement and which can provide powerful aids to management in the decision making. The models prescribe how a bank's management should allocate whatever funds are available for investment to provide adequate profitability while operating within the liquidity constraints imposed by management (from within) or by regulatory authorities (from without). The manipulation of these models may be of great assistance to bank management in realizing increased profitability from bank operations. The scientific method for the solution of problems involved, requires a statement of objectives, identification of the relationships among various elements of the problem, identification of variable elements that are, and are not under the control of management, an estimate of the way non controlled variables may behave, and identification of constraints imposed on the behaviour of management (from within or

without). The method attempts to answer three questions: What is the problem? What are the alternative solutions? Which alternative is best? (see Reed *et al.* 1980:chapter 5).

(5) **Liability Management:** Prior to the 1960s it was believed that bank's liquidity comes almost entirely from the asset side of its balance sheet and that the only other source of liquidity is the central bank when it is approached as the lender of last resort but because this latter source was available only in cases of emergency, the banks used to assume that their liabilities as given and start from there to allocate them among their assets. The 1960s marked the beginning of a new era in bank liquidity practices (Kidwell and Peterson 1981:195).

Liability Management has come to be known as the activities involved in supplementing liquidity needs by actively seeking borrowed funds when needed. It enables a bank to aggressively expand its lending activities through increased leverage. The liquidity gained may be used to smooth out deposit inflows and outflows and reduce their variability. It may also be used to meet increases in loan demand by the bank's customers as long as the expected marginal return of the new loans exceeds the expected marginal cost of funds (see Reed *et al.* 1980:25 and Kidwell and Peterson 1981:196). The Islamic bank when using this method must of course avoid interest based liabilities.

(6) **Balance Sheet Management:** Kidwell and Peterson (*ibid*) reported that: "Beginning with the rise of liability management in the 1960s, it became apparent that decisions about the composition of a bank's assets and liabilities were no longer independent. Balance Sheet Management gives explicit recognition that the decisions about a bank's asset and liability holdings are highly interrelated and that the entire balance sheet of the bank should be regarded as the portfolio for which financial planning is undertaken". This type of analysis is extremely complicated, requiring the use of computers and the construction of financial models of bank operations employing linear programming and other mathematical techniques that need to be solved simultaneously. The result should give an optimal solution providing the bank's management with actual numbers for how much to invest and in what assets.

#### 6.4.6 Risk management in Islamic banks:

All business operations involve risk. As Revell (1975:80) contends: "It is not only insurance companies that have a portfolio of risk but also all credit institutions and all financial institutions". In fact as Crosse and Hempel (1980:59) contend: "taking risks can almost be said to be the business of bank management. A bank that is run on the principle of avoiding all risks, or as many of them as possible, will be a stagnant institution and will not adequately serve the legitimate credit needs of its community. On the other hand, a bank that takes excessive risks or, what is more likely takes them without recognising their extent or even their existence will surely run into difficulties". IFIs are no exception, in fact it is argued that since Islamic banks would be more involved in direct and indirect businesses, and not charging predetermined interest but share in the profits and losses of their customers to whom they give finance, their portfolio of risk is greater than their counterparts (the IBBs). Here, we shall look into this claim and see how IFIs could hedge against these risks.

The first most important step in the risk management approach is to identify all possible risk exposures, so as to be able to evaluate them and hedge against them. Perhaps one of the most useful and comprehensive classification of the specific types of risks peculiar to the operations of IBBs is the one given by Revell (1975:82) and produced below:

Types of risks	Sources of risks
1. Credit	Default or delay in fulfilment of obligations
2. Investment	Changes in interest rates, foreign exchange rates and assets's prices
3. Liquidity	Faulty balance sheet structure, changes in assets prices
4. Earning	Changes in interest rates, asset prices and operating expenses
5. Operating	Operating errors, inefficiency, faulty control procedure
6. Insured	Excess on insurance policies, risks not covered

All of the types of risk mentioned above together with fraud and fiduciary risks, which are omitted as these can be insured against, may be present in an IFI, however the sources would be somewhat different. For instance the IFI will not be subject to risks from changes in interest rates since they do not deal in interest bearing instruments but

will be subject instead to risks originating from sharing the losses of unsuccessful PLS investments.

The most obvious risk in banking, as Crosse and Hempel (1980:60) remarked is the credit risk -the possibility that loans will not be repaid or that investments will deteriorate in quality or go in default with consequent loss to the bank. Although IFIs do not deal with interest securities and all their assets with the exception of premises, plant and equipment are subject to credit risk, nevertheless their risk exposure would, I believe, be less than IBBs for the following reasons: (1) The IFI does not give loan advances (credits) except in very limited circumstances and although these are interest-free they are secured by pledges. (2) The IFI gives PLS finance or buys goods and then sells or leases them to its customers. If the finance is in the form of Murabahah (Mark-up sale), Bai Muajjal (Sale at deferred payment), Bai Bit-Taqseet (sale by instalments), Ijarah (leasing) and Ijarah Waqtina' (hire-purchase), then the finance is guaranteed by the fact that the ownership of the good involved remains with it until full payment is received. If, on the other hand the finance is in the form of a PLS contract as in Musharakah, Mudharabah, Muzaraah and Musaqah projects, the IFI does not give any of these until it makes sure not only that the customer is credit-worthy but that the project financed is itself viable and profitable or 'self-liquidating' and have the right of follow up and intervention whenever necessary and able to prevent a loss to the project. This does not say that the IFI will be protected all along but only to say that the risk of not recovering all or part of their finance would perhaps be minimal as compared to IBBs' credit risks, unless the partner it gives finance too turn to be a crook who fraudulently uses the finance in a different venture without the bank knowledge or the IFI turns a blind eye on him, which is unlikely.

Perhaps investment and earning risks are the most obvious in Islamic banking and not credit risk, and that is why it is claimed that Islamic banks are more risky than IBBs. This may be true when the bulk of the Islamic bank's finance is in the form of PLS projects, but if the bulk of its finance is in the form of a Murabahah, Bai Muajjal, Bai'

Bit-Tagseet, Ijarah or Ijarah Waqtina' then, the risk would perhaps be lower. Hedging against the risk of PLS investments could be done through appropriate diversification, intimate knowledge of the partners, accurate feasibility studies of the PLS projects and follow up with intervention when necessary to stop the erosion of the assets' values. This may prove to be expensive and difficult to implement, but if followed, may benefit the bank greatly.

As far as the other risks are concerned, The IFIs would be subject to these risks just as IBBs are, except those emanating from the volatility of interest which is not present in the IFS. To protect itself, from the liquidity risk for example, the IFI should maintain adequate liquidity in the form of assets readily convertible into cash at a minimum risk of loss, manage itself properly and assure itself of its ability to get needed funds in the market. And to protect or say reduce the risk of fraud, theft and other risks, the IFI should have adequate internal and external controls, safeguards, audits and insurance.

## 6.5 CONCLUSION

The IBS is an equity rather than debt based system and the relationship between an IFI and its customers is of partnership rather than of debtor/creditor. It can work without recourse to interest. In other words, interest is not a necessary component of banking, as it used to be held. There are a number of instruments, such as Mudharabah, Musharakah, Muzaraah, Musaqah, Murabahah, Juala, Ijarah, Bai' Muajjal, Bai' Bit-Tagseet, etc., that can be used to mobilise savings or invest them without transgressing the Divine law against interest. Not only that but even monetary policy could be implemented without recourse to interest. The ICB and the IFIs can design and adopt any variety of banking and monetary techniques according to the needs of the circumstances and depending on the level and stage of the development of the IFS as long as they do not transgress Allah's Shariah. Thus, the absence of interest does not reduce the scope of banking generally nor of monetary policy in particular. This may prove to be hard to achieve and requires more manpower and capital than IBBS, but that is where the test lies.

## CHAPTER SIX

### THE ISLAMIC BANKING SYSTEM (IBS)

#### 6.1 INTRODUCTION

In every modern society, the banking system is the main and vital institution that mobilises the society's savings and channels them to economic and social uses. In an Interest Based Banking System (IBBS), banks borrow funds at interest from the depositors and extend credits at interest to creditworthy borrowers, thus acting to induce investment, increase employment and production, and presumably achieve greater growth and economic development. In addition to this vital function banks also provide other important financial services of which the most important is perhaps the provision of current deposit accounts facilities or what is also called the payment mechanism (a convenient device to make payments through cheques). Indeed this service is, as Cooper (1984:49) pointed out: "one of the banking services which must be provided by an institution in order for it to become a recognised 'bank' and thus entitled among other things, to use the word bank".

Other services provided by interest based banks include the supply of foreign exchange, purchase and sale of securities, acceptance and collection of promissory notes and commercial bills, discounting, safe-keeping, etc.. Their main goal is to maximise their profits from interest rate differences and various fees and commissions, subject of course to a reasonable level of liquidity, safety and soundness.

As Sayers (1967:15) pointed out: "the banking systems of different countries vary substantially from one another but there has been during the present century a universal tendency for each nation to develop a wide network of banks centred upon the chief trading centre of the country with the largest banks themselves established in that centre and grouped round a quite different institution referred to as the central bank". The purpose of this chapter is to theoretically compare and analyse the structure, functions and management of an advanced Islamic Banking System (IBS) vis-a-vis those of an advanced IBBS.



## 6.2 THE ISLAMIC CENTRAL BANK (ICB)

The central bank is a special institution entrusted with the management of the money supply and of government finance together with the supervision and control of banks and other financial institutions. "The central bank" as Z. Ahmed (nd:1) described: "holds the key position in the financial system of a country. It is expected to act as a guardian of the country's monetary and banking system. It is the primary institution responsible for implementing monetary policy suited to the achievement of a country's socio-economic objectives". The ICB is no exception. However, in fulfilling its functions, it would not use or permit the use of interest or other prohibited financial instruments. As any other central bank, the ICB would be:

- 1-) The Bank of Issue and Custodian of the Nation's Reserves;
- 2-) The Bank of the Government;
- 3-) The Custodian of the Financial Institutions' Cash Reserves;
- 4-) The Bankers' Bank and Clearing Bank;
- 5-) The Lender of Last Resort;
- 6-) The Supervisor and Controller of Financial Institutions; and
- 7-) The Controller of Credit and Applicant of Monetary Policy.

### 6.2.1 The Bank of Issue and Custodian of the Nation's Reserves

The ICB may assume this function with little or no difference to other central banks. For the general interest of the Ummah (nation) the ICB should have the sole right of issue of the nation's currency so as to attain not only uniformity in the state note circulation but effective elasticity to meet the legitimate currency requirements of business and the general public and the effective supervision over a credit instrument which had for the sake of convenience to be declared legal tender money (De Kock 1974:22).

### 6.2.2 The Government Banker, Agent and Adviser

The ICB may also act as the government banker, adviser and agent. It would manage the banking accounts of government departments, boards, and enterprises, not only because it is more convenient and economical but also "because of the intimate connection between public finance and and monetary affairs. The state is, in every country the largest receiver of revenue and its expenditure has come to play an increasingly important part in the economic life of the nation" (ibid:36). The turnover is huge and "because transfers of this magnitude might be embaras-

sing to a commercial bank, it is a recognised principle of central banking that the central bank should manage the government's accounts" (Hanson 1978:52), so as to cushion the commercial banks against the impact of large movements of cash originating in this way. However, the ICB is not to lend money to the government at interest nor float interest bearing bonds, it can lend interest free or float PLS securities. In providing the government with foreign exchange requirements, the ICB would not deal or allow dealings 'on the forward' market. It would deal and allow dealings only 'on the spot' market.

In its role as adviser to the government, the ICB should advise the government with the best ways of achieving economic development, avoiding inflation, establishing proper financial institutions that provide finance that can finance not only the large sized industries but also the small and medium enterprises in urban and rural areas.

#### **6.2.3 The Custodian of the Financial Institutions' Cash Reserves**

"The concentration of cash reserves in the central bank is", as De Kock (1974:58) contended: "a source of great strength to the financial system at any time. Centralised cash reserves can at least, serve as the basis of a larger and more elastic credit structure than if the same amounts were scattered among the individual banks. It is obvious that, when bank reserves are pooled in one institution which is moreover, charged with the responsibility of safeguarding the national economic interests, such reserves can be employed to the fullest extent possible and in the most effective manner during periods of seasonal strain and in financial crises or general emergencies". The obligation imposed on IFIs to keep minimum cash reserves with the ICB gives the latter a strong means with which it could operate and which, not only strengthens its financial position, but also gives it some means of control over the banking and credit situation.

#### **6.2.4 The Bankers' Bank and Clearing Bank**

It is more convenient and more advantageous for the financial institutions to entrust their surplus cash to the central bank just as it is convenient and advantageous for individuals and companies to entrust their surpluses to commercial banks and other financial institutions.

This should be in addition to the minimum reserve requirements that each financial institution must maintain with the central bank in order to protect the interests of their depositors and the interests of the nation. Likewise, the ICB would provide the IFIs with similar banking facilities and act therefore as the bankers' bank.

#### **6.2.5 The Lender of Last Resort**

It is the responsibility of the central bank to protect banks that have been honestly and competently managed from the consequences of a sudden and unexpected demand for cash. In other words the central bank should but rather must act as a lender of last resort to banks so as to maintain the public confidence in the banking system and prevent its collapse. To do this effectively it is necessary that the central bank be permitted either to buy the assets of commercial banks or to make advances against them (Encyclopedia Britannica 1974:Vol2:708). "In a more recognisable terms the central bank must, as Sayers (1967:101) put it: "lend without a stint in times of financial crises". The ICB should be ready at any time to help any financial institution which might fail temporarily to match its liabilities so as to give confidence not only to depositors in current accounts but to investors as well. However in doing so it must not charge any interest but may either give very short interest free credits, buy some of the PLS securities held by the bank concerned at a slightly lower price than their market price or requires from it, after one or two warnings, to keep with it a larger future reserve for a certain time, as a penalty, until this latter settles or until the ICB decides to waive the penalty.

#### **6.2.6 Supervisor and Controller of Financial Institutions**

"Given the importance of banks in modern financial systems and recent experiences in the banking sector, therefore, effective supervision is clearly, as Gardener (1981:63) put it: "an attractive economic good. Experience has shown that there are always a few operators who, given the opportunity, will cross the barriers of prudent banking if the rewards appear to be high enough. There has to be a higher authority responsible for ensuring that such banks are kept in line to

preserve the stability and safety of the entire system. That higher authority must be the supervisory authorities (the central bank)".

The regulation of financial institutions is necessary and very essential to ensure that banks are not only safe but seen as safe to help preserve the overall financial stability of the economy and to provide adequate 'consumer protection' to depositors; control the monetary system; and finally, protect financial markets from being inherently uncompetitive (see Gardener and Molyneux 1989:35).

In order to minimise the risks of banks and other financial institutions' failures due to mismanagement or unscrupulous practices, the ICB, like the other central banks all over the world, should have regular contact with the financial institutions by way of examination and close supervision of their operations and have the power to inspect, audit, control, advise, guide and impose penalties. Through regular inspection and contact, the ICB can acquaint itself with the finance and investment practices of the financial institutions and provide them with advice and guidance on such matters as staffing, branch expansion, investment, etc. and issue to them directives on all matters concerning liquidity, capital adequacy, monetary policy, etc.. It will usually consult them in all such matters, but if necessary such instructions can be issued in the form of rules and regulations for their guidance.

#### 6.2.7 Controller of Credit and Applicant of Monetary Policy

In view of its rather special position as the only bank with the right of issue, the custodian of the nation's reserves and the holder of the government and all financial institutions balances and reserve requirements, the ICB should, with the cooperation of the government, the treasury and the financial institutions be the principal controller of credit and applicant of the monetary policy in the Islamic state. To be in position to control credit, it must have an unchallengeable voice in deciding the volume of credits to be available from time to time.

The ICB, like any other conventional central bank, should, as De Kock (ibid:143-144) pointed out, aim at being able to assess approximately the extent to which bank credit is reasonable for a given economic situation at any time as compared with the operations of non

monetary factors since the relation between the two is very important for the purpose of formulating the correct credit policy. Secondly, it should aim at being able to determine the particular stage of the business cycle at any time, with a view to deciding not only when to act but what to do, how to do it and how far to go. Thirdly, it should try to secure the active and continuous cooperation of all the financial institutions for the more effective execution of its monetary policy... Fourthly, owing to the much wider sphere of government operations under modern conditions and the increased economic importance of the public sector generally, the ICB would need the cooperation and support of the government, because monetary policy has proved elsewhere to have only limited scope as an instrument for the maintenance of general economic stability and growth which has come to be widely accepted as the principal objective of national economic policies. It needs to be supplemented by, and coordinated with fiscal measures designed to secure appropriate adjustments in the level of public investment and current expenditures as well as in the incidence of taxation on private investment and consumption. In short, it is no longer a question of what monetary policy can achieve by itself but what it can do in conjunction with fiscal policy. Fifthly, the ICB must always keep watchful eye on the state of the country's balance of payment and monetary reserves, in view of their internal and external implications. Finally, in line with the objective of general economic stability, monetary and fiscal policies should not only be directed towards the maintenance of stable exchange rate, but also to the extent that these obligations can be reconciled with each other, towards the minimisation of fluctuations in business activity and the general price level (ibid).

The principal methods or instruments, which have been devised and employed, separately or collectively, by conventional central banks for the control or adjustment of credit include, among others:

- (1) The Discount Rate or Bank Rate Policy (BRP);
- (2) The Variable Reserve Requirements (VRR);
- (3) The Open Market Operations (OMO);
- (4) The Credit Rationing Policy (CRP);
- (5) The Selective Credit Control (SCC);
- (6) The Moral Suasion Policy (MSP)

The foregoing methods of credit control have come to be employed in different combinations instead of one at a time, and have varied in relative importance not only from time to time; but from country to country depending on the prevailing international or internal conditions and the current trend of monetary policy (De Kock (1974:126-127). Some of these are in force continuously, others are imposed and withdrawn at various times; some are mainly imposed to control the size of the money supply; some are concerned with the allocation of credit between different sectors of the economy. Although, the need for such control is almost universally accepted, they should not be allowed to impede competition or suppress innovation (CLCB 1978:67).

The choice of policy tools in an IFS would depend greatly on their compatibility with Islamic Shariah, on the economic situation of the country and on the policy objectives to be pursued. Five main objectives seems to have gained wide recognition among Muslim economists. These are: (1) Internal Stability, (2) Distributive justice, (3) External Equilibrium, (4) Allocative Efficiency and (5) Economic Growth.

#### **The Discount Rate or Bank Rate Policy**

The Discount Rate or Bank Rate Policy (BRP) represents one of the oldest instruments of credit control. "The basic approach of using this policy is", as Hawtrey (1962:273-274) pointed out: "not the level of rate of interest but the degree of rise or fall in Bank Rate which matters. It is a change in Bank Rate, rather than continuance either of a high rate or of a low rate which produces an effect. But the effect produced may be either strictly limited, a temporary retardation or modification of whatever movement in progress at the time, or it may be encouraged. The starting point of a big new movement amplified by the inherent instability of credit, the vicious circle of expansion or contraction, whether the effect is to be large or small, depends often on a psychological response. The rise or fall of Bank Rate is required to counteract expectations". Uzair (1982:215, 216) commented that: "The trouble with this approach is that it requires a constant and continuous manipulation of Bank Rate. This may create problems of instabili-

ty in the economic conditions of the country... The question about the effectiveness of Bank Rate has occupied the attention of experts in banking. Even in Britain where Bank Rate has been given a high importance opinion is divided... In certain situations a rise in Bank Rate may not check the demand for credit but may affect the cost of production, thus causing or aggravating 'cost push inflation'".

It is very important to note here, from the beginning, the absence of this instrument in the IBS because Bank Rate or Discount Rate is the rate of interest at which non Islamic central banks are prepared to discount or more accurately rediscount first class bills to the non Islamic banks in fulfilling their function of lender of last resort; and because, as we have seen in chapter five above, all interest based instruments are prohibited in Islam. M.N. Siddiqi (1983b:60) argued that: "the ICB would continue to perform its conventional functions even though it would lack the 'Bank Rate' as an instruments of policy", and suggested the use of two complementary instruments as alternatives. These, he called 'The Refinance Ratio' and 'The Lending Ratio'. The refinance ratio refers to the offer of the ICB to provide additional cash to the financial institutions to the extent of a certain percentage of the interest free loans granted by them. Raising or lowering this ratio will have the effect of expanding or contracting the supply by the commercial banks of short term credit. Prescribing different ratios in respect of credit extended to different sectors of the economy can be a means of channeling credit into desired directions... The Lending Ratio refers to the percentage of demand deposits which the commercial banks will be obliged to lend out as Interest Free loans. This instrument too according to him, can be manipulated to affect the supply of credit.

Uzair (1978) suggested the control of the PLS ratios, between the depositors and the bank and between the latter and the entrepreneurs as instruments of monetary policy. Saqr (1978) thinks that these are a matter between the bank and its customers and that it is not Islamic for the ICB to intervene and unilaterally change contractually determined Profit-Sharing Ratios which must not be altered after acceptance except by mutual consent of the parties to the contracts in question.

Chapra (1978) also advises against interference in this regard as the ICB can control credit in other ways. He prefers leaving the determination of these ratios to the market forces, on the ground of efficiency and competition. I agree with Saqr and Chapra and I think, the ICB can, instead, purchase equity securities, it chooses from the equity portfolio of the bank needing cash, at a discount (say 1 or 2% or more or less under their market prices) and pays in cash. This latter discount is not similar to the discount rate used by IBCBs on bills because bills are interest bearing securities and are not allowed in the IFS and the purchase and sale of equities and PLS securities is allowed whether their prices go up or down. Lowering or raising this discount rate on PLS securities may in some way encourage or hinder the IFIs to approach the ICB for funds and to expand or contract credit.

Uzair (1982:214-5) also suggested that the ICB should hold 25% or any other stipulated percentage of the capital stock of all the commercial banks operating in the country. This will, according to him, have several advantages: "(1) Since the central bank by virtue of its equity share, will automatically get a part of the profits of the commercial banks in the form of dividends, the need for interest payments to the central bank from the commercial bank on the latter's borrowings from the former will be obviated; (2) It will provide an additional lever to the central bank in controlling and regulating the activities of the commercial banks in the overall national interest. The nominees of the central bank of the boards of directors of the commercial banks regardless of whether they are privately-owned or state-owned, will ensure that the instructions of the central bank are complied with; (3) It will give the central bank a stake in the success and healthy development of the commercial banks. Such a close link between the central bank and the commercial banks will prove to be all the more important in fostering a healthy growth of the interest-free banking system as a whole. If the commercial banks face any problem in the transition period because of the new experiment it will be as concern of the central bank as that of commercial banks themselves". The danger,



however, is that such equity participation may lead to the creation of vested interests which may prevent the ICB from acting judiciously.

### Open Market Operations

"In its wider sense, Open Market Operations (OMO) may be held" as De Kock (1974:179) described: "to cover the purchase or sale by the central bank in the market of any kind of (financial) paper in which it deals, whether government securities or bankers' acceptances of foreign bills". In an Islamic economy, where no interest and no interest bearing securities are allowed, the ICB can also use OMO but by selling and purchasing ordinary shares and PLS securities of government and of first class financial, industrial and commercial institutions to control and stabilise their prices on one hand and to use them as monetary policy weaponry weapons in the right time at the other. The ICB should have an adequate supply of 'ammunition' in form of highly diversified marketable securities so as not to affect tremendously the prices of the securities it involves in any one day. "Lack of ammunition as, Basu (1974:100) pointed out: "obviously stands in the way of the central bank's pursuing open market operations to their logical extent".

Basu (ibid) contended that: "The success of open market operations depends primarily upon first, the existence of broad and well organised money and capital markets and secondly, on the maintenance by financial institutions of a relatively stable cash ratio. The absence of a wide and active market for securities and the maintenance by the commercial banks of an elastic cash ratio in several countries have caused such operations to be practically of limited significance".

OMO have two impacts on the financial system. First, the immediate effect of a purchase or sale of securities is to increase or decrease the reserve base. However, there is always some questions as to whether the central bank can buy or sell the amount of securities it desires. But according to Cargill (1979:288) this is no problem because "the central bank does not conduct open market operations to make profits and will simply bid up the price on securities to a high enough level to purchase the securities from either banks, stockholders or individuals by simply creating the funds to purchase the securities, by inc-

raising the reserve accounts of the banks involved in the transactions. Likewise the central bank can sell any amount of securities it possesses because it will continue to lower the price until the securities are purchased. Second the effect of the central bank as a net purchaser or seller of securities shifts the demand or supply function of securities in the open market and immediately affects security prices".

This is the normal tendency in the direction of the foregoing assumptions but deviation from it cannot be excluded. Firstly because the quantity of money and the banks' cash reserves do not always increase or decrease in proportion to the purchase or sale of securities by the central bank as one or more counter forces might be operating simultaneously. Secondly, banks do not always increase or decrease their loans and investments in proportion to the increase or decrease in their cash reserves. There are various circumstances of monetary, economic or political nature which might deter banks from employing increased cash reserves fully if at all or from contracting credit when their reserves were reduced. Thirdly, it is not just a case of banks refraining at times from the full employment of their increased reserves but also one of a lack of willing or deserving borrowers (De Kock *ibid*:183-184).

OMO, though a major instruments of monetary control in the hands of central banks in the more mature and more sophisticated markets, are not the kind of weapon that can be readily and quickly adapted to LDCs where money and capital markets are immature or non-existent and where savings are very small or negotiable securities are lacking. Besides, even in some well DCs with very sophisticated money and capital markets the scope of OMO might be limited at times by the simultaneous operations of various counterforces in respect, not only of the supply of money and bank credit but also the demand therefrom. The question, as De Kock (*ibid*) put it: "is whether and to what extent the central bank could offset the effects of the counterforces concerned at any time by suitably adjusting its open market operations, by purchasing or selling securities in a greater or lesser measure than would otherwise have been considered necessary. The primary problem of course, would be that

of gauging accurately the extent and duration of all the actual or potential disturbing factors, and this in turn would depend not only on the experience and skill of the central bank in this field but also the degree of complexity of the prevailing economic conditions and trends".

#### **Variable Reserve Requirements (VRR)**

The use, by central banks, of the VRR is perhaps the most powerful tool, a central bank possess, because changes in VRR affect not only excess reserves but also the deposit money creation multiplier of the banking system (Binhammer 1968:125). This monetary instrument came to be adopted by all DCs and LDCs. However, "the range of variation is", as noticed by De Kock (1974:234-235): "not uniform but differ from one country to another. In many countries this instrument was employed only in the form of changes in cash reserve requirements and in some only in respect of commercial banks, and both these factors tended to limit its effectiveness as a restrictive measure". The primary purpose of the VRR is to enable the central bank to exercise some degree of control over banks especially when these have a volume of reserves far in excess of legal requirements, which makes the other instruments ineffective. This is a method of quantitative credit control that affects their reserves directly as opposed to bank rate or OMO which affect them indirectly.

This instrument of VRR can also be used by the ICB in an Islamic Economy so long as these reserves are kept with it on interest free or PLS bases. The ICB may impose a certain minimum cash and liquid reserve requirements equal to a certain percent of their deposits and designated non deposit liabilities and change it from time to time. The percent requirements should vary with the kind of financial institution, the deposits size and the type of deposit or source of funds. However, this must be taken with great caution because as Horvitz (1969:298) argued: "the large impact of VRR has some serious adverse side effects. Many banks may find it difficult to adjust promptly to increased reserve requirements. The bank that is fully loaned up will find it necessary to sell sizeable amounts of securities in what are probably depressed market. this can mean large capital losses and can put many banks in a severe liquidity bind".

Three more major criticisms have been levelled against the use of VRR. It is clumsy; it is discriminatory in its effects; and it is inflexible (Basu 1974:120). Perhaps that is why, as Horvitz (1969:299) pointed out: "there are few situations in which use of this weapon is called for. One such circumstances might be during wartime or other national emergencies which require large government expenditures during a period of full employment. An increase in reserves requirements could immobilise the excess reserves that would otherwise be created by deficit spending. The treasury could then borrow the needed funds from the central bank, thus avoiding the dangers of postwar inflation that could result from banks and others selling government bonds purchased during the emergency". There is also a substantial measure of agreement that the VRR can, as Basu (1974:119) noticed: "be appropriately pressed into service when a country is experiencing large and sudden movements in its gold and foreign exchange assets, especially as a result of speculative international capital movements. The effects of large inflows and outflows of foreign capital, it has been believed, can be counteracted more smoothly and effectively by changes in the required reserve ratio rather than by other monetary measures".

### **Credit Rationing**

Credit rationing is a direct control over the level of bank advances by requesting them from time to time to observe credit ceilings. This may be used by the ICB, as an alternative or as a supplement to other methods of credit controls. It consists of allocation of credit quotas to the financial institutions, not arbitrarily but in relation to their capital and reserves or to their proportionate share in the resources of the central bank to curb excessive inflationary pressures especially when other methods prove to be inadequate. It should be discontinued in normal times and to be used only in times of war, real crises or abnormal conditions, for it is a pernicious form of control, incompatible with the function of Lender of Last Resort and rigid.

### **Selective credit controls (SCC)**

The directional or selective control on bank advances in the shape of restrictions of credit to 'low priority' sectors of the economy and

its diversion to 'high priority' ones is sometimes used to encourage neglected sectors of the economy like agriculture and industry and to discourage sectors like trade and personal sector. SCC may take different forms. It may take the form of portfolio ceiling devices which involve the setting of ceiling on loans to be made for specified purposes or to certain specific sectors. The ceiling may be specified either in the form of percentages of loans and advances to be extended to different sectors or they may be stated in terms of the maximum aggregate amount of loans allocable to the specified sectors. Another type of portfolio-ceiling device, is the setting of incremental ceiling specifying the maximum increases allowed for loans for various purposes.

Alternatively these may be put in the form of a requirement for prior approval to be obtained from the central bank for loans to be extended above specified levels or specified percentages to the different sectors. The central bank may also tie this policies to the discount mechanism by charging preferential rates in rediscounting paper originating from the sectors earmarked 'high priority' in order to provide an added incentive for the banks to increase lending to these favoured activities, and higher rates to 'low priority' areas. A third way of imposing SCC is to link differential reserve requirements to the composition of the financial institutions portfolios. Banks whose portfolios conform to the requirement of certain prescribed percentages of loans to the 'high priority' areas are allowed to maintain lower cash or liquidity ratios than the normal ratio, which, of course will continue to be applied to the other financial institutions which do not meet the credit requirements. The prescribed percentages and/or the associated cash or liquidity ratio may be changed as Central Bank's emphasis shifts from one 'high priority' area to another. These instruments are to be distinguished from the quantitative instruments in that their impact is not on the total amount of credit but on the amount that is put to use in a particular sector of the economy (O.E. Johnson 1974).

There is nothing to prevent the ICB from using this instrument when necessary, except where interest is involved. The use of SCC in an IFS would assign a distributive or allocative role to the central bank in

cases where certain sectors that are vital for the overall national interest do not receive due attention of the IFIs either because they are more difficult to handle or because they are less lucrative than others (Uzair 1982:218). The ICB may also use it to curb the IFIs from extensive use of Murabahah, Ijarah or Bai Muajjal and to encourage them use PLS methods of finance such as Musharakah, Mudharabah, Muzaraah, etc..

### **Moral Suasion Policy**

Moral Suasion Policy is a qualitative instrument of monetary policy that consists of persuading the financial institutions that it is in their interest and in the interest of the nation as whole, that they should follow the issued instructions and directives. In an IFS moral suasion would play a significant role. The ICB would try to secure the active and continuous cooperation of all IFIs for the more effective execution of its monetary policy by developing closer relationships with them in order to persuade them that all financial institutions ultimately have a common interest in the maintenance of sound credit conditions and thereby increase its potential power of moral suasion over them whenever the occasion demands corrective action since experience of central banking elsewhere shows that it cannot rely on its legal powers and weapons at all times (De Kock 1974:143).

### **6.3 THE ISLAMIC COMMERCIAL BANKS**

The Islamic commercial banks, in fulfilling their services towards their customers, are faced with four categories of services as follows:

- A-) Services used by IBBS and prohibited by the Islamic Shariah;
- B-) Services developed by IFIs to replace the prohibited ones;
- C-) Services used by IBBS but doubtful or subject to controversy;
- D-) Services used by IBBS but which are Islamically permissible.

A-) The banking services that are provided by the IBBS and which are unacceptable from the Islamic point of view include:

1. All interest based financial claims;
2. Syndication, management or underwriting them;
3. Forward foreign exchange;
4. Discounting of interest based commercial papers;
5. Finance of interest based documentary credits;
6. factoring (buying of trade debt at discounts).

B-) The banking services that have been somewhat developed by Muslim economists to comply with Islamic Shariah are concerned with the

main banking services: collection of deposits and allocation of finance or in other words with the intermediary function (see 5.2 above).

C-) The banking services provided by IBBs but which are doubtful or controversial to Muslim scholars are, as reported by Attia (1985):

1. **Fees for letters of guarantee:** There is no controversy among Muslim Jurists as to the permissibility of the issuing of letters of guarantee or to the issuing charges that are not related to the amount of the letter to cover the expenses to the banks. However, the question arises as to the fees and commissions related to the amount of the letter of Guarantee. The legal aspect behind this controversy is not that the Letter of Guarantee is considered as finance and that these fees are considered as interest, but the point is that according to traditional Islamic Jurisprudence, the guarantee is classified under the non lucrative contracts, and as such it is assumed to be rendered as 'human service', free of charge.

2. **Bonus on current and savings accounts:** The predetermined yield on any deposit or loan is pure interest, and prohibited by Islamic law, whether it is on fixed term deposits, saving deposits or demand deposits.. meanwhile it is allowed that the debtor, when paying back his debt, gives the creditor a bonus whether expressed in increasing the amount of the loan or any other privileges or services and this is even recommended and expected from a pious debtor, provided that there is no previous condition or undertaking in this respect. Such a decision, if repeated and taken the form of a settled custom and is taken into consideration by the depositors when depositing their funds will amount to a prefixed condition or engagement considered as prohibited interest. There is even a question of whether the services rendered by banks to depositors of current accounts are to be considered as a kind of remuneration, and thus not allowed.

D-) Finally, the fourth category includes almost all the other banking services not involving interest. These are, as Attia (1985:4) pointed out: "in general, permissible under Islamic law, being pure services for which a fee or commission is allowed".

## **6.4 MANAGEMENT OF ISLAMIC FINANCIAL INSTITUTIONS**

An efficient management of a financial institution not only improves the mobilisation of savings but also allocates them to the production needs of the society and realises good profits for the shareholders and depositors without falling in the pitfalls of liquidity or solvency. Management of IFIs requires that the operations of the IFIs are carried out Islamically (ie complying with Shariah) and effectively through the use of management techniques such as: planning, organising, coordinating, communicating, negotiating, controlling and decision making so as to attain maximum operating efficiency and profitability.

### **6.4.1 Planning the activities of an Islamic bank**

Planning is perhaps the first very important thing to do in a process of good management. It is, as described by Hayes (1980:76): "deciding where we would like to be in the future and what and who may be involved in our getting there. It involves setting a plan with long and short range objectives, determining how to allocate resources in relation to the objectives, setting priorities, and assuring their fulfilment by making available the necessary people, plant and materials". Hayes (ibid:77) contends that: "planning is more complex than getting from here to there. It is the basis for cost control, budgetary administration, morale and productivity. In effect, any deficiency in these areas points to a defect in planning."

There is no objection from the Islamic point of view concerning the methods and techniques of planning so long that, in formulating the objectives and determining the tools, the management would not be involved in any prohibited transaction or injustice.

### **6.4.2 The Structure and Organisation of an Islamic Bank**

Organising follows and supports planning. When the objectives have been agreed upon and the policies determined, organisation must follow to get things going on smoothly, efficiently and properly. Crosse and Hempel (1980:36) contended that: "a commercial bank is much more than a building. It is an organisation that combines human effort and financial resources to perform the banking function required by the community it serves, and to earn an adequate return on its owners' investments".



As Searle (1980:26) pointed out: "the particular organisational structure which a commercial banking organisation adopts depends upon a number of factors. Among these are the financial aspects of the decision opportunities in the market place, competitive considerations, and legal constraints related to the structure of the commercial banking system as they apply to that particular banking organisation".

Hayes (ibid:78) says that: "Organising is bringing people together in a way that most effectively and efficiently will achieve the objectives". It involves the definition of jobs and determination of responsibilities in writing. Far more importantly, however, as Hayes (ibid) put it: "organising is bringing people with relationships where each individual can find satisfaction in the job and yet all are united in a common accomplishment.. The objective is the responsibility of the team and to bring this about, participation is required". The organisation of any institution aims at achieving the objectives and policies of that institution. There is no objection in the Islamic Shariah as to the organisation of a bank or any other institution.

As Mudawi (1984:3) contends: "there is no prototype organisational set-up for an Islamic bank. Each Islamic bank should have the organisational shape and body which suits its environment, the laws of its country, the type of activity which dominates the economic scene and the level of advancement it has attained. An Islamic bank could be established, subject to regulatory approval, as a private company or a government owned institution or it could even be a mixture of both". It may take the form of a unit, branch or group bank, joint-holding company, or merge with another bank, etc.. It may also be involved in international banking through various organisational units such as representative offices, agencies, branches, subsidiaries, affiliates, etc.. Whatever form an Islamic bank takes, it has to have certain traditional organs. These organs may comprise a General Assembly in which the powers of ownership are vested, and a Board of Directors who are finally responsible to the supreme organisation of its owners. As such the organisational characteristics of an Islamic bank are:

**Shareholders:** The shareholders of any institution are the real owners of that company. It is they who choose the Board of Directors and agree or reject the overall policies of the institution. And it is they who bear the fortunes and misfortunes of the institutions. Crosse and Hempel (1980:49) pointed out that: "part of a bank's special character is related to the distribution of its stocks. A bank's stock may be closely held by a single individual or a relatively small group, or it can be widely distributed in the community".

**Investment Deposits Holders:** Unlike in conventional banks where depositors have a debtor/creditor relationship, receive predetermined interest returns that have no relation whatsoever with the profits and losses of the bank and have precedence over shareholders in case of a liquidation, the holders of investment deposits and PLS certificates in Islamic banks are like shareholders, share in the fortune and misfortune of the Islamic bank in proportion to their investment deposits and have no precedence over the shareholders in case of liquidation. In other words they also have the right of ownership in the bank. The only difference perhaps is that their deposits have maturities while those of shareholders have not. Thus, I think depositors of this sort with investment deposits maturing say after a year or more from the time of the the annual general meetings of shareholders should have the right to be represented albeit with less powers than the shareholders, of course in view of the difference in commitment.

**Board of Directors:** As Reed et al. (1980:64) pointed out: "Stockholders, depositors, and regulatory authorities look to directors for policy decisions and management ability that will result in the safety of funds and profitable operations". Depending on the banking act of the country and on the size of the institution, the Board of Directors of an Islamic Bank may be determined by the stockholders' general meeting. Each director may be required to directly own some shares in the institution he is involved with. The Board of Directors plays the role of agent towards the shareholders and represents the top echelon of authority. It should be responsible for the performance of the institution by selecting competent executive officers, effectively

supervising the bank's affairs, adopting and following sound policies and objectives and avoiding self-serving practices (ibid).

Probably the most important functions of the Board of Directors of an Islamic Bank, are the establishment of its objectives, the determination of policies and the supervision of the activities. The powers, duties, responsibilities and liabilities of the Board of Directors are determined by a combination of statutory law, common law, articles of association, bylaws and custom, subject of course to Islamic Shariah. The objectives can and should be set with respect to public relations, personnel training and development, and community progress and the development of policies is necessary in planning a course of action.

**Religious Supervisory Board:** Because for the present time Muslim bankers have little or no knowledge about the Shariah laws there are nowadays religious supervisory boards supervising and controlling the activities of the Islamic banks to make sure that the contracts agreed upon between the bank and its customers comply with the Shariah. However, in the future when Muslim bankers would be educated not only in the conventional banking studies but also in Shariah, this exclusive feature of religious supervisory boards should disappear.

**Different Departments:** For an effective and efficient management of an Islamic bank, it is perhaps very important that the tasks and responsibilities of the personnel are well defined and coordinated. A Typical Islamic bank could have an Investment Department, a follow up Department, A Legal department, A Recruitment and Training Department, A social Department, etc. (see Presley 1988a:64-5).

#### 6.4.3 Profitability Management

Islamic commercial banks, like other commercial banks, are profit-maximizing businesses subject of course to the Shariah and other constraints. They can increase their profits by investing more of their asset portfolio in higher yielding but more risky investments. However higher bank profits must not be achieved at the expense of bank safety. Thus, the central problem for bank management is reconciling the conflicting bank goals of solvency and liquidity, on one hand, and profita-

bility on the other or what is known as the 'banking dilemma' because the trade-off between profitability and safety is more acute for banks than for most other businesses (see Kidwell and Peterson 1980:188).

Bank earnings, as Crosse and Hempel (1980:102) pointed out: "are the foundation upon which rest the two main pillars of banking strength adequacy of capital and competence of management... Thus, earning power proved to be the first line of defence against the risks inherent in banking". In an IBBS, bank earnings, as Crosse and Hempel (ibid) put it: "provide the return on capital investment in banks. It is for the sake of this return on his or her investment that the stockholder is willing to supply the capital that enables a bank to engage in the risky business of creating credit, and it is by retaining assets generated by earnings that the major portion of bank capital has been accumulated". Gross income of IBBS is determined by the rate of return on loans and investments, by the level of various fees and charges imposed for the performance of services, and by the size and composition of assets. Although service fees have increased and will probably do so in the future, interest on earnings assets, from loans and investments provides almost 90% of IBBS's income (Reed et al. 1980:184).

The profitability of IFIs depends greatly on the realised profits and losses of their project investments which they finance, the rotation of their financial resources and the termination or completion of the operations. A large part of an IFI income would be in form of Juala (fees or commissions) and profits from Murabahah, Bai Muajjal, Bai Bit-Tagseet, Ijarah and Ijarah Waqtina' but not from interest. With a good capable management, IFI would be very much profitable except, perhaps in times of recession or mismanagement. The existing Islamic banks have proved this since most if not all of them realised substantial profits from their first year of business (see chapters 8-11 below) despite the fact that, like any other corporation, they had substantial amounts of establishment and overheads costs in their first years of business.

One of the principle byproducts of an analysis of revenue and expense is a budget that involves forecasting revenues, expenses and the resulting profits on savings. The IFI should follow this practice and

look for ways of increasing the earnings of the bank because the earning of an IFI do not go only to its shareholders but investment depositors also have their share in them. Unless an Islamic bank makes good profits, depositors will not approach it because their return depend directly on the profits realised by it.

#### 6.4.4 Capital Adequacy Management

As Crosse and Hempel (1980:67) contended: "the ultimate strength of a bank lies in its capital funds. Such is the consensus of writers on banking and bank supervisors. But the problem of bank capital is not quite that simple. It is not merely a question of the more capital the better; rather, it is how much capital for what reasons or purposes". Reed et al. (1980:158) pointed out that: "the effective management of capital funds may enhance the profitability of a bank while maintaining the traditional and necessary function of safety for depositors".

Capital adequacy is so important for banks because banks normally have a very high degree of financial leverage than do most other businesses, which means that the majority of their assets (around 90%) are financed by debt (the funds of the depositors). This state of affairs demands that capital must be adequate to maintain the confidence of the depositors who otherwise would be worried over the safety of their deposits and would withdraw them in fear that the bank may not be able to meet its obligations. Capital adequacy is also important for a bank to meet the regulations drawn by bank supervisors who decide how much capital is adequate and who have to make sure that the public confidence is maintained not only as far as a certain bank is concerned but for the banking system as a whole. Perhaps, that is why, banks are the most strictly supervised and regulated businesses all over the world. As Lachab (1987:8) pointed out: "This function of capital depends on its ability to maintain confidence in the banking system rather than its ability to pay off bank creditors under crisis situation. After all, no level of capital is sufficient, except 100 percent to absorb all bank losses. The emphasis on the capital ratios by the regulatory authorities can also be seen as a mean of controlling bank's rapid growth".

As in the case of IBBS the ultimate strength of an Islamic bank lies in its capital funds and so it must maintain the level of capital adequacy required by the supervisory authorities. But it is very important to note here as Reed et al. (1980:172) pointed out that: "although a ratio may be helpful as a starting point in analysing the capital adequacy of an individual bank, it should not be considered an end in itself. A bank does not have adequate capital just because it meets some statistical average, nor it is beyond criticism just because it meets some ratio... The inquiry must go beyond the ratio to an examination of the bank's operations and the risks it assumes in its loan and investment portfolio". Thus a number of factors such as the liquidity of assets, the volatility of deposits, the structure of deposits, the history of earnings, the quality of management, etc., must be taken into consideration when assessing the adequacy of capital of a bank.

It is perhaps also very important to note that an Islamic bank can raise its capital only through ordinary shares, retained profits and reserves. No preferred stock or subordinated capital debt involving interest are allowed in Islam or used by Islamic banks. However, investment deposits and other PLS instruments should not be considered as debts when calculating the capital adequacy ratios of Islamic banks but as part of the cover of debt because their holders are not debtors towards the Islamic banks but, as argued above, partners who have temporary ownership in the assets of the banks. Investment depositors, like the shareholders, share in the profits and losses of the bank and in times of crisis they should help the bank maintain the confidence of other depositors rather than withdraw their deposits if they are not to lose, because withdrawing their deposits does not exempt them from the liabilities of the banks since they have to bear part of the ultimate loss in case a loss occurs in proportion of their deposits in the total funds (capital and reserves plus investment deposits) and that, what makes them different from time depositors in IBBS. Furthermore, the Islamic bank should not allow investment depositors to withdraw their deposits before maturity, first because they have a contract to fulfil and secondly, it is in their own interest. However, current and saving

account depositors who do not share in the bank's result have the priority over investment depositors and their deposits must be guaranteed not only by the capital and reserves of the bank but with investment deposits as well. This means that the real leverage of Islamic banks is very low and their capital ratios are very high especially if investment deposits are considered as part of the capital and not as part of the debts as in the following formula:

$$\text{Capital Ratio} = \frac{\text{K\&R} + \text{ID}}{\text{DD} + \text{SD}}$$

Where: K&R = Capital and Reserves; ID = Investment Deposits;  
 DD = Demand Deposits; SD = Savings Deposits.

#### 6.4.5 Liquidity and Balance Sheet Management

The problem of liquidity for commercial banks is essentially that of having available at all times sufficient funds to meet demands for deposit withdrawals and contingencies. "Throughout the history of banking", as Revell (1975:13) noticed: "there have been many changes in the sources of liquidity, and these changes have been associated with the growth and adaptation of money markets and the forms of bank lending... The theory of liquidity has therefore been an operational one.. The theory has thus changed as practice has changed".

(1) The commercial loan theory or the Real Bills Doctrine, as it was also called is perhaps the oldest theory of solving the liquidity problem. It states that commercial banks should grant only short-term, 'self-liquidating' loans. There is, of course, no such thing as 'self-liquidating' loan especially when there is a slump in trade (Revell 1975:13-4). Banks used to adopt this method because there were not many ways of finding liquidity as are available today. The Islamic banks, in their present situation where they cannot use the interbank market and where they have no lender of last resort or a secondary market for their assets, could use this method but not in its original form because an Islamic bank does not give commercial loans, it provide finance on Murabahah which is somewhat a self-liquidating or on PLS basis where they share in the fortunes and misfortunes of the busines-

ses financed after they make sure that they are viable or say 'self-liquidating' to some extent. However, when things improve, they do not need to stick to this method, they could follow one or more of the other ways of solving the 'dilemma'.

(2) **The shiftability theory** emerged in the 1930s as a new theory replacing the old commercial loan theory. It states that banking liquidity depends upon the ability of the bank to sell or shift its assets to others at a predictable price. "The doctrine of shiftability is", as Revell (ibid) argued: "subject to the same fallacy as 'the real bill' doctrine, that of assuming that liquidity for individual banks and for the banking system are identical. The fact is that no assets are liquid when all banks are simultaneously trying to 'shift' them". Individual Islamic Banks may also use this method when not all banks are doing the same, if they have a portfolio of negotiable PLS financial instruments and there is quite a good secondary market for them.

(3) **The anticipated income theory** emerged in the 1940s as a new way of assuring liquidity for banks. It expanded the menu of bank loans from short term loans to longer term loans and non business loans. It reasons that bank loans are paid off out of the future earnings of the borrower, from anticipated income and so it focuses on the borrower's ability to successfully repay a loan in stages over a period of time. The critical factor in the decision to grant a loan is the borrower's ability to repay the loan out of his future earnings. (Kidwell and Peterson 1980:192,193). When Islamic banks offer finance on the basis of the PLS system which relates their returns to the anticipated income of the customer, one can say that they use this technique.

(4) **Asset Management:** Asset Management is the term used to describe the allocation of funds among cash, security investment, loans and other assets so as to achieve the highest rate of return for the level of risk assumed within the liquidity and regulatory constraints. According to Reed et al. (1980:96), three different approaches to asset management have been espoused in attempts to resolve the liquidity-profitability dilemma. Each differs in its emphasis on the form of the management process and in the degree to which quantitative analysis is



employed in evaluating the alternatives available. No one approach can be considered a panacea for bank management because problems and deficiencies are associated with each. These are:

(a) **The Pool-of Fund Approach** which is the simplest to administer and whose basic idea is that all funds should be pooled together and then allocated to whatever asset investment is appropriate.

(b) **The Asset Allocation Approach or Conversion of Funds Approach** which was developed to meet the deficiency of The Pool of-Fund Approach which failed to distinguish among the different liquidity requirements of demand deposits, savings deposits, time deposits and capital funds. Under this method and as Baker (1978) described: "liabilities are categorised according to their volatility and then allocated to assets that share the same volatility characteristics. Volatility is assumed to be a function of deposit size as well as type... Determination of deposit volatility by category may be made either intuitively or through the use of statistical inference techniques".

(c) **The Management-Science Approach** which involves the application of computer-aided analysis and use sophisticated models and advanced mathematical techniques such as linear programming to analyse the complex interrelationships among various components of the balance sheet and income statement and which can provide powerful aids to management in the decision making. The models prescribe how a bank's management should allocate whatever funds are available for investment to provide adequate profitability while operating within the liquidity constraints imposed by management (from within) or by regulatory authorities (from without). The manipulation of these models may be of great assistance to bank management in realizing increased profitability from bank operations. The scientific method for the solution of problems involved, requires a statement of objectives, identification of the relationships among various elements of the problem, identification of variable elements that are, and are not under the control of management, an estimate of the way non controlled variables may behave, and identification of constraints imposed on the behaviour of management (from within or

without). The method attempts to answer three questions: What is the problem? What are the alternative solutions? Which alternative is best? (see Reed et al. 1980:chapter 5).

(5) **Liability Management:** Prior to the 1960s it was believed that bank's liquidity comes almost entirely from the asset side of its balance sheet and that the only other source of liquidity is the central bank when it is approached as the lender of last resort but because this latter source was available only in cases of emergency, the banks used to assume that their liabilities as given and start from there to allocate them among their assets. The 1960s marked the beginning of a new era in bank liquidity practices (Kidwell and Peterson 1981:195).

Liability Management has come to be known as the activities involved in supplementing liquidity needs by actively seeking borrowed funds when needed. It enables a bank to aggressively expand its lending activities through increased leverage. The liquidity gained may be used to smooth out deposit inflows and outflows and reduce their variability. It may also be used to meet increases in loan demand by the bank's customers as long as the expected marginal return of the new loans exceeds the expected marginal cost of funds (see Reed et al. 1980:25 and Kidwell and Peterson 1981:196). The Islamic bank when using this method must of course avoid interest based liabilities.

(6) **Balance Sheet Management:** Kidwell and Peterson (*ibid*) reported that: "Beginning with the rise of liability management in the 1960s, it became apparent that decisions about the composition of a bank's assets and liabilities were no longer independent. Balance Sheet Management gives explicit recognition that the decisions about a bank's asset and liability holdings are highly interrelated and that the entire balance sheet of the bank should be regarded as the portfolio for which financial planning is undertaken". This type of analysis is extremely complicated, requiring the use of computers and the construction of financial models of bank operations employing linear programming and other mathematical techniques that need to be solved simultaneously. The result should give an optimal solution providing the bank's management with actual numbers for how much to invest and in what assets.

#### 6.4.6 Risk management in Islamic banks:

All business operations involve risk. As Revell (1975:80) contends: "It is not only insurance companies that have a portfolio of risk but also all credit institutions and all financial institutions". In fact as Crosse and Hempel (1980:59) contend: "taking risks can almost be said to be the business of bank management. A bank that is run on the principle of avoiding all risks, or as many of them as possible, will be a stagnant institution and will not adequately serve the legitimate credit needs of its community. On the other hand, a bank that takes excessive risks or, what is more likely takes them without recognising their extent or even their existence will surely run into difficulties". IFIs are no exception, in fact it is argued that since Islamic banks would be more involved in direct and indirect businesses, and not charging predetermined interest but share in the profits and losses of their customers to whom they give finance, their portfolio of risk is greater than their counterparts (the IBBs). Here, we shall look into this claim and see how IFIs could hedge against these risks.

The first most important step in the risk management approach is to identify all possible risk exposures, so as to be able to evaluate them and hedge against them. Perhaps one of the most useful and comprehensive classification of the specific types of risks peculiar to the operations of IBBs is the one given by Revell (1975:82) and produced below:

Types of risks	Sources of risks
1. Credit	Default or delay in fulfilment of obligations
2. Investment	Changes in interest rates, foreign exchange rates and assets's prices
3. Liquidity	Faulty balance sheet structure, changes in assets prices
4. Earning	Changes in interest rates, asset prices and operating expenses
5. Operating	Operating errors, inefficiency, faulty control procedure
6. Insured	Excess on insurance policies, risks not covered

All of the types of risk mentioned above together with fraud and fiduciary risks, which are omitted as these can be insured against, may be present in an IFI, however the sources would be somewhat different. For instance the IFI will not be subject to risks from changes in interest rates since they do not deal in interest bearing instruments but

will be subject instead to risks originating from sharing the losses of unsuccessful PLS investments.

The most obvious risk in banking, as Crosse and Hempel (1980:60) remarked is the credit risk -the possibility that loans will not be repaid or that investments will deteriorate in quality or go in default with consequent loss to the bank. Although IFIs do not deal with interest securities and all their assets with the exception of premises, plant and equipment are subject to credit risk, nevertheless their risk exposure would, I believe, be less than IBBs for the following reasons: (1) The IFI does not give loan advances (credits) except in very limited circumstances and although these are interest-free they are secured by pledges. (2) The IFI gives PLS finance or buys goods and then sells or leases them to its customers. If the finance is in the form of Murabahah (Mark-up sale), Bai Muajjal (Sale at deferred payment), Bai Bit-Taqseet (sale by instalments), Ijarah (leasing) and Ijarah Waqtina' (hire-purchase), then the finance is guaranteed by the fact that the ownership of the good involved remains with it until full payment is received. If, on the other hand the finance is in the form of a PLS contract as in Musharakah, Mudharabah, Muzaraah and Musaqah projects, the IFI does not give any of these until it makes sure not only that the customer is credit-worthy but that the project financed is itself viable and profitable or 'self-liquidating' and have the right of follow up and intervention whenever necessary and able to prevent a loss to the project. This does not say that the IFI will be protected all along but only to say that the risk of not recovering all or part of their finance would perhaps be minimal as compared to IBBs' credit risks, unless the partner it gives finance too turn to be a crook who fraudulently uses the finance in a different venture without the bank knowledge or the IFI turns a blind eye on him, which is unlikely.

Perhaps investment and earning risks are the most obvious in Islamic banking and not credit risk, and that is why it is claimed that Islamic banks are more risky than IBBs. This may be true when the bulk of the Islamic bank's finance is in the form of PLS projects, but if the bulk of its finance is in the form of a Murabahah, Bai Muajjal, Bai'

Bit-Tagseet, Ijarah or Ijarah Waqtina' then, the risk would perhaps be lower. Hedging against the risk of PLS investments could be done through appropriate diversification, intimate knowledge of the partners, accurate feasibility studies of the PLS projects and follow up with intervention when necessary to stop the erosion of the assets' values. This may prove to be expensive and difficult to implement, but if followed, may benefit the bank greatly.

As far as the other risks are concerned, The IFIs would be subject to these risks just as IBBS are, except those emanating from the volatility of interest which is not present in the IFS. To protect itself, from the liquidity risk for example, the IFI should maintain adequate liquidity in the form of assets readily convertible into cash at a minimum risk of loss, manage itself properly and assure itself of its ability to get needed funds in the market. And to protect or say reduce the risk of fraud, theft and other risks, the IFI should have adequate internal and external controls, safeguards, audits and insurance.

## 6.5 CONCLUSION

The IBS is an equity rather than debt based system and the relationship between an IFI and its customers is of partnership rather than of debtor/creditor. It can work without recourse to interest. In other words, interest is not a necessary component of banking, as it used to be held. There are a number of instruments, such as Mudharabah, Musharakah, Muzaraah, Musaqah, Murabahah, Juala, Ijarah, Bai' Muajjal, Bai' Bit-Tagseet, etc., that can be used to mobilise savings or invest them without transgressing the Divine law against interest. Not only that but even monetary policy could be implemented without recourse to interest. The ICB and the IFIs can design and adopt any variety of banking and monetary techniques according to the needs of the circumstances and depending on the level and stage of the development of the IFS as long as they do not transgress Allah's Shariah. Thus, the absence of interest does not reduce the scope of banking generally nor of monetary policy in particular. This may prove to be hard to achieve and requires more manpower and capital than IBBS, but that is where the test lies.

## CHAPTER SEVEN

### THE SOCIO-ECONOMIC IMPLICATIONS OF INTEREST AND PLS BASED FINANCE

#### 7.1 INTRODUCTION

Most assuredly the changeover, from an Interest Based Financial System to an Islamic one, based on PLS system of finance would have far reaching socio-economic implications on the different social and economic aspects of the society. However the switchover is not easy and cannot come overnight or in a very short time. To be successfully applied, it must be implemented gradually in an Islamic society that applies Islamic Shariah in all its aspects and where the people must be willing to apply it because nothing succeeds if it forced on the people or the people do not know much about it, because, as Presley (1988b:8) put it: "It may be counter-productive in trying to proceed too quickly in the evolution of Islamic banking without thinking through the practical implications of the theory and the need to re-educating the Islamic population in the ideal conduct of their economic and social life". Thus, for the Islamic system to be successfully implemented, the people should know about it and should prefer it over other systems. In other words, a change of hearts is necessary. This is confirmed by Allah when He said: "Allah will not change the condition of a people until they change what is in their souls" (Koran 13:11). This change does not come suddenly but requires education, persuasion, conviction and reminding.

There are several criteria for judging the appropriateness of a financial system, or its implications, but for the purpose of this analysis five have been singled out as especially important. These are: (1) Mobilisation of Savings; (2) Promotion of Entrepreneurship, Investment and Employment; (3) Financial Stability; (4) Social Justice; and (5) LDCs' Debt Problem. Although, it is not possible to say very much, at this stage about the implications that the introduction of the PLS system would have on these economic aspects, as these various issues

will clearly require further research and concerted efforts at both the theoretical and empirical levels and as there is no complete and mature IFS that applies PLS system extensively anywhere in the world, to use its data for empirically testing and comparing the hypotheses presented in this chapter, it is still possible to draw certain policy implications from this study that relate to the practice of the PLS system in contrast to the interest based system, the purpose of this chapter.

## 7.2 MOBILISATION OF SAVINGS

As Iqbal and Mirakhor (1987:5) reported: "Concerns have been expressed that the adoption of an Islamic Financial system may lead to a reduction of savings and a retardation of financial intermediation and development". Pryor (1985), for example, is one who is quite skeptical about the feasibility of such a system. "The few studies that have considered the question have tended to compare the effects on savings of a fixed and certain rate of return with those of an uncertain rate of return, implicitly assuming the same mean rate of return with greater variability. The result, obviously shows a reduction in saving. The conclusion, however, is far from obvious when both risk and return are allowed to vary... Other studies have shown that under reasonable assumptions, in the face of uncertainty, households will increase their saving as a precaution (see for example Leland 1968). Theoretical analysis has not, therefore, provided a clear cut testable hypothesis in this regard, and it becomes an empirical question whether saving will increase or decrease in an Islamic system" (Iqbal and Mirakhor, *ibid*). It can however be reasonably expected, as Hahn (1970:24) remarked that: "a rational planner may make more provision for the future when the future becomes more uncertain". In a recent theoretical study in which variations in riskiness, as well as in the rate of return are taken into account, Ul-Haque and Mirakhor (1986b) concluded that: "there is no strong theoretical reason to believe that on balance savings will decline as a result of introducing an Islamic economic system" .

A number of theories have been advocated to explain the relationship between savings and other variables and a number of variables have

been promulgated as affecting the volume of personal savings, viz., the rate of saving as a function of income, income distribution, rate of interest, the presence of financial institutions which provide for savings, the existence of incentive and opportunities for social advancement, etc. (see Wai 1972 and Beheiry 1980).

As seen in chapter two above, there are three different, but not mutually exclusive, ways of achieving this objective (mobilisation of savings). One of these ways is the fiscal approach whereby the government uses taxation to acquire savings and then channel them to investment; the second way is to rely on financial institutions of one sort or another, which issue their own liabilities to the public to transfer resources for investment and the third way is to channel savings directly from surplus economic units to deficit economic units by having the latter issue medium and long term instruments, such as bonds, shares, and debentures to savers. The first one is never popular, it is clumsy, costly, and sometimes involves bureaucracy, corruption, disputes, etc.. The second one is the most popular and easy to implement, however, the way, the financial systems operate, differs from one country to another and affect the behaviour of economic units of the economy especially the personal sector which contributes the most to the success of the system. The third way, "usually requires", as Khatkhate and Riechel (1980:494) pointed out: "both underwriting to facilitate the original issue and the emergence of a market for secondary trading to enhance the liquidity of these longer term instruments to make them more attractive to savers". It is the last two ways that are most important in the development of financial systems.

Prior to the recent re-emergence of Islamic economics, the possible impact of the interest rates on the volume of saving mobilisation formed one of the most controversial issues between the Classical economists and the Keynesians. The classical theory considered saving as a function of the rate of interest. Since interest is paid to the saver for abstaining from consumption, saving should increase with a rise in the interest rate and decrease with a fall in the interest rate. On the other hand interest is a cost of investment, therefore, investment is a



negative function of interest. The equilibrium rate of interest is depicted by the intersection of the saving and investment functions. It is always assumed that both saving and investment are sufficiently interest-elastic to permit adjustment toward a new equilibrium, should the rate of interest change. Therefore the interest rate has, according to them, a positive and direct effect on the volume of savings.

The Keynesian school, on the other hand, advocated the idea that the volume of savings is chiefly determined by the income level from which the savings originated and not by the level of interest, thus, a direct impact of the interest rate on the overall savings volume was rejected; moreover, it was accepted that interest produced a certain indirect but negative effect through its impact on investment and hence on income (See Keynes 1936; Panhuyzen 1975; Kahf 1982 and Gupta 1984).

Wai (1972), however, argued that the reality cannot be explained by a single theory because people behave differently under different circumstances. In his attempt to incorporate all relevant variables in past theories, he contended that: "the decision to save by each unit in an economy is influenced by the Ability, the Willingness and the Opportunity to do so. Thus each unit's savings may be regarded as a function of three factors. For the economy as a whole it would be the sum of the individual units' savings less whatever duplication occurs and whatever reductions would take place between ex-ante and ex-post savings due to changes in total income a la Keynes or to other sociological factors".

$$\text{Thus, we have: } S = o(A,W,O) \quad (1)$$

where: S = Savings, A = Ability, W = Willingness and O = Opportunity.

Each of these economic independent variables is a function of economic and non economic variables. Ability (A), for example, depends on income (Y), structure of population or dependency (N) and wealth (K).

$$A = a(Y,N,K) \quad (2)$$

Willingness (W), depends on inducement through interest rates (i); the stage of life of the individual (L) and on cultural factor (C).

$$W = B(i,L,C,..) \quad (3)$$

Finally the Opportunity (O) principle is related to the question of financial intermediation (F) available to the saving unit or possibility of using self finance (Ir), thus:

$$O = k(F, Ir, \dots) \quad (4)$$

o, a, B, k are functional notations.

If the functions and the changes in savings in these variables could be specified, then the changes in savings could be determined during future plans. The ex-post savings of the household sector as a whole may be limited by any of the three factors A, W, or O and any one can be the constraining factor.

Concerning the effect of interest on savings, many empirical studies have shown that savings is not positively correlated to interest rates in all times and across countries (see Williamson 1968; Wai 1972; Panhuyzen 1983; Gupta 1984 and chapter two above). Panhuyzen (1983:15), for instance, concluded his empirical study on the measuring of the interest elasticity of the overall Belgian savings volume between 1952 and 1969 by stating that:

It strikes one immediately that all interest elasticities take a negative value. This does not fit with the opinion of those who argue that the interest rate is an incentive to saving and that this incentive grows stronger as the interest rate is raised. It appears now that a rise in the interest rate causes on the contrary, a certain shrinking of the overall savings volume and vice-versa. This may seem odd at first sight; on closer examination, however, this negative interest elasticity is far from being illogical.

Similar results were also found in my empirical study in chapter two above which regressed and correlated the real rates of interest with the volume of savings in 18 Muslim and non Muslim, Developed and Less Developed Countries. "Theoretically this means that the classical vision on this subject is rejected by applying the macromodel as well as by utilising the regression analysis... From a practical viewpoint the foregoing implies that an interest policy is not an efficient means of manipulating the saving behaviour of the population" (ibid:25). However even if savings were interest sensitive in some countries, this does not necessarily mean that this is a universal law that works at all times in all countries. In fact as the comparative empirical study, in chapter 2 above, shows, the relationship between interest and sa-

vings is less powerful in some countries than in others but still it is even less powerful in Islamic countries. Thus, the elimination of interest from the financial and banking system of an Islamic country and its replacement by the Islamically legitimate PLS system of finance would not adversely affect the saving of the economy. On the contrary it may increase it because it would attract the savings of those people who were reluctant to deposit their savings with banks because of the existence of interest. This can be seen from the performance of some of the Islamic banks, which are operating in many parts of the world (see chapters 8-11 below). This is not to suggest that PLS system is a better system to mobilise savings anywhere. What it suggests is that PLS system is perhaps more appropriate in societies where interest is looked upon as an evil not to be touched. As for its effect in increasing or decreasing the level of saving in an economy, this may be no different from interest as the level of savings depends on a number of other factors as we saw above.

### 7.3 ENTREPRENEURSHIP, INVESTMENT AND EMPLOYMENT

The promotion of entrepreneurship is another desideratum that the LDCs generally and Islamic countries particularly must strive to provide if they are to achieve any real progress. The IBBs, being interested merely with securing the principal of their loans together with interest, militate against indigenous entrepreneurs, and particularly new ones (Khatkhate and Riechel 1980:507), who have no collateral to secure the finance they need even though they may be very enthusiastic, keen, clever, expert, and hardworker. Criticising the role of IBBs in this respect, M.N. Siddiqi (1983b:88) wrote:

The entrepreneur's obligation to repay the borrowed capital as well as a predetermined rate of interest to the bank severely constrains his willingness to take risk. No project can be taken up unless the expected profits are sufficiently high to cover the risk of loss, assure a return equal to the rate of interest, plus yield a surplus to the entrepreneur himself at least equal to his alternative earnings on the labour market.

In LDCs where finance is interest based, "entrepreneurs are", as Khatkhate and Riechel (1980:507) put it: "impelled to choose only those investment projects that can yield a certain, albeit moderate return, a

return that would not fall below what is considered to be a 'critical income level'. A further problem facing the new and small entrepreneurs in LDCs is that their cost of funds is usually very high, since for a bank the cost of administering a loan to them is generally considerably higher on average than it is for loans to larger, well established companies". Besides, in order that an entrepreneur succeed to get finance from an IBFI, he must show his ability to pay back the finance together with its interest and provide a collateral that covers and guarantees the repayment of the credit in case he would not succeed in his enterprise. Moreover, as Khatkhate and Riechel (ibid:507) put it "the difficulties of the local entrepreneurs tend to multiply since they do not have easy access to necessary knowledge, information and expertise".

The introduction of the PLS system will not automatically eliminates these difficulties but reduces them to a greater extent if applied properly. A major advantage attributed to PLS system, if applied, is that the finance given under this system may not depend solely on the financial ability of the person to whom finance would be given; but to a great extent, it depends on the feasibility of the project to be financed. This opens the door widely to talented individuals who may not be able to provide the collateral required by the IBBs.

Salama (1984:9) arguing from his experience in FIBS contended that: "PLS system is particularly important in developing countries, it makes possible extension of finance to artisans and handicrafts, supplying them with machines that suit their talents, as well as machines that are adapted to local conditions level of technology and using raw materials available in those countries. If such finance is widely extended to those classes this will promote and modernise handicraft industries and if labour intensive industries are encouraged and established by those banks, such methods may break the vicious circle of poverty prevailing in many developing countries".

Salama (1984:1-2) further argued that unlike interest based finance, the PLS does not discriminate against projects that yield returns lower than the prevailing interest rates. Where interest rate exists,

it acts as a lower bench-mark beyond which no investor takes a decision to invest (ie if the expected rate of return is below interest rate he will not go into the venture). In a world free of interest rate, investment decisions will depend on economic factors and the rate of return will be the true allocator of funds. The cost of capital will therefore be reduced. Interest-free finance may also reduce risks faced by the investor. In case of loss, for example the investor will share the loss with the supplier of capital; this contrasts to the interest based finance where he has to pay the principal plus the interest".

Besides, as the return to the IFIs giving the PLS based finance, depends directly on the returns to the entrepreneurs, it is in their interest to offer as much information, technical assistance and help to the latter if they are not to loose on their investments. Thus one could say that the PLS system has an opposite impact to interest on the promotion of investment, employment and entrepreneurship.

Concerning investment and employment no one can deny that interest stands in the way of the fuller utilisation of available resources thus limiting investment and creating unemployment. S. Ahmed (1975:13) argued that: "Before an entrepreneur engages himself in an act of production he calculates costs of production and probable return that he can expect. If the cost of production is higher than the probable return, he will abstain. If the probable return is higher than the cost of production, he will go ahead and invest. Now interest enters into the calculation of the entrepreneur at both these crucial points. It increases the cost of production on the one hand and decreases the probable return on the other". And he (ibid:32) commented that: "This is both scientific truism and plain common sense that the rate of interest is inversely related to the level of investment. The higher the rate of interest, the lower the level of investment; and the lower the rate of interest, the higher the level of investment".

Although Keynes (1936) observed that, the rate of interest on money plays a peculiar part in setting a limit to the level of investment and employment, since it sets a standard to which marginal efficiency of a capital asset must attain if it is to be newly produced and he was con-

vinced, as he put it that: "It is to our best advantage to reduce the rate of interest to that point at which there is full employment" which cannot be other than zero, he did not call for its abolition but justified it in terms of liquidity preference (see 4.2.10 above) and suggested instead, to fill the gap of unemployed physical resources occasioned by the impact of interest, with the help of investment in the public sector, meaning that whomsoever the entrepreneur leaves as unemployed can thus be employed by the State. The result was: not only full employment was never achieved but higher inflation became the issue.

The reason, as S. Ahmed (1975:36-7) argued: "is that as soon as we proceed artificially to create jobs and go some distance in doing it, the price level starts rising because of the built-in push given by interest and keeps on rising, eroding the value of wages. If wages are also raised to match the rise in prices, prices spurt still further and a wage-price spiral gets under way which threatens our monetary structure. When this happens, we immediately raise the rate of interest to cool down the economy in the private sector which of course results in further unemployment". Thus, as S. Ahmed (ibid:16) put it: "interest then, is inversely related with investment, and so long as interest dominates an economy, unemployment must persist".

Here comes the idea of the trade-off between inflation and unemployment introduced by A.H. Phillips in 1958 and known as 'The Phillips Curve' which, as Treynor (1975:21) pointed out: "attempts to reduce to numbers the intuitively appealing idea that the inflation rate depends loosely on the level of unemployment. It expresses this kind of trade-off: "if we are willing to tolerate high rates of price inflation we can enjoy low levels of unemployment; if we are willing to tolerate high levels of unemployment we can enjoy low rates of price inflation". There is a great number of economists who criticised the Phillips curve and asserted that there is no historical evidence of a stable relationship between unemployment and inflation or that if such a relationship ever existed, it exists no more. They cite the current stagflation, a very high level of inflation coupled with rising unemployment, as evi-

dence. For instance Al-Naqib and Moosa (1984:107) concluded that: "contrary to the widely held views, in the long run higher unemployment was found to be associated with higher inflation and lower unemployment with lower inflation. There is no trade-off between unemployment and inflation; in fact they have a high positive correlation. This means that an attempt to reduce inflation by increasing unemployment (through raising interest rates) is likely to increase inflationary pressures later on in the cycle. Thus to abort recoveries in the hope of easing inflationary pressures is counter-productive. This long term approach purposely disregard changes in the inflation rate within a cycle on which past research tended to focus".

In a pure IFS, where PLS is practiced and where there is no interest on finance, investments are worthwhile up to the level where their marginal rates of return are not equal to a certain rate of interest but up to the point where they are equal to zero. This allows a maximisation of investment and employment, far much greater than the interest based system allows. This does not mean that full employment would be achieved under the PLS system at all times but the level of unemployment would be very much lower than under the interest based system and under the same conditions, because there are, of course a number of other factors which affect the level of employment such as the availability of capital for investment, the wage-price flexibility, etc..

#### 7.4 FINANCIAL STABILITY

Financial stability is one of the most important, if not the most important, objective of any financial system. "Stability in the value of money should", according to Chapra (1983:30), "be accorded high priority in the Islamic frame of reference because of the unequivocal stress of Islam on honesty and fairness in all human dealings and because of the negative impact of inflation on socio-economic justice in general welfare". Chapra (ibid:31) further argued that while inflation is in conflict with Islamic values, prolonged recession and unemployment are also unacceptable because they bring misery to certain sectors of the population and also act counter to the goal of broad-based economic well-

being. Recession also tends to increase uncertainty and discourages investors from undertaking risk associated with projects that earn a return over many years. Hence in the interest of achieving overall objectives of Islam, it would be necessary for the Islamic state to adopt all available measures to minimise economic fluctuations and to stabilise the value of money and the economy.

A positive correlation between the levels of interest rates and prices has been pointed out many times by many economists. Thomas Tooke (1844:76-78) was probably the first to notice this positive correlation followed perhaps by A.H. Gibson who published a series of articles, mostly in the Banker's Magazine between January 1923 and November 1926 emphasising the extraordinary close correlation over a period of more than a hundred years between the rate of interest, as measured by the yield of consols, and the level of prices, as measured by the wholesale price index number. Keynes (1930:198) named this empirical regularity the 'Gibson Paradox' since it seemed to contradict the prediction of the classical monetary theory. Although many papers have been written on the topic (see for example Meiselman 1963; Cagan and Gandolfi 1965; Friedman 1968; Yohe and Karnosky 1969 and W. Gibson 1970), no single explanation of the relationship between inflation and interest commands wide acceptance. As proof of this statement, it is sufficient to note, as Sergent (1973:385-386) put it: "that the name, that Keynes gave to that relationship, 'the Gibson Paradox', has stuck".

Whether or not this positive correlation can be called a 'paradox', numerous explanations of it have been advanced. Wicksell (1899:78,167) and Keynes (1930:198-208) suggested that increases in the demand for loans raise interest rates and result in an increased money supply and level of prices and conversely for decreases in the demand for loans.

Fisher (1930) suggested that the positive correlation may simply be an 'accidental' result of this fundamental hypothesis that nominal interest rates reflect expected inflation combined with imperfect foresight concerning inflation and the upward and downward movement of prices historically. This explanation has been found inadequate by some, because the estimated distributed lag of inflation rates to explain in-



terest rates seems too long when estimated with data over long periods of time (see Cagan 1965; Macaulay 1938 and Sargent 1973).

Sargent (1973:444) argued that: "our empirical results imply that, to explain the 'Gibson Paradox', it is not adequate to hypothesize a one-way influence directed from inflation to interest rate (which most economists follow) or for that matter, from interest to inflation. Instead, with the context of bivariate models, interest and inflation appear to influence one another. One implication of this finding is that Irving Fisher's explanation of the 'Gibson Paradox' which posits a unidirectional influence flowing from inflation to interest is inadequate. Instead, to explain the 'paradox', it is necessary to view interest and inflation as being mutually determined."

Despite this disagreement about the so called 'Gibson Paradox' and despite the fact that economists have, as Horwich (1966:16) noticed, never satisfactorily integrated their theories of interest as a production cost, as a return to the claimants of capital, or as a variable in monetary policy; and also despite the fact that there is no agreement among economists as to why interest should be paid viz. for productivity of capital, use of capital, risk of capital, time preference, liquidity preference, etc. (see chapter four above), the majority of economists, when writing about inflation and interest rates, write as if inflation is the cause and interest is the effect and rarely the other way round. Not only that but the monetarists among them suggest that to curb inflation, it is necessary to raise interest rates, and teach that high interest rates are anti-inflationary, when it cannot necessarily be true. For it may be true that raising interest rates in an IBFS where economic units are interest-sensitive may curb inflation in the short run when it curbs the demand for credit on one hand and encourage savings on the other, but on the long run it will definitely result in the opposite because raising interest rates raises the cost of borrowing not only to the personal sector and the governmental sector but also to the private productive business sector. This would lead to higher cost of production which in turn lead to one of three possi-

bilities: (1) canceling new production whose rate of return is lower than the new interest rate, or (2) reducing the existing output to the level where the marginal product is not lower than the marginal rate of interest. These, both lead to lower supply of goods in the future than otherwise which may lead in turn to inflation, or (3) raising prices if possible to compensate for the higher costs incurred.

Hoston (1982:1-4) argued that: "it is irrational to seek lower prices by policies which raise costs. It is inefficient to use 'blunt instruments' such as quantitative controls over money when selective credit controls are so much more 'cost effective', for interest is a cost, and when cost go up, so do prices, unless indirectly the higher interest costs result in the fall of other costs". Panico (1985:143) also demonstrated this latter view when he argued that:

Variations of interest can affect distribution and prices in two ways. First, since interest payments on short term lending to firms are directly introduced into the cost of production of commodities, the variation in interest causes an immediate variation in the same direction in this cost. If for instance, we suppose an increase in interest, an increase in the cost of production and an immediate transfer of profits from industrialists to bankers will result. Industrial producers may then try, if circumstances allow them to pass their higher costs on in higher prices. In this case workers will then suffer a loss in their purchasing power. In the presence of real wage resistance, however, this may generate a demand for higher money wages and consequent inflation process. Second, if the variation in interest is considered to be permanent, a change in the same direction in the long term interest rate can come about together with a change in the same direction in  $r$  and  $p$ . As a consequence, workers will have to suffer a loss in their purchasing power, unless they are able to resist it by demanding higher money wages. Once again, an inflationary process may set in. It is impossible to say a priori how and where this process will end. The specific economic, social and political conditions prevailing at the time will determine whether workers will accept a lower real income, whether a monetary policy leading to lower interest rates will be started or whether for other reasons not touched upon here, the Social product increases and makes the demand of different social groups compatible. Yet as long as these demands are not compatible with the existing Social product, adjustment process, most probably in the form of price variations, will go on.

Kaldor (1980:315 and 1982:56-63) also claimed on more than one occasion, that interest costs on working capital enter the cost of production of commodities and that: "there is evidence for believing that interest costs are passed on in higher prices in much the same way as wage costs" (Kaldor 1982:63). This implies that, ceteris paribus higher interest rates lead to higher prices, and vice-versa.

Another major source of instability in the present-day economies, is, as M.A. Khan (1983:240) pointed out: "speculation on the stock exchange which provides a happy rendez-vous to the jobbers and brokers. Almost all the major monetary crises of the capitalist world can be traced to the activities of speculators and financiers. In each case, credit was expanded to abnormal limits to finance speculative activity, until a 'spelling spree' broke the spell and the resulting crisis ruined millions". The collapse of Souq El-Manakh the unofficial stock market of Kuwait in 1982 (see chapter 10 below) and the worldwide stock markets crashes of 1929 and 1987 are examples of this speculation.

The question that arises here is what would happen in an Islamic society where interest and speculation are prohibited and where finance is made on the basis of profits and PLS system as explained earlier?. M.N. Siddiqi (1983b:127) argued that: "the Islamic PLS system has the unique advantage of not being prone to inflation. This characteristic, according to him, follows from the way money capital is supplied for business". It is evident from the model of IFS discussed in chapter 5 above that there are a number of ways to advance finance to DEUs in an Islamic economy. If most of the finance given by the IFIs is on PLS basis (ie Musharakah, Mudharabah, Muzaraah, Musaqat) then inflation would be minimal in view of the fact that no consumer finance could be given under these methods, in other words the bulk of the finance would be productive creating more supply of output that may lead to lower prices if not offset by the demand that would also be created by the high level of employment. If on the other hand the bulk of the IFIs' finance is in the form of Murabahah, Bai Bit-Tagseet, Bai Muajjal, Ijarah and Ijarah Waqtina', then it depends whether the goods financed were for productive or consumer purposes. But even in the latter case, there would be little or no credit money creation than under IBFS since the IFIs do not advance loans to customers but provide them with goods. Add to this the other factors which should limit the demand in the Islamic economy such as the moderation called for by Islam, the prohibition of Ihtikar (speculation), Israaf (indulgence), Tabtheer (extrava-

gance), sculptures, ornaments for men, golden or silver utensils, etc.. which would act in an IFS, as built in stabilisers.

Qardh Hassan, however, is very restricted in an IFS, because the IFIs are not allowed to get any return on such credits. This means, as M.A. Khan (1982:239) noticed that: "the possibility of extending credit for speculative purposes will be considerably reduced. This is in contrast with modern (interest based) banking where credit is extended for speculative purposes as well. As a matter of fact, most of the speculative activity in stock markets is carried out with borrowed funds". Besides, as M.N. Siddiqi (1983b:127) argued: "In a fractional reserve system supply of investible funds by banks involves creation of new money (credit money). This applies to the profit-sharing system also, but the creation of new money in the profit-sharing system is effectively linked with genuine possibilities of creating additional value. It may not be so in the interest-based system where creditworthiness of the borrower is more important than the prospective productivity of the project". And both these two measures make the level of inflation lower in the IFS than it would have been under IBFS.

## 7.5 SOCIAL JUSTICE

"Perhaps the most pernicious consequence of interest based finance is the creation of a debt ridden economy wherein the entire entrepreneur class, the government and the bulk of consumers find themselves heavily in debt to the financiers. this has important economic, social, psychological and political consequences" (M.N. Siddiqi 1983b:69). Thus one could say that this method of finance is unjust and results in maldistribution of income and wealth in the society since under this system and as, Taylor and Evans (1987) pointed out: "if interest rates are high and a loan recipient makes a loss, then the full amount of the interest would still have to be repaid. Similarly, if interest rates are low, is it just for the recipient of the loan to make disproportionately high returns whilst savers are inadequately rewarded?".

PLS system, on the other hand, and as Salama (1984:4) pointed out: "ensures a fair distribution of profits especially when high profits

are achieved. In case of interest based system there is no built in mechanism whereby such profits are distributed but in case of profit sharing system profits will be distributed to a large number of shareholders and investment account holders". M.N. Siddiqi (1983b:126-127) contended that: "Whereas the system based on interest is unjust for it guarantees a definite positive return to the financier whereas, the value productivity of investment is uncertain. It transfers additional wealth to owners of capital even when no additional wealth has been created through the employment of their capital in productive enterprise. The system results in a constant transfer of existing wealth from loss incurring entrepreneurs to wealth owners, which makes the distribution of wealth inequitable with the passage of time. By contrast, profit-sharing ensures justice both at the micro and macro level. When the returns to productive employment of capital are high, the entrepreneurs, the banks as intermediaries and the savers all get good returns as agreed out of the new wealth created. When the returns are low each one still receives a share. In the case of a loss the entrepreneur goes unrewarded but does not lose his own assets as happens in the interest-based system. The banks get back what remains of the capital supplied. A policy of pooling of deposits and diversification of investment can ensure that the banks do not sustain a loss on the totality of their investments and hence the depositors do not get negative returns, except in the case of deep recession".

#### 7.6 THE LDCs' DEBT PROBLEM

Perhaps, the worst socio-economic implications of interest may be seen quite clearly from what is called 'The International Debt Crisis' or 'The Debt Time Bomb'. Since the beginning of the 1980s there has been a growing concern about the magnitude of the debt burden of LDCs. There are more than 35 countries which are either in the process of rescheduling or have recently rescheduled their debts involving over a thousand banks in North America, Europe, and Japan. In the five years 1976-1981 total LDCs' debt grew by 20% a year. It was US\$251 bn in 1976, but the part owed to banks grew by 25% a year, and the short term part grew

fastest of all by 29% a year. In the early 1980s the combination of rocketing interest rates and bunching of maturities has put a number of countries into a position of very high obligations. They can pay them from net foreign earnings or by drawing down reserves. But LDCs' reserves had fallen rapidly and in trade they have had net deficits, not net earnings. The only way they can meet their debt obligation is by borrowing more. Total foreign indebtedness of the developing countries reached some US\$630bn in 1981. It consisted of US\$490bn of medium or long term debt, and US\$140bn of short term debt. Of these sums, about half was owed to commercial banks. According to the World bank's statistics the debtor nations owed an estimated US\$1019bn at the end of 1987.

Although many factors are said to have contributed significantly to the problem of The International Debt Crisis, the single most important factor in precipitating the crisis seems to be the level of interest rates on the dollar (see Errunza and Ghalbouni 1986:231).

Pietro Manes (1982) explored the interrelation between international indebtedness, interest rates and inflation and arrived at the conclusion that high indebtedness is a by-product of interest rates higher than the gross return on capital employed, and inflation is one of the two alternatives to which this condition must necessarily lead, the other being a worldwide deflationary crisis of the 1929 type.

In order to relate his analysis specifically to the subject of international indebtedness, he defined  $D_n$  as the average amount of the foreign indebtedness of a given country in the year  $n$ ,  $i_n$  as the average interest rate applied to the debt  $D_n$ . Then the amount of interest,  $I$ , paid by the debtor country in the year  $n$  is:

$$I_n = D_n \cdot i_n \quad (1)$$

He argued that during the same year  $n$ , the country, besides paying interest on the outstanding indebtedness will repay some of the capital and presumably will also have to borrow new sums from abroad. Defining  $R_n$  as the reimbursement of old debts effected during the year and  $C_n$  as the new gross borrowing during the year  $n$ , then the net new borrowing,

or the net indebtedness increase, in the year n, is the difference:

$$C_n - R_n = B_n \quad (2)$$

In order to simplify the analysis, he assumed that new borrowing and repayment of old debts are spread evenly throughout the year:

$$D_n = D_{n-1} + B_n \quad (3)$$

By combining the equations (1) and (3), he got the following set of equations describing the flow of interest payments from the debtor to creditor in successive years:

$$I_0 = D_0 \cdot i_0 \quad (4)$$

$$I_1 = (D_0 + B_1) i_1 \quad (5)$$

$$I_2 = (D_0 + B_1 + B_2) i_2 \quad (6)$$

.....

$$I_n = (D_0 + B_1 + B_2 + \dots + B_n) i_n \quad (7)$$

Answering the question: where do these money flows come from? he said: "They should come out of the income produced by the use of the borrowed sums. They should be part of the gross profit resulting from the investment of the borrowed capital, including any reinvested profits and any related losses". In other words he is suggesting that the natural and just way to deal with international indebtedness is the Islamic way based on PLS system, though he did not pronounce it clearly.

Calling  $G_n$ : the average amount of the cumulative investment in the year n (resulting from the employment, over the years, of the borrowed sums which constitute the indebtedness  $D_n$  plus any accumulated reinvested profits or losses); and  $r_n$ : the average gross rate of return on the said investment (ie after deduction of all expenses, but before the payment of interest) the total gross return  $Y_n$  obtained from the investment in the year n will be:

$$Y_n = G_n \cdot r_n \quad (8)$$

Assuming that all borrowed sums and all net profits are forthwith invested, the relationship between  $G_n$  valued at cost and  $D_n$  would be:

$$G_n = D_n + \sum_{n=0}^{n=n} P_n \quad (9)$$

where:  $P_n = Y_n - I_n$  is the net profit or, if negative, the net loss obtained in the year  $n$  from the investment made from the borrowed sums. For the debtor country to be able to pay interest on its indebtedness, we must obviously have:

$$P_n = Y_n - I_n \geq 0 \quad (10)$$

Hence, taking into account (1), (4) and (9)

$$r_n \geq \frac{D_n}{D_n + \sum_{n=0}^{n=n} P_n} i_n \quad (11)$$

"As long as this condition is met", as Manes (ibid:111) contended, "everything is all right. The debtor country can not only pay interest on its indebtedness and repay the capital, but can also obtain a net profit which can be reinvested together, with the new net borrowings. But if the gross return on investments made from borrowing is smaller than the required interest payments, then the debtor is in trouble, and so is the creditor who sees his credit in jeopardy".

The interest payment to be made by the debtor may be larger than the return he obtains on borrowed capital and this is not merely a theoretical proposition but it is something which can actually be observed quite often in reality. When this happens, interest payments either cannot be made, or, if they are made, they are no longer paid entirely out of profits, but partly out of fresh indebtedness. In this case, only a part of the net new borrowing can be invested, since a part of it must be used to pay interest on old debts and even perhaps to repay capital. calling required borrowing  $L_n$ , the sum which must be borrowed in order to enable the debtor to service the old debts; and  $\bar{B}_n$ , the part of the net new borrowing available for investment in the year  $n$ , we get:



$$\overline{B}_n = B_n - L_n \quad (12)$$

and it is obviously  $L_n = -P_n$  (13)

and hence, generally  $\overline{B}_n = B_n + P_n$  (14)

This equation (14) tells us that, when the net profit,  $P_n$  is positive, the yearly sum available for investment is equal to the net new borrowing plus the net profit. When the net profit is negative, (ie there is a loss), the yearly sum available for investment is equal to the net new borrowing minus the loss; and the loss, once it has appeared, tends to increase rapidly, because, while interest has to be paid on the entire amount of the net borrowing, only a part of this can now be invested and yield a return.

In mathematical terms, if  $i'_n$  is the rate of interest to be paid on the new net borrowing  $B_n$ , the gross rate of return  $r'_n$ , which must be obtained on the new net investment  $\overline{B}_n$  in order not to have an additional loss, must be:

$$r'_n \geq i'_n \frac{B_n}{\overline{B}_n} \quad (15)$$

This means that  $r'_n$  must be so much higher than  $i'_n$ , the higher the ratio  $\frac{B_n}{\overline{B}_n}$ . Thus, unless the profitability of investment is quickly restored to positive levels, indebtedness becomes a self-feeding process, which after a certain point cannot be reversed, but gains speed, like an avalanche, at a compound rate, since a large and growing part of the net new borrowing is practically nothing else but the capitalisation of interest payments which otherwise could not have been made (ibid). Two corollaries follow:

a-) the outcome of this process must be inflation, for if the banking system creates spendable money assets through loans which are used to service older debts, it is clear that this buying power against which there are no real assets and there is no production of goods and services, must lead to higher prices.

b-) while the banking system remains solvent, it cannot be hoped to overcome inflation through high interest rates because high interest rates are the very factor which feeds higher indebtedness and hence the creation, in the form of increasing volume of bank liabilities, of purely monetary buying power (see Manes 1982:100-114).

The conventional assumption that the LDC debts can be managed by good housekeeping practices supervised by the IMF has been questioned by Lever (1984), Clausen (1985), Chakravarty (1986) and others. Chakravarty (ibid) argued: "the debts are too large to be serviced... It is neither in the interest of the debtors nor in the interest of the lenders that the loans be serviced at the present level. Debtor countries would suffer because, even under generous terms of rescheduling, necessary trade surpluses could not be generated without massive sacrifice. The manufacturing nations in Europe would lose in output and employment". Lever (1984:34) argued that: "to pay the debts back, the borrowing countries would have to run trade surpluses against the lending countries on a scale which would cause problems in the west". Even if one supposes as Chakravarty (1986:5) did, that "severe restraints on internal consumption were applied and exports encouraged, an optimistic outcome would be a reduction in imports by half and an increase of exports by 50%... Austerity measures of this kind would entail massive upheaval. Productive capacity would be destroyed, the poor would suffer untold miseries and the middle class would be alienated. The debts would still remain unpaid after years of deflationary policies".

More than 15 economic summits have been organised between 1980-88, spending millions of pounds and dollars, in order to solve the problem of the world financial system, and The International Debt Crisis, but the crisis continues and goes from bad to worse. This is because they could not agree on a radical solution to the problem. All they did is suggesting ineffective and even counter-productive weapons such as rescheduling the debts (extending debt maturities which is usually made at even higher interest rates) making thus the problem even worse by accumulating the debts for later times. The consequence would be as Clausen (1985) put it: "debt repudiation which, can occur because of either

'incapability' or 'unwillingness'. The former corresponds to insolvency and the latter might occur through political difficulties in asking for domestic sacrifices beyond a certain point entailed in debt servicing". According to World Bank statistics, no country involved in rescheduling its debts has significantly reduced its debt ratios since 1982.

In fact debt rescheduling has merely postponed the crisis, it is a short term solution to a long term problem. A strategy of this kind, even if it eases the problem in the short run, it makes the problem even worse in the future (the long run) and unless interest rates are completely removed on existing debts, new finance based on PLS system is extended and the exchange rates stabilised, the problem will not be solved. On the contrary the problem will worsen even further with adverse consequences not only on the borrowers (the LDCs) but on the lenders (the DCs) as well. As Erbe (1983:205) argued: "there would be a growing medium-term danger of banks collapsing on account of the increasing concentration of poor risks on a decreasing number of institutions. And in view of the considerable ramifications in the international banking system the chances of larger scale bankruptcies not leading to chain reactions are very slim. Secondly, many debtor nations are faced by growing political instability. Stagnation or falling real income levels have weakened the position of many governments. What is more, the drying-up, of the flow of capital, forces many governments to resort to socially painful and thus politically risky measures to put the current account and public finance situation back on its feet. This twofold pressure of endogenous and exogenous factors on the government, restricts the latter's room for manoeuvre. There is an increasing tendency to blame the foreign creditors and the IMF for the economic crisis". Chakravarty (1986) suggests: "The sooner these realities are faced and some mechanism is found to write off much of the loans now outstanding, the less the probability of a major financial crisis triggered off by default".

Muslim economists believe that, had the LDCs' debt been in form of PLS finance, the problem would not have reached this state of affairs.

First, because Islamic banks do not give interest based loans but before agreeing to finance a project in any country they make sure that the project is viable and profitable for both the country involved and the banks themselves and provide it not only with the finance but will all necessary expertise, technical assistance and follow-up that should prevent the diversion of the finance from being used in other purposes and watch over the project to make sure that it goes as planned. If the project turns out to be successful, both parties benefits and if turns out to be a failure, then the loss is shared between the banks and the country involved in proportion to the participation of each in the capital of the project. Thus, no heavy burdens on any of them. This is, according to Presley (1988a:61): "undoubtedly one of the main strengths of an Islamic Banking System in which the risk is born by the investor and the financier. It is therefore in the financier own interest to pay particular attention to the viability of the project in which the financial support is vested".

## 7.6 CONCLUSION

It appears from the above theoretical discussion that, though PLS system, may not prove to be a panacea to all the economic problems of today, it would perhaps, if implemented properly in an Islamic society, offer better solutions than interest or at least, if it does not solve any of these problems, it would not contribute in worsening them, as interest does. Thus one could conclude that the PLS system of finance is perhaps better, juster and more conducive to greater growth, development and prosperity than interest based system. Consequently, Islam is not an obstacle to, but a promoter of, economic growth and development, prosperity and social justice.

## CHAPTER EIGHT

### PERFORMANCE OF THE ISLAMIC DEVELOPMENT BANK (IDB)

#### 8.1 INTRODUCTION

The IDB is an International Islamic Development Bank set up in Jeddah (Saudi Arabia) in 1975 as a development, investment and welfare oriented international financial institution based on the Islamic principles of Shariah. It is one of the oldest Islamic banks.

The purpose of this chapter is to analyse the performance of the IDB's financial operations during the first ten years of its existence. But before doing this, it is, perhaps, very important to first give an overview on the economies of its member countries.

#### 8.2 THE ECONOMIES OF THE IDB MEMBER COUNTRIES: A BRIEF OVERVIEW

The 43 membership of the IDB include a wide range of countries ranging from the richest in the world, the UAE with the highest per capita income in the world (US\$23,770) to the poorest in the world, Chad, with the lowest per capita income in the world (US\$80) in 1982. However all of them are considered as LDCs for the reasons advanced below. Because of their different economic potentials, any generalisation cannot fully reflect the diverse economic conditions in individual countries, therefore, even though not satisfactory, it is perhaps more appropriate to divide them into three groups: high, middle and low per capita income countries, to use the World Bank classifications.

1. The first group with per capita income of more than US\$5,000 includes the highest per capita income country in the world, the UAE with US\$23,770 in 1982, followed by Qatar with US\$21,880; Kuwait with US\$19,870; Saudi Arabia with US\$16,000; Bahrain with US\$9,280; Libya with US\$8,150 and Oman with US\$6,090 for the same year (see Table 8.1).

All of these countries are members of OPEC and so their high incomes are the result of the last decade high oil prices and production, which provided them with substantial amounts of income and foreign exchange. But nowadays with the sharp drop in oil demand and prices, caused by: 1) the recession in the DCs; 2) the competition from the non

OPEC oil producers, whose share in the oil market has grown impressively in recent years; 3) the development of alternative energy resources; 4) energy efficiency and 5) energy conservation, these countries have started experiencing and suffering balance of payments deficits and other related problems (see Tables 8.1 and 8.2).

Table 8.1 IDB High Income Member Countries: Basic Economic Indicators

	UAE	Qatar	Kuwait	S.Arabia	Bahrain	Libya	Oman
Area in sq km (000)	84	11	18	2,150	0.67	1,760	212
Population (m) (1983)	1.21	0.28	1.67	10.48	0.40	3.35	1.13
Density (person per km <sup>2</sup> )	14	25	93	5	645	2	5
ARG of the pop. (%)	15.5	5.4	6.3	4.8	1.1	4.1	4.3
Life Expectancy (years)	71	71	71	56	68	57	52
GNP/c (US\$000) (1982)	23.8	21.9	19.9	16.0	9.3	8.5	6.1
ARG of GNP (1960-80) (%)	-0.7	na	2.2	9.8	na	4.1	5.8
BOP c/a in US\$bn (1980)	23.02	na	15.30	41.40	0.39	8.21	0.94
BOP c/a in US\$bn (1984)	na	na	5.57	-18.43	-0.011	-1.80	0.15

Sources: IDB 9th Annual Report (1984)

The World Bank, World Development Report, (1984)

IMF, International Financial Statistics, Yearbook 1985

Arabia, oct. 1984

Table 8.2 External Trade position of Oil Exporting IDB Member Countries

	1977	1978	1979	1980	1981	1982	1983	1984
C/a balance in US\$ bn	29.3	15.7	53.1	103.9	58.4	-5.9	-15.5	-6.6
C/a balance in %	25.9	13.6	29.8	39.0	22.3	-2.9	-9.4	-3.8
Terms of trade change	-1.6	-10.1	24.8	13.5	2.3	-8.1	-1.4	-2.6

Source: IDB 10th annual report.

Oil exports constitute more than 80% of the total GDP and more than 90% of total exports of these countries and so any fluctuation, in production or prices, directly affects their GDPs and their BOPs. Thus, high per capita incomes in these countries are not the result of real economic and industrial development. Production of oil in these countries is tied more to external than internal factors related to the course of economic and social development of these countries. According to Attigua (1984:136): "World demand of Arab oil is what is known as 'residual demand', meaning that it meets fluctuations in the level of world demand for energy in general and for oil in particular. Therefore

a drop in world demand implies a bigger drop in demand for Arab oil, and a rise in demand implies greater pressure on their oil production".

So, despite the high incomes and the substantial foreign exchange and reserves enjoyed by these countries during the last decade, these countries are still classified as LDCs because of their dependence on one product (oil) and because of lack of domestic technology, lack of diversified industry and lack of capital formation. Other features of these countries include a high rate of illiteracy, lack of skilled labour, and little real investment since most of their petrodollars are placed in the banks of the West especially in the USA and Switzerland. These countries can also be qualified as consumer orientated rather than producer orientated societies. Apart from oil, very little is produced in economic terms by these countries and the rates of inflation in these countries are also very high. Saudi Arabia for example had an annual average rate of inflation of 22% for the period 1970-80. Such high rates of inflation have serious repercussions on the development in these countries. El Agraa (1985:77) pointed out that:

Countries like Bahrain, Kuwait, Libya, Oman, Qatar and the UAE depend heavily on oil revenues. These revenues cannot be guaranteed indefinitely, they last as long as the oil lasts. Once oil is exhausted, these countries will have to depend on the returns from investing their financial resources, which will be no more than a small percentage of the present flows. Of course, these countries have made attempts to construct huge plants (especially for petrochemicals, steel, chemical fertilisers and cement) with prohibitive running costs to produce goods and products for which they are not suited... Such attempts are doomed to failure since their running costs are sustainable only for as long as the oil revenues last.

The implication of the sharp decline in oil prices on the economies of these oil exporting countries has affected all their economic aspects and sectors. These were exhibited by the cuts in subsidies, in budget expenditures, in investments, in imports of capital goods, etc., worsening, thus, the world recession which, combined with the DCs restrictive monetary policies and protectionism, has had a profound adverse affect on the rates of growth of these and other LDCs and this revealed how fragile were the development patterns of these oil exporters.

The spectacular collapse of Kuwait's Souq El-Manakh stock market in 1982, which left in circulation post dated cheques totalling more

than US\$90bn, and the Iran-Iraq war have affected the Gulf countries adversely even further, both economically and politically.

2. The Second group of the IDB member countries (ie the middle income countries) with per capita incomes ranging from US\$4,000 for Gabon and US\$580 for Indonesia (see Table 8.3), comprises some of the OPEC members like Gabon, Algeria, Iraq and Indonesia and some other energy exporters like Malaysia, Syria, Tunisia, Cameroon and Egypt, but because all of these countries are more populous than the Middle-East oil exporters, their per capita incomes are lower than those of the Gulf countries and so are their life expectancy and annual average rate of population growth. Such countries, are classified by most economists as 'high absorbers' countries since they tend, as indicated by Hamid (1983:41): "to expand imports as their export revenues rise. They have shown substantial current account surpluses only during the oil shock years of 1974, 1979 and 1980. Otherwise the surpluses have been small, and in 1978 and 1981 the accounts were in deficit" (see Table 8.3).

Table 8.3 IDB Middle Income Member Countries: Basic Economic Indicators

	Area (000) sq. km	Population (m) 1982	Population density Persons /sq. km	Life Exp. ARG %	Life Exp. Years	GNP/c US\$ 1982	GDP ARG 1970-80	Average Inflation 1970-80	BOP c/a in US\$m 1980 1983	
Gabon	268	0.7	4	1.1	49	4,000	4.4	19.5	392	75
Algeria	2,382	20.5	9	3.1	57	2,350	9.8	13.9	249	-86
Iraq	435	14.7	34	3.5	59	2,100	na	na	na	na
Malaysia	330	14.9	45	2.5	67	1,860	7.7	7.2	-285	-3,379
Jordan	98	3.6	37	2.5	64	1,690	9.3	83	13	
Jordan	33		24		6	2	35		57	43
Kuwait	84		1		1	5	9		85	15
Libya	100		-		-	-	-		100	-
Malaysia	36		44		3	12	5		80	20
Morocco	44		28		10	1	17		72	28
Niger	81		17		1	-	1		46	2.5
Indonesia	1,905	160.3	84	2.3	53	580	7.7	19.9	2864	-6338

Sources: IMF World Development Report, 1984  
 IMF International Financial Statistics Yearbook, 1985  
 IDB Annual Report 1984

Jordan, Turkey, Morocco and Djibouti are oil importers. They experienced current account deficits during the oil shock years and surpluses in other years. Jordan and Morocco are mainly phosphate expor-



ters, Turkey and Djibouti are rather agricultural exporters. The continuing recession in the industrialised world severely constrained these countries' growth. The drop, in industrial countries' demand, resulted in declining both prices and volumes of these countries' primary exports. As these countries relied heavily on foreign debt for the last 20 years to finance their ambitious development plans, their outstanding debts and debt services have grown substantially (see Table 8.4).

Table 8.4 IDB Middle Income Countries Member Public External Debt

	Outstanding debt in US\$m			Debt service as % of exports		
	1970	1978	1982	1970	1978	1982
Gabon	na	na	na	na	na	na
Algeria	937	13,168	12,897	3.2	20.9	24.6
Iraq	274	na	na	2.2	na	na
Malaysia	390	2,671	7,671	3.5	8.8	5.1
Jordan	118	840	1,686	3.6	4.0	6.1
Syria	232	2,091	2,616	10.8	15.1	14.2
Tunisia	545	2,359	3,472	17.5	12.3	15.1
Turkey	1,854	6,188	15,933	16.3	11.0	19.6
Cameroon	131	1,167	1,912	3.1	7.7	15.6
Morocco	711	5,139	9,030	7.7	18.7	36.8
Djibouti	na	na	na	na	na	na
Egypt	1,644	9,879	15,468	28.7	22.2	20.2
Indonesia	2,443	13,089	18,421	6.9	13.0	8.3

Source: IMF World Development Reports, 1980 and 1984

Besides, the restrictive monetary policies, pursued by a number of industrial countries to control inflation, maintained interest rates at high levels, thus greatly increasing developing countries' service payments on floating rate debt generally. The combination of the recession, restrictive monetary policies, the drop in the export of these countries, the increasing debt and debt services resulted in a severe reduction in the growth rates of these countries' economies. Many of these countries resorted to imports' restrictions in order to contain their BOP deficits, thus, worsening the world economy and causing more economic and social problems both within and without their economies. Although exact statistics are hard to obtain, lower growth rates in these countries has undoubtedly resulted in increasing unemployment and underemployment, and in delaying economic development.

During the 1970s these countries registered relatively high rates of growth (see Table 8.3) but since 1980 their rates of growth declined substantially for the reasons mentioned above. Now unless these countries co-operate with each other and with other countries to reduce the effects of the recession by encouraging trade among themselves and with other countries and by advancing aid and technical assistance to each other with little or no charge at all, their conditions will only worsen. The primary task of the IDB is to play the role of the coordinator and the intermediary between these countries.

3. The third group of the IDB member countries consist of the least developed countries, not only as compared to other IDB members but as they are classified by the IMF, the World Bank and the OECD. Of the remaining 23 IDB low income countries, 16 are from Sub-Saharan Africa, the poorest region in the world. The other 7 countries are among the poorest in Asia either because of their large population like Bangladesh and Pakistan or because of little resources, as in the case of the two Yemens or because of the war as in the case of Afghanistan, Palestine and Lebanon. So all of these countries are among the least developed countries of the world and the most exposed to the changes of the world economy. These countries are characterised by low per capita incomes, short life expectancy, very low or negative rates of growth, high rates of illiteracy, deficit BOPs (see Table 8.5), increasing debt burdens, high rates of unemployment, high infant mortality rates, etc..

Since 1980 the recession in the industrial countries combined with restrictive monetary policies pursued on their part to control inflation has had a profoundly adverse effect on the rates of growth of many LDCs (see World Bank 1984:32). The Sub-Saharan African countries have been particularly vulnerable to the impact of the recession combined with the current drought which played a role in the decrease of crop production thus intensifying food shortage and causing the problem of famine and refugees which have, recently, grown dramatically.

Other factors which hamper economic growth and development in these countries to mention just a few, include scarcity of educated people, the dominance of land extensive agricultural systems, extreme ethnic

diversity with consequent political fragility, climatic and geographical factors hostile to development, administrative constraints on mobilising and managing resources for development given the widespread weakness of planning, decision making and management capacities, over-valued exchange rates, etc.. Moreover, basic infrastructure is, in some areas, almost nonexistent: roads, rails, ports, communications, etc..

Table 8.5 IDB Low Per Capita Income Countries Members: Basic Indicators

	Area (000) sq. km	Population (m) density Persons	Life Exp. % Years	GNP/c US\$ 1982	GDP ARG 1970-80	Average Inflation 1970-80	BOP c/a US\$000 1980	1983		
Yemen AR	195	6.3	32	3.0	44	500	8.5	15.0	-685.2	-559.0
Senegal	196	6.3	32	2.7	44	490	2.9	7.9	-442.1	-399.5
Mauritania	1,031	1.8	2	2.3	45	470	2.0	8.7	-134.3	-308.9
Yemen PDR	333	2.2	6	2.2	46	460	na	na	-159.2	na
Sudan	2,506	20.4	8	3.2	47	440	0.6	15.2	-320.2	-219.7
Sierra Leone	72	3.7	52	2.0	38	390	2.0	12.2	-182.7	-169.8
Pakistan	804	89.7	112	3.0	50	380	5.0	12.7	-924	14
Maldives	0.3	0.2	533	3.1	52	373	na	na	na	na
Gambia	11	0.7	60	3.0	36	360	2.5	9.7	-75.08	-49.7
Comoros	2	0.4	210	2.9	48	340	0.9	11.7	na	na
Benin	113	3.7	33	2.7	48	310	1.3	9.6	na	na
Guinea	246	5.4	22	2.0	38	310	0.8	3.3	na	na
Niger	1,267	5.8	5	3.3	45	310	-1.4	12.1	-27.9	-75.5
Lebanon	10	2.7	265	0.5	65	na	na	na	-1,919	-2,715
Palestine	na	na	na	na	na	na	na	na	na	na
Somalia	638	5.2	8	2.8	39	290	-0.5	12.6	-136.2	-149.9
Uganda	241	14.5	60	2.7	47	230	-1.5	47.4	-83.1	7.1
Burkina Faso	274	6.5	24	2.0	44	210	3.4	na	-48.7	-155.2
Mali	1,240	7.5	6	2.7	45	180	1.3	9.8	-124.5	-102.7
Guinea Bissau	36	0.9	24	1.6	38	170	-1.7	7.1	na	na
Afghanistan	648	17.2	27	2.5	36	160	na	na	na	na
Bangladesh	144	94.7	657	2.6	48	140	4.1	14.9	-757.0	-78.9
Chad	1,284	4.8	4	2.0	44	80	-2.6	7.8	8.6	37.9

Sources: IMF World Development Report, 1984  
 IDB annual reports, various issues  
 IMF International Financial Statistics, various issues

Finally, because the tropical climate of the Sub-Saharan African countries is especially hospitable to bacterial, parasitic and epidemic diseases such as malaria, cholera and the like, human energy and productivity are adversely affected. The problem of such countries cannot be solved by emergency food relief which take place from time to time when things get really worse but can only be solved, if these countries are helped with interest-free loans, grants, capital goods, PLS joint-ventures, technical assistance and the like. For the present little is

done in this respect, in fact, as reported by the IDB 9th report 1404H: "official development assistance has been diminishing. According to the OECD estimates the total of such resources received by the LDCs in 1983 was US\$33.5bn, some US\$200m less than in 1982 and the total net capital inflows including short-term bank lending, has been on a downward trend ever since 1981 from US\$132bn in 1981 to US\$112bn in 1982 to US\$101bn in 1983. Therefore, the evidence emphasises the current reality that external financial inflows desperately needed by the developing countries for their growth and development are being severely diminished".

As mentioned above, no real economic recovery will last long in the DCs as well as in the LDCs, in fact the world economic situation will only deteriorate further unless more co-operation, more investment and more co-ordination are undertaken between the North and the South and between the countries of the South themselves, to use the 'Brandt Commission' names for developed and developing countries. The IDB task, however, is to foster the well-being of its member countries, and to try to achieve a harmonious and balanced development, giving due regard and priority to the needs of the least developed member countries, through mutual financial and economic co-operation.

### **8.3 PERFORMANCE OF THE ISLAMIC DEVELOPMENT BANK (IDB)**

#### **8.3.1 Establishment, Purpose and Operations of the IDB**

The Islamic Development Bank (IDB) was established in 1975 as a development, investment and welfare oriented international financial institution, based on the Islamic principles of the Shariah. It opened, officially, on the 20th October 1975 and so is considered to be one of the oldest and pioneering banks in promoting and implementing Islamic banking and Islamic economics. According to A.M. Ali (1979:336): "The bank has been set up in recognition of the need for fostering the well-being of the peoples of the participating countries and for achieving a harmonious and balanced development of these countries. It is based on the conviction that such development can be best advanced through mutual, financial and economic co-operation among the states, which are members of the Organisation of Islamic Conference (OIC). It is designed

to promote and strengthen co-operation among its members in the economic, social and other fields of activity... and seeks to mobilise financial and other resources both from within and outside its member countries and is expected to promote domestic savings and investment and a greater flow of development funds into member countries".

The bank's principal office is located in Jeddah in Saudi Arabia and is authorised to open agencies or branch offices elsewhere. At present it has not yet opened any branch or office neither in Saudi Arabia nor elsewhere, but it has maintained a close relationship with National Development Financing Institutions (NDFIs) in member countries and with Islamic commercial banks in different countries.

IDB's functions and powers include, among others:

- 1 Participation in equity capital of productive projects
- 2 Investment in economic and social infrastructure projects by way of participation or other financial arrangement (conform with Islamic Shariah of course);
- 3 Provision of interest free loans to the private and public sectors for the financing of productive projects;
- 4 Establishment and operating special funds for specific purposes, such as, a fund for assistance to Muslim communities in non-member countries and trust funds;
- 5 Accepting deposits and raising funds Islamically;
- 6 Assisting in the promotion of foreign trade, especially in capital goods, among member countries;
- 7 Suitable investment of funds not needed in its operations;
- 8 Provision of technical assistance to member countries;
- 9 Extension of training facilities for personnel engaged in development activities in member countries;
- 10 Undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to Shariah;
- 11 Co-operation, subject to agreement, in such a manner as the bank may deem appropriate, with all bodies, institutions and organisations having similar purposes, in pursuance of international economic co-operation;
- 12 Any other activities which may advance its purpose;

### 8.3.2 Membership and Capital

The IDB authorised capital is ID2000m divided into 200,000 shares, having a per value of ID 10,000 each, and may be increased by the board of governors at such and upon such terms and conditions as it may deem advisable by a vote of 2/3 of the total number of governors, representing not less than 3/4 of the total voting powers of the members. The unit of account of the bank is known as the Islamic Dinar (ID), the value of which is equivalent to 1 SDR (Special Drawing Right). The minimum number of shares to be subscribed by a member is 250 shares with a

per value of ID10,000 each, (ie ID2.5m). The bank's financial year is the lunar Hijra year which is 11 days shorter than the Gregorian year.

29 countries signed the agreement before the end of October 1974, thus, qualifying as founding members. Their total subscription amounted to ID755m, the largest share of which ID200m, contributed by Saudi Arabia, followed by that of Libya, ID125m. By the end of 1985, membership had increased to 43 countries with total subscription of ID1,952.07m. The major 5 participants in the 1985 capital are Saudi Arabia, Libya, Kuwait, UAE and Turkey (see Tables 8.6 and 8.7). The basic condition for membership is that the prospective member country should be a member of the OIC and be willing to accept such terms and conditions as may be decided upon by the board of governors (see Mannan 1984:454)

Table 8.6 Initial Subscription to the Authorised Capital of IDB by the Founding Members (in ID million and %)

Country	Amount of subscription	Share
Afghanistan	2.5	0.33
Algeria	25.0	3.31
Bahrain	5.0	0.66
Bangladesh	10.0	1.32
Chad	2.5	0.33
Egypt	25.0	3.31
Guinea	2.5	0.33
Indonesia	25.0	3.31
Jordan	4.0	0.53
Kuwait	100.0	13.24
Lebanon	2.5	0.33
Libya	125.0	16.56
Malaysia	16.0	2.12
Mali	2.5	0.33
Mauritania	2.5	0.33
Morocco	5.0	0.66
Niger	2.5	0.33
Oman	5.0	0.66
Pakistan	25.0	3.31
Qatar	25.0	3.31
Saudi Arabia	200.0	26.49
Senegal	2.5	0.33
Somalia	2.5	0.33
Sudan	10.0	1.32
Syria	2.5	0.33
Tunisia	2.5	0.33
Turkey	10.0	1.32
UAE	110.0	14.57
Yemen (Northern)	2.5	0.33
	755.0	100.00

Source: IDB 10th annual report.

Table 8.7 Member Countries Subscriptions as on 29.12.1405H  
(in million Islamic Dinars)

Member country	Initial	Increase	Total	%
1 Afghanistan	2.5	-	2.5	0.13
2 Algeria	25.0	38.1	63.1	3.23
3 Bahrain	5.0	2.0	7.0	0.36
4 Bangladesh	10.0	15.0	25.0	1.28
5 Benin	2.5	-	2.5	0.13
6 Burkina Faso	2.5	3.8	6.3	0.32
7 Cameroon	2.5	3.8	6.3	0.32
8 Chad	2.5	-	2.5	0.13
9 Comoro Islands	2.5	-	2.5	0.13
10 Djibouti	2.5	-	2.5	0.13
11 Egypt	25.0	-	25.0	1.28
12 Gabon	3.0	4.5	7.5	0.38
13 Gambia	2.5	-	2.5	0.13
14 Guinea	2.5	3.8	6.3	0.32
15 Guinea Bissau	2.5	3.8	6.3	0.32
16 Indonesia	25.0	28.1	63.1	3.23
17 Iraq	10.0	15.2	25.2	1.29
18 Jordan	4.0	6.1	10.1	0.52
19 Kuwait	100.0	152.2	252.2	12.92
20 Lebanon	2.5	-	2.5	0.13
21 Libyan	125.0	190.3	315.3	16.15
22 Malaysia	16.0	24.4	40.4	2.07
23 Maldives	2.5	-	2.5	0.13
24 Mali	2.5	-	2.5	0.13
25 Mauritania	2.5	-	2.5	0.13
26 Morocco	5.0	7.6	12.6	0.65
27 Niger	2.5	3.8	6.3	0.32
28 Oman	5.0	2.0	7.0	0.36
29 Pakistan	25.0	38.1	63.1	3.23
30 Palestine	2.5	2.5	5.0	0.26
31 Qatar	25.0	25.0	50.0	2.56
32 Saudi Arabia	200.0	306.4	506.4	25.94
33 Senegal	2.5	3.8	6.3	0.32
34 Sierra Leone	2.5	-	2.5	0.13
35 Somalia	2.5	-	2.5	0.13
36 Sudan	10.0	15.2	25.2	1.29
37 Syria	2.5	-	2.5	0.13
38 Tunisia	2.5	2.5	5.0	0.26
39 Turkey	10.0	150.0	160.0	8.20
40 Uganda	2.5	3.8	6.3	0.32
41 United Arab Emirates	110.0	84.7	194.7	9.97
42 Northern Yemen	2.5	3.8	6.3	0.32
43 Southern Yemen	2.5	3.8	6.3	0.32
<b>TOTAL</b>	<b>798.0</b>	<b>1,154.0</b>	<b>1,952.0</b>	<b>100.00</b>

Source: IDB 10th annual report.

IDB financial resources consist of the following:

**Ordinary Capital Resources**

- 1 the capital subscribed
- 2 deposits placed with the bank
- 3 amounts received in repayment of loans, from the sale of its equity holdings and as income from investment related to its ordinary operations
- 4 any other funds raised or received by the bank, or placed at its disposal for specified purposes other than special funds resources and trust funds resources.

### Special Fund Resources

- 1 funds contributed by members for inclusion in any special fund;
- 2 funds allocated by the bank to any special fund from net income arising out of its ordinary operations;
- 3 funds repaid in respect of financing from the resources of special funds
- 4 income derived from operations financed by a special fund;
- 5 any other resources received by, or placed at the disposal of any special fund.

### Trust Fund Resources

- 1 resources received by the bank to be administered in accordance with the terms of the trust;
- 2 funds received in respect of operations financed by trust funds; and
- 3 income derived from operations financed by trust funds.

The operations of the Bank are separated according to these designations. Its resources are not fungible, and separate financial statements for each type of operations are mandated.

#### 8.3.3 The IDB Balance Sheets

Because the only financial reports made available to me were those between 1400-1405H, the Balance Sheet discussion is limited to those 6 years only (see Table 8.8). Three striking observations attract the attention from the first glance at these balance sheets: First, the cash to assets ratio is very high (ranging between 54% and 35.5%) and having the highest share in total assets compared with other items of the BS. This means that the bank is too liquid and needs to invest and allocate such funds for the economic development of its members which need such funds. Second, the total of ordinary operations finance to total assets is relatively very low (less than 20%) though these are supposed to be the main functions of the bank and Third, more than 80% of the bank operations are financed from capital and reserves which means that little use is made of external sources of funds. This requires that the bank should develop the ways and means to attract such funds. This also requires that the surplus oil exporting countries should deposit some of their petrodollars in interest-free deposits or on PLS basis with the bank, so that the bank will have enough funds to finance more projects especially in the least developed counties to help them develop and overcome the difficulties of capital scarcity.



Another observation is that, although Foreign Trade Finance (FTF) was not intended to be the main function of the bank at the time of the establishment of the bank, it is the most practised by the bank. For instance, FTF/TIA ratio ranged between 27.4% in 1980 and 42.7% in 1985 coming second after liquid assets to total asset ratio. This means that most of the bank finance is in the form of FTF. The reason for this may be that FTF is the most easy short term investment, the most profitable and the least risky for the bank to undertake as compared to ordinary finance which includes loans and technical assistance that are in the form of interest-free loans or even in the form of grants that are not repayable, equity investment, leasing and profit sharing, all of which need substantial amounts of time and efforts to undertake.

During the period 1400-1405H the IDB's TIA increased from ID973.2m in 1400 to ID2109.6m in 1405 at an annual ARG of 16.9%, thus, more than doubled in the last 6 years. Among the ordinary operations, equity investments was the most important with an average share of about 46% of total ordinary operation finance followed by loans and technical assistance with an average share of 35.3% and leasing with a share of 18.3%. The share of profit sharing is very negligible (0.6% only) (see Tables 8.8, 8.9 and 8.10).

The IDB introduced the investment deposit scheme in September 1980 in order to provide both acceptable opportunities to investors and to mobilise financial resources for the Bank. During the period 1400-1405H these deposits registered 83.2% growth rate, the 2nd highest annual ARG after profit which registered an annual ARG of 91.2%. The level of deposits at the end of 1405H decreased by 56% compared to that of 1403H. The Bank did not give any reason for this, but in my opinion the drop is due to the fact that most if not all of these deposits were those of other Islamic banks which were too liquid in previous years in view of being newly established, not yet involved in real investment or in view of operating in highly liquid financial environments like the case of Kuwait Finance House which had to limit and restrict accepting deposit in 1403H. But now that the Gulf banking boom years are over, especially

Table 8.8 The IDB Balance Sheets for the Years 1400-1405H (in ID million and in % )

	1400		1401		1402		1403		1404		1405	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Cash	523.7	53.8	395.6	35.5	619.3	45.0	874.1	51.6	780.2	41.5	771.1	36.6
FTF	267.4	27.4	468.4	42.0	430.5	31.3	434.1	25.6	660.7	35.1	901.6	42.7
Ordinary Operations	136.0	14.0	197.9	17.8	269.9	19.7	325.8	19.3	388.9	20.7	395.2	18.7
Sundry Debit Accounts	23.0	2.5	30.5	2.7	33.1	2.4	36.6	2.1	28.3	1.5	18.5	0.9
Fixed Assets	22.4	2.3	22.0	2.0	21.6	1.6	23.4	1.4	23.4	1.2	23.2	1.1
<b>Total Assets</b>	<b>973.2</b>	<b>100.0</b>	<b>1114.4</b>	<b>100</b>	<b>1374.4</b>	<b>100.0</b>	<b>1694.0</b>	<b>100.0</b>	<b>1881.6</b>	<b>100.0</b>	<b>2109.6</b>	<b>100.0</b>
Capital	760.4	78.2	775.0	69.6	932.4	67.8	1082.6	64.0	1275.0	67.8	1428.2	67.7
Reserves	107.2	11.0	156.7	14.0	208.3	15.2	269.2	15.9	316.5	16.9	333.7	15.8
Profit or Loss	10.2	1.0	14.7	1.3	16.9	1.2	2.4	0.1	8.4	0.4	28.6	1.4
Deposits	13.0	1.3	53.7	4.8	42.6	4.6	155.4	9.2	77.3	4.1	47.9	2.2
Special Assistance	79.7	8.2	111.6	10.0	144.9	10.5	171.3	10.1	194.6	10.3	203.4	9.1
Sundry Credit Account	2.6	0.4	2.8	0.3	9.3	0.7	13.1	0.7	9.8	0.5	47.8	2.3
<b>Total Liabilities</b>	<b>973.2</b>	<b>100.0</b>	<b>1114.4</b>	<b>100.0</b>	<b>1374.4</b>	<b>100.0</b>	<b>1694.0</b>	<b>100.0</b>	<b>1881.6</b>	<b>100.0</b>	<b>2109.6</b>	<b>100.0</b>

Source: IDB, various Annual Reports, 1400-1405

Table 8.9 The Breakdown of IDB Ordinary Finance (in million ID and % 1400-1405H)

	1400		1401		1402		1403		1404		1405		Averages	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Tech. Assist.	38.7	28.5	58.8	29.7	81.5	30.2	117.0	35.9	140.1	37.0	165.2	41.8	100.9	35.3
Equity	81.6	60.0	110.0	55.6	130.4	48.3	152.4	46.8	169.9	43.7	144.5	36.3	131.3	45.9
Leasing	12.6	9.3	27.0	13.6	56.9	21.1	56.4	17.3	74.9	19.3	86.1	21.8	52.3	18.3
Profit Sharing	3.1	2.3	2.1	1.1	1.0	0.4	-	-	-	-	0.4	0.1	1.6	0.6
<b>Total</b>	<b>136.0</b>	<b>100.0</b>	<b>197.9</b>	<b>100.0</b>	<b>269.8</b>	<b>100.0</b>	<b>325.8</b>	<b>100.0</b>	<b>388.9</b>	<b>100.0</b>	<b>395.2</b>	<b>100.0</b>	<b>285.6</b>	<b>100.0</b>

Source: IDB various Annual Reports

after the Souq El-Manakh financial market collapse, the drop in housing prices in which KFH was involved, the sharp drop in oil prices, and the general trend of the drop in TLA of banks not only in the Islamic ones, but in most banks even at the international level, these banks had to withdraw some of their deposits with the IDB to meet contingencies.

Table 8.10 Growth Rates of the Most Important Items of the IDB Balance Sheets between 1400-1405H (in Percentages)

	$\frac{1401}{1400}$	$\frac{1402}{1401}$	$\frac{1403}{1402}$	$\frac{1404}{1403}$	$\frac{1405}{1404}$	Averages
Cash funds	-24.5	56.5	41.1	-10.7	-1.2	12.2
Foreign trade financing	75.2	-8.1	0.8	52.2	36.5	31.3
Project financing and technical assistance	45.5	36.3	20.8	19.4	1.6	24.7
Capital and reserves	7.4	22.4	18.5	17.7	10.7	15.3
Special assistance account	39.7	29.8	18.2	13.6	4.5	21.2
Deposits	313.6	16.6	148.4	-50.3	-12.2	83.2
Profits	43.7	15.0	-85.5	242.3	240.5	91.2
Total assets	14.5	23.3	23.3	11.1	12.1	16.9

Source: Table 8.8 above

In the year 1403H, the Bank conducted studies relating to the estimates of its resource needs up to the year 1415H. The studies indicated that a resource gap aggregating approximately ID11bn was projected over the years 1409H to 1415H, if the Bank was to provide for a modest growth in its operations allowing for inflation and taking into account the needs of its least developed member countries. Thus the need to improve the Investment Deposit Scheme to make it responsive to the needs of the Bank and prospective investors and the need to develop new PLS financial instruments which could help the Bank fill the gap and carry out its activities with little or no problem.

Unlike other international development banks whose task of resource mobilisation is somewhat easier as they can borrow funds from capital markets on the basis of interest through issuing bonds, certificates of deposit and term loans, the task before the IDB is much more difficult. Firstly, because as an Islamic bank whose operations must conform to Shariah, it cannot borrow funds from capital markets on the basis of

interest which is prohibited in Islam. Secondly, because the Islamic Financial System is still in its infancy, Islamic capital markets and Islamic financial instruments conform to Shariah are yet to be developed. Nevertheless the IDB, in addition to its planning to improve the Investment Deposit Scheme, is paying particular attention to the development and issuance of the following:

- 1 short-term investment certificates, the receipt of which are to be used in the Foreign Trade Finance (FTF);
- 2 long-term investment certificates, the receipt of which are to be used in leasing operations of the IDB.
- 3 closed-end mutual funds, the receipts of which are to be used in the Bank's equity investments.
- 4 general type certificates, the receipt of which are to be utilised in 'a basket' of various modes of investment.

The IDB is also considering and following with great interest the experience of Jordan Islamic Bank (JIB) in issuing Mudharabah Certificates of Deposit (MCDs). The holder of these certificates would not be assured a predetermined return on the capital he has provided but would receive an agreed percentage of the net profits of the project if there is any profit and bear his share of any loss that might occur. Besides, the IDB is also considering co-operation with other Islamic banks to mobilise more resources through the initiation of various institutional arrangements such as the formation of a consortium of Islamic banks, investment companies and secondary markets.

The Special Assistance Account, which represents about 10% of IDB's TLA and which increased from ID79.7m in 1400H to ID203.4m in 1405H, at an annual ARG of 21.2% (see Tables 8.8 and 8.10), is still insufficient to meet the need of the member countries and Muslim communities that are affected by natural disasters, as in the case of the Sub-Saharan member countries which are affected by long droughts and by diseases. Although the amount of funds in this account has more than doubled between 1400 and 1405H, more funds are needed from the rich member countries to ease the problems of the least developed countries. Funds for this account can also be raised during the Hajj (pilgrimage) season in Mekkah (Saudi Arabia) where more than 2 million people from all over the world gather every year and who could donate on average at least US\$25 each, which means the collection of about US\$50m a year. Funds

for this purpose can also be raised through collection of Zakat from the places that are of no need to places where these are most needed.

During the period 1400-1405H the IDB made quite substantial amounts of profits ranging from ID2.4m to ID28.6m, growing at an annual ARG of 91.2%, albeit the sharp drop in profit from ID16.9m in 1402H to ID2.4m in 1403H representing 85.5% decrease due in part to the decline in the value of the bank equity investment and in part to the creation of ID10m provision for any further decrease.

As for the Foreign Trade Financing (FTF), investment loans and technical assistance, I think it is better to look at them in greater detail in the next section because their appearance in the BS does not give much information on the number of operations financed, neither the effective amounts spent on them, all it gives is the outstanding debt of member countries at the end of each year in the form of FTF, loans or technical assistance, however, the outstanding FTF at the end of each year increased with an annual ARG of 31.3% from ID267.4m in 1400H to ID901.6m in 1405H, thus, more than tripled. And project financing and technical assistance which include loans, shares in companies, leasing, technical assistance, etc., also increased by 24.7% during the same period from ID136m in 1400 to ID395.2m in 1405H, thus recording almost threefold increase during the 6 years under review.

#### 8.4 THE IDB FINANCE OPERATIONS

As mentioned earlier, the IDB finance operations consist of:

- 1 Ordinary operations which include project financing and technical assistance;
- 2 foreign trade operations; and
- 3 special assistance operations.

Table 8.11 summarises the IDB total financing operations since establishment in 1396H till the end of 1405H. During this period, the IDB financed 575 operations amounting to ID4,873m (US\$5,360m) in its first 10 years of activity. On average the IDB financed about 58 operations per year amounting to ID487m (US\$536m) or to ID8.5m (US\$9.3m) each. The annual number of operations grew from 2 in 1396H to 97 in 1405H and their corresponding amounts increased from ID13.45m to ID1,005.22m at an annual ARG of 134% (see Tables 8.11 and 8.12).

Table 8.11 IDB Total Financing Operations From Establishment till 1405H (in ID million and in %)

Year	Proj. Finance		Tech. Assistance		FTF		Special Assistance		Grand Total	
	No	Amount %	No	Amount %	No	Amount %	No	Amount %	No	Amount %
1396	2	13.45 100.0	-	-	-	-	-	-	2	13.45 100.0
1397	20	98.86 69.0	3	0.84 1.0	5	43.61 30.0	-	-	28	143.31 100.0
1398	12	69.09 35.0	3	0.82 0.4	14	127.44 64.6	-	-	29	197.35 100.0
1399	16	89.77 25.3	5	1.37 0.4	25	262.45 74.1	1	0.71 0.2	47	351.30 100.0
1400	24	128.19 26.0	3	3.38 0.7	33	352.67 71.6	7	8.46 1.7	67	492.70 100.0
1401	19	104.79 21.5	10	6.83 1.4	32	370.24 76.0	9	5.33 1.1	70	487.19 100.0
1402	25	150.26 28.7	8	4.44 0.8	28	359.77 68.7	8	9.25 1.8	69	523.72 100.0
1403	26	178.55 26.5	12	5.99 0.9	28	480.61 71.4	7	7.95 1.2	73	673.00 100.0
1404	25	202.74 20.6	7	2.96 0.3	47	714.31 72.7	14	62.65 6.4	93	982.66 100.0
1405	35	266.48 26.5	13	6.63 0.7	38	668.21 66.5	11	63.90 3.2	97	1005.22 100.0
Total	204	1302.29 26.7	64	33.26 0.7	250	3372.31 69.3	57	158.15 3.3	575	4872.90 100.0

Source: IDB 10th Annual Report for the year 1405H

Of the IDB total 575 operations, during the 10 years, 268 operations, amounting to ID1,335.54m (US\$1,469m) and representing 27.4% of the total, were in the form of ordinary operations which included 204 project financing operations amounting to ID1,302.28m (US\$1,432.52m) representing 26.7% of the total and growing from 2 operations in 1396H amounting to ID13.45m to 35 operations in 1405H amounting to ID266.48m at an ARG of 85% and 64 technical assistance amounting to ID33.26m (US\$36.6m) and representing 0.71% of the total and growing from 3 operations in 1397 amounting to ID0.84m (US\$0.93m) to 13 operations in 1405 amounting to ID6.63m (US\$7.29m) at an annual ARG of 48%.

250 operations of the total 575, amounting to ID3,379.31m (US\$3,717.24m) and representing 69.3% of the total, were in the form of FTF. FTF grew from 5 operations amounting to ID43.61m (US\$47.97m) in 1397H to a peak 47 operations amounting ID714.31m (US\$785.74m) in 1404H and dropping to 38 operations amounting ID668.21m (US\$735.03m) in 1405. The annual ARG of FTF for the period was 52% (see Tables 8.11 and 8.12)

Table 8.12 Growth Rates of IDB Total Finance Operations (1396-1405H)  
(in Percentages)

Years	Project Financing	Technical Assistance	FTF	Special Assistance	Total
1396	-	-	-	-	-
1397	635	-	-	-	966
1398	-30	-2	192	-	38
1399	30	67	106	-	80
1400	43	147	34	1092	39
1401	-18	102	5	-37	-1
1402	43	-35	-3	74	7
1403	19	35	34	-15	29
1404	14	-51	49	698	46
1405	31	124	-6	2	2
Averages	85	48	52	227	134

Source: Table 8.11.

The remaining 57 operations, amounting ID158.15m (US\$173.97m) and representing 3.3% of the total, were in the form of special assistance operations and financed from the special assistance account. They increased from ID0.71m (US\$0.78m) in 1399H for 1 operation to ID63.90m (US\$70.29m) in 1405H for 11 operations growing at an ARG of 227%.

#### 8.4.1 IDB Ordinary Operations

Table 8.13 gives more detail about the IDB's ordinary operations which include project financing and technical assistance. Project financing which represents 98% of the bank total ordinary finance includes: 1) interest-free loans for constructional projects of infrastructural nature such as roads, dams, communications, etc., 2) equity participation in the capital of agricultural and industrial companies, 3) leasing of machinery and other equipment; 4) Murabahah and installment sale; and 5) profit sharing.

The remaining 2%, of the total, is in the form of technical assistance to enable member countries execute the necessary social, economic and financial feasibility studies to prepare projects for financing by the financial institutions. The table shows the number of operations of each of these forms of financing, their amounts, the percentage of each in the total, their yearly percentage changes and their averages.

##### A- Loan Financing

During the first 10 years of activity, the IDB approved 85 loan projects amounting to ID492.97m (US\$543.27m) in 36 member countries and representing 37% of the total ordinary finance. The loans given by the Bank were interest-free, however, the IDB collected service fees, which are controversial, to cover its relevant administrative expenses.

The approved loan projects increased from 1 in 1396H amounting to ID6m to 15 in 1405H amounting to ID98.62m at an average of 8.5 projects per year amounting to ID49.30m or to ID5.80m each and growing at an ARG of 11.2% per annum, the highest among those of the other forms of project financing. In 1397H it recorded a peak rate of growth of 824% when it jumped from 1 loan amounting to ID6m in 1396 to 11 loans amounting to ID55.41m in 1397, and a lowest rate of -54% in the following year 1398H when it approved only 5 projects amounting to ID25.46m. The fluctuation depends of course on the number of applications for loans every year and on the feasibility of the projects.

Most of these loans were given to the least developed member countries for socio-economic infrastructural projects that help bringing about better growth and development, but because of the inadequate phy-



sical, administrative and social infrastructure, the magnitude of investment needed for development in the least developed member countries will remain for many years to come at a level far beyond the saving capacity of these countries and the IDB financial resources.

Table 8.13 The Evolution of the IDB Ordinary Operation (1396-1405H)  
(in ID million and in %)

		Loans	Equity	Leasing	Inst. Sale	PLS	Total proj. finance	Tech. Ass.	Grand Total
1396	No.	1	1	-	-	-	2	-	2
	Amount	6.00	7.45	-	-	-	13.45	-	13.45
	%	45	55	-	-	-	100	-	100
	Growth	-	-	-	-	-	-	-	-
1397	No.	11	8	1	-	-	20	3	23
	Amount	55.41	38.32	5.22	-	-	98.95	0.84	99.70
	%	56	38	5	-	-	99	1	100
	Growth	824	414	-	-	-	636	-	641
1398	No.	5	5	1	-	1	12	3	15
	Amount	25.46	29.36	10.00	-	4.27	69.09	0.82	69.91
	%	36	42	14	-	6	99	1	100
	Growth	-54	-23	92	-	-	-30	-2	-30
1399	No.	6	8	2	-	-	16	5	21
	Amount	33.74	39.79	16.25	-	-	89.78	1.37	91.14
	%	37	44	18	-	-	98	2	100
	Growth	33	36	63	-	-	30	67	30
1400	No.	9	10	5	-	-	24	3	27
	Amount	52.68	39.04	36.47	-	-	128.19	3.38	131.57
	%	40	30	28	-	-	97	3	100
	Growth	56	-2	124	-	-	43	147	44
1401	No.	6	10	3	-	-	19	10	29
	Amount	28.12	45.98	30.69	-	-	104.79	6.83	111.62
	%	25	41	27	-	-	94	6	100
	Growth	-46	18	-16	-	-	-18	102	-15
1402	No.	9	8	8	-	-	25	8	33
	Amount	48.03	28.70	75.53	-	-	150.26	4.44	154.70
	%	31	19	48	-	-	97	3	100
	Growth	71	-38	140	-	-	43	-35	39
1403	No.	11	5	10	-	1	26	12	38
	Amount	73.45	15.61	86.43	-	3.06	178.55	5.99	184.54
	%	40	8	47	-	2	97	3	100
	Growth	53	-46	18	-	-	19	35	19
1404	No.	12	1	12	-	-	25	7	32
	Amount	71.46	6.00	125.27	-	-	202.73	2.96	205.70
	%	35	3	61	-	-	99	1	100
	Growth	-3	-62	45	-	-	14	-51	11
1405	No.	15	4	9	7	-	35	13	48
	Amount	98.62	9.87	92.10	65.90	-	266.49	6.63	273.12
	%	36	4	34	24	-	98	2	100
	Growth	38	65	-26	-	-	31	124	33
Total	No.	85	60	50	7	2	204	64	264
	Amount	492.97	260.13	475.96	65.90	7.33	1302.29	33.25	1335.54
	%	37	19	36	5	1	98	2	100
Average	No.	8.5	6	5	0.7	0.2	20.4	6.4	26.4
	Amount	49.30	26.01	47.60	6.53	0.73	130.23	3.33	133.55
	%	112	40	49	-	-	85	48	86

Source: IDB Annual Reports, Various issues.

Mannan (1984:485) argued that: "It has to be acknowledged that in real terms project lending even with high service charge cannot be considered to be a profitable operation for the bank if the present inflation rate is added to the normal monetary rate of discount", and so he suggested that the IDB has to divert its resources to explore other avenues of investment opportunities either in the form of equity participation or in the form of expanded foreign trade financing operations or similar lines of investment. But if we take into consideration that the IDB as a development bank should not be a profit seeker (ie profit-maximiser) and that loans for financing infrastructural projects are the most needed especially in the least developed countries to alleviate or remove the bottlenecks and to ease the difficulties accounting for most if not all other economic activities, one has to disagree with Dr. Mannan. This is not to suggest that the Bank should give all its finance in the form of interest-free loans, but a diversification in its forms of financing is best for both the bank and its customers.

#### **B- Equity Participation**

Since 1396H, the year of establishment until 1405H the 10th year of activity, the IDB participated in 60 equity operations amounting to ID260.13m, representing 19% of the total ordinary finance and varying from 1 equity participation in 1396H amounting to ID7.45m to 10 in 1401 amounting to ID45.98m and to 1 only in 1404 amounting to ID6m and then to 4 in 1405 amounting to ID9.87m. On average the IDB participated annually in 6 equity operations amounting to ID26m.

Though equity financing had been expanding till 1401H, it has suffered a decline since 1402H. The relative decline in equity financing is, according to IDB 10th Annual Report, primarily attributed to poor financial performance of some of the IDB's equity projects due to the general world economic recession, delayed implementation, cost overrun, marketing, currency depreciation and management. Consequently the profitability of some of these projects has been adversely affected and considerable losses have been incurred in others.

Furthermore as rightly pointed out by Mannan (1984:460): "The guidelines of equity participation presuppose the existence of adequate and sound physical and social infrastructure and administrative machinery capable of formulating and implementing policies in all sectors of the economy. Unfortunately this presupposition is not the reality in many developing countries not to speak of the least developed member countries of the Bank". All these factors have without doubt contributed to the limitation of the bank equity participation and to the decline in the value of its investments, in the rate of return and dividend of some companies in which it has equity participation. But as a safeguard for the future, the Bank has formulated new equity guidelines which among others, include:

- (a) selective approach in choosing suitable equity projects;
- (b) more rigorous marketing study;
- (c) involvement of the Bank at the early stage;
- (d) stricter financial evaluation;
- (e) proper follow up and post evaluation.

The IDB's equity financing includes direct participation in projects and the granting of mixed line of equity and leasing to National Development Financial Institutions (NDFIs) in order to extend assistance to small and medium industrial projects; particularly in the private sector. The NDFIs act as agencies of the Bank for the purpose of identifying, appraising and implementation of the local projects which are suitable for this type of financing by the Bank. In this manner it can participate even in smaller size projects which it cannot otherwise do but the lack of suitable and profitable projects remains the obstacle.

### C- Leasing

Leasing is the second most important mode of finance used by the IDB after loan projects in terms of its share in the total ordinary finance (36%) and its annual ARG was 49% (see Table 8.13). Total lease financing approved by the Bank from the commencement of its operations till the end of 1405H amounted to ID475.96m for 50 operations, that is 5 operations per year on average, each amounting to ID9.52m increasing from 1 operation amounting to ID5.22m in 1397H to 12 operations in 1404 amounting to ID125.27m and decreasing to 9 operations in 1405H amounting to ID92.10m recording an annual ARG of 49%. Its share in the total

amount of ordinary finance grew from 5% in 1397H to 61% in 1404H and declined to 34% in 1405H because of the introduction in 1405H of the new type of finance 'the instalment sale' to supplement leasing and which accounted for 24% of the total ordinary finance in 1405H.

The IDB introduced leasing operations in 1397H in order to assist its members in the procurement of necessary equipment and machinery for the production of various intermediate and capital goods in its member countries. Lease financing has also been used for the acquisition of ocean-going vessels towards building up necessary transportation facilities thereby augmenting foreign trade activities. Most of the leasing operations approved were applied for, by the middle income member countries (see IDB's Annual Reports 1400-1405H).

This type of finance is in my view more beneficial to the recipient than loans, since the latter needs not to buy very expensive machinery, vessels or equipment that it cannot afford to buy or even if it can, it would cost it too much to maintain, repair and keep in case some difficulties arise. Besides, even if the beneficiary can afford to buy the machinery or whatever, it may need it only for some time which may be less than its life span. Thus, getting it through leasing would save substantial amounts of capital that can be used to procure other things needed for development. This is also beneficial to the Bank under the condition of diversification whereby a large number of leasing operations is necessary so that if one operation goes wrong other operations would offset it and compensate for the loss that may arise. The Bank would receive regular inflows of incomes from its leasing operations to improve its cash flow and carry out other operations.

#### D- Instalment Sale

The IDB introduced this type of finance in 1405H to supplement leasing which, according to the IDB 10th Annual Report, has some constraints relating to the Bank's ownership of the leased assets and which did not provide it with the necessary flexibility to finance fixed assets for its members. For example, the asset in question may not be eligible for leasing either because it is not separately identifiable

or because of its short useful life span. Besides, the legal or tax regulations of the prospective lessee may not make leasing an attractive or even a feasible proposition. Moreover, many prospective lessees (mainly in the private sector) fail to get a commercial bank guarantee in case of leasing because they do not hold ownership of the assets leased. As a result of this limitation in the leasing mode, IDB introduced the mode of instalment sale whereby the ownership of the asset is immediately transferred to the buyer, while the sale price (which is higher than the original price) is payable by instalments. Though this means that IDB cannot repossess the asset if the buyer defaults in any instalment, it also means that the Bank does not have to worry about the risks associated with the ownership of the asset. Nevertheless the asset may be offered as a counter guarantee to any financial institution which would, in turn, provide a guarantee for IDB instalments.

7 instalment sales were approved in 1405H for 6 member countries. They amounted to ID65.90m, representing over 24% share in the 1405H total ordinary finance. This type of finance is, perhaps, going to be the most important one in the future.

#### **E- Profit Sharing**

Profit sharing is the most fundamental principle of Islamic banking finance, but because it requires a great deal of involvement from the Bank in evaluating, appraising, implementing, managing, supervising and following up the projects financed by this method more than any other type of financing and because the total area of the IDB member countries covers more than 24m sq. km, the IDB found that it is difficult to expand it due to the above mentioned and other various conceptual and operational problems. As such, the Bank approved only 2 profit sharing operations during the first 10 years amounting to ID7.33m and representing only 0.55% of the total ordinary finance. The first operation was approved in 1398H for Badr Housing Complex project in the UAE with Dubai Islamic Bank (DIB) and amounted to ID4.27m and the second was approved in 1403H for Marakesh awqaf project in Morocco involving an amount of ID3.06m.

## **F- Technical Assistance**

In addition to the above mentioned forms of project financing which constitute about 98% of the IDB total ordinary finance, the IDB also provided technical assistance to its member countries either in the form of loans or grants (not exceeding ID150,000) or a combination of both, primarily for feasibility studies, preliminary and detailed designs and consultancy services, as well as procurement of research and training equipment during the execution phase of a project. Technical assistance activities of the Bank are important since they relate to the identification and development of viable projects and to allocation of scarce resources to the most appropriate areas.

70 technical assistance operations were approved by the Bank up to the end of the year 1405H, involving an amount of ID34.15m in 29 countries. This included 6 operations involving ID0.917m which were later cancelled, thus the effective technical assistance operations approved by the Bank during the period under review were 64 operations amounting to ID33.25m that is about 6.5 operations per year on average amounting to ID3.66m or ID0.57m each and growing with an annual ARG of 48% from 3 operations amounting to ID0.84m in 1397H to 13 operations amounting to ID6.63m in 1405H (see table 8.13).

## **G- Sectoral Allocation**

Of the total ordinary operations financed, 37% were allocated to industry, amounting to ID490.21m, 20% to transport and communications corresponding to ID263.78m, 17% to agriculture involving an amount of ID230.52m, 14% to utilities corresponding to an amount of ID187.14m, 9% to social services involving ID121.13m and 3% to other sectors amounting to ID42.76m (see Table 8.14).

The annual allocation to the industrial sector fluctuated between 55% in 1396H and 24% in 1405H taking the lead over all other sectors except in 1397 and 1403 when it was overtaken by the transport and communication sector and in 1405 when it was overtaken by the agricultural sector. But in general it is the sector number one in terms of finance allocations followed by the sector of transport and communication which include the financing of building roads, railways and oil pipelines.

The share of the transport and communication sector in the total ordinary finance fluctuated from year to year between 45% in 1397H and 3% in 1405H. The fluctuation of course depends on the number of projects applied for, the viability of the projects submitted and the condition and terms of each project.

Table 8.14 Sectoral Allocation of IDB Total Ordinary Finance  
(in ID million and in Percentages)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1396 Amount	-	7.45	-	6.00	-	-	13.45
1396 %	-	55	-	45	-	-	100
1397 Amount	11.12	28.74	44.27	-	5.38	10.19	99.70
1397 %	11	29	45	-	5	10	100
1398 Amount	13.00	37.96	-	9.65	-	9.30	69.91
1398 %	19	54	-	14	-	13	100
1399 Amount	9.45	42.75	24.42	9.48	5.04	-	91.14
1399 %	10	47	27	10	6	-	100
1400 Amount	15.49	57.18	22.72	17.56	10.23	8.39	131.57
1400 %	12	43	18	13	8	6	100
1401 Amount	24.10	60.08	22.32	5.12	-	-	111.62
1401 %	22	54	20	5	-	-	100
1402 Amount	23.26	65.51	34.12	25.10	5.00	1.71	154.70
1402 %	15	43	22	16	3	1	100
1403 Amount	6.06	45.20	74.22	21.18	27.53	10.35	184.54
1403 %	3	25	40	11	15	6	100
1404 Amount	28.79	79.42	34.43	21.20	41.37	0.49	205.70
1404 %	14	39	17	10	20	0.2	100
1405 Amount	99.25	65.92	7.28	71.75	26.58	2.33	273.11
1405 %	36	24	3	26	10	0.9	100
Total Amount	230.52	490.21	263.78	187.14	121.13	42.76	1335.54
Total %	17	37	20	14	9	3	100

Source: IDB Annual Reports, various issues.

Notes : (1) Agriculture and Agro-industry; (2) Industry and Mining;  
(3) Transport and Communications; (4) Utilities;  
(5) Science; (6) Others;  
(7) Total.

The agricultural sector comes in the 3rd place with an average share of 17% of the total ordinary operations financed fluctuating from 11% in 1396 to 3% in 1403 and to 36 % in 1405H, followed by the sector of utilities which includes financing dams for producing electricity

and generators for electric power necessary for the development of other sectors of the members' economies. This sector accounted for 14% of the total ordinary finance for the 10 year period and its annual share varied from 45% in 1396 to 5% in 1401 and to 26% in 1405H.

The social services sector includes the financing of hospitals, schools and the like, things that are very much needed especially in the least developed member countries where diseases, malnutrition and illiteracy are very widespread. This sector accounted for a share of 9% in the total ordinary finance of the period growing steadily from 5% in 1397 to 20% in 1404 then declining to 10% in 1405H.

#### 8.4.2 IDB Foreign Trade Financing Operations

As noted by the IDB 9th Annual Report for the year 1404H and by Nienhaus (1983:5), the general level of trade among Islamic countries is rather low and foreign trade of IDB member countries has the same general characteristics as the trade of developing countries as a whole. Among these characteristics is the domination by primary goods, complemented by a relatively smaller proportion of manufactured goods in their total exports. At the same time, there is a relatively high share of consumer and manufactured goods in their total imports and a high dependence on the markets of the industrial countries.

Available data on the foreign trade of 23 of IDB member countries whose share in the total of all IDB member countries for the year 1401H accounted for more than 75% in both export and import, reveal that the share of fuel and other primary goods was more than 90% of their total export, while the share of manufactured goods formed more than 65% of their total imports (see IDB 9th annual report 1984:40 and table 8.15).

Table 8.15 shows the structure of foreign trade of the 23 IDB member countries mentioned above and shows also that complementarity of the economies of these countries for co-operation and trade improvement is at too low a level to allow for rapid expansion in the flow of trade among them. However, the IDB, in addition to its ordinary project financing operations, started financing foreign trade operations for its



Table 8.15 Foreign Trade Structure of Some IDB Member Countries (in %)

EXPORTS							
	Fuels, Minerals & metals 1	Other Primary Commod. 2	Textiles and Clothing 3	Machinery Transport Equipment 4	Other Manuf. Goods 5	All Primary Commod. 1+2	All Manuf. Goods 3+4+5
Algeria	99	1	-	-	-	100	-
Bangladesh	-	32	56	1	11	32	68
Burkina Faso	-	85	2	6	7	85	15
Cameroon	33	64	1	-	2	97	3
Egypt	69	23	7	-	1	92	8
Indonesia	83	13	1	1	2	96	4
Jordan	33	24	6	2	35	57	43
Kuwait	84	1	1	5	9	85	15
Libya	100	-	-	-	-	100	-
Malaysia	36	44	3	12	5	80	20
Morocco	44	28	10	1	17	72	28
Niger	81	17	1	-	1	98	2
Oman	94	1	-	4	1	95	5
Pakistan	7	40	41	1	11	47	53
Saudi Arabia	99	-	-	-	1	99	1
Senegal	52	29	4	4	11	81	19
Somalia	5	94	-	-	1	99	1
Sudan	5	94	1	-	-	99	1
Syria	74	18	4	1	3	92	8
Tunisia	57	10	15	2	16	67	33
Turkey	7	56	19	4	14	63	37
Yemen AR	-	49	6	25	20	55	45
Yemen PDR	75	25	-	-	-	100	-
IMPORTS							
	Foods 1	Fish 2	Other Primary Commod. 3	Machinery Transport Equipment 4	Other Manuf. Goods 5	All Primary Commod. 1+2+3	All Manuf. Goods 4+5
Algeria	21	2	5	38	34	28	72
Bangladesh	20	8	11	21	40	39	61
Burkina Faso	25	16	3	24	32	44	56
Cameroon	9	12	2	34	43	23	77
Egypt	34	3	6	28	29	43	57
Indonesia	11	13	6	36	34	30	70
Jordan	17	17	3	33	30	37	63
Kuwait	14	1	2	41	42	17	83
Libya	18	1	2	38	41	21	79
Malaysia	13	17	5	37	28	35	65
Morocco	23	27	9	19	22	59	41
Niger	23	15	4	26	32	42	58
Oman	13	13	2	39	33	28	72
Pakistan	14	28	8	23	27	50	50
Saudi Arabia	14	1	2	40	43	17	83
Senegal	28	30	1	18	23	59	41
Somalia	33	1	4	35	27	38	62
Sudan	19	19	3	22	37	41	59
Syria	14	25	4	23	34	43	57
Tunisia	14	21	8	27	30	43	57
Turkey	3	44	6	22	25	53	47
Yemen AR	28	7	1	28	36	46	54
Yemen PDR	17	47	1	23	12	65	35

Source: The World Bank: World Development Report, 1984

Note : - stands for less than 0.5 per cent

members in 1397H to provide its member countries with facilities for obtaining essential commodities for their development programme and to assist them procuring the necessary new materials and capital goods needed by domestic industries. This facility serves for the bank as a short-term placement operation in conformity with Shariah. The difference between the purchase and the resale prices constitutes a source of income for the bank.

Because of the small size of the manufacturing sectors in these countries; their demand for manufactured goods is met primarily by imports from the industrial countries. Likewise their supply of fuel and raw materials depends mostly on the demand of the industrial countries for these goods and so the prospects of their economies depend too much on the changes that happen in the developed world.

This is clear from the effects of the recent world recession which affected the trade of LDCs in different magnitudes, with a particular adverse impact being made on the trade of the IDB member countries. The IDB 9th Annual Report (1984:42) states that: "Total world trade declined by 10% during the period 1980-1983 (1400-1403H). The estimated decline in the exports of developing countries and member countries was 15% and 33% respectively. Exports of oil and non oil member countries declined by the same percentage. The impact of this recession on the total imports of developing countries started in 1982, total imports were 12% less in 1983 than in 1981. The decline in the imports of non-oil member countries started in 1983, their total imports in that year were 23% less than in the preceding year" (see Table 8.16 which compares IDB member countries' total trade to that of the world and of the LDCs from 1978-1984). The share of IDB member countries in world trade declined steadily from 15% in 1980 to 14.5% in 1981, 12.2% in 1982, 11.2% in 1983 and 10.3% in 1984. The situation must be even worse after 1985 when the price of oil fell from US\$29 to about US\$15 a barrel.

In conclusion the foreign trade of the LDCs generally and of the IDB member countries in particular is highly dependent on the supply and demand conditions in the markets of the industrial world which has

Table 8.16 Total Member Countries' Trade as Compared to Total World and LDCs' Trade (1978-1984)

Groups	1978		1979		1980		1981		1982		1983		1984	
	Value	%	Value	%	Value	%	Value	%	Value	%	Value	%	Value	%
EXPORTS														
World Total	1203.2	-	1525.4	-	1867.3	-	1832.8	-	1702.1	-	1671.2	-	1776.2	-
LDCs Total	332.7	27.7	457.2	30.0	608.1	32.6	592.2	32.2	524.5	30.8	516.3	30.9	532.3	29.6
All Members	125.9	10.5	129.3	12.6	280.9	15.0	268.4	14.5	209.2	12.2	187.9	11.2	182.7	10.3
Oil Members	88.0	7.3	140.4	9.2	213.2	11.4	196.8	10.7	146.8	8.6	142.8	8.5	133.1	7.5
Non-Oil Members	37.9	3.2	51.9	3.4	67.7	3.6	69.6	3.8	62.4	3.6	45.1	2.7	49.6	2.8
IMPORTS														
World Total	1246.0	-	1568.0	-	1927.4	-	1906.7	-	1796.7	-	1740.4	-	1851.1	-
LDCs Total	343.9	27.6	410.4	26.2	536.4	27.9	587.9	30.6	557.6	31.0	519.1	29.8	519.0	28.0
All Members	100.1	6.0	119.8	7.6	147.7	7.7	183.3	9.6	195.1	10.9	182.2	10.5	172.3	9.3
Oil Members	49.2	3.9	61.4	3.9	78.5	4.1	93.8	4.9	102.0	5.7	110.2	6.3	92.8	5.0
Non-Oil Members	50.9	4.1	58.4	3.7	69.2	3.6	79.5	4.7	93.1	5.2	72.0	4.1	79.5	4.3

Source: IMF Direction of Trade Statistics Yearbook, 1983, 1984 and 1985

Notes: Exports in fob and imports in cif

Percentage figures are relative to total world trade

been adopting many restrictive measures and trade barriers against the flow of goods from the LDCs into their markets. Now unless the developing world in general including IDB member countries try to overcome the problems of the recession and of the restrictive measures adopted against them, by improving South-South trade and by starting effective co-operation among themselves in any grouping and on regional bases in all fields and especially in the field of trade, the problems of these countries will only worsen in the future if the existing circumstances continue to prevail. It is true, as Nienhaus (1983:5) argued that: "a policy of nothing but trade liberalisation cannot speed up the trade volumes within a short period of time as long as most exports of Islamic countries consist of agricultural products and raw materials while the complementary capacities in manufacturing industries are very limited or completely missing in the Muslim world". But something has to be done and so the necessity of co-operation and integration in all fields and especially in the field of industrialisation which should have the priority in the development policies of these countries so as to diversify their economies and be able to increase volumes of trade among themselves, thus at least, partially substituting trade with industrial countries and resisting the recession. In this respect, the IDB started FTF activities in 1397H in order to promote such co-operation and help its member countries import developmental commodities preferably from member countries, thereby encouraging the flow of trade between them.

During the period 1397-1405H the IDB approved 250 FTF operations amounting to ID3,379.1m (US\$3,790.49) for 29 of its members, with an average size of US\$14.77m each (see Table 8.17). The number of operations increased from 5 operations in 1397H to 47 operations in 1404H, then dropped to 38 operations in 1405H recording thus, an annual ARG of 41% and their corresponding amounts increased from US\$50.52m in 1397H to US\$748.22m in 1404H, then decreased to US\$659.4m in 1405H recording thus, an annual ARG of 49%.

Table 8.17 IDB Foreign Trade Financing Operations (1395-1404H)

Year	Number of Beneficiary Countries	Number of Operations	Amounts Approved in IDm	Approved in US\$m	% Change of the Number of Operations	% Change of the US\$ Amounts
1397	4	5	43.61	50.52	-	-
1398	9	14	127.44	155.82	180	208
1399	13	25	262.46	338.09	79	117
1400	19	33	352.86	459.99	32	36
1401	15	32	370.34	456.44	-3	-1
1402	12	29	379.68	424.70	-9	-7
1403	11	27	460.40	497.50	-7	17
1404	16	47	714.31	748.22	74	50
1405	13	38	668.21	659.40	-19	-12
Total	29	250	3,379.31	3,790.49	ARG=41	ARG=49

Source: IDB, Annual Reports, various issues.

The IDB' FTF represents about 70% of its total finance which means that nearly three quarters of its finance was in the form of FTF. This may perhaps be explained by the following: (1) FTF is the easiest form of finance to carry out, compared to the other forms adopted by the bank such as project financing since it does not require extensive evaluations of the operation as the other forms do. All it requires is the signing of agreements with the buyer and seller countries on the quantities and prices of the commodities to be financed and carrying on of the operation; (2) It is perhaps the most profitable form of finance with or after leasing operations for the bank, as compared to project financing, profit sharing or even equity participation because before financing a foreign trade operation the bank agrees with the buyer country on a mark up price which would, more or less assure, the bank of a return on its financing; (3) This mark up price is allowed in Islam since it is a profit out of trade Murabahah and not interest on loans. (4) Perhaps FTF is also the preferred form of finance to the beneficiary country, which, after receiving the commodity it need, is free from the bank supervision and following up in contrast to profit sharing for example, where the bank has the right to follow, supervise and even decide on where and how finance should be used; and (5) FTF also involves less staff and requires less time to carry out compared to other forms of finance adopted by the IDB.

Out of the 250 operations approved by the bank, 241 operations amounting to ID3,374.12m (US\$3,785.18m) were effectively carried out during the period 1397 to 1405H. Of these operations 212 operations amounting to ID2,682.74m (US\$3,103.67m) were between member countries representing 80% of the total amount. This means that the IDB is promoting trade among member countries which are all included in what is called the 'South' thus, promoting South-South trade.

As can be seen from table 8.18, the commodities financed by the bank include: crude oil, refined petroleum products, different types of fertilisers, materials of construction, phosphates, vegetable oil, jute products, cotton and other intermediate industrial goods; the most important commodity being crude oil, intermediate industrial goods and refined petroleum products representing altogether about 80% of the total FTF during the period under review.

Table 8.18 Breakdown of IDB FTF Operations by Commodity (in US\$ and %)

Product	Total since 1397	%
Crude oil	1,856.62	48.5
Refined petroleum products	411.30	11.1
Intermediate industrial goods	617.17	19.9
Fertilisers	114.93	3.4
Capital goods	10.40	-
Cement/construction materials	137.23	4.4
Bicycles	1.76	-
Jute and jute products	106.18	2.4
Cotton	72.30	2.0
Vegetable oil	281.50	5.4
Ammonia	24.00	0.7
Rock phosphate	28.34	0.8
Ore	19.00	0.6
Sun flower (seed)	15.00	0.5
Clinker	19.00	0.6
Others	21.76	0.7
<b>Total</b>	<b>3,790.49</b>	<b>100.0</b>

Source: IDB, Annual Reports, various issues.

Crude oil and petroleum products represent about 60% of the total FTF, this is because oil and petroleum products are the commodities that are the most available in some of the member countries and at the same time are the most demanded by the other member countries which do not have them. These commodities contribute the most of the intermember

trade financed by the bank. This very high percentage share of oil and petroleum products in the IDB total foreign trade operations should decline with time in favour of other commodities if the bank is to promote the least developed countries' commodity trade, to help them export more, thus gaining more foreign exchange which may improve their balance of payments and ease their foreign debts and therefore helping them getting better rates of growth.

#### 8.4.3 Special Assistance Operations

According to Resolution No. BG/14/99 of the Board of Governors of the IDB adopted at its Third Annual Meeting in 1399H, the financing of operations out of the special assistance account can be made for:

- 1 Training and research aimed at assisting and guiding member countries to re-orient their economic, financial and banking activities in conformity with Islamic Shariah through an institute set up in Jeddah (Saudi Arabia);
- 2 The provision of relief in the form of necessary goods and services to member countries and Islamic communities affected by natural disasters;
- 3 The provision of financial assistance to member countries for the promotion and furtherance of Islamic causes.

According to the IDB 8th Annual Report: "The special assistance account is funded from the net proceeds derived from its deposits with financial institutions operating in the international financial markets through allocations made by the Board of Executive Directors". No other source of finance is mentioned which means that the resources of this fund are very much limited and not sufficient to cope with the need of the least developed IDB member countries which represent more than a third of the total member populations and which are very much affected by drought, malnutrition, diseases etc., in Sub-Saharan Africa and by floods and other social and economic handicaps as in Bangladesh. Therefore, the need for raising the sources of funds of the special assistance account through the collection of donations, Zakat, or any other lawful means, is necessary.

From 1400H, the date of commencement of this form of finance, to 1405H, the bank financed 57 special assistance operations amounting to ID158.16m (US\$163.68m) for the benefit of various member countries and Muslim communities in non member countries (29 in member countries and 28 Muslim communities in non member countries). In other words, the IDB

financed on average 9.5 operations per year, amounting to ID2.77m (US\$2.87m) each. These operations include contribution to finance a feasibility study for earthquake early warning systems in Algeria, grants for construction of schools for Muslim communities in Vietnam, Kampochea, Eritheria, Yemen AR, South Africa, Sri Lanka, India, Zambia, Philippines, etc.. These operations also include assistance to drought and flood affected areas, like Sub-Saharan Africa and Bangladesh, grants for building hospitals and for constructing nursing schools, clinics, mosques and orphanages for Muslim communities both in member and non-member countries where these are most needed.

The Islamic Research and Training Institute (IRTI) has already been set up and is expanding and strengthening its organisational structure and continuing its research and training activities but no information is given by the Bank in its annual reports on how this is financed, or by how much or whether this is financed out of the special assistance account or is self-financed. At present, IRTI is composed of 3 divisions: (1) Research, (2) Training and (3) Administration and Finance. The research division of IRTI carries out various internal and external research activities, focusing on Islamic economics, Islamic jurisprudence and economic co-operation among IDB member countries. The training division provides training facilities in Islamic economics and banking to its staff with the co-operation of other financial institutions and to personnel engaged in development activities in Shariah observing institutions. The training includes seminars and courses in economic, legal and administrative spheres and financial analysis. Furthermore, the IDB also accords special attention to the building up of its library to enable it to perform its role in the collection of information and statistical data related to economics, finance, business, development, banks, etc.. By the end of 1404H and according to the IDB 9th Annual Report, the library acquired the following:

- 1 about 2,000 reports and studies on member countries;
- 2 10,224 books and reference materials in Arabic, English and French languages;
- 3 798 journals and magazines in the three languages;
- 4 1,950 publications released by international agencies.



The bank has also prepared a study for a microfilm and microfiche system to copy all relevant documents and reports and is striving to obtain from the competent authorities of member countries, reports, statistical information and studies on the economic development, so that it will have a better picture on the needs of each member country and be able to assess their priorities.

Since 1403H, the IDB has also been actively involved in arranging and distributing the sacrificial meat which the pilgrims offer every year during the pilgrimage season and of which a great proportion of the hundreds of thousands of sheep slaughtered at Mina (Saudi Arabia) every year, used to be wasted creating problems of health, pollution and disposal of carcasses. Table 8.19 shows how the IDB has managed in the 3 years (1403-1405H) to distribute more than half a million sheep to the poor and needy refugees of Africa, Bangladesh, Palestine and Afghanistan, thus helping to solve and ease the problems of famine and hunger of these people on one hand and the problems of sacrificial meat on the other. The bank's role lies in the recruitment of the required number of slaughterers, veterinarians and other staff and arranging the distribution of the sacrificial meat. It utilised the services of a number of butchers and veterinaries together with the voluntary participation of its own staff and of boy scouts for carrying out the mission.

Table 8.19 The IDB Distribution of Sacrificial Meat (1403-1405)

Country/operation	1403		1404		1405		Total	
	No.	%	No.	%	No.	%	No.	%
Bangladesh	-	-	44,111	24	66,891	22	111,002	20
Palestine	-	-	42,429	23	40,960	13	83,389	15
Afghanistan	23,243	39	25,478	14	30,667	10	79,388	14
Djibouti	15,830	27	10,000	5	17,000	6	42,830	8
Sudan	15,771	26	-	-	-	-	15,771	3
Chad	-	-	5,335	3	7,080	2	12,415	2
Yemen AR	-	-	16,100	9	-	-	16,100	3
Mauritania	-	-	-	-	6,780	2	6,780	1
Mali	-	-	-	-	5,190	2	5,190	1
Burkina Faso	-	-	-	-	5,890	2	5,890	1
Saudi Arabia	5,000	8	42,742	22	126,808	41	174,305	32
<b>Total</b>	<b>59,844</b>	<b>100</b>	<b>186,195</b>	<b>100</b>	<b>307,266</b>	<b>100</b>	<b>553,305</b>	<b>100</b>
% Change	-	-	211%	-	65%	-	-	-

Source: IDB 10th Annual Report for 1405H

The estimated cost, according to the IDB 10th Annual Report, on executing the programme was US\$7.36m of which the pilgrims contribution was US\$6.41m and the balance of US\$0.95m was contributed by IDB. Saudi Gazette (27/6/1989) reported that the IDB utilised more than 350,000 heads in 1406H, more than 478,000 in 1407 and more than 473,000 in 1408 and is planning to utilise about 500,000 heads in 1409H, thus making use of more than 2,350,000 heads in 7 years.

## 8.5 CONCLUSION

However impressive may be the performance of the IDB in view of some, it seems to me that its task is still far from complete, and though its operations, run into millions of dollars, they are still not sufficient to cause any significant change in the economic situation of its 43 members all of which are less developed countries and most of them are among the world's least developed countries. This is not to suggest that the bank is not doing well but only that during its short existence, it has created an impact less than expected from a bank operating at the International level and serving 43 member countries. This may be due to its limited financial resources which need to be raised, or to the lack of experience in the kind of operations it implements in diverse socio-economic settings or to the shortness of its life time. Presley (1988a:51) pointed out that: "ten years is not a long time in the life of an international institution in dealing with development finance. This is really a short period for the institution to make its mark, more so where, as in the case of the IDB, it has no precedent to follow and no analogous institution from which to learn". Nevertheless, as Mannan (1984:469) put it: "The IDB represents a significant milestone towards achieving the goals of Islamic economics in member countries and towards achieving economic development conform to Shariah". In spite of operating in an environment where there are still no capital or money markets dealing in Islamically acceptable financial instruments, it managed not only to carry out its operations without recourse to interest which is prohibited by Shariah but mobilised quite substantial deposits and made quite good profits.

In order to make its mark in contributing to the the welfare and development of its member countries, the IDB should give priority to 'multinational projects' which benefit several member countries at the same time, such as telecommunication, transport links, joint production and/or distribution of electric power, irrigation, etc., A special preference should also be accorded to the least developed member countries. Technical assistance in the field of management, project identification, preparation and evaluation may be provided freely to these countries, if circumstances permit. To do this the bank needs to mobilise more financial resources for all its different funds. Now the IDB has well established its facilities like the IRTI and computer, and acquired more information on its member countries economies and their needs and more experience, it should be able to undertake more financial operations on a profit sharing basis than it has done up to now. Furthermore, the IDB is also expected as Mannan (1984:405) suggests: "To assume the entrepreneurial role in due course of time in trade and industry particularly in countries where necessary infrastructure facilities are lacking. The bank's involvement in joint ventures may not be based merely on equity participation and consequent profit sharing, but also on the basis of assumptions of controlling interest in the venture. It goes without saying that this type of venture is to be undertaken on the basis of comparative cost advantage and/or proper market research".

This would also help increase the so-called 'absorptive capacity' of its member countries and develop the lacking industries. The IDB should last but not least establish subsidiary companies that can specialise in carrying out the diversified forms of finance in the different sectors of its member countries. This would enable the bank to raise its financial resources on one hand and finance more projects on the other. It also eases the task of the bank and probably makes it more efficient, though this may be very costly in its first phase.

## CHAPTER NINE

### PERFORMANCE OF KUWAIT FINANCE HOUSE (KFH)

#### 9.1 INTRODUCTION

KFH is the second oldest surviving Islamic commercial bank to be established in the world after Dubai Islamic Bank (DIB). It has just completed 10 years of activity. Nevertheless, its success and the success of DIB to mobilise substantial deposits and to make good profits in their first few years encouraged other Muslim businessmen to open Islamic banks in their respective countries, thus giving them the green light that Islamic banking is a workable and feasible formula to do banking at least in the Muslim World. This led to a greater confidence that led in turn to the establishment of other Islamic banks elsewhere such as JIB (Jordan Islamic Bank), FIBE (Faisal Islamic Bank of Egypt), FIBS (Faisal Islamic Bank of Sudan), BIB (Bahrain Islamic Bank), etc..

The purpose of this chapter is to compare the performance of KFH to that of the oldest and largest commercial interest based bank in Kuwait, the National Bank of Kuwait (NBK), to Other Commercial Banks (OCB that is the KBS excluding KFH and NBK) and to the Kuwaiti Banking System (KBS) as a whole for the period 1978-87. But before doing this, it is perhaps very important to give an overview on the Kuwaiti economy and the Kuwaiti Banking System, where these banks operate.

#### 9.2 THE KUWAITI ECONOMY: AN OVERVIEW

Kuwait is a tiny country in the Gulf with only 17,818 sq. km and a population of about 1.8m in 1987 of which only 36.8% are Kuwaitis and the remaining 63.2% are foreigners. Kuwait is bounded on the West and the North by Iraq, on the East by the Gulf and on the South by Saudi Arabia. It is mainly a desert except for Al-Jahrah Oasis and a few fertile patches in the South Eastern and Coastal areas.

Before 1946, Kuwait's traditional activities were mainly trading, pearling, seafaring and fishing. As for the emergence of its modern economy, this goes back to 1946 when, the first oil shipment was exported.

since then, as Khouja and Sadler (1979:25) reported: "the country's growth has largely mirrored the smooth and swift exploitation of its vast oil reserves. Within a span of no more than 15 years its population came to enjoy living standards normally considered the prerogative of the most developed among the industrialised countries".

The pattern of growth, Kuwait has experienced since 1946, the development of its infrastructure, institutions and the welfare system that has evolved are unparalleled. But the problem is that most if not all of these developments depended and still depend on oil which contributes more than 95% to its foreign exchange earnings, 90% to the government revenue and about 60% to its GDP.

According to OPEC Bulletin (September 1982), the estimates of Kuwait's oil reserves in the 1980s varied between 65,000m and 81,000m barrels, sufficient to allow for production to continue at the present rate for the next 100 years. Though its oil revenues are huge and its population relatively small, Kuwait is nevertheless acutely aware of its heavy reliance on a single resource with the risk that when oil runs out or is replaced by a cheaper source of energy, there will be no alternative to fall back on. For this reason the economic and political planners of Kuwait concentrate on several main issues. The first is how to diversify the economy away from depending on one resource (oil) and to make plans for further improvement in the standard of living. The other main issue is how to strike a political equilibrium internally and regionally. In 1976, a reserve fund was set up to take care of future generations. "After a large initial funding by the government this fund is now fed with an annual 10% of the state's oil revenues, and there is a statutory requirement that its assets cannot be touched for 25 years" (Boudjellal 1982:93). By 1986, about KD14.3bn (US\$51bn) were held in this fund (see NBK annual report 1988:11).

The need to diversify sources of income and develop new productive activity is self-evident for Kuwait which depends on a single exhaustible resource because apart from oil, there is scarcely any other usable natural resource in Kuwait, at least none that is known. There are no other minerals than oil, and even the large expanses of sand, being

very solid, are not economically exploitable. The soil is very poor and fresh water is almost non-existent, thus, the possibilities of agricultural development are severely limited. Only about 3% of the land is at all arable and owing to the scarcity of water, deficiencies of soil and lack of manpower trained in agricultural skills, barely 1% of the land area is under actual cultivation (Encyclopedia Britannica 1974:549). Together with fishing, agriculture contributes only 0.2% to the GDP of the country. Fish are plentiful in the Gulf and fishing is probably going to assume more importance in the future of the economy and to play a significant role in its diversification.

For a desert country like Kuwait, where there had been an ever present need for water it was only natural to give top priority to solving this acute problem. In earlier days people depended on a few artesian wells, or rainwater collected from the roofs of houses and on irregular supply from Shatt-El-Arab by boat. The supplied water was very expensive and often contaminated. With the rapid growth of population which increased almost twenty fold over a period of about 40 years from an estimated 90,000 people in 1946 to approximately 1.8m by 1985 due mainly to the influx of expatriate workers from other countries, who came, after the discovery of oil, to work in the construction of the country's infrastructure, the government of Kuwait built the first sea-water distillation plant in 1953 with a designed capacity of almost a million gallons per day of potable water from the sea. According to Khouja and Sadler (1979:29): "the supply of water has continued to enjoy the highest priority in all government plans. The growth of this activity is truly phenomenal, production increased from about 250m gallons in 1957 to 2.2bn in 1964 and 6.6bn by 1970. Kuwait's production of desalinated water is the highest in the world reaching in 1978 a capacity of 102m gallons a day".

The expansion of electric facilities has also been remarkable due mainly to the introduction of desalination plants which paved the way for the development of the country's power sector. The power generating capacity of the country increased phenomenally from 2.5m watts in the

early 1950s to 150m watts in 1962, to over 500m watts in 1967 and a staggering production of 12,016m watts in 1982 (see Khouja and Sadler 1979:29 and Encyclopedia Britannica Yearbook 1985:720).

Since 1946, the Kuwaiti government has been assuming a paternal attitude towards its population and has been responsible for the creation of the welfare state system. Its aim, as Boudjellal (1982:86) pointed out: "has been to give its citizens all they require in basic needs via a comprehensive and entirely free social security system, while providing the financial liquidity and the opportunities for more substantial acquisition of wealth". Today, as described by Encyclopedia Britannica (1974:549): "there has been a comprehensive scheme of social welfare covering most of the misfortunes that might befall Kuwaiti citizens. For the needy there is financial assistance, for the handicapped there are loans to start a profitable business, for the invalid and deformed there are treatment and training, for the adult illiterates there is education and for those of limited income there is comfortable housing. General education in Kuwait is entirely free and includes not only tuition but also school meals, books, uniforms, transportation and medical attention". All these services are financed almost exclusively from government oil revenues rather than from the usual sources of taxation. But recently and with the sharp drop in oil prices from US\$30 a barrel in the 1970s to around US\$15 a barrel in the 1980s, these services are very much likely to be hard hit or most probably cut unless the government starts collecting taxes, borrows or the price of oil improves. In fact, as the NBK (1988:11) reported: "the council of ministers approved in September 1987 legislation enabling the government to launch a public debt program to the tune of KD1,400 million in a move aimed at providing partial funding to the budget deficit as much as introducing more flexibility in the money market and financial system".

Reflecting the deterioration in the world oil market conditions, Kuwait's GDP registered negative growth rates in 1981 and 1982 of -9.5% and -11% respectively, and although it recovered by 7% in 1983, it went down again by -6.3% in 1984, -7.9% in 1985 and -15.6% in 1986 (see Table 9.1 showing the development of Kuwait GDP between 1980 and 1986).

Table 9.1 Kuwaiti Gross Domestic Product between 1980 and 1984 (in KD million and in %)

	1980		1981		1982		1983		1984		
	Value	Share Growth	Value	Share Growth	Value	Share Growth	Value	Share Growth	Value	Share Growth	
Oil sector	5059	67.9	4118	61.1	2806	46.8	3086	48.1	2902	48.3	-6.0
Industry	464	6.2	370	5.5	430	7.2	471	7.3	533	8.8	13.2
Construction	220	3.0	263	3.9	283	4.7	289	4.5	318	5.3	10.0
Agriculture and fishing	17	0.2	28	0.4	31	0.5	34	0.5	37	0.6	8.8
Transp. & communications	124	1.7	146	2.2	174	2.9	193	3.0	221	3.7	14.5
Trade	449	6.0	485	7.2	669	11.2	607	9.5	211	3.5	-65.2
Financial institutions	184	2.5	232	3.4	288	4.8	319	5.0	332	6.0	4.1
Others	930	12.5	1097	16.3	1317	22.0	1416	22.1	1455	24.2	2.8
Total \ Average	9447	100.0	6739	100.0	5998	100.0	6415	100.0	6009	100.0	-6.3

Source: NBS Economic Bulletin, Various issues.



It is clear from the Table that almost all the sectors of the economy have been adversely affected because of the oil crisis.

Arabia (June 1984) reported that the fall in government resources has been followed by a cut in the budget and with the retreat of investment allocations in budgets, various methods have been developed to reduce foreign labour. Many sectors have already stopped importing new foreign labour and have initiated a comprehensive review of their foreign labour policies. Decisions made to control expenditure included:

- Elimination of state subsidies on basic commodities
- Reconsideration of free services, especially for foreigners.
- Reduction of loans to Third World countries.

Add to this the financial crisis that hit the Kuwaiti financial sector in 1982 after the collapse of Souq El-Manakh, the unofficial stock exchange, which according to Stoneman (1986:102): "behaved in a bizarre fashion by European standards. New issues were oversubscribed 100 times as vast sums of capital pursued relatively few securities. Security was largely a question of names and not of prospects... The government was unable to unravel the knot when the Manakh fell in a welter of US\$94bn of complex transactions largely backed by postdated cheques, the Manakh crisis sent shock waves through the financial community. In 1984 the profits of the commercial banks fell for the first time in ten years".

During the period under review, and as Lascelles (1985:45) noticed: "the destabilising exogenous factors of the Iraq-Iran war and the international recession continued to exert themselves on the local scene, building up a negative psychology and a moode of hesitancy in the business circles, and to create an atmosphere of gloom that brought about a slump in share prices and property values and has undermined confidence in Kuwait's investment community".

It is against this background of political and economic circumstances that the performance of the Kuwait Finance House (KFH), the Islamic Bank in Kuwait, should be judged in comparison to the NBK, OCB and KBS.

### 9.3 THE KUWAITI BANKING SYSTEM

Prior to 1952 year of the establishment of the first Kuwaiti commercial bank, the National Bank of Kuwait (NBK), there was no bank in

Kuwait except a branch of the British Bank of the Middle East which was opened in 1941 and which was replaced in 1971 by the Bank of Kuwait and the Middle East. However, according to Sabbagh (1981:57): "Kuwait's present banking system traces its origin to the early 1800s when the Kuwaiti sailors sailed to the sea-ports of India and East Africa, handling much of the Gulf region's trade estimated then at around US\$4.5m per year... It was these merchant families which provided the social, economic and political leadership and which founded the first Kuwaiti Bank in 1952, the National Bank of Kuwait".

The NBK was established in 1952 with a capital of KD982,500. After ten years, its paid up capital was raised to KD1.96m then kept rising to reach together with reserves KD234.78m in 1987. It has more than 50 branches within Kuwait and overseas. It is the largest bank in Kuwait with total assets exceeding KD2,935m in 1987 and ranks 10th among the top 100 Arab banks (see The Banker, December 1987:65)

Two more Kuwaiti banks were established in 1960, about a year before the independence, these are the Commercial Bank of Kuwait and the Gulf Bank. But the Kuwait monetary system did not become fully independent until the Currency Board was established and the Kuwaiti Dinar (KD) was put into circulation on the 1st April 1961, replacing the Indian Rupee that was the circulating currency throughout the Gulf area. The Currency Board was replaced in 1968 by the Central Bank of Kuwait (CBK). Now KBS is made-up of eight banks: the National Bank of Kuwait (1952), the Commercial Bank of Kuwait (1960), the Gulf Bank (1960), El-Ahli Bank (1967), Bank of Kuwait and the Middle East (1971), Kuwait Real Estate Bank (1972), Burgan Bank (1975), and Kuwait Finance House (the Islamic Bank established in 1977). The KBS is heavily over-banked with more than 200 branches in 1987.

Unlike the other Gulf states where foreign banks are allowed to operate, the expansion of the banking system in Kuwait has come about through local initiative due mainly to the private sector's entrepreneurial ability and traditional interest in the field of finance being greatly enhanced by the substantial wealth acquired through government

policy. This included banning the operation of foreign banks on its soil and concentrating on developing large and powerful national financial institutions which will handle the placing and investment of its own enormous funds abroad and will be able to stand by themselves as a major force in the international market. The result has been the emergence of the present financial system which is considered by far the largest and most developed in the region and which has, according to Khouja and Sadler (1979:164), the potential to evolve into one of the world's most important financial centres. Although these banks are all independent commercial banks, the government has acquired a significant stake in the banking industry through its recent operations to prop up the stock market. This interest ranges from as little as 3% in the NBK to as much as 60% in Burgan Bank (see Lascelles 1985:41).

As in other Gulf countries, the KBS has had a remarkable expansion record since 1970 both in terms of assets and deposits as a result of the oil boom in the 1970s, but with the sharp drop in oil prices in the 1980s, the repercussion of the Gulf war and the collapse of Souq El-Manakh, "the Kuwaiti banking has lost its fizz" (J. Wilson, 1984:105).

As can be seen from Table 9.2 below, which shows the consolidated balance sheets of the KBS between 1972 and 1985, the banking sector recorded a substantial and unprecedented fall in total assets. The overall decline was almost entirely the result of a fall in total deposits. Notice for example the rates of growth of total assets, they used to be more than 20% every year and in 1976 and 1977 they even reached the rate of more than 41% while after 1982 they dropped to 9.3%, -4.2% and -7.9% for the years 1983, 1984 and 1985 respectively. The same trend can be seen for other items of the balance sheets such as total deposits, claims on the private sector, foreign assets, etc..

The question, however, remains: will the situation change for the better or will it worsen?. Experts and financial executives believe that the return of confidence in Kuwait is going to be a very long slow process and notably will only start with the ending of the Iran-Iraq war and the improvement of oil prices.

Table 9.2 Consolidated Balance Sheets of the Commercial Banks in Kuwait for 1973-85 (in KD m) and their Growth (in %)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Liquid Assets	26.9 (94.9)	58.0 (115.6)	67.2 (15.9)	92.4 (37.5)	270.9 (193.2)	122.7 (-54.7)	143.3 (16.8)	221.7 (54.7)	321.6 (45.1)	626.0 (94.7)	372.5 (-47.7)	323.0 (-13.3)	329.9 (2.1)
Foreign Assets	479.1 (-6.7)	561.4 (17.2)	616.1 (9.7)	674.9 (9.5)	823.2 (22.0)	1214.2 (47.5)	1407.5 (15.9)	1880.0 (33.6)	2245.4 (19.4)	2251.0 (0.3)	2301.2 (2.2)	2507.6 (9.0)	2232.5 (-11.0)
Total Finance	266.3 (42.1)	361.9 (35.9)	506.7 (40.0)	934.3 (84.4)	1238.5 (32.6)	1559.4 (25.9)	2119.3 (35.9)	2671.7 (26.9)	3453.6 (29.3)	4292.5 (24.3)	4752.6 (10.7)	5035.8 (6.0)	5049.8 (0.3)
Other Assets	31.1 (41.4)	56.3 (81.0)	110.7 (96.6)	131.4 (18.7)	262.1 (99.5)	382.2 (45.8)	621.8 (62.7)	876.0 (40.9)	1587.4 (80.2)	1967.9 (24.7)	2567.9 (30.5)	1703.8 (-33.7)	1215.4 (-27.8)
Total Assets	803.4 (9.1)	1037.6 (29.2)	1300.7 (25.4)	1839.0 (41.4)	2594.7 (41.1)	3278.5 (26.4)	4291.9 (30.9)	5649.1 (31.6)	7599.0 (34.5)	9146.2 (20.4)	9994.2 (9.3)	9597.7 (-4.2)	8827.5 (-7.9)
Priv. deposits	500.8 (7.3)	638.9 (27.6)	789.5 (23.6)	1091.2 (38.2)	1432.4 (31.3)	1773.3 (23.8)	2073.8 (17.0)	2606.2 (25.7)	3583.0 (37.5)	3840.1 (7.2)	4027.2 (4.9)	4150.7 (3.1)	4108.9 (-1.0)
Gov. deposits	50.7 (-18.9)	73.2 (44.4)	87.3 (19.3)	71.0 (-18.7)	114.9 (61.8)	99.3 (-13.6)	139.9 (40.9)	171.3 (22.4)	211.0 (23.2)	393.8 (86.6)	362.4 (-8.0)	387.8 (7.0)	385.5 (-0.6)
Foreign liab.	136.1 (31.4)	143.4 (5.4)	169.0 (17.9)	324.1 (91.8)	419.8 (29.5)	601.5 (43.3)	803.9 (33.6)	1134.3 (41.1)	1264.1 (11.4)	1526.5 (20.8)	1550.4 (1.6)	1560.7 (0.7)	1358.8 (-12.9)
Capital and Res.	45.5 (11.5)	51.0 (12.1)	63.8 (25.1)	89.2 (39.8)	197.4 (121.3)	218.4 (10.6)	268.6 (23.0)	336.9 (25.4)	411.0 (22.0)	576.9 (40.4)	664.4 (15.2)	823.3 (23.9)	837.6 (1.0)
Other liab.	70.3 (11.2)	131.1 (86.5)	191.1 (45.8)	263.5 (37.9)	430.2 (63.3)	586.0 (36.2)	1005.7 (71.6)	1400.4 (39.2)	2129.8 (52.1)	2809.0 (31.9)	3389.9 (20.7)	2683.1 (-20.9)	2142.7 (-20.1)
Total Liab.	803.4 (9.1)	1037.6 (29.2)	1300.7 (25.4)	1839.0 (41.4)	2594.7 (41.1)	3278.5 (26.4)	4291.9 (30.9)	5649.1 (31.6)	7599.0 (34.5)	9146.2 (20.4)	9994.2 (9.3)	9579.7 (-4.2)	8827.5 (-7.2)

Sources: NBK Economic Bulletin, various issues  
IMF International Financial Statistics Yearbook, 1987

## 9.4 PERFORMANCE OF KFH AS COMPARED TO NBK, OCB AND KBS

### 9.4.1 Establishment, Objectives and Operation of KFH

KFH was established on 23rd March 1977, as an Islamic institution for banking and investment. It began its operations on 31st August 1978 thus it has just completed 10 years old. Now it is the largest Islamic financial institution among Arab banks. It is a Kuwaiti shareholding company founded by the Ministry of Awqaf and Islamic Affairs, the Ministry of Finance and the Ministry of Justice holding together between them 49% of the institution's shares and the remainder 51% was left to the general public. The objectives of KFH, as described by article 5 of the Memorandum of Agreement, are:

- 1 To conduct all banking operations and services, whether for its own account or third parties, without practicing usury.
- 2 To carry out direct investment, or purchase finance projects or activities owned by others, on non usurious basis.
- 3 May co-operate with other organisations which engage in activities similar to its own, or which may assist it to achieve its own objectives. The company may further participate in such organisations, or associate with them in one way or another through agency or procuration or integration and may join any consortium recognised by law or by custom, covering holding, subsidiary or associated companies and corporations.

With respect to its banking services and operations, KFH may, according to article 6 of its Memorandum of Agreement:

- 1 Receive various types of cash deposits, either for safe custody or for conditional or unconditional reinvestment, provided that this shall be on non-usurious basis.
- 2 Purchase and sell gold bullion, acquire foreign exchange and sell or purchase drafts in such exchange.
- 3 Provide short term financing against collateral in the form of commercial papers and at an agreed commercial yield not involving Riba.
- 4 Open letters of credit and provide banking credit facilities. with or without security.
- 5 Issue guarantees in favour of third parties.
- 6 Collect the value of drafts, promissory notes, cheques, bills of exchange and all other instruments against commission for the account of permanent customers and other parties.
- 7 Receive subscription payments related to establishment of new shareholding companies or capital increases.
- 8 Purchase and sell shares, certificates of investment and similar financial papers either for its own account or for the account of other parties (on non usurious basis).
- 9 Safe-keep all kinds of currencies, precious metals, jewellery, documents and packages, and rent safes for private use.
- 10 Act as depository agent, accept agencies and appoint agents.

Concerning its depository function, the KFH offers 3 kinds of deposit accounts with 5 choices in the following way:

#### **(a) Current Accounts**

The client can deposit or withdraw any amount he wishes from his account at any time. The credit balance is a demand or call deposit and the client is neither entitled to any profit nor is he liable to bear any loss. These deposits are guaranteed and KFH commits itself to pay in full the credit balance of such accounts on demand. The depositor is supplied with a cheque book, cash book and cheque deposit book. A statement of the account is sent to him quarterly, unless otherwise there are special arrangements in this respect. Recently KFH issued cheque card and visa credit cards for its customers.

#### **(b) Savings Accounts**

Two possibilities are open to the clients: saving accounts with or without authority for investment. The former shares in the profits and losses of the bank but the latter not. In case a saving account without the authorisation for investment is opened, the current account provision of neither getting profit nor bearing losses applies except that depositors are furnished with a savings account book only. As for the saving accounts with authorisation for investment, the return (profit or loss) is calculated on the lowest monthly balance. The profit is paid and the loss deducted periodically as determined by the administration. The client may deposit and withdraw any amount he wishes in or from his account. He is supplied with a saving account book, showing the account's movements and balances after his initial deposit which should not be less than one Kuwaiti Dinar.

#### **(c) Investment Accounts**

Two possibilities are again open here to the clients: fixed time investment deposit, the minimum period of which, is one year renewable at the depositor's wish on the due date and open time investment deposit the minimum period of which is one year renewable automatically for the same period unless the client notifies KFH to the contrary in writing at least 3 months before the due date. The client in both cases is supplied with a certificate of deposit in the name of the beneficiary of deposited amounts after depositing a minimum of KD1000. The depositor or the beneficiary or whoever has the right to withdraw, cannot with-

draw any part of the deposit before the due dates. The investment of the deposit is carried out on the basis of absolute Mudharabah and KFH has a free hand to invest in the way seen proper for realising the mutual advantages. The return (profit/loss) on the deposit will be paid or deducted periodically as determined by the administration of KFH.

In general, it may carry out all banking operations and services as well as other operations permissible by law, regulations and statutes observed by banks, on condition that such operations shall not be usurious. Thus, one can say that KFH is not a finance house that deals in consumer credit as its name may suggest, but is more than an ordinary bank, an investment company or a building society. We can safely qualify it as an Islamic Multipurpose Financial Institution.

#### 9.4.2 Performance in Terms of Capital and Reserves (K&R)

The initial authorised capital of KFH was fixed at KD10m (US\$36m) divided in 10m shares of 1KD each to be paid in cash and subscribed as follows: 49% for the government (20% for the Ministry of Finance, 20% for the Ministry of Justice and 9% for the Ministry of Awqaf and Islamic affairs) and 51% for the general public.

According to article 9 of the Articles of Association, the shares of KFH shall be nominal and shall not be owned by non-Kuwaitis. KFH authorised capital was raised up to KD15m (US\$54m) in 1982, to KD18.75m (US\$67.5m) in 1983 and to KD20.65m (US\$75m) in 1986. As for the paid up capital and reserves (K&R), see Tables 9.3 which compares the growth of KFH's K&R to those of the NBK, OCB and KBS in current and constant prices for the period 1978-87 and for a clearer picture see figure 9.1 exhibiting the relative development of the K&R of KFH as compared to those of the NBK, OCB and KBS in the form of indices in current and constant prices, taking 1980 as a base year.

It is quite clear from Table 9.3 that, although KFH started from a very small base, its K&R in current prices increased from KD2.81m in 1978 to KD42.61m in 1987, recording a rise of more than 15 fold at an annual ARG of about 49%, while for the same period the NBK, the largest and oldest bank in Kuwait recorded less than 4 fold rise from KD62.75m

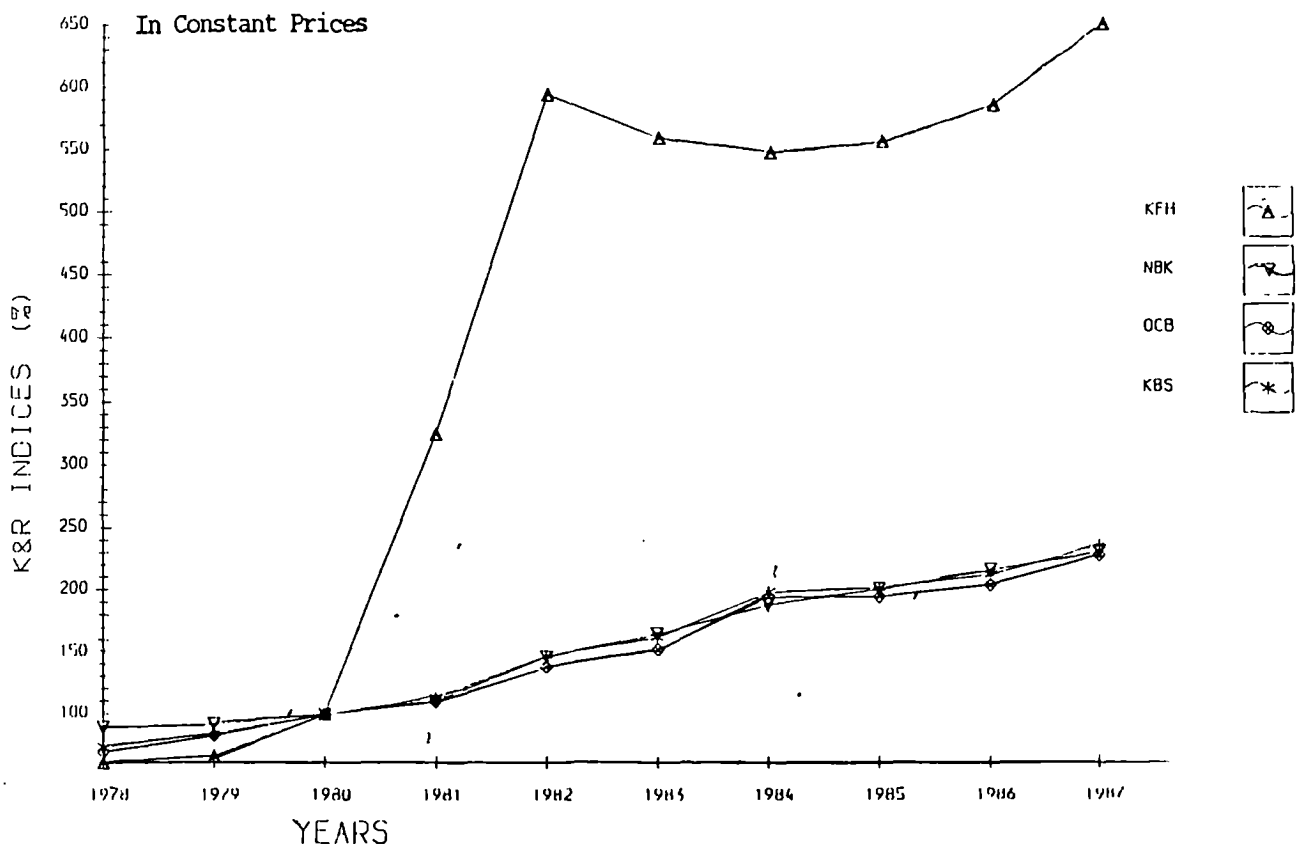
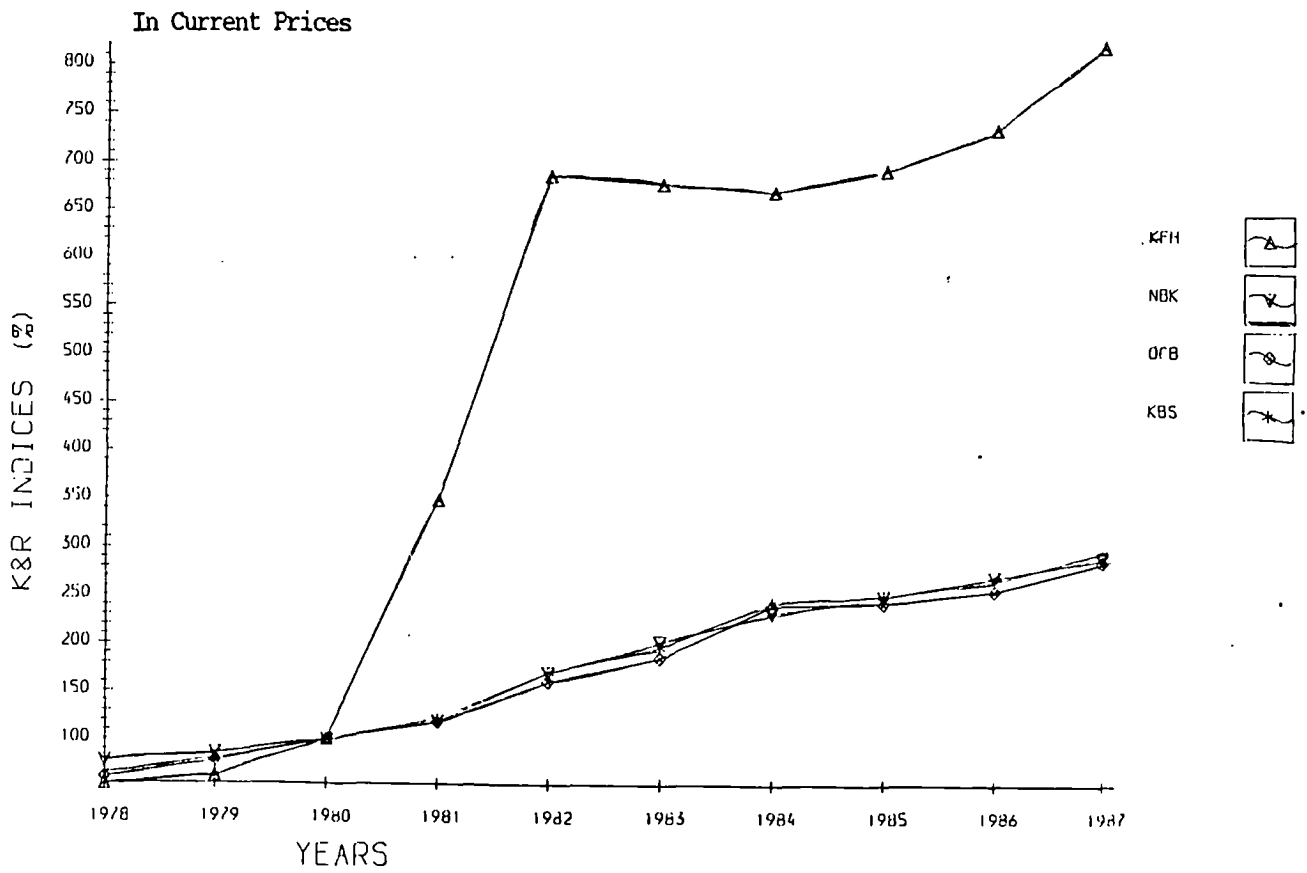
Table 9.3 Comparative Analysis of the K&R of KFH, NBK, OCB and KBS (in KD million and in Percentages)

	KFH			NBK			OCB			KBS		
	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth
In Current Prices												
1978	2.81	54	-	62.75	78	-	152.84	61	-	218.40	65	-
1979	3.25	63	15.7	69.74	86	11.1	195.61	78	28.0	268.60	80	23.0
1980	5.18	100	59.4	80.68	100	15.8	251.04	100	28.3	336.90	100	25.4
1981	18.09	349	249.2	96.33	119	19.4	296.58	118	18.1	411.00	122	22.0
1982	35.63	688	97.0	136.90	170	42.1	404.37	161	36.3	576.90	171	40.4
1983	35.18	679	-1.3	162.78	202	18.9	466.44	186	15.3	664.40	197	15.2
1984	34.77	671	-1.2	187.17	232	15.0	601.36	240	28.9	823.30	244	23.9
1985	35.90	693	3.3	201.32	250	7.6	609.38	243	1.3	846.60	251	2.8
1986	38.14	736	6.2	218.85	271	8.7	641.81	256	5.3	898.80	267	6.2
1987	42.61	823	11.7	234.78	291	7.3	721.71	287	12.5	999.10	297	11.1
Average Growth			48.9			16.2			19.3			18.9
In Constant Prices												
1978	3.22	62	-	71.80	89	-	174.78	70	-	249.89	74	-
1979	3.48	67	8.1	74.59	92	3.9	209.21	83	19.6	287.28	85	15.0
1980	5.18	100	48.9	80.68	100	8.2	251.04	100	20.0	336.90	100	17.3
1981	16.84	325	225.1	89.69	111	11.2	267.15	110	10.0	382.68	114	13.6
1982	30.80	595	82.3	118.32	147	31.9	349.50	139	26.6	498.62	148	30.3
1983	29.03	560	-5.7	134.31	166	13.5	384.85	153	10.1	548.19	163	9.9
1984	28.36	548	-2.3	152.67	189	13.7	490.51	195	27.5	671.54	199	22.5
1985	28.86	557	1.8	161.83	201	6.0	487.87	195	-0.1	680.56	202	1.3
1986	30.37	586	5.2	174.24	216	7.7	511.00	204	4.3	715.61	212	5.2
1987	33.71	651	9.9	185.74	230	6.6	570.98	227	11.7	790.43	235	10.5
Average Growth			41.5			11.4			14.4			14.0

Sources: NBK Economic Bulletin, various issues  
 KFH Annual Reports, 1978-1987  
 NBK Annual Reports, 1978-1987



Figure 9.1 Performance of KFH, NBK, OCB & KBS in Terms of K&R



to KD234.78m, increasing at an annual ARG of growth of 16.2%. The K&R of the OCB and KBS increased by less than 5 fold each from KD152.84m to KD721.71m and from KD218.40m to KD999.10m with an annual ARG of 19.3% and 18.9% respectively during the same period. When allowing for inflation by deflating the current prices by the corresponding CPI, it was found that while the annual ARG of KFH's K&R was more than 40%, that of NBK was 11.4% and those of OCB and KBS were 14.4% and 14% respectively.

From its first year of business KFH managed to get a market share of 1.3% in the KBS's aggregate K&R. This increased to reach 6.2% in 1982 but dropped to 4.2% in 1984 and 1985 then improved to 4.3% in 1986 and 1987, but on average KFH's share recorded a positive annual ARG of 24.3%. At the same time the NBK share dropped from 28.7% in 1978 to 23.4% in 1981, then kept fluctuating between 24 and 23% for the rest of the period, thus recording an annual negative ARG of -2.2%. As for the market share of OCB, this fluctuated between 70 and 74.5% during the same period recording an annual ARG of 0.3% (see Table 9.4).

Table 9.4 The Market Share of KFH, NBK and OCB in KBS's K&R (in %)

Years	KFH		NBK		OCB		KBS Total
	Share	Growth	Share	Growth	Share	Growth	
1978	1.3	-	28.7	-	70.0	-	100
1979	1.2	-7.7	26.0	-9.4	72.8	4.0	100
1980	1.5	25.0	24.0	-7.7	74.5	2.3	100
1981	4.4	193.3	23.4	-2.5	72.2	-3.1	100
1982	6.2	40.9	23.7	1.3	70.1	-2.9	100
1983	5.3	-14.5	24.5	3.4	70.2	0.1	100
1984	4.2	-20.8	22.7	-7.3	73.1	4.1	100
1985	4.2	0.0	23.8	4.8	72.0	-1.5	100
1986	4.3	2.4	24.3	2.1	71.4	-0.1	100
1987	4.3	0.0	23.5	-3.2	72.2	1.1	100
		24.3		-2.1		0.4	

Source: Table 9.3

As table 9.5 shows, KFH average capital ratio for the period 1978-87, is lower than those of the NBK, OCB and EBS. It was 5.1%, when measured by K&R/TLA, compared to 6.8% for NBK, 8.2% for OCB and 7.5% for KBS and 5.4% when measured by K&R/TLD, compared to 7.3% for NBK, 9% for OCB and 8.1% for KBS. This may be explained by the fact that KFH's TLA grew faster than its K&R because of the deposits which kept coming in

at an even greater rate despite that KFH does not promise any guaranteed return on deposits (see Table 9.6 comparing the average rates of growth of the K&R, TLA, TLD and TLF for KFH, NBK, OCB and KBS).

Table 9.5 Capital Ratios of KFH, NBK, OCB and KBS 1978-87

Ratio	Bank	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Aver.
K&R/TLA	KFH	10.9	4.3	3.1	5.2	6.3	4.4	4.1	4.5	4.4	4.0	5.1
	NBK	7.9	7.1	5.9	4.9	5.9	6.2	7.1	7.8	7.5	8.0	6.8
	OCB	6.2	6.0	6.1	5.6	6.5	7.1	9.9	11.2	12.0	11.4	8.2
	KBS	6.7	6.3	6.0	5.4	6.3	6.6	8.6	9.6	9.9	9.9	7.5
K&R/TLD	KFH	12.2	4.5	3.2	5.4	6.7	4.6	4.3	4.7	4.6	4.2	5.4
	NBK	8.6	7.6	6.2	5.2	6.3	6.6	7.6	8.4	8.2	8.7	7.3
	OCB	6.6	6.4	6.5	5.9	6.9	7.7	11.0	12.6	13.6	12.9	9.0
	EBS	7.1	6.7	6.3	5.7	6.7	7.1	9.4	10.6	10.9	10.7	8.1

Sources: Tables 9.3 and 9.7

Table 9.6 Comparison of the ARG of the K&R, TLA, TLD and TLF of KFH, NBK, OCB and KBS (in percentages)

	KFH	NBK	OCB	KBS
K&R	48.9	16.2	19.3	18.9
TLA	61.8	16.6	12.3	14.6
TLD	64.2	16.7	11.5	14.2
TLF	100.4	17.1	12.6	15.9

Sources: Tables: 9.3, 9.7, 9.9 and 9.11

#### 9.4.3 Performance in Terms of Total Assets (TLA)

In order to better judge the performance of KFH versus those of NBK, OCB and KBS in terms of TLA, TLD and TLF, it is very essential at the outset to take into consideration that:

- 1 With the exception of KFH, the whole of the Kuwaiti banking system (KBS) is based on interest.
- 2 The NBK is the oldest and largest bank in Kuwait established in 1952. It has 37 years of experience whereas KFH is the last Kuwaiti bank to be established in 1977; it has just completed 10 years.
- 3 The Kuwaiti banking system is made up of eight commercial banks with more than 200 branches of which the NBK has 58 branches and KFH has only 15 in 1987.
- 4 The NBK has overseas branches in London, New York and Singapore which give it the advantage of dealing more conveniently in foreign assets and liabilities over KFH which does not have branches overseas.
- 5 Unlike other banks, KFH does not guarantee the investment deposits and in case of loss, deductions are made from the original deposits of the depositors. KFH only guarantees the demand deposits which do not share in the profits of the bank.

Taking into consideration the above mentioned facts, KFH may be said to have performed quite well compared to NBK, OCB and KBS despite the interest based hostile environment in which it operates. Table 9.7 compares its performance in terms of TLA in current and constant prices with those of the NBK, OCB and KBS for the period 1978-87. Its TLA rose more than 40 fold from KD25.87m in 1978 to KD1057.50m in 1987 at an ARG of 61.8%. At the same time The NBK's TLA rose by less than 4 fold from KD794.82m in 1978 to KD2935.33m at an ARG of only 16.6%. As for OCB, their TLA grew a little bit more than 2.5 times from KD2457.81m in 1978 to KD6316.77m in 1987 at an ARG of 12.3%. The TLA of KBS recorded just a little more than 3 fold increase during the period, increasing from KD3278.5m in 1978 to KD10309.6m in 1987 at an ARG of 14.6%. Allowing for inflation by deflating the TLA of the banks by the corresponding CPI, it was found that the TLA of KFH in constant prices rose more than 22 times from KD29.60m in 1978 to KD836.63m in 1987 at a real annual ARG of 54%, whereas the TLA of NBK recorded only about 2.5 fold during the same period increasing from KD909.41m in 1978 to KD2322.25m in 1987 at an annual ARG of 11.6%. The TLA of OCB and KBS managed only to record an annual ARG of 6.4% and 9.7% respectively (see Table 9.7).

Relatively speaking, from these tables and from Figure 9.2 which shows the indices of KFH, NBK, OCB and KBS's TLA for the period 1978-87 taking 1980 as a base year, it is quite clear that the Islamic KFH performed much better than not only the average bank in Kuwait but also better than the oldest and largest bank of the country, the NBK.

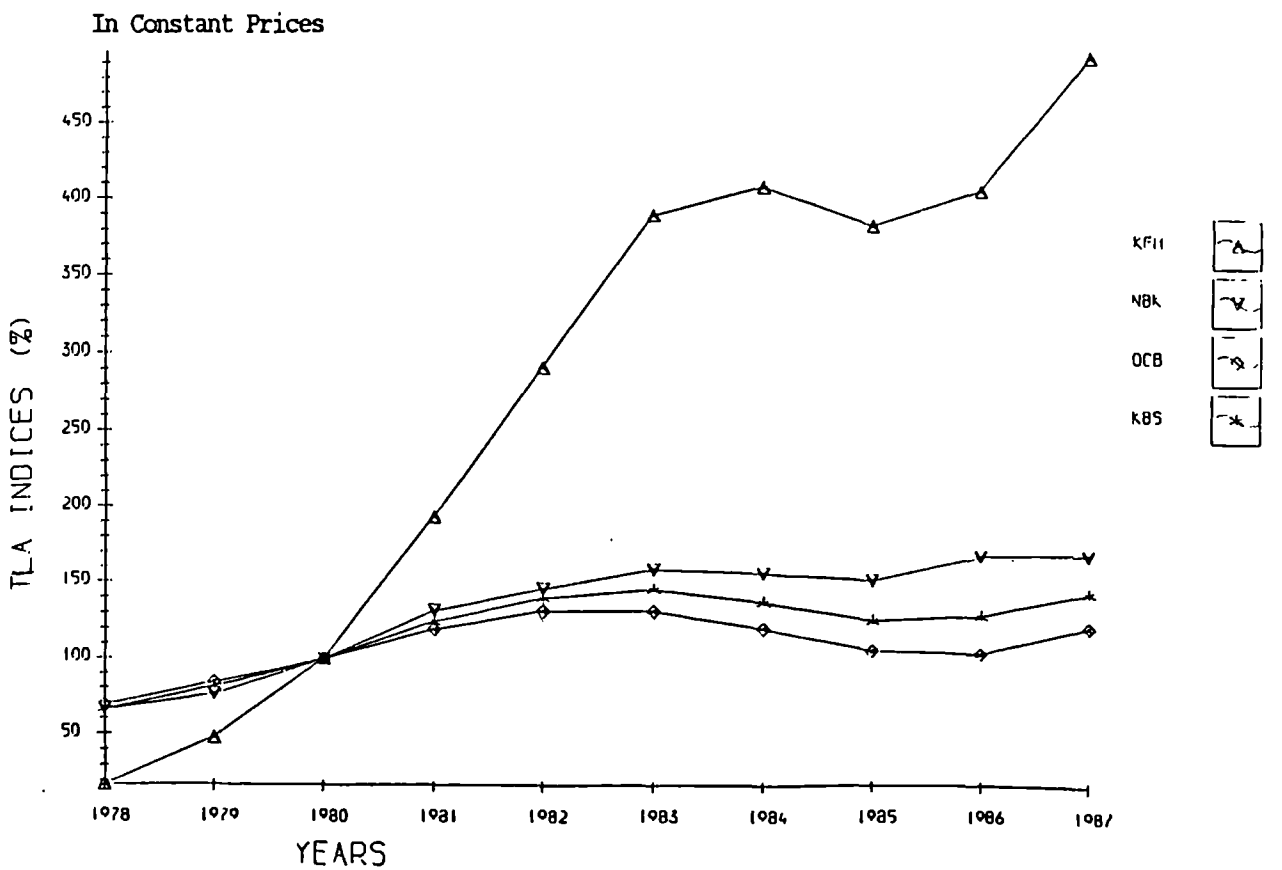
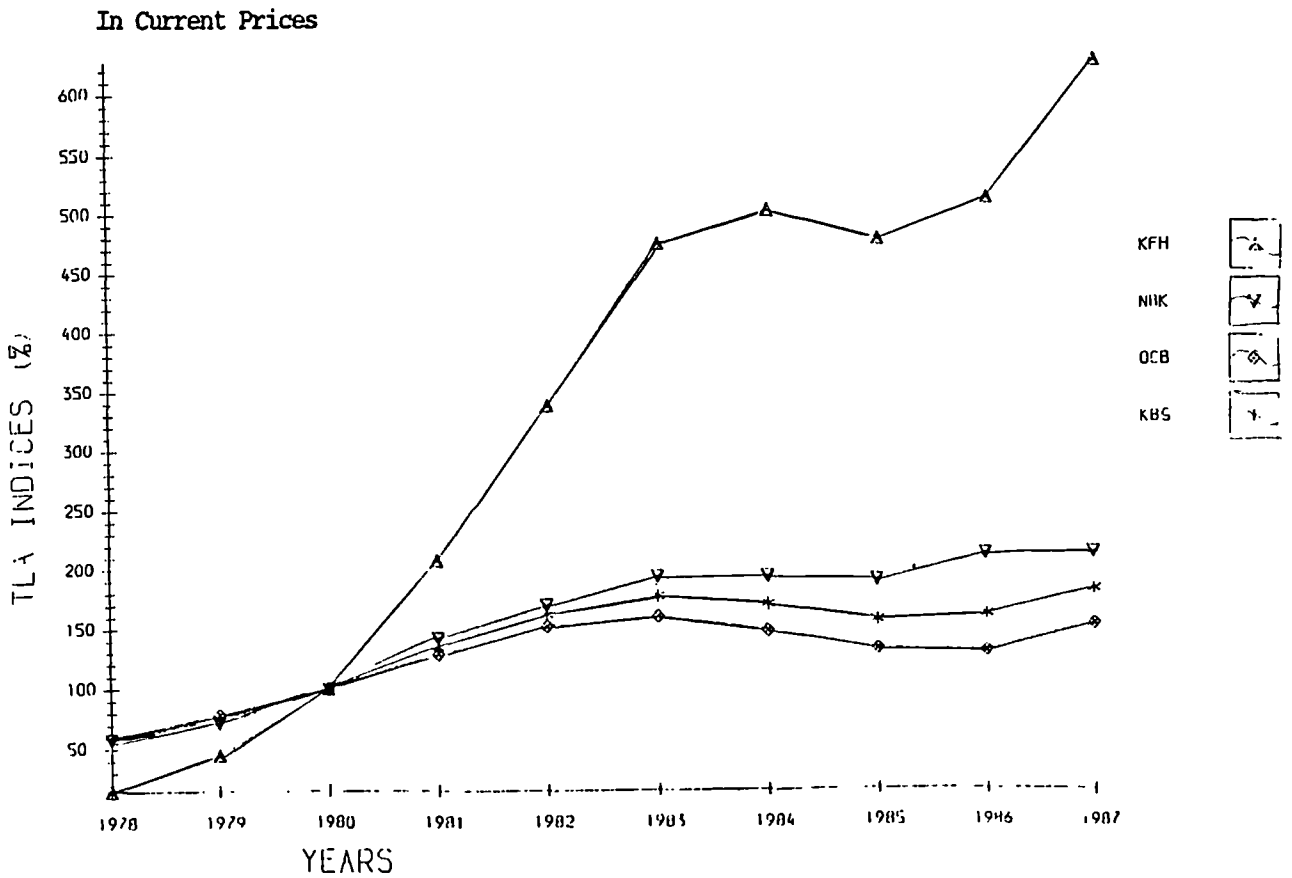
The effects of the 1982 Souq El-Manakh collapse, the sharp decline in oil prices in 1983 and thereafter, the world recession and the Gulf war can clearly be seen in the slow and even negative rates of growth in the TLA of not only KFH but also of NBK, OCB and KBS as a whole. This can be seen across Table 9.7 and Figure 9.2 as well. In fact the world recession of the 1980s has affected not only Kuwaiti banks but banks all over the world. The total assets of most if not all the banks across countries have experienced meagre if not negative rates of growth (see The Banker surveys of the top 500 banks for 1983-1987).

Table 9.7 Comparative Analysis of the TLA of KFH, NBK, OCB and KBS (in KD million and in percentages)

	KFH			NBK			OCB			KBS		
	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth
In Current Prices												
1978	25.87	15	-	794.82	58	-	2457.81	60	-	3278.50	58	-
1979	75.26	45	190.9	981.78	72	23.5	3234.86	79	31.6	4291.90	76	30.9
1980	168.45	100	123.8	1373.93	100	39.9	4106.72	100	27.0	5649.10	100	31.6
1981	351.13	208	108.4	1953.11	142	42.2	5294.76	129	28.9	7599.00	135	34.5
1982	568.72	338	62.0	2321.25	169	18.8	6256.23	152	18.2	9146.20	162	20.4
1983	799.04	474	40.5	2646.68	193	14.0	6548.48	160	4.7	9994.20	177	9.3
1984	845.75	502	5.9	2652.40	193	0.2	6081.55	148	-7.1	9579.70	170	-4.1
1985	803.96	477	-4.9	2589.86	189	-2.4	5433.68	132	-10.7	8827.50	156	-7.9
1986	861.82	512	7.2	2905.61	212	12.2	5347.77	130	-1.5	9115.10	161	3.3
1987	1057.50	628	22.7	2935.33	214	1.0	6316.77	154	18.1	10309.60	183	13.1
Average Growth			61.8			16.6			12.3			14.6
In Contant Prices												
1978	29.60	18	-	909.41	66	-	2812.14	69	-	3751.15	66	-
1979	80.49	48	171.9	1050.03	76	15.5	3459.74	84	23.0	4590.27	81	22.4
1980	168.45	100	109.3	1373.93	100	30.8	4106.72	100	18.7	5649.10	100	23.1
1981	326.94	194	94.1	1818.54	132	32.4	4929.94	120	20.0	7075.42	125	25.2
1982	491.55	292	50.3	2006.27	146	10.3	5407.29	132	0.7	7905.10	140	11.7
1983	659.27	391	34.1	2183.73	159	8.8	5403.04	132	0.1	8246.04	146	4.3
1984	689.85	410	4.6	2163.46	157	-0.9	4960.48	121	-8.2	7813.79	138	-5.2
1985	646.27	384	-6.3	2081.88	152	-3.8	4367.91	106	-11.9	7096.06	126	-9.2
1986	686.16	407	6.2	2313.38	168	11.1	4257.70	104	-2.5	7257.25	129	2.3
1987	836.63	497	21.9	2322.25	169	0.4	4997.45	122	17.4	8156.33	144	12.4
Average Growth			54.0			11.6			6.4			9.7

Sources: NBK Economic Bulletin, various issues  
 KFH Annual reports 1978-1987  
 NBK Annual Reports 1978-1987

Figure 9.2 Performance of KFH, NBK, OCB & KBS in Terms of TLA



KFH's market share in the KBS's TLA increased from 0.8% in 1978 to 9.3% in 1987 at an annual ARG of 37% and NBK's share dropped from 24.2% in 1978 to 22.9% in 1979, improved to reach 31.9% in 1986 and then dropped again to 28.5% in 1987 at an annual ARG of 2%. However, OCB's market share declined from 75% in 1978 to 58.7% in 1986 and then improved to 61.3% in 1987 at a annual ARG of -2% (see Table 9.8).

The growth of the NBK share in the KBS total assets may be due to the diverse services that it introduced recently such as the Watani Express Service of more than 50 automated teller machines which provides more than 100,000 cardholders with unparalleled convenience of 24 hours service express cash capability, current account balances, mini-statements covering the last 12 entries and request for cheque books and full account statements. The other banks have just started to follow suit. KFH has also just started in 1986 to offer such services at its head-office. The growth of NBK's TLA may also be explained by its involvement in international banking for the last eight years. As for the high growth of KFH's share in KBS's TLA, this can partly be explained by the high profits it managed to realise from its first year of operation and the high share of the depositors in these profits since it shares its profits with its depositors and, perhaps by the fact that a large section of the Muslim Kuwaiti population would like to observe the rules of the Islamic Shariah by depositing their savings with an Islamic bank rather than with an interest based bank.

Table 9.8 The Market Share of KFH, NBK and OCB in KBS's TLA (in %)

Years	KFH		NBK		OCB		KBS Total
	Share	Growth	Share	Growth	Share	Growth	
1978	0.8	-	24.2	-	75.0	-	100
1979	1.8	125	22.9	-5	75.4	1	100
1980	3.0	67	24.3	6	72.7	-4	100
1981	4.6	53	25.7	6	69.7	-4	100
1982	6.2	35	25.4	-1	68.4	-2	100
1983	8.0	29	26.5	4	65.5	-4	100
1984	8.8	10	27.7	5	63.5	-3	100
1985	9.1	3	29.3	6	61.6	-3	100
1986	9.5	4	31.9	9	58.7	-5	100
1987	10.3	8	28.5	-11	61.3	4	100
		37		2		-2	

Source: Table 9.7 above

#### 9.4.4 Performance in Terms of Total Deposits (TLD).

Because the NBK does not give a separate entry for its TLD in its balance sheets and adds other liabilities including contingencies to its deposits, I was obliged to do the same for KFH, OCB and KBS to get a comparable set of figures, thus total liabilities are used instead of total deposits in the tabular and graphical analysis though under the name of Total Deposits (TLD). From the 1st day of opening to the general public on 31st August 1978 until the end of the year on 31st December 1978, KFH managed to collect more than KD23m (US\$82.8m) of deposits in just four months. The KFH first annual report (1978:11) states that: "The accounts that have abundantly been registered with a steadily increasing number have surpassed all predictions based on the trend of deposits of the other banks which have... come into being in Kuwait".

One year later the TLD of KFH more than tripled and by the 7th year (1984) it recorded more than a 35 fold increase. Though in 1985 it declined by a negative rate of growth (-5.3%) over the previous year. This drop did not last long, in fact it was reversed the year after by a positive rate of growth of 7.2% followed by an even stronger rate: 23.2% the following year. Table 9.9 below compares the TLD of KFH to those of NBK, OCB and KBS in current and constant prices for the period 1978-87. KFH managed in less than 10 years of business to record a staggering 44 fold increase in its TLD which rose from KD23.06m in 1978 to KD1014.89m in 1987 at an annual ARG of 64.2%, while the NBK managed to increase its TLD by 3.7 times only, from KD732.07m in 1978 to KD2700.55m in 1987 at an annual ARG of only 16.7%. OCB's TLD rose from KD2304.97m in 1978 to KD6082.14m in 1983, fell to KD4824.30m in 1985 and then rose again to KD5595.06m in 1987, thus increasing at an annual ARG of 11.5% for the current prices and 6.8% for the constant prices. The KBS's TLD recorded just a little bit more than a 3 fold increase in nominal terms and just above 2 fold in real terms. Its TLD in current prices increased from KD3060.1m in 1978 to reach KD9329.8m in 1982 then decreased to KD7980.9m in 1985 and then improved to reach KD9310.5m in 1987. The ARG of KBS' TLD for the period 1978-87 was 14.2% for the current prices and



Table 9.9 Comparative Analysis of the TLD of KFH, NBK, OCB and KBS (in KD million and in percentages)

	KFH			NBK			OCB			KBS		
	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth
	In Current Prices											
1978	23.06	14	-	732.07	57	-	2304.97	60	-	3060.10	58	-
1979	72.01	44	212.3	912.04	71	24.6	3039.25	79	31.9	4023.30	76	31.5
1980	163.27	100	126.7	1293.25	100	41.8	3855.68	100	26.9	5312.20	100	32.0
1981	333.04	204	104.0	1856.78	144	43.6	4998.08	130	29.6	7187.90	135	35.3
1982	533.09	327	60.1	2184.35	169	17.6	5851.96	152	17.1	8569.30	161	19.2
1983	763.86	468	43.3	2483.90	192	13.7	6082.14	158	3.9	9329.80	176	8.9
1984	810.98	497	6.2	2465.23	191	-0.8	5480.19	142	-9.9	8756.40	165	-5.9
1985	768.06	470	-5.3	2388.54	185	-3.1	4824.30	126	-12.0	7980.90	151	-9.0
1986	823.68	505	7.2	2686.77	208	12.5	4705.85	122	-2.8	8216.30	155	2.9
1987	1014.89	622	23.2	2700.55	209	0.5	5595.06	145	18.9	9310.50	175	13.3
Average Growth			64.2			16.7			11.5			14.2
	In Constant Prices											
1978	26.38	16	-	837.61	65	-	2637.27	68	-	3501.26	66	-
1979	77.02	47	192.0	975.44	75	16.5	3250.54	84	23.3	4303.00	81	22.9
1980	163.27	100	112.0	1293.25	100	32.6	3855.68	100	18.6	5312.20	100	23.5
1981	310.09	190	89.9	1728.85	134	33.7	4653.71	121	20.7	6692.65	126	26.0
1982	460.75	282	48.6	1887.95	146	9.2	5057.87	131	8.7	7406.57	139	10.7
1983	630.25	386	36.8	2049.42	159	8.6	5018.27	130	-0.8	7697.94	145	3.9
1984	661.49	405	5.0	2010.79	156	-1.9	4491.10	117	-10.5	7163.38	135	-6.9
1985	617.41	378	-6.7	1920.05	149	-4.5	3890.11	101	-13.4	6427.57	121	-10.3
1986	655.80	402	6.2	2139.15	165	11.1	3746.70	97	-3.7	6541.64	123	1.8
1987	802.92	492	22.4	2136.51	165	-0.1	4426.47	115	18.1	7365.90	139	12.6
Average Growth			56.2			11.7			6.8			9.4

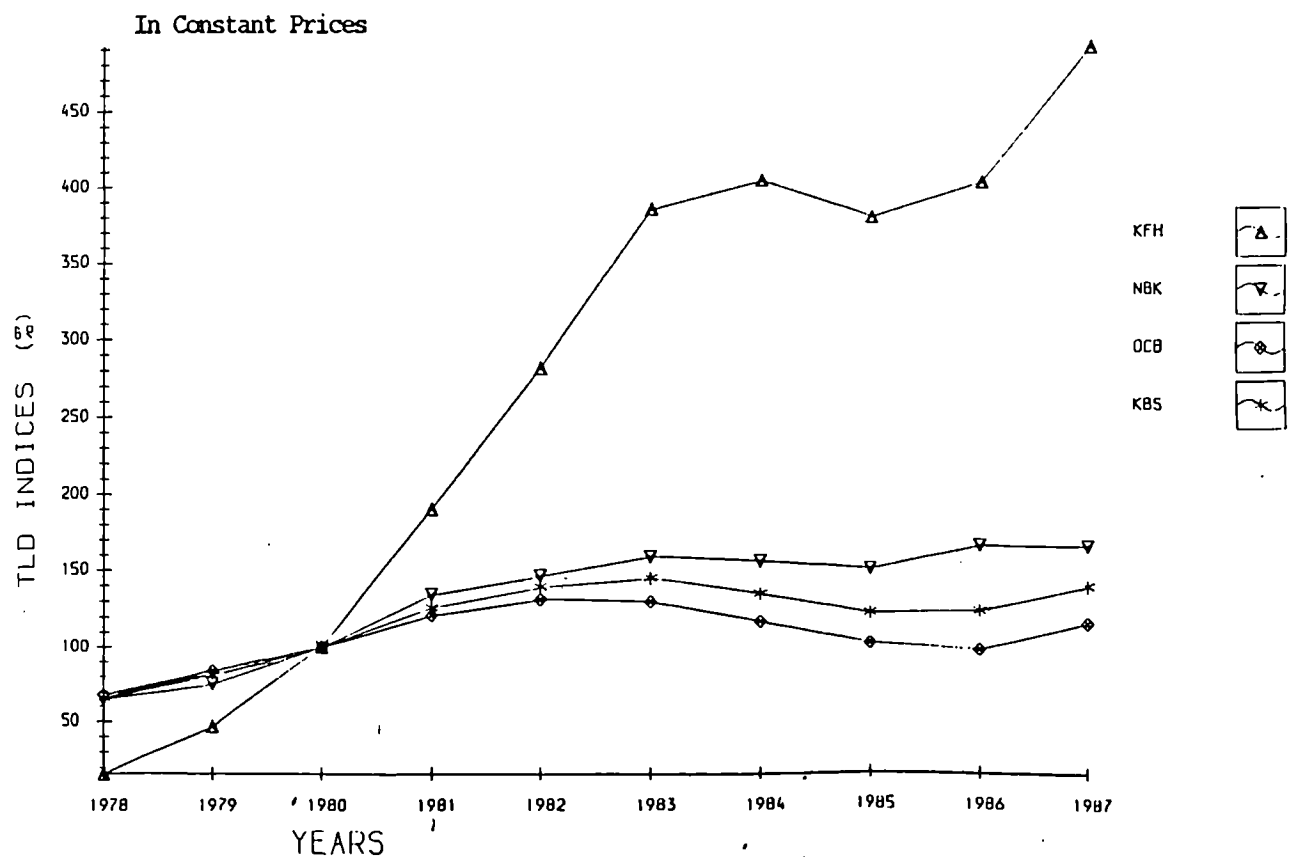
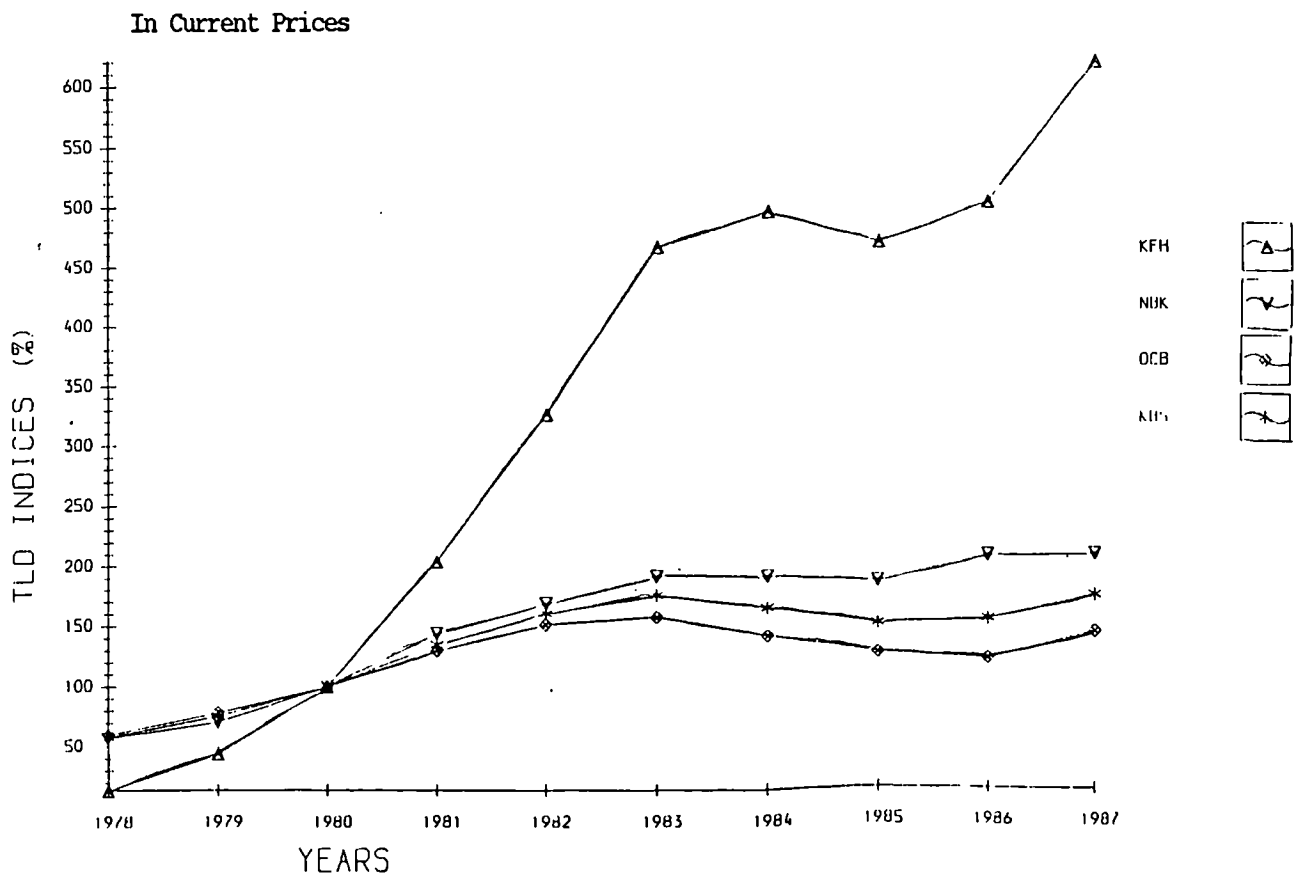
Source: NBK Economic Bulletin, various issues  
 KFH Annual Reports 1978-1987  
 NBK Annual Reports 1978-1987

9.4% for the constant prices (see Tables 9.9). A clear comparative picture can be seen from Figure 9.3 which shows the relative development of current and constant prices TLD indices of KFH, OCB and KBS.

The decline in deposits in 1985 was not limited to KFH alone but was general to other banks as well, mainly because of loss of confidence in the banking system caused by the 1982 collapse of Souq El-Manakh, the Gulf war and its consequences which have spread the fear of insecurity especially after the attempt in 1984 to kill the Emir and the bombing of the airport, pipelines, etc., in 1985 and 1986, and by the general recession which has hit almost all countries. The decrease in KFH deposits in 1985 may also be due to the decision of the bank not to distribute any profits to depositors or shareholders in 1984 because the real value of its assets dropped drastically as a consequence of the sharp drop in its investments in real estate. Thus, may be some of the depositors withdrew their deposits. Another reason is that in 1983, KFH decided to stop accepting new deposits for some times in view of the limited demand for investment in the Gulf countries generally and in Kuwait in particular. "The astonishing thing", as put by Boudjellal (1982:117): "is the determination of the public to bank with KFH which has surpassed all expectations" despite that KFH does not guarantee any return on the investment deposits and in fact it shares its losses as well as its profits with its depositors so that in the case of the bank making a loss, it deducts from the original investment deposits their corresponding shares in the loss.

KFH market share in the aggregate TLD of KBS has kept growing impressively from 0.8% in 1978 to about 11% in just 10 years of business despite as mentioned earlier, the circumstances surrounding the bank, the small number of branches, the little experience, the shortness of the period, the competition from the other older and larger banks, etc.. Its share has risen by more than 13.6 times in just 10 years growing at an annual ARG of 38%. The NBK share has also kept rising steadily from 23.9% in 1978 to 32.7% in 1986, however it dropped back to 29% in 1987. The annual ARG of the NBK market share was 2% whereas the OCB share in

Figure 9.3 Performance of KFH, NBK, OCB & KBS in Terms of TLD



the deposit declined dramatically from 75.3% in 1978 to 57.3% in 1986 and improved in 1987 to 60%, at an ARG of -2% annually.

Now if the NBK share has kept growing though at a slow but steady rate because of the diverse services it provides and because of its involvement in international banking, the question that arises here is: why is that the deposits in KFH have grown extraordinarily well beyond expectations despite the PLS system that it applies to investments deposits which represent the bulk of KFH total deposits?. The main reason behind this may be, as the KFH annual report for 1979:9 put it: "the desire of Kuwaiti Muslims to practice their banking and investment formalities through Islamic banks", that observe Islamic Shariah by basing their banking operations on PLS system rather than on interest which is prohibited in Islam.

Table 9.10 The Market Share of KFH, NBK and OCB in the KBS's TLD

	KFH		NBK		OCB		KBS Total
	Share	Growth	Share	Growth	Share	Growth	
1978	0.8	-	23.9	-	75.3	-	100
1979	1.8	125	22.7	-5	75.5	0	100
1980	3.1	72	24.3	7	72.6	-4	100
1981	4.6	48	25.8	6	69.6	-4	100
1982	6.2	35	25.5	-1	68.3	-2	100
1983	8.2	32	26.6	4	65.2	-5	100
1984	9.3	13	28.2	6	62.6	-4	100
1985	9.6	4	29.9	6	60.5	-3	100
1986	10.0	4	32.7	9	57.3	-5	100
1987	10.9	9	29.0	-11	60.1	5	100
		38			2		
						-2	

Source: Table 9.9 above

#### 9.4.5 Performance in Terms of Total Finance (TLF)

KFH's TLF in current prices recorded more than 75 fold increase in just 7 years from KD9.69m in 1979 to KD734.64m in 1984 and although its total finance dropped in 1985 by 3.8% against that of 1984, it soon recovered to reach KD842.95m in 1987 thus, recording an 87 fold rise in just 10 years increasing at a staggering annual ARG of more than 100%. NBK recorded about 4 fold increase in the same period from KD409.75m in 1978 to KD1607.73m in 1987 at an annual ARG of 17.1%. At the same time the OCB did not achieve more than 3 fold increase for the same period

going from KD1139.96m in 1978 to KD3146.22m in 1987 at an annual ARG of only 12.5%. As for the KBS, it recorded just about 4 fold increase from KD1559.4m in 1978 to KD5596.90m in 1987 at an ARG of 15.9% per annum. In real terms the KFH managed to achieve a 66 fold increase for its TLF from KD11.09m in 1978 to KD666.89m in 1987, rising at an ARG of 90.1% annually compared to less than 3 fold increase for each of the NBK, OCB and the KBS at annual ARG of 12.7%, 7.9% and 11% respectively (see Table 9.11). The difference in performance can clearly be seen from the comparison of the indices of each of the TLF of KFH, NBK, OCB and KBS taking 1980 as a base year (see Figure 9.4).

Unlike other banks KFH does not grant loans at interest but instead it invests in real estate, buildings, plots of land through direct purchase and sale. It is also involved in commercial investments which involves direct buying and selling of cars, furniture, food, etc., on Murabahah, Bai' Muajjal, Ijarah, Ijarah Waqtina' bases. It, also offers consultancy services to customers who are interested in investing their funds according to the Shariah.

Because of the lack of demand on funds for project financing in Kuwait and the excess liquidity, KFH stopped, for some time accepting new deposits in August 1983 because as an Islamic bank it cannot use overnight funds and its minimum time period for utilisation of funds is one month though they are working on a 14-day investment performance and that is why the bulk of its finance is direct investment, Murabahah and Ijarah. KFH runs supermarkets, car showrooms and real estate companies. It takes part in export and import trade flows, as a Kuwaiti banker said: "on the incoming side it is a commercial bank but on the outgoing side it is an investment holding company" (Rashid 1984:172).

Because investment in real estate was perhaps the most profitable investment before 1982, KFH made the mistake of investing the bulk of its funds in this sector, but after the Souq El-Manakh crisis, prices of houses fell by 35% in 1983; share prices in real estate companies by 40% and this affected the value of its investment portfolio dangerously

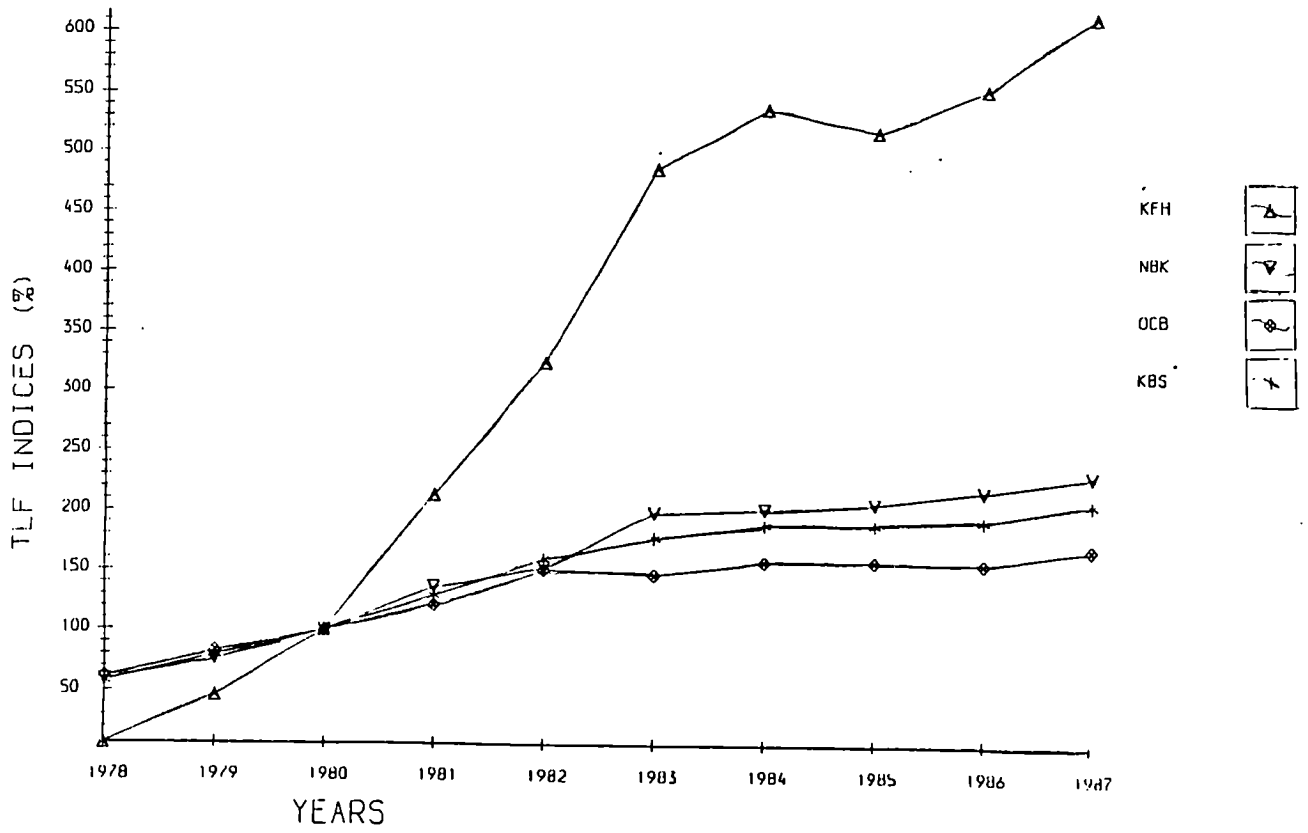
Table 9.11 Comparative Analysis of the TLF of NBK, OCB and KBS (in million KD and in percentages)

	KFH			NBK			OCB			KBS		
	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth	Amount	Index	Growth
In Current Prices												
1978	9.69	7	-	409.75	59	-	1139.96	62	-	1559.40	58	-
1979	62.45	46	544.5	527.43	76	28.7	1529.42	83	34.2	2119.30	79	35.9
1980	136.63	100	118.8	691.15	100	31.0	1843.92	100	20.6	2671.70	100	26.1
1981	291.47	213	113.3	941.31	136	36.2	2226.22	121	20.7	3459.00	129	29.5
1982	443.95	325	52.3	1058.78	153	12.5	2774.97	151	24.6	4277.70	160	23.7
1983	665.44	487	49.9	1372.53	199	29.6	2705.13	147	-2.5	4743.10	178	10.9
1984	734.64	538	10.4	1395.53	202	1.7	2905.63	158	7.4	5035.80	189	6.2
1985	706.96	518	-3.8	1430.00	207	2.5	2915.54	158	0.3	5052.50	189	0.3
1986	758.85	555	7.3	1503.05	218	5.1	2892.40	157	-0.8	5154.30	193	2.0
1987	842.95	617	11.1	1607.73	233	6.9	3146.22	171	8.8	5596.90	209	8.6
Average Growth			100.4			17.1			12.5			15.9
In Constant Prices												
1978	11.09	8	-	468.82	68	-	1304.30	71	-	1784.21	67	-
1979	66.79	49	502.3	564.10	82	20.3	1635.74	89	25.4	2266.63	85	27.0
1980	136.63	100	104.6	691.15	100	22.5	1843.92	100	12.7	2671.70	100	17.9
1981	271.39	199	98.6	876.45	127	26.8	2072.83	112	12.4	3220.67	121	20.5
1982	383.71	281	41.4	915.11	132	4.4	2398.42	130	15.7	3697.23	138	14.8
1983	549.04	402	43.1	1132.45	164	23.8	2231.96	121	-6.9	3913.45	147	5.8
1984	599.22	439	9.1	1138.28	165	5.1	2370.00	129	-6.2	4107.50	154	5.0
1985	568.30	416	-5.2	1149.52	166	1.0	2343.68	127	-1.1	4061.50	152	-1.1
1986	604.18	442	6.3	1196.70	173	4.1	2302.86	125	-1.7	4103.74	154	1.0
1987	666.89	488	10.4	1271.94	184	6.3	2489.10	135	8.1	4427.93	166	7.9
Average Growth			90.1			12.7			7.9			11.0

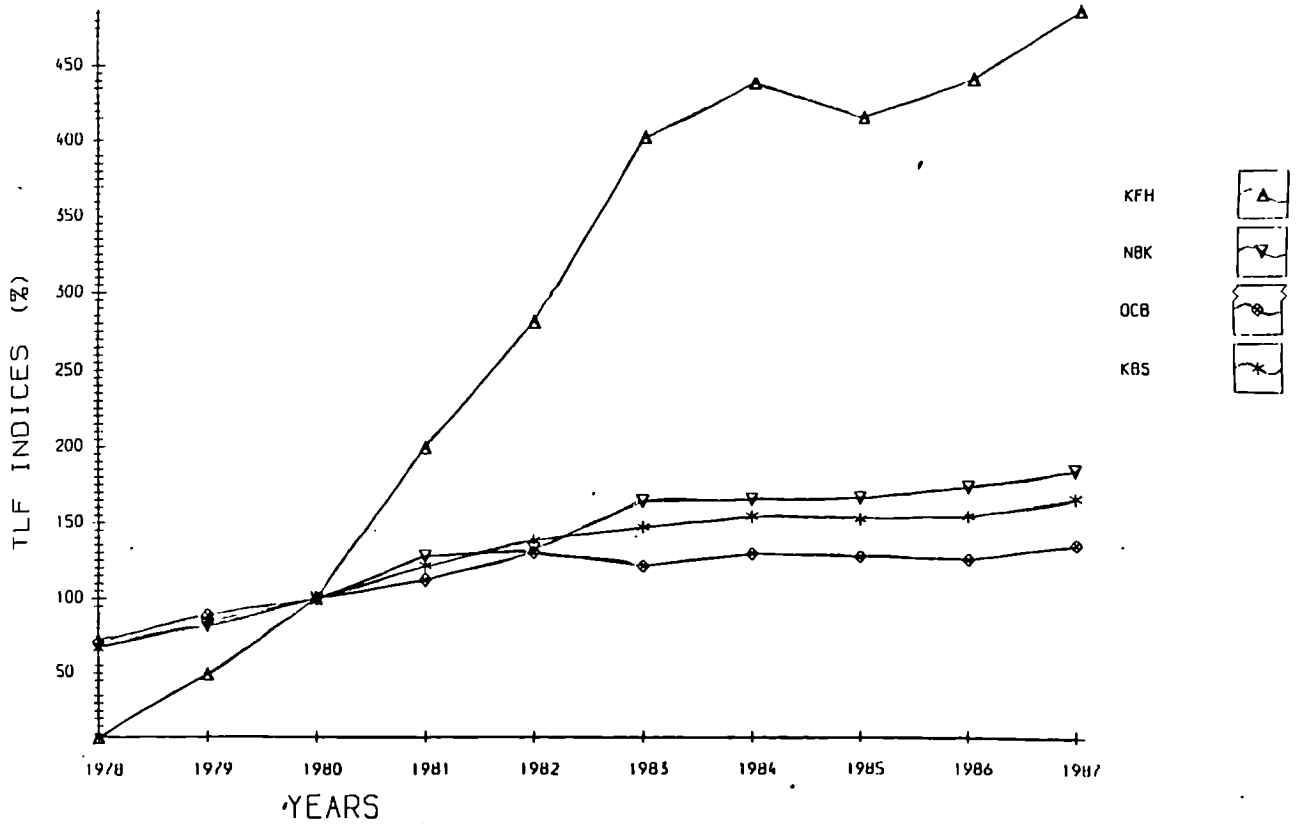
Sources: NBK Economic Bulletin, various issues  
 KFH Annual Reports, 1978-1987  
 NBK Annual Reports, 1978-1987

Figure 9.4 Performance of KFH, NBK, OCB & KBS in Terms of TLF

In Current Prices



In Constant Prices



to the point that it did not declare or distribute any profits in 1984 neither to shareholders nor to depositors. This led KFH to change its investment policies in 1985 towards more diversification in order to avert pitfalls. KFH market share in KBS total finance rose from 0.6% in 1978 to 14.6% in 1984, and although it slightly went down to 14% in 1985, it soon recovered and was able to get more than 15% of the aggregate finance of the KBS, growing at an ARG of 67% annually, compared to that of the NBK which fluctuated between 24.8% and 29% growing at an annual ARG of only 1% during the period of study. As for the market share of OCB in KBS total finance, this declined from 73.1% in 1978 to 56.2% in 1987 at a negative ARG of -3 annually (see table 9.12).

Table 9.12 The market Share of KFH, NBK and OCB in the KBS's TLF

	KFH		NBK		OCB		KBS Total
	Share	Growth	Share	Growth	Share	Growth	
1978	0.6	-	26.3	-	73.1	-	100
1979	3.0	400	24.9	-5	72.2	-1	100
1980	5.1	70	25.9	4	69.0	-4	100
1981	8.4	65	27.2	5	64.4	-7	100
1982	10.4	24	24.8	-9	64.9	1	100
1983	14.0	35	29.0	17	57.0	-12	100
1984	14.6	4	27.7	-5	57.7	1	100
1985	14.0	-4	28.3	2	57.7	0	100
1986	14.7	5	29.2	3	56.1	-3	100
1987	15.1	3	28.7	-2	56.2	0	100
		67		1		-3	

Source: Table 9.11 above

KFH does not engage in short term interbank operations, and its foreign exchange dealings are all on the spot market only, because forward exchange is not allowed in Islam for currencies. Although it cannot provide overdrafts or similar facilities that would be construed as pure 'money lending' its programme does allow for the possibility of Qardh Hassan or charitable interest-free credits (Rizq, 1980:34). The total of such loans granted between 1980 and 1987 amount to KD973,699 and covered 692 beneficiaries (see KFH Annual Report 1987:21).

Because there is no other information on the sectoral distribution of the KFH, NBK or KBS finance except for the year 1985, table 9.13



shows the sectoral distribution of the TLF of KFH, NBK and KBS for 1985 only. It is clear that KFH was greatly involved in real estate investment (56.9%). The table also shows that only about 3% of the KBS total finance goes to industry which is very limited and that no credit is allocated for agriculture which is almost non-existent. This indicates the lack of demand of credit by these sectors because Kuwait is neither an industrial nor an agricultural country as we saw above. Most of KBS TLF goes to personal use which contributes to inflation but to which KFH does not contribute in view of the fact that personal credit is not profitable for an Islamic bank that does not involve in interest transactions, as for interest free credit, these are given only for emergency cases and are very limited. What is needed for KFH to diversify its investment portfolio is to involve itself in international banking if it is to achieve any success in diversifying its finance outlets.

Table 9.13 Comparative Analysis of KFH, NBK and KBS Portfolio Investment: Sectoral Distribution for 1985

	KFH	NBK	KBS
Trade	33.8	30.2	22.8
Real estate	56.9	13.8	18.0
Construction	6.7	13.2	16.3
Personal	-	22.7	27.6
Finance	1.8	9.9	8.7
Industry	-	4.0	3.0
Others	0.8	6.2	3.6
Total	100.0	100.0	100.0

Source: KFH Annual Report, 1985  
NBK Annual Report, 1985

#### 9.4.6 Performance in Terms of Other Proxies

Table 9.14 below shows that KFH performed better than NBK, OCB and KBS in terms of intermediation as measured by both ratios: TLF/TLD and TLF/TLA. While on average KFH managed to use more than 80% of its deposits in financing the economy the other banks only managed to use less than 55.5% of their deposits. The exceptional case of KFH in recording higher intermediation than other banks may be explained by the fact that as an Islamic bank having the right to invest its funds directly

Table 9.14 Comparative Analysis of KFH Performance in Terms of Intermediation, liquidity, Efficiency and Profitability, as Compared to those of NBK, OCB and KB (in %)

Ratio	Bank	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987 Averages
Intermediation as measured TLF/TLD	KFH	42.0	86.7	83.7	87.5	83.3	87.1	90.6	92.0	92.1	83.1
	NBK	56.0	57.8	53.4	50.7	48.5	55.3	56.6	60.0	55.9	59.5
	OCB	49.5	50.3	47.8	44.5	47.4	44.5	53.0	48.2	61.5	50.3
	KBS	51.0	52.7	50.3	48.1	49.9	50.8	57.5	63.3	62.7	60.1
Intermediation as measured TLF/TLA	KFH	37.5	83.0	81.1	83.0	78.1	83.3	86.9	87.9	88.1	79.7
	NBK	51.6	53.7	50.3	48.2	45.6	50.2	52.6	55.2	51.7	54.8
	OCB	46.4	47.3	44.9	42.1	44.4	41.3	47.8	53.7	54.1	49.8
	KBS	47.6	49.4	47.3	45.5	46.8	47.5	52.6	57.2	56.5	54.3
Liquidity ratio as measured by LA/TLD	KFH	na	17.6	19.1	16.6	22.5	16.5	12.4	10.6	10.2	19.3
	NBK	na	47.7	50.7	51.9	55.7	49.1	46.8	44.8	48.0	44.5
Liquidity ratio as measured by LA/TLA	KFH	na	16.8	18.5	15.8	21.1	15.8	11.9	10.1	9.8	18.5
	NBK	na	44.3	47.7	49.3	52.4	46.1	43.5	41.4	44.4	41.0
Profitability as measured by PBT/K&R	KFH	13.1	29.7	45.9	33.0	36.4	11.3	0.0	4.5	7.1	11.8
	NBK	12.0	13.6	15.5	16.6	14.6	14.1	11.1	11.4	11.6	11.7
Profitability as measured by PBT/TLA	KFH	1.4	1.3	1.4	1.7	2.3	0.5	0.0	0.2	0.3	0.5
	NBK	0.9	1.0	0.9	0.8	0.9	0.9	0.8	0.9	0.9	0.9
Efficiency as measured by TLA/NOB	KFH	25.9	37.6	42.1	58.5	71.1	88.8	84.6	67.8	61.6	70.5
	NBK	22.7	27.3	36.2	48.8	55.3	58.8	51.0	47.1	50.0	49.8
Efficiency as measured by TLD/NOB	KFH	23.1	36.0	40.8	55.5	66.6	84.9	81.1	64.0	58.8	67.7
	NBK	20.9	25.3	34.0	46.4	52.0	55.2	47.4	43.4	47.1	45.8
Efficiency as measured by TLF/NOB	KFH	9.7	31.2	34.2	48.6	55.5	73.9	76.8	58.9	54.2	56.2
	NBK	11.7	14.7	18.2	23.5	25.9	31.0	26.8	26.0	26.4	27.2

Sources: NBK Economic Bulletin, various issues  
 KFH annual reports 1978-87  
 NBK annual reports 1978-8

and not necessarily through third parties, it did not wait for finance application but instead invested most of its finance funds on its own risk, by buying and selling buildings, land, cars, construction materials and by creating co-operatives that sell clothes, food, etc.. Perhaps, that is the reason why its liquidity is lower than that of the NBK (see table 9.14). Thus, we can say that KFH is more involved in direct investment than in finance. It is a bank if we look at its liabilities but an investment company if we look at its assets.

Because there is no available data on the aggregate profits, the number of branches, the number of staff and on the detailed liquidity of the KBS and thus of OCB, the profitability, liquidity and efficiency comparative analysis in table 9.14, is made only between KFH and NBK. Concerning profitability as measured by return on equity and return on total assets for the period 1978-87, the average return on equity for KFH is 19.28% during the period 1978-87 looks better than that of NBK (13.22%) and so its average return on assets (0.96%) better than that of NBK (0.88%), however as the table also shows the profits of the NBK were steadier than those of the KFH which fluctuated considerably from year to year. The striking thing is that, from its first year 1978, or more accurately in just four months, KFH succeeded in realising a profit that is relatively speaking better than that of the NBK which was at the time twenty six years old, the oldest and largest bank in Kuwait with more than 30 branches all over Kuwait. The other thing is that, after the first year (1978) and up to 1982, KFH realised phenomenal profits. Its return on equity ratio for each of these years was about 30% or more. It even reached 45.85% in 1980 while the return on equity ratio for NBK fluctuated between 13.62% and 16.61% for the same years. During this same period, KFH return on total assets ratios were greater than 1.28% while those of NBK were less than 1% despite the fact that, in view of its size, the NBK should be the most profitable bank in Kuwait because it enjoys economies of scale that smaller banks like KFH do not. However, after the 1982 collapse of Souq El-Manakh, which affected badly the economy and especially the real estate sector in which

KFH was very much involved, the KFH profitability dropped sharply so that in 1984 it did not declare or distribute any profit neither to its depositors nor to its shareholders. In the following years (1985-1987), KFH recovered. It made a modest profit in 1985, thereafter it improved its profits by diversifying its portfolio, which means that the failure of KFH to realise good profits after 1982 is not due to the Islamic technique of doing banking, but rather was the result of lack of diversification and thus, is the result of mismanagement.

Because neither KFH nor the NBK give information about their operating costs or on the number of their staff in their annual reports, the efficiency comparative analysis is measured only by the ratios: total assets, total deposits and total finance to the number of branches (see table 9.14). As can be seen from the table, it is quite clear that KFH is more efficient in terms of TLA/NOB, TLD/NOB and TLF/NOB since its average ratios for the period 1978-87, are 60.9%, 57.9% and 49.9% compared to those of the NBK which were 44.7%, 41.8% and 23.1%.

In addition to its banking and investment activities, the KFH, as an Islamic Bank not only interested in maximising profits, undertook the social responsibility of collecting and distributing Zakat (poor due) and Sadaqat (charity). The total funds collected between 1979 and 1987 amounted to KD2,873,513 (more than US\$10m) and total funds distributed locally and abroad, amount to KD2,811,830 (about US\$10m) and covered 2896 beneficiaries (see KFH Annual Report for 1987:21). KFH also organised seminars and conferences on Islamic economics and Islamic banking and by way of various press and television interviews, aiming at raising the public awareness of Islamic economics that prohibits interest, gambling and hoarding and allows profits, PLS and investment.

## 9.5 CONCLUSION

Taking into consideration the environment in which it operates, the shortness of the period since it started operating, the small number of its branches, the little experience in Islamic banking, KFH managed to perform better than the oldest and largest bank in Kuwait, the NBK and the OCB and KBS taken as a whole in terms of K&R, TLA, TLD,

TLF, intermediation, efficiency and profitability. This indicates again that interest is not necessary to do banking and that banking can be carried out without it. This also indicates that when Islam prohibited interest it did not prohibit profit sharing which has proved once again that it may be beneficial not only to the bank but also to its depositors and other customers if the bank was well managed, thus Islam is not an obstacle to economic development.

KFH only failed in making good profit in 1984 because it did not have a good diversification of its investment portfolio and because it created a provision of KD28.5m (US\$85.5m). It was very much involved in real estate (more than 50% of its finance funds) which deteriorated very rapidly after the 1982 Souq El-Manakh crash, which caused a rapid fall in the property market because people wished to sell their properties to meet their obligations, thus flooding the property market and brought prices sharply down (Arabia November 1985:58). But generally and relatively speaking KFH performed better than the rest of the other banks in Kuwait during the period 1978-1987 proving that banking can be carried out without recourse to interest which is prohibited by Islam and offering its services to the devout Muslims who used not to use banks for investing their savings.

## CHAPTER TEN

### PERFORMANCE OF FAISAL ISLAMIC BANK OF EGYPT (FIBE)

#### 10.1 INTRODUCTION

Although Egypt may be qualified as 'the cradle of Islamic Banking' because it was the first country to experience successful Islamic banking in the 1960s (see chapter 3 above), FIBE is the first joint venture Islamic commercial bank to be established in Egypt in 1978 in accordance with the principles of Islamic Shariah and under the legislation covering the investment of Arab and foreign capital. It is, thus, one of the oldest existing Islamic Banks in the world.

The present chapter attempts to gauge and analyse the performance of FIBE as compared to those of the oldest and largest bank in Egypt, the NBE (National Bank of Egypt), the OCB (Other Commercial Banks: that is the EBS excluding FIBE and NBE) and to the EBS (Egyptian commercial Banking System) as a whole but before doing this, it is perhaps, very important to give an overview on the Egyptian economy and on the development of its banking system.

#### 10.2 THE EGYPTIAN ECONOMY: AN OVERVIEW

Egypt is a developing country, with 1m sq Km and a population of about 50m in 1987. Its income per capita is very low (US\$820 in 1984). In comparison to other Arab Middle Eastern countries, Egypt is one of the poorest Arab countries. Birks and Sinclair (1982:35) noted that: "The Arab region is generally thought of as wealthy, being the recipient of a large income from oil. In reality, oil wealth is confined to a small minority of states and peoples. Most of the region's population are poor". They cited Egypt among the poorest Arab countries though it has recently started exporting some oil. Its economy exhibits a number of poverty features such as low per capita income, low rates of saving and investment, high propensity to consume, maldistribution of incomes, limited satisfaction of basic needs, high rates of inflation, falling standards of living and rising level of unemployment.

Egypt is the most populous country of the Arab World and the second of the African countries after Nigeria. Peasant farmers make up over 50% of the population living in rural areas (about 58% in the 1970s and more than 80% in the 1960s), but less than 4% of Egyptian land is suitable for farming and about 96% of its total area is desert (Encyclopedia Britannica 1974). The lack of forests, permanent meadows or pastures, throws a heavy burden on the available arable land which totals less than 7m acres. This limited area, which sustains on average almost 7 persons per acre, is however highly fertile, and is cropped more than once a year, although still mainly ploughed and harvested by archaic means. Traditionally Egyptian farmers had to await the arrival of the annual flood of the Nile river to plant their crops. During the 20th century, however, an extensive system of dams, reservoirs and canals has been built to control and use the waters of the Nile more effectively. For instance, the Aswan High Dam helped providing enough power and water to irrigate an additional 2m acres of Egypt's farm land and to convert part of the former desert into fertile land.

Before 1975, agriculture was the most important sector of the Egyptian economy, contributing more than 30% of its GDP and more than 60% of its exports. Cotton is the most important cash crop grown throughout the Nile valley and the Delta and occupies about a fifth of the arable land. Other principal crops are: maize, rice, millet, broad beans, wheat and onions. Despite a considerable output, cereal production in Egypt falls short of total consumption and a substantial proportion of foreign exchange is spent annually on the import of cereals and milling products (see Birks and Sinclair 1982, Marlowe 1966 and El-Zohry 1978).

After 1975, agriculture's share in GDP and in exports declined substantially to less than 15% of the exports and less than 20% of the GDP in the 1980s (see tables 10.1 and 10.2). This is attributable mainly to the 1974 'open door' policy which diverted investments into other sectors such as industry and services and to the discovery of some oil reserves and also to upswings in the domestic consumption.

According to El-Zohry (1978:1): "the process of industrialisation began after the 1930s world depression when the prices of cotton, the

Table 10.1 Contribution of Each of the Economic Sectors to the Egyptian GDP, 1974-85  
(in LE million and in %)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Agriculture	1280 34	1469 31	1491 28	1490 26	1561 25	1613 24	2910 20	3021 19	4000 19	3965 18	4070 17	4205 16
Industry	963 26	1285 27	1460 28	1361 24	1459 23	1605 23	2632 18	2929 19	4037 19	4333 20	4858 20	5369 20
Oil and mining	** **	** **	** **	324 6	378 6	577 8	2504 18	2808 18	3548 17	3500 16	3913 16	4258 16
Distribution	572 15	882 18	1074 20	1176 20	1410 23	1490 22	3654 26	4080 26	5703 27	6289 28	7275 30	7766 29
Services	935 25	1143 24	1243 24	1354 24	1424 23	1558 23	2539 18	2899 18	4027 19	4073 18	4436 18	4784 18
Total	3751 100	4779 100	5268 100	5715 100	6232 100	6843 100	14339 100	15737 100	21316 100	22160 100	24560 100	26383 100

Notes: \*\* Included in industry

Sources: NBE Economic Bulletin, various issues.  
CBE Annual Reports, various issues.

Table 10.2 The Main Egyptian Exports and their Relative Importance (in LE Million and %)

	1980	%	1981	%	1982	%	1983	%	1984	%
Agricultural Commodities	374.6	15.8	391.6	14.1	332.8	12.0	347.2	12.9	483.4	16.9
Industrial Commodities	1930.2	81.4	2304.0	82.9	2293.1	82.8	2151.8	80.2	2218.9	77.5
A Petroleum industry	1497.0	63.2	1919.4	69.1	1914.6	69.1	1859.3	69.3	1796.7	62.8
B Spinning and weaving	235.3	9.9	223.1	8.0	195.2	7.1	157.5	5.9	212.3	7.4
C Other industries	197.9	8.3	161.5	5.8	183.3	6.6	135.0	5.0	209.9	7.3
Undistributed Goods	65.1	2.8	83.4	3.0	142.5	5.2	184.3	6.9	159.4	5.6
Total = 1 + 2 + 3	2369.9	100.0	2779.0	100.0	2768.4	100.0	2683.3	100.0	2861.7	100.0

Source: CBE Annual Reports, various issues.



main Egyptian crop, fell more sharply than most other commodities. Attempting to break its dependency on agriculture through rapid industrialisation, Egypt developed many industries. Textile manufacturing and food processing are traditionally the most important industries, but newer industries such as the manufacturing of steel, chemicals and automobiles, though still not sufficient, are expanding quite rapidly".

The largest section of Egypt's manufacturing industry in the late 1960s was represented by spinning and weaving. This was followed in the 1970s by food processing, engineering industries, chemicals and building materials, other manufactured products included cotton yarn, textiles, edible oils, refined sugar, cheese, bleached rice, cigarettes, vehicles, tyres and pneumatic tubes, paper, soap, commercial fertilisers and glass products. Aswan High Dam contributes greatly in the development of more industries, which are expanding especially after the 1974 'open door policy' which encouraged foreign investments in Egypt, by providing enormous amounts of electricity for industrial use. Now the industrial sector is contributing about 40% of the GDP. This includes petroleum, electricity and construction. During the last decade the industrial sector succeeded in achieving a continuous increase of output, exports, domestic sales as well as a growth in the volume of the labour force engaged therein. The GDP generated by this sector according to Ministry of Finance's figures, has recorded an annual growth ranging between 7.5% and 17.8% especially the petroleum sector which in 1976 realised for the first time a surplus in its balance of payment as against a deficit of LE92m in 1974 and which, since then, has become the leading sector in the economy ranking first among the basic sources of foreign exchange contributing about 66% to the total value of Egyptian exports and about 17% to the GDP (see tables 10.1 and 10.2).

### 10.3 THE EGYPTIAN BANKING SYSTEM (EBS)

The origin of the interest based Egyptian Banking System may be traced back not only to 1898 when the National Bank of Egypt (NBE), the oldest surviving bank, was established but long before that. According to Abdou (1976:156), attempts to establish banks in Egypt, started in

1830 when the then ruler of Egypt, Mohammed Ali Pasha, tried with the help of some foreigners to open the first bank in Egypt. The attempt did not succeed because Mohammed Ali did not pay up the capital he promised. Another unsuccessful attempt was made by an Armenian called El-Kessinyan in 1848 when he demanded and obtained from El-Khedivi Abbas, son of Mohammed Ali, the right to manage the treasury resources at his own risk and in return, pay 10% interest back to the Treasury. El-Kessinyan could not succeed in making profit and could not even pay back the resources of the Treasury and was thus jailed. Then during the rule of Saeed and Ismael, a great number of foreign banks started operating in Egypt for two main reasons. First, during the period 1863-79 Egypt depended almost completely on foreign debts because of Saeed's involvement in the high cost digging of the Suez Canal and because of the extravagance of Ismael's spending on fine arts. Second, the demand on Egyptian cotton increased manifold because of the American Civil War (1861-65) which reduced American supply to Europe.

Some of these foreign banks came to Egypt mainly to manage closely their claims on the Egyptian government and the others mainly to secure cotton supplies at cheaper prices to Europe. The former disappeared with the redemption of foreign debts in 1876 and the creation of the debt funds. Some of these banks, to mention only a few are, Greenfield Bank, Egyptian Austria Bank, Goldsmith Bank, Egyptian French Bank, Rothschild's Bank, etc.. As for the foreign banks which came to Egypt to finance and secure the export of cotton to European industry and to promote European trade to Egypt, the British banks were the first to arrive in Cairo and Alexandria, followed by the French, the Italians, the Japanese, the Greeks, the Belgians and the Germans. The First Bank was established in 1856 by an Armenian in London, with a paid up capital of £250,000 fully subscribed in London and with its general office in Alexandria and a branch in Cairo. It was called Bank Misr (this has nothing to do with the 1920 purely Egyptian Bank, Banque Misr). Its purpose was to secure the supply of cotton to the British textile market and to promote British trade to Egypt, but it was involved in giving a large loan to El-Khedivi Abbas. Faced by buying the largely

available treasury bonds at 30% interest rate, this bank was bankrupt in 1911 because of the 1907 banking crisis (ibid:161). For other banks see table 10.3 below and for further details see Abdou (1976:181-91).

Table 10.3 Foreign Banks in Egypt before 1900 AD

Name of Bank	Date of Operation in Egypt	Headquarters
Bank Misr (old)	1856	London (Britain)
The Anglo-Egyptian Bank	1864	London (Britain)
Ottoman Bank	1866	Istanbul (Turkey)
Yukuhuma Bank	1870	Tokyo (Japan)
Credit Lyonnais	1874	Paris (France)
Bank Roma	1880	Rome (Italy)
Discount and Savings Bank	1887	Cairo (Egypt)
Athens Bank	1895	Athens (Greece)
National Bank of Egypt	1898	Cairo (Egypt)

Source: Abdou (1976)

In the early years of the 20th century, the continually rising prices of cotton and the relative political stability in Egypt in view of the Anglo-French agreement in 1904, induced tens of other foreign banks to come to Egypt and so a large amount of foreign capital flooded the country causing hyper-inflation, financial crisis and a collapse of the economy in 1907. The NBE, established in 1898 as a joint stock company with half of its capital of £1m, subscribed in London by one individual (Sir Ernest Cassel) and the other half by two British companies residing in Egypt, could do nothing to save the situation because although it had the privilege to issue bank notes, make advances to the government, discount bills and receive deposits, in other words acting as a Central bank and as a commercial bank at the same time, it did not play the role of lender of last resort and of supervision. This was because foreign banks with strong links with their parent banks outside Egypt, did not feel the need for it, nor did they want to be closely scrutinised. Each bank used to discount its bills and borrow from its principal headquarters or from foreign money markets especially London and each bank was protecting its independence and its operational secrecy. Besides, each bank used the language of its country and did not publish reports on its operations in Egypt, except the Discount and

Savings Bank, which was in the form of an Egyptian joint stock company. Hansen and Marzouk (1965:214) reported that: "statistics of the balance sheets of commercial banks were little known before 1946 in Egypt".

As most of these banks had foreign control or ownership, they were not interested in the economic or financial development of the country. On the contrary, they were rather concerned in expatriating the maximum profits possible and in securing the interests of their respective countries especially at a time when there was no control over them and no restriction on the movement of funds between Egypt and their head-offices. As Hansen and Marzouk (1965:215) noted: "until 1947, Egypt was almost a country without monetary policies of its own. Movements of funds between London and Cairo were free, and this enabled the commercial banks, since most of them were branches of foreign banks, to rely on their head-offices abroad for funds to finance the cotton crop. They were engaged mainly in financing those expatriates and borrowers whose collateral and reputation were very well known to them and who were engaged in the large scale export of cotton". Eshag and Kamal (1967:97), describing their failure to serve the Egyptian community wrote:

At the turn of the century, some three-quarters of a million farmers representing over 80% of Egypt's landowners were small in the sense that their lands consisted of lots of less than 5 feddans (5.20 acres). Most if not all of these farmers had no access to credit on normal credit terms from the country's... commercial banks (which) were mainly concerned with financing the principal export crop cotton by advancing short-term loans to big landlords, merchants and exporters but they were unwilling to undertake small credit transactions with the mass of small cultivators. Some of the funds advanced by the banks were passed down to small cotton growers but the interest charged by the intermediaries was invariably much higher than the statutory maximum of 9 per cent charged by the banks.

At that time the majority of the Egyptians were also not interested in depositing their savings with these banks. Many reasons may be given, of which, perhaps the most important, is the problem of interest which is not allowed in Islam. Second, they were very poor and lived in rural areas with little to save or no contact with the banks which were concentrated in the big cities (Cairo and Alexandria). Third, the lack of confidence in bankers who came with the French and the British colonisation and fourth, gold and silver were the most respected forms of money while paper money was more of a joke than a reality.

Seeing the 1907 economic and financial crisis caused to the country by foreign banks, the famous Egyptian economic leader Mohammed Talaat Harb started thinking about the establishment of a pure Egyptian bank to look after the interests of the country and to help the small depositor and borrower. In 1908 he presented the idea to the first national congress which came up with a communique urging the Egyptian population to support the establishment of a pure Egyptian bank which: "would save the Egyptian economy from bankruptcy and the Egyptian wealth from the hands of foreign banks and their usurious transactions". In 1911 Talaat Harb published a book entitled: The Economic Solution to Egypt and the Project of an Egyptian Bank. In 1920, he succeeded in establishing the first purely Egyptian bank, Banque Misr. The subscription to its initial capital of LE80,000 was encouraged by newspapers, magazines and schools. For instance, each schoolboy was required to subscribe to at least one share of the bank (see Abdou 1976:76). In addition to traditional banking the bank was authorised by its statutes to participate in the establishment of national industrial ventures.

Being a purely Egyptian bank and claiming to be established on the basis of the Shariah, though not really, "the initiative was crowned with success and made possible the promotion of a number of important industries, especially in the field of textiles" (Tadros 1980:163); many of which still form an important part of Egypt's industrial base. At present Banque Misr is the second largest bank after the NBE and is competing for the first place by opening branches that work according to Islamic Shariah alongside its interest-based banking and by offering various savings schemes similar to those offered by the NBE.

Until the revolution of 1952, the banking system was mainly in foreign hands. The commercial banking system was divided into 3 main sections: the partially and increasingly Egyptianised NBE, the purely Egyptian Banque Misr and the rest, branches of foreign banks or banks registered in Egypt but owned mainly by foreigners. In late 1952 the second purely Egyptian bank, Banque du Caire was established with an initial capital of LE500,000. Its activity was primarily concerned un-

til recently with the services sector in accordance with banking specialisation, but it has expanded its operations in the last few years and is the third largest bank in the country. In 1957 year of the Egyptianisation of the banking system, El-Gamhuria Bank was established to take over the offices of the Ottoman Bank and Bank of Alexandria was established to take over the local branches of Barclays Bank DC&O.

The NBE's de facto position of central bank remained till 1951 when the Egyptian law No.571 of 1951 changed it into de jure position. The bank remained a private company and although not called upon to withdraw from commercial banking activity, was required not to deal with small accounts. On the 1st of January 1961, it was divided into two separate banks, one for carrying out central banking functions proper under the name of the Central Bank of Egypt (CBE) and the other for conducting ordinary commercial banking operations to retain the name of the National Bank of Egypt (see A. Ali 1958:55 and Tadros 1980:153).

Owing to the predominance of foreign banks in Egypt and following the military aggression on the country in 1956 which led to the confiscation of British and French banks operating in Egypt, another important step was taken in the late 1950s. Mackie (1981:131) reported that:

In the late 1950s, Egypt withdrew from the world. Foreign contacts with the West were cut in an effort to redress the balance which until the 1952 revolution, had been in favour of the foreigners. Egyptianisation eventually became nationalisation and the banking sector was one of the first to feel the wind of change. The small private banks were all absorbed in the four biggest: the NBE, which until the creation of the Central Bank in 1961 performed its functions, Banque du Caire, Bank of Alexandria and Banque Misr.

This situation of closed door policies and of highly concentrated socialist strategy of development remained until 1974, date of proclaiming the 'open door policy'. During this period the banking system was unsuccessful to attract sufficient savings for the economic development of the country, despite the various savings schemes devised by the NBE, Banque Misr, Banque du Caire and Bank of Alexandria to attract savings. For instance the NBE, in addition to ordinary demand, savings and time deposits, devised 3 types of saving certificates in order to suit different categories of savers and to attract the maximum possible volume of savings and time deposits. First it introduced in January 1965 sa-

vings certificates with a progressively appreciating value, known as group A certificates. Originally these bonds were issued in denominations ranging between LE5 and LE500 to be redeemed at 165% tax free of their nominal value provided they were held for 10 years until maturity. With the gradual raising of interest rates, the redeemable value of such certificates at maturity had risen to 240% in 1979, 325% in 1981 and 365% in 1985. However, reimbursement is permitted after an initial period of six months or more in accordance with a graduated scale so that the surrender value rises gradually to yield the maximum if held for 10 years. The second type of savings certificates known as group B or current income bonds were also introduced in 1965 and issued in denominations varying from LE10 to LE5000. The returns payable every six months, originally 5%, has been raised gradually in the last few years in accordance with the rise of interest rates to reach 13.25% if the certificates are held until maturity. Reimbursement is also permitted after six months subject to discount and the third type, known as group C or lottery certificates introduced on the 4th of February 1968 are supposed to be non interest-bearing certificates but the holder is entitled to take part in five monthly drawings in each of which the first prize, originally amounts to LE10,000 was raised to LE15,000 in 1981, the second LE2,000 raised to LE5,000, while the remaining prizes range between LE1000 and LE10.

As Table 10.4 shows, the poor performance of interest based banks in the period 1953-73 to attract deposits can be seen from the very low average rate of TSD/GNP which was 7.2% growing from 4.5% in 1953 to only 9.1% in 1973 at an annual ARG of 4.5%, and by the low average per capita savings of LE5.07 which grew from only LE1.96 to LE9.29 at an annual ARG of 9%. The Banking habit, as measured by DD/M1, is also very low. In fact the average DD/M1 ratio for the period was only 35.6% growing at less than 1% annually and so is the average TSD/TLD which stood at 39% growing from 20% in 1953 to 44% in 1973 at an annual ARG of less than 3%. This means that the average DD/TLD ratio was more than 60% which indicates that even among those who dealt with banks in those

days preferred interest free demand deposits over interest based deposits to avert the sin of taking interest which is prohibited by Islam.

Table 10.4 Contribution of the EBS in the Promotion of Savings, Banking Habits and GDP (1953-73)

YEAR	TSD/GNP %	MG %	TSD/c LE	MG %	DD/M1 %	MG %	TSD/TLD %	MG %	BTA/GDP %	MG %
1953	4.5	-	1.96	-	30.8	-	29	-	na	-
1954	4.8	6.7	2.17	10.7	34.7	12.7	29	0.0	na	-
1955	4.8	0.0	2.26	4.1	36.5	5.2	30	3.4	21.5	-
1956	4.6	-4.2	2.21	-2.2	34.0	-6.8	28	-6.7	22.4	4.2
1957	4.4	-4.3	2.20	-0.5	38.7	13.8	26	-7.1	23.2	3.6
1958	5.4	22.7	2.76	25.4	38.7	0.0	31	19.2	24.1	3.2
1959	6.1	13.0	3.33	20.7	42.0	8.5	34	9.7	26.8	11.2
1960	5.7	-6.6	3.05	-8.4	40.7	-3.1	32	-5.9	28.6	6.7
1961	5.9	3.5	3.24	6.2	43.5	6.9	30	-6.3	34.4	20.3
1962	8.9	50.8	4.95	52.8	37.7	-13.3	45	50.0	36.0	4.7
1963	0.3	15.7	6.19	25.0	33.1	-12.2	50	11.1	38.5	6.9
1964	9.5	-7.8	6.25	1.0	32.0	-3.3	47	-6.0	42.0	9.1
1965	9.0	-5.3	6.70	7.2	30.3	-5.3	50	6.4	39.7	-5.5
1966	7.6	-15.6	6.00	-10.4	34.2	12.9	44	-12.0	37.8	-4.8
1967	8.1	6.6	6.47	7.8	34.7	1.5	43	-2.3	42.2	11.6
1968	8.9	9.9	7.04	8.8	35.3	1.7	47	9.3	44.1	4.5
1969	9.5	6.7	7.78	10.5	33.5	-5.1	50	6.4	44.6	1.1
1970	9.2	-3.1	8.10	4.1	32.9	-1.8	41	-18.0	44.8	0.4
1971	7.7	-16.3	6.98	-13.8	33.9	3.0	45	9.8	40.7	-9.2
1972	7.8	1.3	7.63	9.3	36.1	6.5	43	-4.4	40.8	0.2
1973	9.1	16.7	9.29	21.8	35.3	-2.2	44	2.3	45.0	10.3
Aver.	7.2	4.5	5.07	9.0	35.6	1.0	39	2.9	37.6	4.4

Source: IMF, International Financial Statistics, various issues.

However, after 1974 'open door policy' and the establishment of Islamic banks such as Nasser Social Bank (NSB), Faisal Islamic Bank of Egypt (FIBE), International Islamic Bank for Investment and Development (IBID) and the opening of the Islamic branches that deals in conformity with Shariah by Banque Misr the 2nd largest bank in Egypt and by the Bank of Commerce and Development (BCD) and others, things have changed dramatically. For instance, as shown in Table 10.5 the average TSD/GDP ratio has increased by about five and a half times in 14 years from 13.5% in 1974 to 74% in 1988 growing at an annual ARG of 13.4% while it took 21 years to only double in the previous period. The average per capita saving also increased substantially in the period 1974-88 as compared to the 1953-73 period. While it was only LE5.07 in 1953-73 period growing at only 9% from LE1.96 in 1953 to LE9.29 in 1973 and recording less than five fold increase, it became LE204.6 for 1974-88



period growing at 32.7% from LE13.70 in 1974 to LE676.5 in 1988 recording more than forty nine fold increase in just 14 years.

Table 10.5 Contribution of the EBS in the Promotion of Savings, Banking Habit and GDP (1974-1984)

YEAR	TSD/GNP %	MG %	TSD/c LE	MG %	TSD/TLD %	MG %	DD/M1 %	MG %	BTA/GDP %	MG %
1974	13.5	-	13.7	-	47.4	-	36.8	-	59.6	-
1975	10.8	-20.0	15.2	10.9	44.5	-6.1	37.9	3.0	63.3	6.2
1976	12.3	13.9	21.7	42.8	49.2	10.6	37.9	0.0	62.4	-1.4
1977	14.1	14.6	29.9	37.8	49.2	0.0	40.6	7.1	64.3	3.0
1978	16.9	19.9	41.7	39.5	54.8	11.1	38.5	-5.2	66.5	3.1
1979	19.7	16.6	60.8	45.8	59.5	8.6	39.0	1.3	61.5	-6.6
1980	23.2	17.8	84.9	39.6	58.9	-1.0	37.0	-5.1	79.7	28.8
1981	34.1	47.0	136.2	60.4	67.2	14.1	37.7	1.9	88.7	11.3
1982	40.6	19.1	184.5	35.5	70.2	4.5	36.6	-8.9	100.2	13.0
1983	44.2	8.9	237.0	28.5	74.1	5.6	34.7	-5.2	103.0	2.8
1984	48.9	10.6	286.9	21.1	74.8	0.9	36.6	5.5	108.0	4.9
1985	46.7	-4.5	329.4	14.8	74.0	-1.1	38.1	4.1	103.3	-4.4
1986	55.3	18.4	425.9	29.3	77.5	4.7	38.4	0.8	120.7	16.8
1987	60.5	2.4	525.0	23.3	78.1	0.8	40.9	6.5	130.9	8.5
1988	74.0	22.3	676.5	28.9	80.3	2.8	41.0	0.2	146.9	12.2
Aver.	34.3	13.4	204.6	32.7	64.0	4.0	38.1	4.3	90.6	7.0

Source: IMF International Financial Statistics, various issues.

The TSD/TLD ratio also registered a remarkable increase from under 50% in 1974 to more than 80% in 1988 growing at an annual ARG of 4%, thus indicating a switch from demand deposits to time and savings deposits to which Islamic banks have contributed very much by attracting the idle savings of the reluctant Muslims who do not want to take interest. However, the banking habit as measured by DD/M1 did not improve much in comparison to the previous period. The average DD/M1 ratio has only gone up by 2.5% to 38.1% in 1974-88 as compared to 35.6% in 1953-73 period which means that people still prefer to use cash rather than cheques. This may be explained first by the fact that in Egypt, cheques are not always accepted as a means of payment and creditors require cash payments rather than payment by cheques which needs a guarantee that sufficient money is available in the debtor's bank to cover his debt. Secondly, it takes time to cash a cheque while cash can be used immediately which explains the creditors' refusal to accept payment by cheques except when they do not need cash immediately and when they

trust the debtor and know him personally. The improvement in Egypt's financial development in the last 14 years over the previous 21 years can also be gauged by the ratio BTA/GDP which many economists use as a proxy for the FIR (financial interrelationship ratio) which was less than 50% before 1974 and which exceeded the 100% level by 1982 and stood at 146.9% in 1988 raising the average ratio from 37.6% for the period 1953-73 to 90% for the period 1974-88.

In the last few years, Egypt have witnessed a number of changes and related problems and the authorities are now unable to end the country's economic brinkmanship. Foreign debt is now around \$60m, the balance of payment deficit is \$554m, inflation is between 30-40%, and foreign exchange reserves are at record lows. With 54m population increasing by 1m every seven months, unemployment is at 20-22% and 2m unemployed graduates are waiting up to five years for government guaranteed jobs (see Laurie 1989:147). The crackdown on what is called 'Islamic Investment companies' added another blow to the confidence of depositors and investors alike in a shaky economy.

As McDougall (1988:36) reported: "Charging or receiving interest (Riba) runs against fundamental Muslim beliefs. So for religious or less orthodox reasons investors voted with their feet. In the early 1980s savers began to switch their money into a fast growing sector of unregulated Islamic Investment houses. As the funds flowed into some 50 of these they got returns as high as 24%". Naturally as M. French (1987:81) put it: "Egyptian depositors have flocked to the new companies at the expense of the nationalised banks. The investment companies have been particularly successful in attracting US dollars remittances from the 2.5 million Egyptians working in the Gulf... By the time the government realised the enormity of their growth, it was too late to stop them... Egyptian officials and economists launched a concerted attack on the investment companies (in 1986). Central bank governor Ali Nagm swore to 'destroy' them as being responsible for many people having withdrawn their money from public sector banks".

With confidence now severely dented, not only has the foreign exchange shortage become critical because the money of the Egyptians wor-

king abroad is staying out of Egypt but also the clampdown on the investment companies has also contributed to liquidity problems in the Egyptian pounds. The fall was triggered by a host of rumours that had further shaken the rocky business confidence. The rumours were aggravated by reports that four Egyptian banks, including Faisal Islamic Bank of Egypt (FIBE) and Islamic International Bank for Investment and Development (IBID), were having serious liquidity problems. The government stepped in to dissolve the latter's board and run it with a central bank committee admitting that the problem is not financial but administrative and FIBE caught the backlash of the Islamic investment companies crisis and the rumours set off a run on the bank. Although things are now calmer and confidence has returned; FIBE has a long way to go to reverse the deficit (Laurie 1989:147-9). It is against this background that the performance of FIBE should be gauged.

#### 10.4 PERFORMANCE OF FIBE AS COMPARED TO NBE, OCB AND EBS

##### 10.4.1 Establishment, Objectives and Operations of FIBE

FIBE opened its door to the general public in July 1979 with the objective to perform all banking and financing in industrial, economic, development and urbanisation projects either locally or abroad in accordance with its statutes and the operations that it can undertake, may be summarised in the following:

- 1 To open current accounts, issue cheques and grant credit;
- 2 Receive deposits and invest them Islamically;
- 3 To keep trusts and receive personal and real securities;
- 4 To receive title documents, company shares, bills of exchange and other commercial documents for safekeeping and collection on behalf of their owners
- 5 To collect and pay cheques and payment orders.
- 6 To handle storage operations.
- 7 To issue shares for the account of institutions and companies and help them in subscription operations at the time of incorporation or increasing their capital and to act as a trustee;
- 8 To represent banks and institutions which exercise similar objects and participate in any way with other companies, institutions or banks performing similar activities in accomplishing its objectives in Egypt and abroad. It may also found such companies or institutions;
- 9 To perform all business operations and transactions as may be necessary to accomplish its objectives provided these shall not involve in any Riba or other prohibited activities;
- 10 To handle commercial, industrial agricultural or other operations either directly or through companies which it can create or participate therein;
- 11 To rent, buy and sell lands or erect buildings and properties.

- 12 To handle foreign exchange operations and any other banking operations not conflicting with Shariah.
- 13 To accept grants and donations from individuals and organisations (for the purpose of spending them in aspects conducive to the attainment of its objects and social services) and aids, provided the acceptance thereof shall be by a decision from the board of directors;
- 14 To offer advice on financial and economic matters based on its Islamic experience to official authorities in the Islamic and other countries which may seek such advice.

From the above mentioned operations that FIBE can perform, one can qualify FIBE as a Multi-purpose Financial Institution rather than just a bank because according to the list of operations it may handle, it is more than an ordinary bank, a building society or a merchant bank. In addition to the CBE supervision over its operations, a religious supervisory board is also formed within the bank to observe its conformance with the principles of the Islamic Shariah.

#### 10.4.2 Performance of FIBE, NBE, OCB and EBS in terms of K&R

FIBE's initial capital, as fixed by article 5 of law No.48/77, was US\$8m divided into 80,000 shares of US\$100 each, 50% of which for Egyptians payable in dollars or in any convertible currency and the remaining 49% for Saudi subscription or any non-Egyptian Muslim, payable in US dollars. But in view of a staggering and unexpected oversubscription that reached US\$20m in the first 4 months, the authorised capital had to be raised from the initial US\$8m to US\$30m, but still subscription to the Islamic bank's capital kept growing to reach US\$36m in the following 5 months of the same first year and consequently authorised capital was raised for the second time in the same first year to US\$40m, in other words to five times the initial suggested capital. On 17/3/83, that is to say, after just 4 years of activity, FIBE's authorised capital was raised again to US\$50m and lastly on 31/1/1984, the general meeting of shareholders agreed to raise the bank's authorised capital to US\$500m to cope on one hand with the increasingly high demand on the subscription in the bank's capital and on the other hand to cope also with the staggering increase of deposits so as to maintain its capital ratio in accordance with the Egyptian banking regulations.

As shown in Table 10.6 the K&R of FIBE in current prices registered more than sixteen and a half fold increase during its first 9 years of

Table 10.6 Comparative Analysis of the Performance of FIBE, NBE, OCB and EBS in terms of K&R

Year	FIBE			NBE			OCB			EBS		
	Amount LEM	Index %	MG %	Amount LEM	Index %	MG %	Amount LEM	Index %	MG %	Amount LEM	Index %	MG %
Current Prices												
1979	9.21	45	-	61.14	88	-	224.65	85	-	295.00	83	-
1980	20.67	100	124	69.43	100	14	264.30	100	18	354.40	100	20
1981	37.90	183	83	84.87	122	22	288.23	109	9	411.00	116	16
1982	32.98	160	-13	108.10	156	27	433.62	164	50	574.70	162	40
1983	42.66	206	29	122.57	177	13	549.57	208	27	714.80	202	24
1984	72.09	349	69	137.84	199	13	667.07	252	21	877.00	247	23
1985	73.97	358	3	156.00	225	13	823.53	312	23	1053.57	297	20
1986	151.66	734	105	169.00	243	8	859.34	325	4	1180.00	333	12
1987	153.17	741	1	180.00	259	7	930.03	352	8	1263.20	356	7
ARG			50			13						20
Constant Prices												
1979	11.11	54	-	73.75	106	-	270.99	103	-	355.85	100	-
1980	20.67	100	86	69.43	100	-6	264.30	100	-3	354.40	100	0
1981	34.33	166	66	76.88	111	11	261.07	99	-1	372.28	105	5
1982	26.10	126	-24	85.25	123	12	341.97	129	31	453.23	128	22
1983	28.98	140	11	83.27	120	-2	373.35	141	9	485.60	137	7
1984	41.62	201	44	79.58	115	-4	385.14	146	3	506.35	143	4
1985	37.90	183	-9	79.92	115	0	421.93	160	10	539.74	152	7
1986	63.38	307	67	70.62	102	-12	359.11	136	-15	493.11	139	-9
1987	53.48	259	-16	62.85	91	-11	324.73	123	-10	441.06	124	-11
ARG			28			-2						3

Sources: IMF, International Financial Statistics  
 FIBE, Annual Reports 1979-87  
 NBE, Annual Reports 1979-87

operations between 1979 and 1987 increasing from LE9.21m in 1979 to LE 153.17m in 1987 at an annual ARG of 50% compared to that of NBE which increased by only 13% from LE61.14m in 1979 to LE180m in 1987 and those of OCB and EBS which increased by 20% each during the same period. Allowing for inflation by deflating the current prices by the CPI of the period, FIBE's K&R grew at an annual ARG of 28% while that of the NBE declined by 2% and those of OCB and EBS grew at only 3% each. The comparison can better be seen from each of FIBE, NBE, OCB and EBS indices of current and constant prices K&Rs, taking 1980 as a base year (see table 10.6 and Figure 10.1).

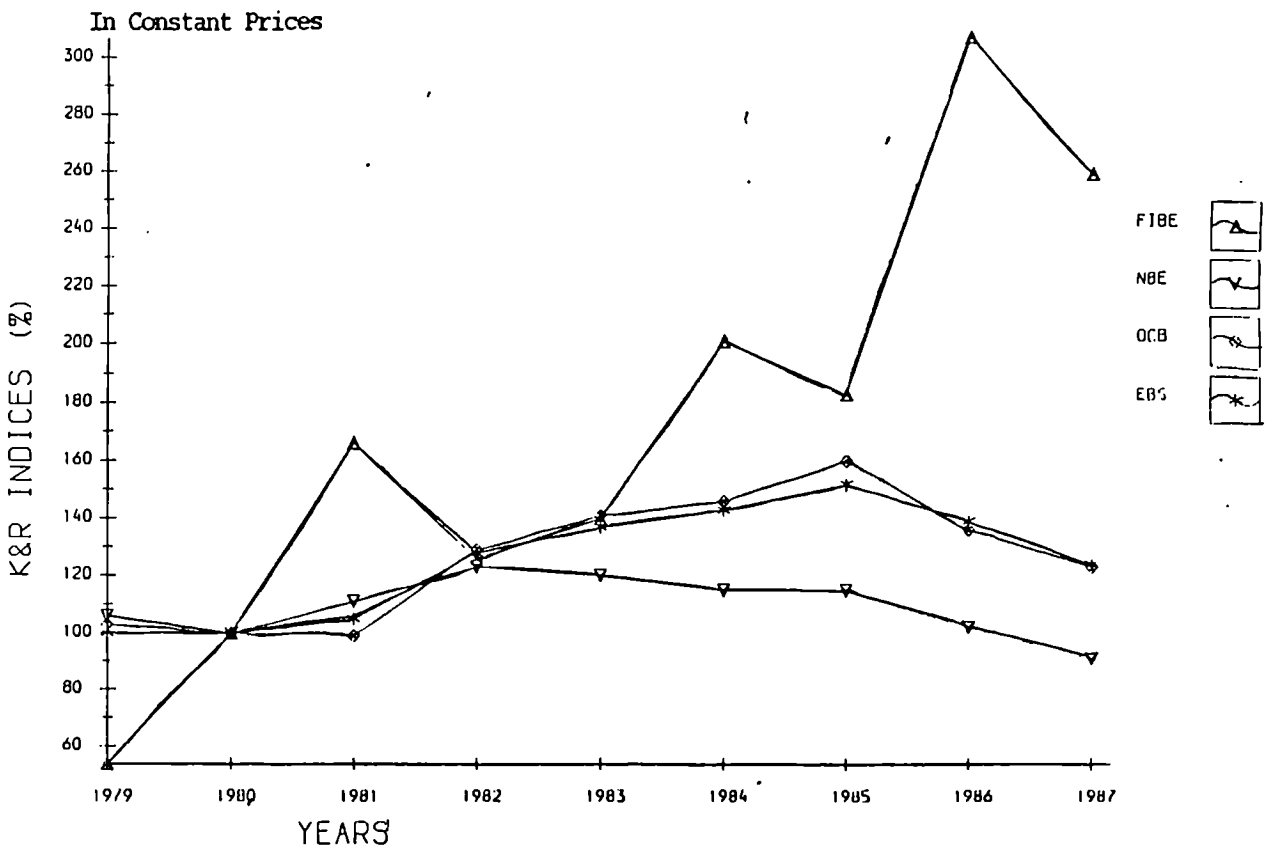
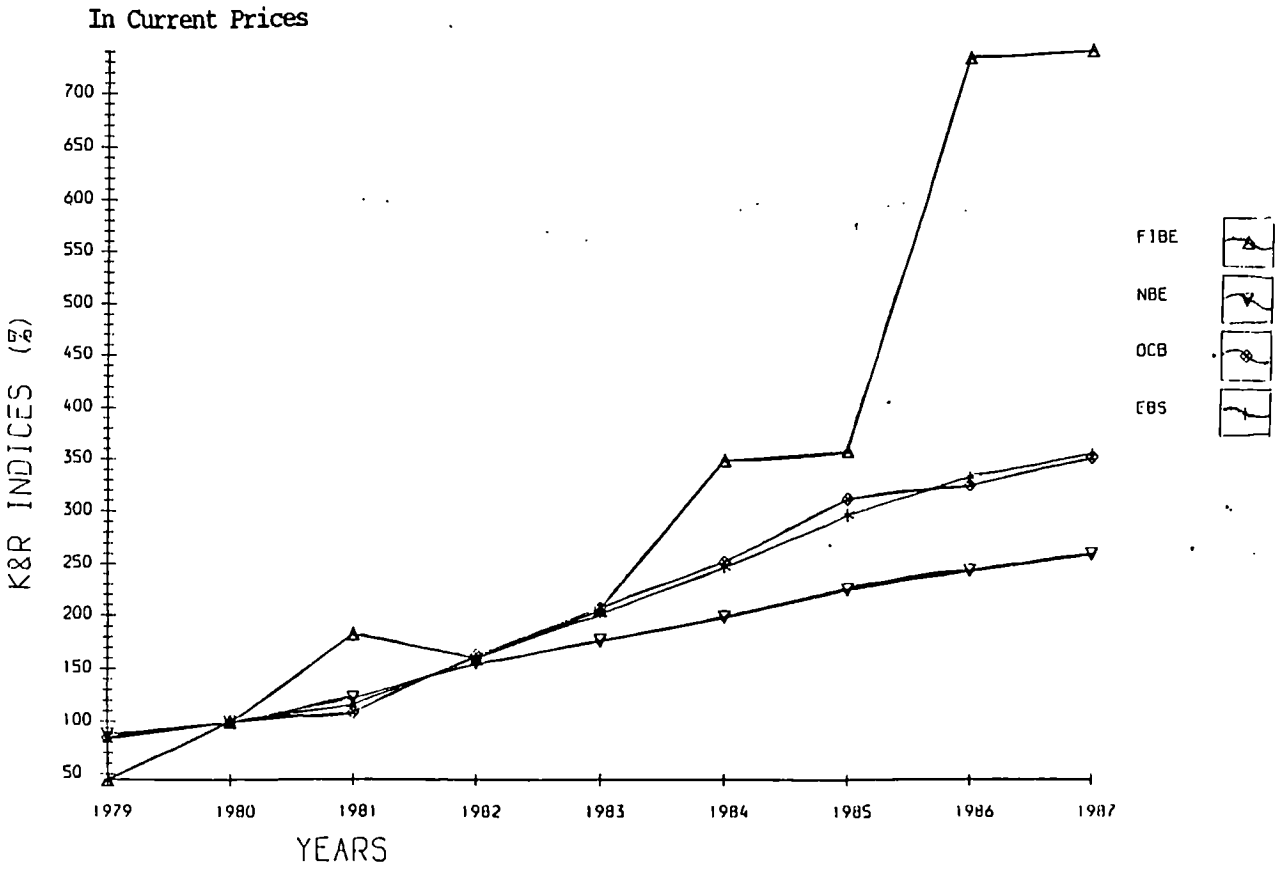
Table 10.7 shows the share of each of FIBE, NBE and OCB in the total K&R of EBS. From the first year of its existence FIBE counted for more than 3% in the EBS aggregate K&R. By 1986 it reached a share of 12.9% but in 1987 its share dropped to 12.1% due mainly to the low rate of growth of its capital and reserves in that year, which was only 1% compared to previous years. Nevertheless, even reaching the level of 12% in the total EBS capital and reserves in this very short time (ie 9 years only) is staggering if we take into consideration the number of 44 commercial banks working in Egypt, up to June 1987, most of them are more than 10 years old and some of them are more than 25 years old. FIBE's share grew at an annual ARG of 26.6% compared to that of NBE and OCB which declined by 4.5% and 0.25% respectively despite the establishment of new banks and the raising of the paid up capital of the reserves some others during this period.

Table 10.7 The Shares of FIBE, NBE and OCB in the K&R of EBS (in %)

Year	FIBE	% Change	NBE	% Change	OCB	% Change	EBS
1979	3.1	-	20.7	-	76.2	-	100
1980	5.8	87	19.6	-5	74.6	-2	100
1981	9.2	59	20.6	5	70.1	-6	100
1982	5.7	-38	18.8	-9	75.5	8	100
1983	6.0	5	17.1	-9	76.9	2	100
1984	8.2	37	15.7	-8	76.1	-1	100
1985	7.0	-15	14.8	-6	78.2	3	100
1986	12.9	84	14.3	-3	72.8	-7	100
1987	12.1	-6	14.2	-1	73.6	1	100
ARG		26.6		-4.5		-0.25	

Source: Table 10.6

Figure 10.1 Performance of FIBE, NBE, OCB & EBS in Terms of K&R



Looking at the above analysis of the FIBE's performance in terms of K&R one might ask a couple of questions. Why is it that FIBE's capital was oversubscribed even before the bank started operating or showing any sign of success? and why is it that people are so interested in a bank that was going to operate in a highly competitive environment, competing with banks which give about 13% as a guaranteed return to depositors while FIBE does not promise any guaranteed return but promises to share not only its profits but its losses as well with the depositors? How such a bank can attract depositors to do business in the first place, let alone make profits? and how can the oversubscription to a bank that was not sure to make a profit be explained.

The answers to these questions can be summarised in the following: First, and perhaps the most important reason of the oversubscription to FIBE's capital is that many Muslims were prepared to invest in somewhat risky but lawful business rather than in unlawful but highly profitable business in other words their religious incentive is greater than their profit incentive. Secondly, some subscribers might have thought that since the depositors in the Islamic bank are going to share any loss that might occur with the shareholders, there is a lesser burden on the latter in case of a loss in an Islamic bank than in a non-Islamic one where the whole loss is charged in whole to the shareholders. Thirdly, some shareholders knew that many, if not most, of the Egyptian Muslims are reluctant to deposit their savings with banks that give interest for religious observance and so these would most probably deposit their savings with the new Islamic bank which gives them a share in the realised profit rather than a predetermined return and so they had no fear that the bank would not be able to mobilise deposits. Fourthly, some shareholders were sure that the bank with a good management can not only attract substantial amounts of deposits but make substantial profits as well by diversification and other financial techniques, especially when they knew that other Islamic banks established before FIBE, such as Dubai Islamic Bank (DIB) and Kuwait Finance House (KFH) which made very good profits from their first year.



#### 10.4.3 The Performance of FIBE, NBE, OCB and EBS in terms of TLA

FIBE's TLA in current prices went up from LE27.12m in its first year of business in 1979 to LE3130.82m in 1986 then slightly declined in 1987 to LE2991.04m, growing at an annual ARG of 110% and recording more than 110 fold increase in just 9 years, while that of NBE, the oldest and largest bank of the country recorded less than 4 fold rise and grew at an annual ARG of 19% during the same period from LE2824.60m in 1979 to LE10820m in 1987 and those of OCB and EBS grew at 29% and 26% from LE4951.28m to LE32088.96m and from LE7803.00m to LE45000m respectively which means that FIBE performed better than the NBE, OCB taken together and the EBS as a whole in terms of TLA despite the fact that, as Johns (1987:22) reported: "In terms of assets the scene is still dominated by the big four public sector banks -National Bank of Egypt, Banque du Caire, Banque Misr and Bank of Alexandria- which currently share as much as three quarters of the market and handle most of the business of the public sector entities".

After allowing for inflation by deflating the current prices by the CPI of the period, it was found that while FIBE's TLA grew at an annual ARG of 80% from LE32.71m in 1979 to LE1044.36m in 1987, NBE's TLA grew at an annual ARG of only 2% from LE3407.24m in 1979 to LE3777.93m in 1987 and those of the NBE, OCB and EBS grew only by 10% and 8% respectively from LE5972.59m and LE9412.50m in 1979 to LE11204.25m and LE16026.54m in 1987 respectively (see table 10.8).

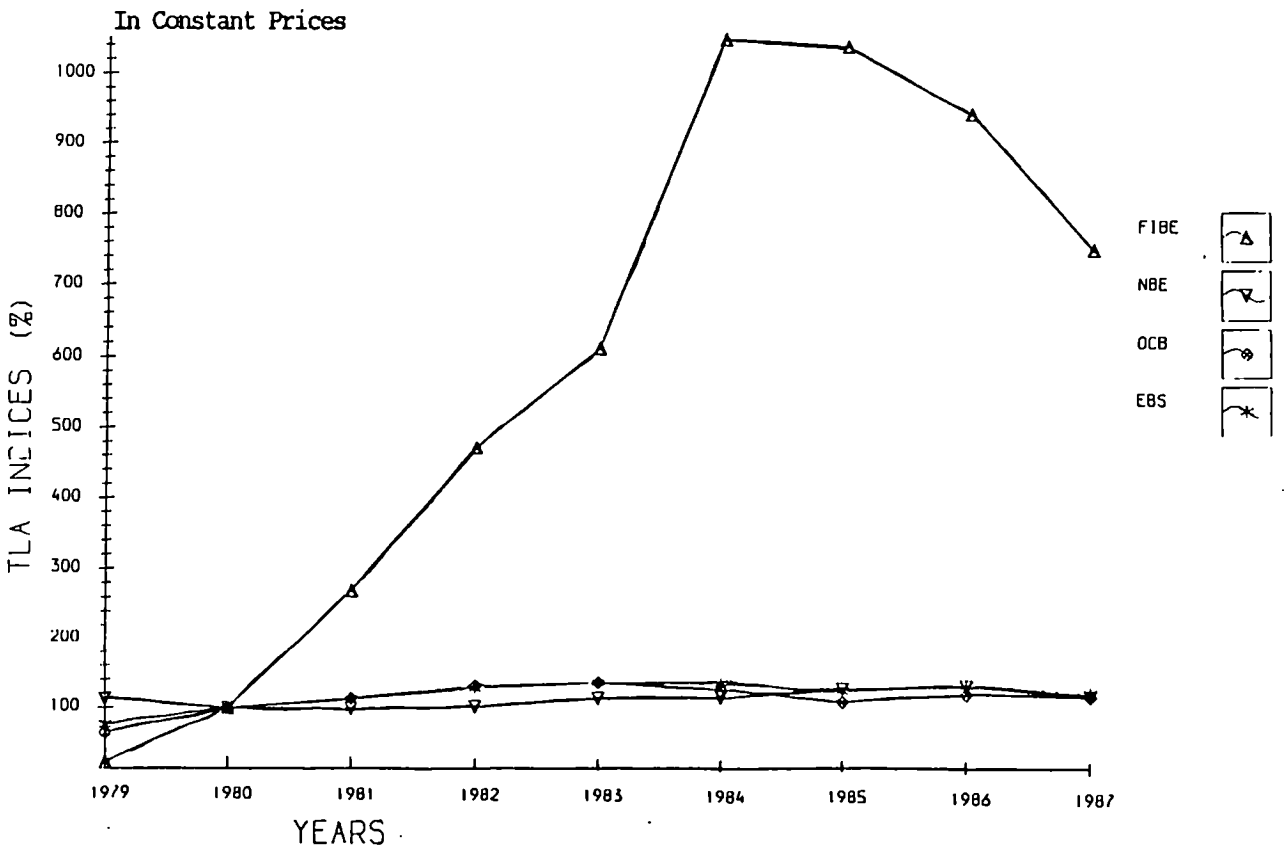
Taking 1980 as a base year, the TLA indices of FIBE in current prices grew from 20% in 1979 to 2167% in 1987, while those of NBE, OCB and the EBS grew only from more than 50% to less than 380%. The indices of FIBE's TLA in constant prices grew from 24% in 1979 to 757% in 1987 while that of NBE grew from 112% to 124% only. OCB and EBS indices grew from 65% to 123% and from 76% to 130% respectively (see table 10.8 and Figure 10.2). The comparison between the performance of FIBE and those of NBE and OCB can also be seen from Table 10.9 which shows the development of their market shares in the TLA of the EBS as a whole. In its first 6 years FIBE managed to get more than 9% share in the EBS's TLA growing from 0.4% in 1979 to 9.1% in 1985 but due to a reduction in

Table 10.8 Comparative Analysis of the Performance of FIBE, NBE, OCB and EBS in terms of TLA

Year	FIBE			NBE			OCB			EBS		
	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %
Current Prices												
1979	27.12	20	-	2824.60	93	-	4951.28	54	-	7803.00	63	-
1980	138.01	100	409	3047.69	100	8	9136.30	100	85	12322.00	100	58
1981	412.22	299	199	3377.31	111	11	11590.47	127	27	15380.00	125	25
1982	827.10	599	101	4006.47	132	19	15490.43	170	34	20324.00	165	32
1983	1248.49	905	51	5256.87	173	31	18844.64	206	22	25350.00	206	24
1984	2513.58	1820	101	6347.00	208	21	20920.42	229	11	29781.00	242	17
1985	2806.25	2033	12	7856.40	258	24	20322.75	222	-3	30985.40	251	4
1986	3130.82	2269	81	10056.00	330	28	27806.38	304	37	40993.20	333	32
1987	2991.04	2167	-5	10820.00	355	8	32088.96	351	15	45000.00	373	12
ARG			110			19			29			26
Constant Prices												
1979	32.71	24	-	3407.24	112	-	5972.59	65	-	9412.50	76	-
1980	138.01	100	322	3047.69	100	-11	9136.30	100	53	12322.00	100	31
1981	373.32	271	171	3059.16	100	1	10498.61	115	15	13931.12	113	13
1982	652.29	473	75	3159.68	104	3	12216.43	134	16	16028.40	130	15
1983	848.16	615	30	3571.24	117	13	12802.07	140	5	17221.47	140	8
1984	1451.26	1052	71	3664.55	120	3	12078.76	132	-6	17194.57	140	0
1985	1437.63	1042	-1	4024.80	132	10	10411.24	114	-14	15873.46	129	-8
1986	1308.32	948	-9	4202.26	138	4	11619.88	127	12	17130.46	139	8
1987	1044.36	757	-20	3777.93	124	-10	11204.25	123	-4	16026.54	130	-6
ARG			80			2			10			8

Sources: IMF, International Financial Statistics  
 FIBE, Annual Reports 1979-87  
 NBE, Annual Reports 1979-87

Figure 10.2 Performance of FIBE, NBE, OCB & EBS in Terms of TLA



its liquidity in form of balances with other banks and in its sundry accounts in 1986 and 1987, its market share dropped to 7.7% and 6.7% respectively. Perhaps that is why there were rumours that it is becoming illiquid which led to the replacement of its governor in 1986 and a run on its deposits after the government clampdown on the Islamic Investment companies.

Table 10.9 The Shares of FIBE, NBE and OCB in the TLA of EBS (in %)

	FIBE	% Change	NBE	% Change	OCB	% Change	EBS
1979	0.4	-	36.2	-	63.5	-	100
1980	1.1	175	24.7	-32	74.2	17	100
1981	2.7	146	22.0	-11	75.4	2	100
1982	4.1	52	19.7	-10	76.2	1	100
1983	5.0	22	20.7	5	74.3	-3	100
1984	8.5	70	21.3	3	70.2	-6	100
1985	9.1	7	25.4	19	65.6	-7	100
1986	7.7	-15	24.5	-4	67.8	3	100
1987	6.7	-13	24.0	-2	71.3	5	100
		56		-4		2	

Source: Table 10.8

This performance of FIBE in terms of TLA is phenomenal considering the short time (9 years only) in which it had realised it, and considering the small number of branches (10 branches only) and the difficulties and obstacles it faced. After only 3 years of business (1979-81), FIBE managed to get the 7th rank among the 44 commercial banks in Egypt and is now competing for higher ranking in the next few years if no more problems happened. The Egyptian authorities have already been trying to slow down its remarkable performance by delaying the permission of opening more than 13 ready branches for more than 5 years now, perhaps with the view to stop it from taking over the first four ranks held by the four largest and public banks. Not only that, but after its first 3 years of business (1979-81) FIBE has also managed to get the 69th rank in 1981, the 48th in 1984, the 45th in 1985 and the 43rd in 1986 among the Arab top 100 banks which means that FIBE did not only perform very well as compared to the Egyptian banks, but as compared to banks in the Arab world as well (see The Banker, July issues).

#### 10.4.4 Performance of FIBE, NBE, OCB and EBS in terms of TLD

The analysis of FIBE's performance in terms of TLD as compared to those of the NBE, OCB and EBS can be seen in Tables 10.10-10.12 and in Figures 10.3. For instance as Table 10.10 indicates, the volume of deposits mobilised by FIBE registered over a 144 fold increase in just 9 years of business, increasing from LE16.54m in 1979 to LE 2363.59m in 1987, in current prices growing at an annual ARG of 133% despite the difficulties mentioned above. In contrast NBE, the oldest and largest bank in Egypt with more than 220 branches all over Egypt (229 branches in 1987) recorded less than 6 fold rise during the same period increasing from LE1349.74m in 1979 to LE7323m in 1987 at an annual ARG of 24%. It is important here to note that the level of deposits reached by FIBE in just 9 years (1979-87) took the NBE, 85 years (1898-1982) to reach.

The TLD of OCB grew from LE2820.72m in 1979 to LE21117.41m in 1987 at an annual ARG of 30%. This includes deposits in the Islamic bank, IBID, which was established in 1980 and which in just 3 years of business managed to attract LE256m in 1984 compared to LE61m in 1981 (see IBID annual reports, 1981-1984) and the deposits in the numerous Islamic branches of Banque Misr and other banks but does not include deposits in Nasser Islamic Bank which is yet to acquire a commercial bank licence because it was initially established as a social rather than commercial bank. The EBS total deposits increased from LE4187m in 1979 to LE30804m in 1987, thus recording more than a 7 fold rise and growing at an annual ARG of 29% (see table 10.10). However, when deflating the current prices of TLD by the CPI of the period, it was found that while FIBE's TLD in constant prices grew at an annual ARG of 93%, the NBE's TLD grew only by 6% and those of OCB and EBS grew by only 11% each.

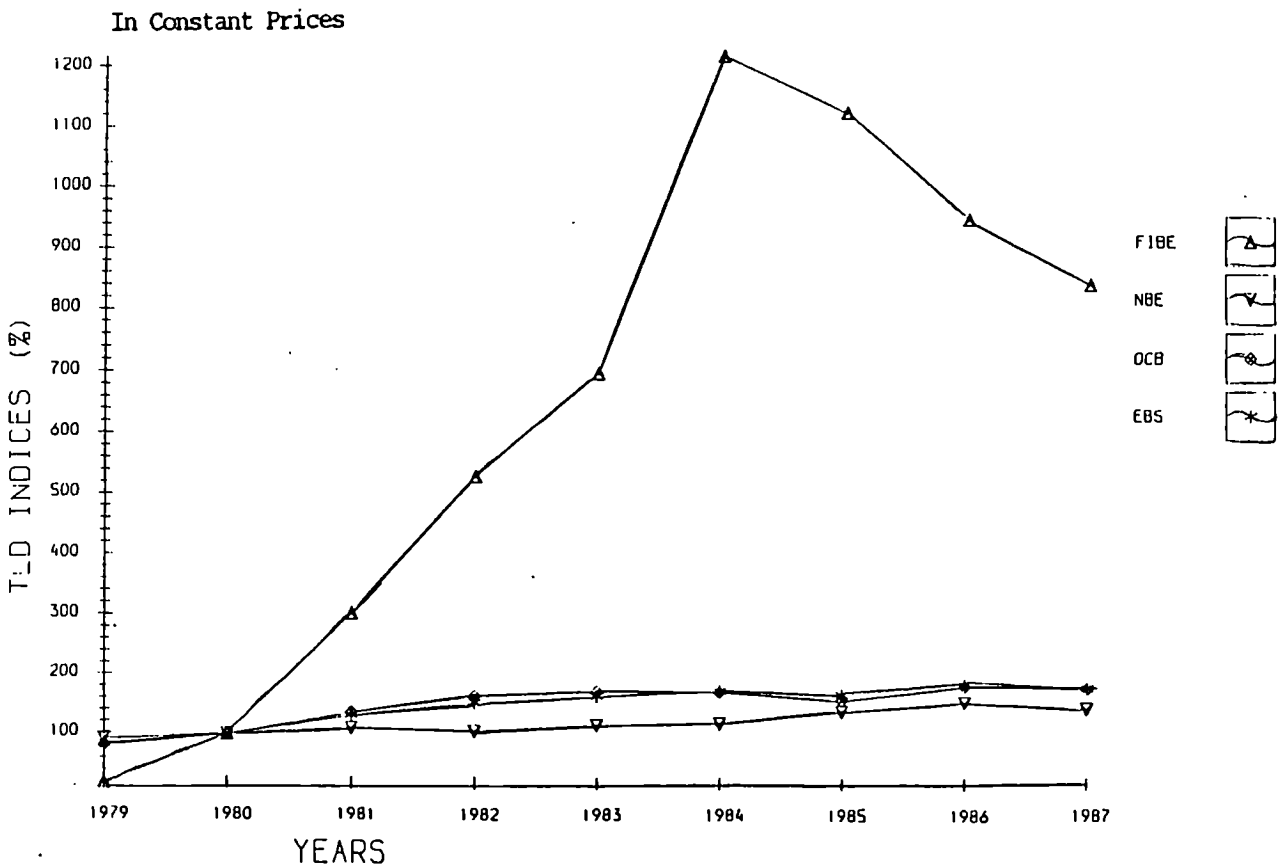
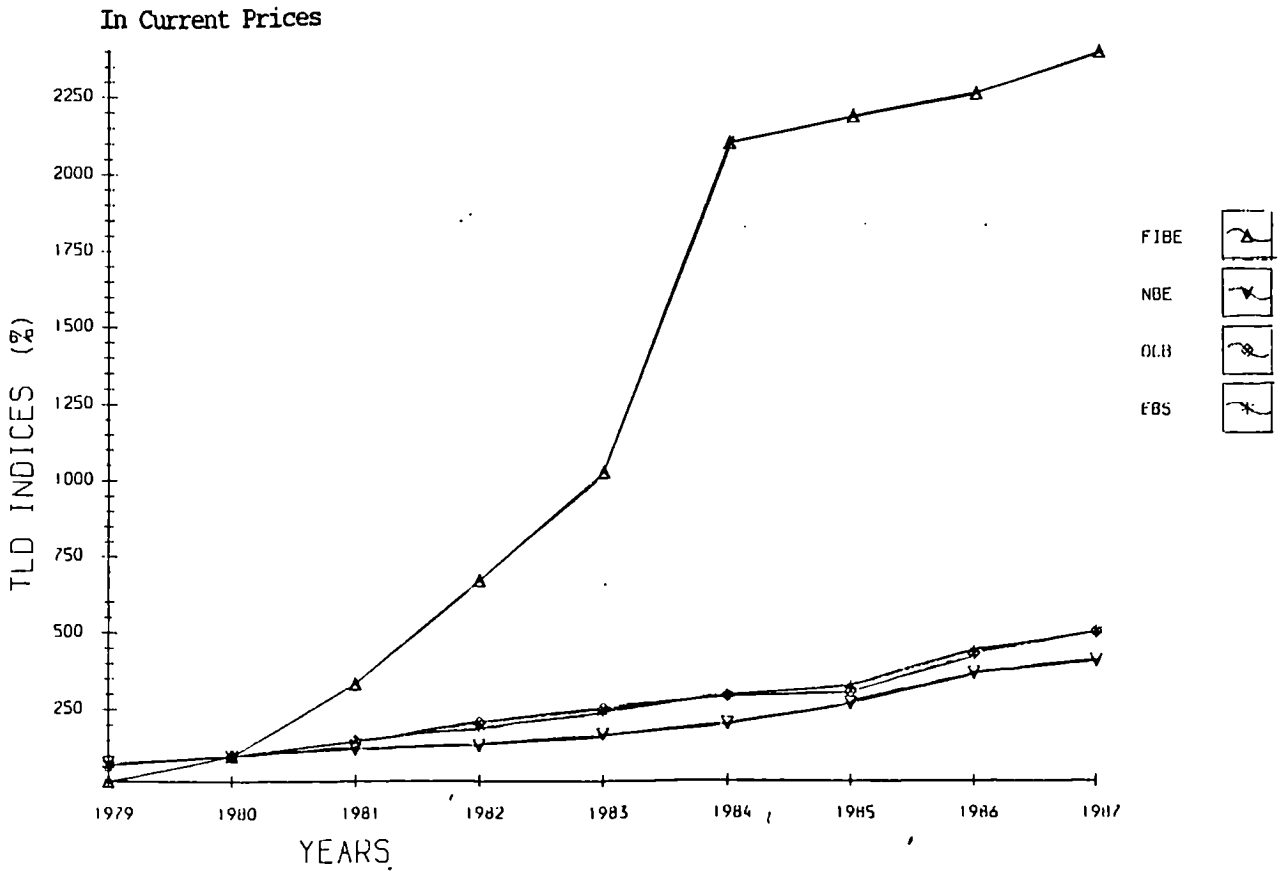
1980 and 1981 were the years in which not only FIBE recorded the highest rates of growth but also the NBE, OCB and the EBS as a whole. This is so because those 2 years witnessed a tremendous increase in government earnings as a result of the increase in its surplus oil which it exported in that period and where the oil prices reached their peak between US\$36 and US\$40 per barrel. During 1980-81 the Egyptian government also took several economic and fiscal measures designed to

Table 10.10 Comparative Analysis of the Performance of FIBE, NBE, OCB and EBS in terms of TLD

Year	FIBE			NBE			OCB			EBS		
	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %
Current Prices												
1979	16.54	17	-	1349.63	75	-	2820.72	67	-	4187.00	69	-
1980	98.10	100	493	1796.06	100	33	4198.84	100	49	6093.00	100	46
1981	328.45	335	235	2161.18	120	20	6316.37	150	50	8806.00	145	45
1982	657.85	671	100	2364.21	132	9	8715.94	208	38	11738.00	193	33
1983	1009.87	1029	54	3031.36	169	28	10640.77	253	22	14682.00	241	25
1984	2067.04	2107	105	3625.22	202	20	12347.74	294	16	18040.00	296	23
1985	2153.91	2196	4	4824.00	269	33	12879.09	307	4	19857.00	326	10
1986	2225.07	2268	63	6587.00	367	37	18062.93	430	40	26875.00	441	35
1987	2363.59	2409	6	7323.00	408	11	21117.41	503	17	30804.00	506	15
ARG		133			24			30				29
Constant Prices												
1979	19.95	20	-	1628.02	91	-	3402.56	81	-	5050.66	83	-
1980	98.10	100	392	1796.06	100	10	4198.84	100	23	6093.00	100	21
1981	297.51	303	203	1957.59	109	9	5721.35	136	36	7976.45	131	31
1982	518.81	529	74	1864.52	104	-5	6873.77	164	20	9257.10	152	16
1983	686.05	699	32	2059.35	115	10	7228.78	172	5	9974.18	164	8
1984	1193.44	1217	74	2093.08	117	2	7129.11	170	-1	10415.70	172	5
1985	1103.44	1125	-8	2471.31	138	18	6597.89	157	-8	10172.64	167	-3
1986	929.83	948	-16	2752.61	153	11	7548.24	180	14	11230.67	184	10
1987	825.28	841	-11	2556.91	142	-7	7373.40	176	-2	10755.59	177	-4
ARG		93			6			11				11

Sources: IMF, International Financial Statistics  
 FIBE, Annual Reports 1979-87  
 NBE, Annual Reports 1979-87

Figure 10.3 Performance of FIBE, NBE, OCB & EBS in Terms of TLD



achieve a higher income growth rate, and to check inflationary pressures, reduce budgetary deficit and alleviate the cost of living burdens as well as to improve the balance of payments and strengthen the Egyptian pound. Some of these measures were: 1) the rationalising of imports and public expenditure to restrict necessary imports and unnecessary public spending; 2) the raising of the minimum limit of wages from LE16 to LE20 per month and the cancellation of the defence and national security taxes levied on workers in the service of the government, the public and the private sectors. 3) the encouragement of domestic savings by raising interest rates on deposits and by introducing new saving pools, as well as activating the stock exchange market.

All the above mentioned factors together led to a general rise in the level of income in the economy in those years and since there is a positive relationship between the rise in income and the level of savings, the volume of deposits in the commercial banks had to rise during those years. Likewise when the earnings from oil exports dropped in 1983-84 the rate of growth of the volume of deposits in commercial banks also slowed down (see table 10.10).

Taking 1980 as a base year, the indices of FIBE's TLD in current prices increased from 17% in 1979 to 2409% in 1987 while that of the NBE increased from 75% in 1979 to only 408% in 1987 and those of OCB and EBS increased from 67% to 503% and from 69% to 506% respectively. As for the indices of constant prices TLD, they increased from 20% to 841% for FIBE and from 91% to 142% for the NBE. Those of OCB increased from 81% to 176% and those of the EBS increased from 83% to 177% for the same period (see Figures 10.3). This clearly shows how FIBE performed during the last 9 years compared to NBE, OCB and EBS as a whole. It is quite clear that FIBE did far better than any of these banks.

This can also be seen by the development of its share in the total deposits of the EBS as a whole as compared to that of the NBE and that of OCB (see table 10.11). FIBE's share in the aggregate deposits of the EBS increased from 0.4% in 1979 to 11.5% in 1984 thereafter it declined to 7.7% in 1987, growing on average at an annual ARG of 106%, while that of the NBE declined from 32.2% in 1979 to 20.1% in 1984 thereafter



rose to 23.8 in 1987 growing at an annual ARG of -3%. As for OCB's share in the total deposit of the EBS, it increased from 67.45% in 1979 to 74.3% in 1982 thereafter decreased back to 68.6% thus hardly growing.

Table 10.11 The Shares of FIBE, NBE and OCB in the TLD of EBS (in %)

	FIBE	% change	NBE	% change	OCB	% change	EBS
1979	0.4	--	32.2	--	67.4	--	100
1980	1.6	300	29.5	-8	68.9	2	100
1981	3.7	131	24.5	-17	71.7	4	100
1982	5.6	51	20.1	-18	74.3	4	100
1983	6.9	23	20.6	2	72.5	-2	100
1984	11.5	67	20.1	-2	68.4	-6	100
1985	10.8	-6	24.3	21	64.9	-5	100
1986	8.3	-23	24.5	1	67.2	4	100
1987	7.7	-7	23.8	-3	68.6	2	100
		67		-3		0	

Source: Table 10.10

Most of the NBE, OCB, and EBS total deposits are in the form of demand deposits which are interest-free while most of FIBE's deposits are in investment deposits that are PLS based and that share in the Bank's profits and losses (see table 10.12 which shows the relative importance of TSD and DD in FIBE and NBE's TLD). A question that arises here again, is why is it that people are so interested in depositing their savings with a small newly established bank which has little or no experience in banking and which does not guarantee any return on the deposits but shares profits as well as losses with the depositors and leaves the well established banks with years of experience, hundreds of branches and substantial accumulated reserves and which offer a number of savings schemes with guaranteed return ranging between 7% and 13.5%. This can be explained by one of two possible explanations. First, either FIBE is distributing higher returns on deposits than other banks are, which is not the case or second, because many of the Egyptian Muslim population prefer investing their savings in the Islamic way and are more interested in the Islamic Shariah than in getting unlawful returns from interest, even if this would cause them to lose part of

Table 10.12 Comparative Analysis of the TSD and DD in FIBE, NBE, OCB and EBS's TLD (1979-84)

	1979		1980		1981		1982		1983		1984		Averages	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
FIBE TSD	11.58	70	92.21	94	305.46	93	627.27	95	944.30	94	1987.11	96	661.32	95
DD	4.96	30	5.89	6	22.99	7	30.98	5	61.57	6	79.93	4	34.32	5
TLD	16.54	100	98.10	100	328.45	100	657.85	100	1009.87	100	2067.04	100	695.64	100
NBE TSD	323.83	24	502.90	28	778.02	36	922.04	39	1339.80	44	1703.85	47	927.40	39
DD	1025.80	76	1293.16	72	1383.16	64	1442.17	61	1697.56	56	1921.37	53	1460.54	61
TLD	1349.63	100	1796.06	100	2161.18	100	2364.21	100	3031.36	100	3625.22	100	2387.94	100
OCB TSD	2154.59	76	1993.89	71	4836.52	77	6690.69	77	8599.90	81	9795.04	79	5845.11	78
DD	666.24	24	1204.95	29	1479.85	23	2024.85	23	2038.87	19	2552.70	21	1661.24	22
TLD	2820.72	100	4198.84	100	6316.37	100	8715.94	100	10640.77	100	12347.74	100	7506.73	100
EBS TSD	2490.00	60	3589.00	59	5920.00	67	8240.00	70	10884.00	74	13486.00	75	7434.83	70
DD	1697.00	40	2504.00	41	2886.00	33	3498.00	30	3798.00	26	4554.00	25	3156.17	30
TLD	4187.00	100	6093.00	100	8806.00	100	11738.00	100	14682.00	100	18040.00	100	10591.00	100

Sources: IMF, International Financial Statistics  
 FIBE, Annual Reports 1979-87  
 NBE, Annual Reports 1979-87

their savings in case the bank makes a loss or goes bankrupt. Furthermore, depositors with FIBE were perhaps confident that the bank will not make losses since it has ample opportunities to diversify its investments and make good profits if it is well managed.

#### 10.4.5 Performance of FIBE, NBE, OCB and EBS in Terms of TLF

In terms of Total Finance (TLF), FIBE also performed unexpectedly better than the NBE, OCB and the EBS. This can be seen from Tables 10.13 and 10.14 and from figure 10.4. FIBE's TLF in current prices rose from LE16.86m in 1979 to LE2543.21m in 1987, recording more than 150 fold increase and growing at an annual ARG of 129%. In the same period, NBE's TLF grew from LE1132.31m in 1979 to LE5912m in 1987 at an annual ARG of 23% thus recording a little bit more than 5 fold rise. OCB's TLF went up from LE3792.83m in 1979 to LE16019.79m in 1987 recording a little bit more than 4 fold increase and growing at 21%. As for EBS's TLF, this went up from LE4942m in 1979 to LE24475m in 1987 recording a little bit less than 5 fold increase and growing at an annual ARG of 23%. Even after deflating the current prices by the corresponding CPI to obtain the constant prices of the TLF of each of FIBE, NBE, OCB and EBS, it was found that while FIBE made a real annual average rate of growth of 94%, NBE made a real growth of only 3%. As for the real ARG of OCB and EBS, these were 4% and 5% respectively (see table 10.13).

The comparative analysis of their performance can also be seen from the comparison of the indices of their current and constant prices TLF, taking 1980 as a base year. FIBE's indices of current prices TLF went up from 16% in 1979 to 2345% in 1987 and the indices of its constant prices TLF rose from 19% in 1979 to 1119% in 1984 thereafter declined to 818% in 1987 as a result of high rates of inflation. At the same time NBE indices of current and constant prices TLF went up from 88% and 106% in 1979 to only 459% and 160% respectively in 1987. OCB's indices went up from 61% to 257% for current prices and from 78% in 1979 to 138% in 1985 followed by a decline to 112% in 1987 for constant prices TLF (see 10.13 and figure 10.4).

Table 10.13 Comparative Analysis of the Performance of FIBE, NBE, OCB and EBS in terms of TLF

Year	FIBE			NBE			OCB			EBS		
	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %	Amount LEm	Index %	MG %
Current Prices												
1979	16.86	16	-	1132.31	88	-	3792.83	61	-	4942.00	65	-
1980	108.44	100	549	1289.42	100	14	6245.13	100	65	7643.00	100	54
1981	248.09	229	129	1638.39	127	27	7499.52	120	20	9386.00	123	23
1982	691.72	638	179	1971.50	153	20	8620.78	138	15	11284.00	148	20
1983	1068.19	985	54	2546.58	197	29	10043.23	161	17	13658.00	179	21
1984	2101.20	1938	97	3417.81	265	34	11882.99	190	18	17402.00	228	27
1985	2177.13	2008	4	4054.00	314	19	14289.87	229	20	20521.00	268	18
1986	2397.30	2211	10	4848.00	376	20	14375.70	230	1	21621.00	283	5
1987	2543.21	2345	6	5912.00	459	22	16019.79	257	11	24475.00	320	13
ARG			129			23			21			23
Constant Prices												
1979	20.34	19	-	1365.87	106	-	4575.19	73	-	5961.40	78	-
1980	108.44	100	433	1289.42	100	-6	6245.14	100	37	7634.00	100	28
1981	224.72	207	107	1484.05	115	15	6793.04	109	9	8501.81	111	11
1982	545.52	503	143	1554.02	121	5	6798.72	109	0	8899.05	116	5
1983	725.67	669	33	1730.01	134	11	6822.85	109	0	9278.53	121	4
1984	1213.16	1119	67	1973.33	153	5	6860.85	110	6	10047.34	132	8
1985	1115.33	1029	-8	2076.84	161	5	7320.63	117	7	10512.81	138	5
1986	1001.80	924	-10	2025.91	157	-3	6007.40	96	-18	9035.10	118	-14
1987	887.99	818	-11	2064.25	160	2	5593.50	90	-7	8545.74	112	-5
ARG			94			3			4			5

Sources: IMF, International Financial Statistics  
 FIBE, Annual Reports 1979-87  
 NBE, Annual Reports 1979-87

Figure 10.4 Performance of FIBE, NBE, OCB & EBS in Terms of TLF

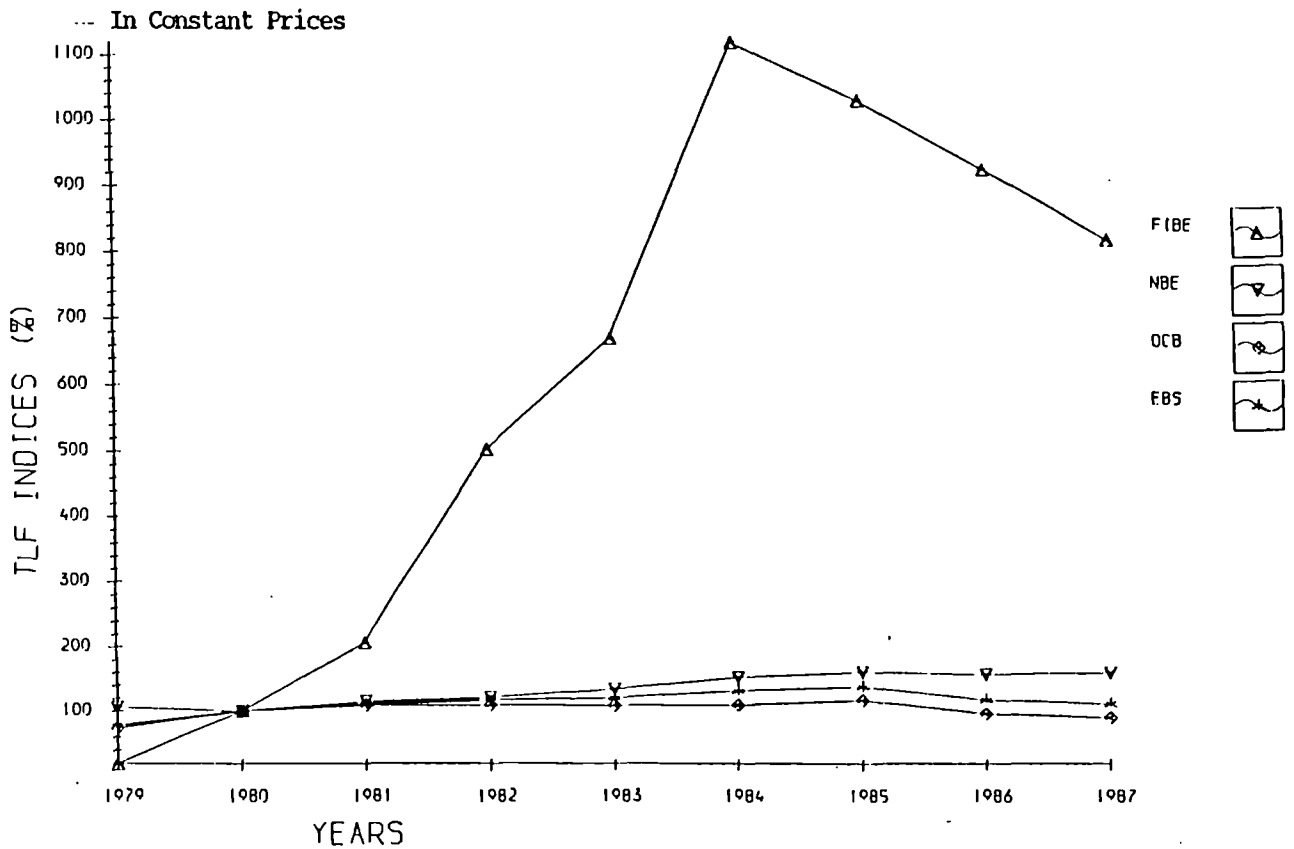
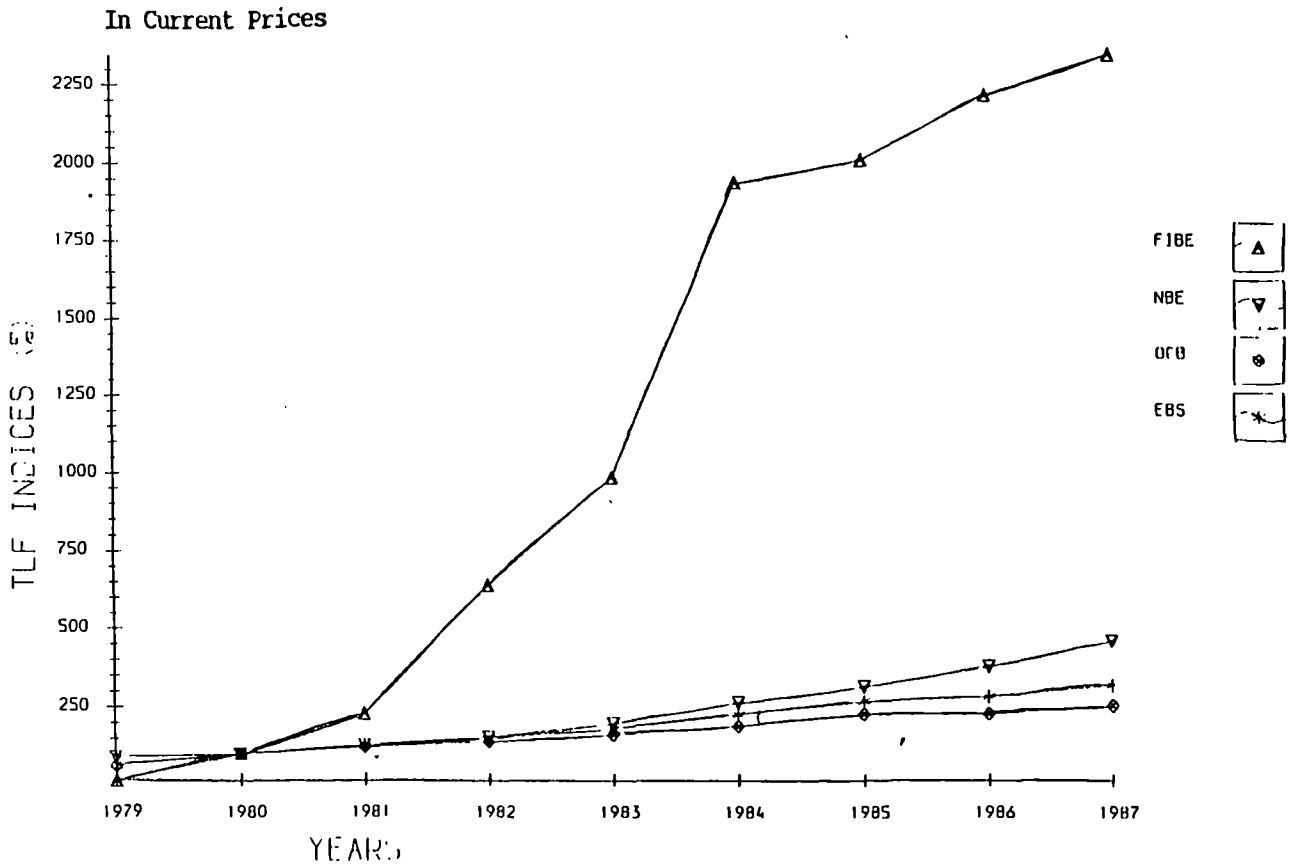


Table 10.14 shows the development of the market shares of FIBE, NBE and OCB in the aggregate TLF of the EBS during the period 1979-87. FIBE's market share rose from 0.3% in 1979 to reach 12.1% in 1984 then declined to 10.4% in 1987 probably as a result of the aftermath of the clampdown on the Islamic investment companies and its effects on FIBE. However, even getting only 10% of the EBS's total finance is not small considering the number of banks and banks' branches in Egypt and considering the problems it faced and the obstacles made in its way. FIBE's market share grew during the period under review at an annual ARG of 82% compared to that of the NBE which went down from 22.9% in 1979 to 16.9% in 1980 then climbed up to reach 24.2% in 1987 perhaps as a result of its involvement in international banking and of opening about 20 branches every year. On average its market share grew at 1% per annum. As for OCB's market share, this went down from 76% in 1979 to 65.5% in 1987 at a negative ARG of -2% per annum (see table 10.14).

Table 10.14 The Market Share of FIBE, NBE and OCB in the TLF of EBS

Year	FIBE	% Change	NBE	% Change	OCB	% Change	EBS
1979	0.3	-	22.9	-	76.8	-	100
1980	1.4	367	16.9	-26	81.7	6	100
1981	2.6	86	17.5	4	79.9	-2	100
1982	6.1	135	17.5	0	76.4	-4	100
1983	7.9	30	18.6	6	73.5	-4	100
1984	12.1	53	19.6	5	68.3	-7	100
1985	10.6	-12	19.8	1	69.6	2	100
1986	11.1	5	22.4	13	66.5	-4	100
1987	10.4	-6	24.2	8	65.5	-2	100
ARG		82		1		-2	

#### 10.4.6 Performance of FIBE, NBE, OCB and EBS in Terms of Other Proxies

Table 10.15 exhibits a number of ratios such as intermediation, deposits, capital, profitability and efficiency ratios. In terms of intermediation as measured by TLF to TLD ratios OCB recorded the highest average ratio of 106.4% for the period under review followed by FIBE with 101.9%, EBS with 99.9% and NBE with the lowest average ratio of 81.3%. When measuring intermediation by the ratio TLF/TLA, FIBE recorded the highest average ratio for the period (77%) followed by those of

Table 10.15 Comparative Analysis of the Performance of FIBE, NBE, OCB and EBS in Terms of Intermediation (in %), Liquidity (in %), Profitability (Z) and Efficiency (in LEm)

Ratio	Bank	1979	1980	1981	1982	1983	1984	1985	1986	1987	Aver.
Intermediation as measured by TLF/TLD	FIBE	101.9	110.5	75.5	105.1	105.8	101.7	101.1	107.7	107.6	101.9
	NBE	83.9	71.8	75.8	83.4	84.0	94.3	84.0	73.6	81.3	81.3
	OCB	134.5	148.7	118.7	98.9	94.4	96.2	111.0	79.5	75.9	106.4
	EBS	118.0	125.4	106.6	96.1	93.0	96.5	103.3	80.5	79.5	99.9
Intermediation as measured by TLF/TLA	FIBE	62.2	78.6	60.2	83.6	85.6	83.6	77.6	76.6	85.0	77.0
	NBE	40.1	42.3	48.5	49.2	48.4	53.9	51.6	48.2	54.6	48.5
	OCB	76.6	68.4	64.7	55.7	53.3	56.8	70.3	51.7	49.9	60.8
	EBS	63.3	62.0	61.0	55.5	53.9	58.4	66.2	52.7	54.4	58.6
Deposits Ratios as measured by TLD/TLA	FIBE	61.0	71.1	79.7	79.5	80.9	82.2	76.8	71.1	79.0	75.7
	NBE	47.8	58.9	64.0	59.0	57.7	57.1	61.4	65.5	67.8	59.9
	OCB	57.0	46.0	54.5	56.3	56.5	59.0	63.4	65.0	65.8	58.2
	EBS	53.7	49.5	57.3	57.8	57.9	60.5	64.1	65.6	68.5	59.4
Capital Ratios as measured by K&R/TLA	FIBE	34.0	15.0	9.2	4.0	3.4	2.9	2.6	4.9	5.1	9.0
	NBE	2.2	2.3	2.5	2.7	2.3	2.2	2.0	1.7	1.7	2.2
	OCB	4.5	2.9	2.5	2.8	2.9	3.2	4.1	3.1	2.9	3.2
	EBS	3.8	2.9	2.7	2.8	2.8	3.0	3.4	2.9	2.8	3.0
Capital Ratios as measured by K&R/TLD	FIBE	55.7	21.1	11.5	5.0	4.2	3.5	3.4	6.8	6.5	13.1
	NBE	4.5	3.9	3.9	4.6	4.0	3.8	3.2	2.6	2.5	3.7
	OCB	8.0	6.3	4.6	5.0	5.2	5.4	6.4	4.8	4.4	5.6
	EBS	7.0	5.8	4.7	4.9	4.9	4.9	5.3	4.4	4.1	5.1
Liquidity ratio as measured by LA/TLD	FIBE	47.8	24.7	40.8	18.7	15.3	15.5	17.2	18.7	10.6	23.3
	NBE	63.4	63.8	67.0	76.4	83.0	74.1	69.6	72.3	59.4	69.9
Liquidity ratio as measured by LA/TLA	FIBE	29.1	17.5	32.5	14.8	12.3	12.8	13.2	13.3	8.4	17.1
	NBE	30.3	37.6	42.6	45.1	47.8	42.1	42.8	47.4	40.2	41.8
Profitability as measured by GR/TLA	FIBE	4.8	6.2	6.1	7.5	7.4	4.6	4.4	5.8	5.7	5.8
	NBE	5.4	3.6	7.4	8.6	13.0	7.8	7.1	6.6	7.1	7.4
Profitability as measured by PBT/TLA	FIBE	na	3.2	1.3	1.1	1.2	1.3	1.6	1.2	1.4	1.5
	NBE	1.2	0.7	0.6	1.0	1.2	0.8	0.7	0.8	0.9	0.9
Profitability as measured by PBT/K&R	FIBE	na	21.2	13.5	28.7	36.2	44.7	62.1	25.1	26.9	32.3
	NBE	54.2	31.6	40.2	43.9	35.4	30.6	39.8	50.3	55.0	42.3
Depositors' Return as measured by DR/TLD	FIBE	na	4.2	6.1	8.0	7.3	7.6	7.2	6.5	5.5	6.6
	NBE	2.9	1.8	3.5	4.9	5.3	6.4	6.3	6.1	6.3	4.8
Efficiency as measured by OC/TLA	FIBE	1.1	0.8	0.4	0.4	0.4	0.6	0.6	0.6	0.5	0.6
	NBE	0.8	0.7	1.0	1.2	0.8	0.8	0.8	0.9	0.9	0.9
Efficiency as measured by TLA/NOF	FIBE	27.1	34.5	82.4	82.7	124.9	251.4	280.5	313.1	299.1	166.2
	NBE	27.2	24.2	23.5	24.4	28.7	31.1	35.2	43.9	47.2	31.7
Efficiency as measured by TLD/NOF	FIBE	16.5	24.5	65.7	65.8	101.0	206.7	215.4	222.5	236.4	128.3
	NBE	13.0	14.3	15.0	14.4	16.6	17.8	21.6	23.8	32.0	19.3
Efficiency as measured by TLF/NOF	FIBE	16.9	27.1	49.6	69.2	106.8	210.1	217.7	239.7	254.3	132.4
	NBE	10.9	10.2	11.4	12.0	13.9	16.8	18.2	21.2	25.8	15.6

Sources: IMF International Financial Statistics; FIBE and NBE annual reports 1979-87

OCB (60.8%) and EBS (58.6%). NBE again had the lowest average ratio (48.5%). The NBE low rates of intermediation may be explained by its high level of liquidity compared to FIBE (see table 10.15).

The average capital ratios of FIBE are higher than those of NBE, OCB and EBS. In 1979/80 because FIBE was still in its first year of business and deposits were just starting coming in and while most attention was towards the bank capital subscription, its capital ratio was obviously very high (34% when measured by the K&R/TLA ratio and 55.7% when measured by the ratio K&R to TLD). The oversubscription to the bank's capital probably gave more confidence to the general public and induced them to deposit their savings with FIBE so after four years this ratio dropped to about the national average level due to a very high annual ARG of its deposits of 133% (see table 10.11) compared to the annual ARG of its capital and reserves of 50% (see table 10.9). In 1984 and 1985, FIBE's capital ratios were less than the average of the EBS and perhaps that is why, it had to increase its paid up capital in 1984 and 1986 to LE40m and LE70m consecutively.

Because there is no available separate data on the aggregate profits, liquidity, operating costs and number of branches of the EBS, the remaining comparative analysis, in table 10.17, is made only as far as FIBE and the NBE are concerned.

As can be seen from Table 10.15 different results are obtained when comparing the profitability of FIBE to that of the NBE depending on which proxy is used in the measurement. Measuring profitability by the ratio of net profit to total assets it is found that on average FIBE did better than the NBE, but when measuring profitability by the return on equity ratios (PBT/K&R) it is found that the NBE performed far better than FIBE. This may be explained by the fact that most of NBE's deposits (61%) are demand deposits on which no return is paid to depositors whereas 96% of FIBE's deposits are investment deposits on which a share in the bank profit is paid to the depositors (see table 10.12). This can also be seen from the comparison of the Depositors' share in FIBE's profit to total deposits and the interest paid to total deposits for the NBE in Table 10.15 which shows clearly how relatively



the cost of funds for FIBE is much greater than that of the NBE. However, this indicates a better and juster distribution of profits in FIBE than in the NBE where most of the profits went to the shareholders whose share in the bank's total assets is only 2.2% and where 60% of the total assets belong to the depositors (see table 10.15).

Because FIBE is an Islamic bank that is supposed to be more involved in its finance operations than the NBE since it has to evaluate the feasibility of the projects financed, participate in their management or at least supervise them and do the follow up, its relative operating costs should be greater than those of the NBE which, just grants loans to creditworthy customers without real concern over how a customer in question is going to spend the loan so long as it is reasonably sure of the repayment of the loans with its interest, and the NBE, being the oldest (more than 90 years old) and largest bank in Egypt, should enjoy more economies of scale on its operations than FIBE which is only 10 years old, because as Agu (1984:326) pointed out, 'Generally speaking, larger banks stand the chance of achieving greater economies of scale than smaller banks mainly because of the greater disability of the latter to spread overhead costs, pool risks and specialise among employees as well as their higher transaction costs of moving funds in smaller amount than in the former'. but, perhaps, because the NBE expanded its branch network from 108 in 1979 to 229 branches in 1987 (ie an increase of 121 branches in 9 years) while FIBE was not given the permission to open its 13 ready branches (since 1983) and it has only 10 operating branches, the NBE operating costs to total assets ratio is greater than that of FIBE (see table 10.15). Perhaps, for the same reason, the efficiency of FIBE, as measured by the ratios: TLA/NOB, TLD/NOB and TLF/NOB, seems to be greater than that of NBE (see table 10.15).

In addition to its business operations, FIBE distributed more than LE18m as Zakat during 1979-87 at an annual average of LE2m per annum to needy people. The amounts distributed were made partly of the Zakat on the shareholders' funds and partly from the Zakat and donations of individuals who entrusted FIBE to channel it to those who really need it.

## 10.5 CONCLUSION

From the comparative analysis in Section 10.4 above concerning the performance of FIBE as compared to the NBE, OCB and the EBS as a whole it was found that although the period, of the analysis 1979-1987 (ie 9 years only) which represent the first 9 years of FIBE's life, is very short and although FIBE had only 10 branches during this period it has, relatively speaking, performed better than the NBE, the oldest and largest bank in Egypt, OCB taken together and the EBS as a whole. In fact it has performed better than expected encouraging thus the movement of Islamic Banking not only in Egypt, where more Islamic banks have been established and where many of the interest-based banks are offering the choice to their customers by running Islamic banking services alongside their ordinary business to keep their competitiveness, but in the whole world. It was also found that within this very short time FIBE has not only managed to mobilise substantial amounts of savings that were idle because of the reluctance of Muslims to deal with interest-based banks, but it has also contributed to the economic growth and development of the country. In spite of not promising any guaranteed return to depositors, FIBE's volume of business, volume of deposits and volume of finance have recorded considerable growth that took other banks in the country longer periods to achieve. Just after three years of business it has managed to get the seventh rank among the 44 commercial banks doing business in Egypt, most of whom are more than 15 years old. This indicates that what is needed for Muslim countries like Egypt to develop is the promotion and establishment of institutions that do not contradict the beliefs of the majority of people but that agree with them. This also indicates that interest is not necessary to mobilise savings for development and that PLS systems may lead to better mobilisation of savings in Islamic countries where the people are concerned in observing the injunctions of Islam, thus when Islam prohibits interest it does not curb development but on the contrary encourages it through lawful means such as PLS systems which as we saw above is more just and may lead to greater growth and development.

## CHAPTER ELEVEN

### PERFORMANCE OF FAISAL ISLAMIC BANK OF SUDAN (FIBS)

#### 11.1 INTRODUCTION

FIBS is the oldest Islamic Bank to be established in Sudan in 1978 and one of the oldest in the world, after DIB (in UAE), IDB (in Saudi Arabia), KFH (in Kuwait) and FIBE (in Egypt). The purpose of this chapter is to analyse its performance as compared to the performance of the largest and oldest bank in Sudan: Bank of Khartoum (BOK), Other Commercial Banks (OCB that is the SBS excluding FIBS and BOK) and the Sudanese commercial Banking System (SBS) in the same way as was done for KFH and FIBE in the preceding chapters, starting with an overview on the Sudanese economy and another one on its banking system.

#### 11.2 THE SUDANESE ECONOMY: AN OVERVIEW

Sudan is the largest country in Africa with 2.55m sq. km and a population of 22m in 1986. Its considerable size, which represents more than 8% of the African Continent and almost 2% of the world's total land area, displays a variety of geographical, climatic and tribal features which influence the structure of the economy and its course of development. The Nile River is the dominant feature and represents the vital link between the North and the South. With its tributaries, it provides a resource of great importance for irrigation, transportation and hydroelectric generation.

This range of climates and geographical positions is favourable for the expansion and diversification of agricultural activities of various forms. But despite the huge tropical and potentially cultivable area, estimated at more than 200m acres, and the abundance of water resources from rivers and from rainfall (before the drought), the land under cultivation is only about 20m acres (ie 10% only). Sudan is also believed to be rich in mineral resources but the political instability of the

country, the shortage of foreign exchange and of skilled labour and other problems have all resulted in their under exploitation. Mining is conducted only on a small scale and contributes little to the overall economy. In addition there are 60m acres of pasture land which is used by traditional herdsmen (Encyclopedia Britannica 1974:Vol.17).

Sudan's fate has worsened in the last few years because of the plagues that have stricken the country since the beginning of the 1980s such as the man-made disaster: desertification (the spread of desert over arable land), caused by deforestation, unsuitable farming techniques and overgrazing, forcing numerous farmers and villagers to abandon their homes and farms in search of a living elsewhere; the drought which lasted for more than four years and was followed by locusts and by a big damaging flood in 1988 that devastated the country and made things even worse. Consequently Increasing numbers of Sudanese are becoming homeless and destitute.

The population suffers from a high rate of illiteracy and from a very low level of vocational and professional training. Associated with the population situation is the added problem of ethnic, religious and linguistic heterogeneity. This is, as Sayigh (1978) argued: "not equal to pluralism, which is a useful quality, in as much as pluralism can be enriched in cultural and social terms, and in terms of motivation and performance, once certain basic features are shared by the whole population... The divisiveness is reflected most strongly in the north-south schism and conflict. The Problem of the South involves political unrest, blockage of social homogenisation and the build up of social and economic frustrations. The north-south war which plagued the country since independence in 1956 is costly in both men and money and has delayed development considerably".

The majority of the population (80%) depends on agriculture which contributes about 30% of the GDP and more than 90% of the country's foreign exchange earnings. Cotton is the most important cash crop, contributing more than 50% of the exports. "Since 1974, realising all the

hazards of developing a one crop economy such as vulnerability to price fluctuations, adverse demand conditions and weather changes, emphasis has been gradually placed on the production of oil seeds, wheat and sugar cane" (El-Zubair 1983:77). Other major crops are: gum arabic, shorgum, millet, corn, sesame seeds, peanuts and castor beans. Recently rice, tobacco, coffee and oil palm have all been cultivated but primarily on an experimental basis.

The livestock wealth of the country contributes about 10% to the GDP, but is also underexploited, as well as primitively exploited. Preliminary estimates indicate that there is about 48m heads of livestock of which 18m cattle, 15m sheep, 13m goats and 2m camels. It is worth noting in this connection, that the exports of livestock are always on the hoof. This is because the country does not have the facilities to deep freeze meat to export it in properly equipped carriages. Furthermore importers prefer live animals owing to their greater confidence in their ability to exercise better sanitary control.

Industrialisation in Sudan did not begin until late 1950s when the government invested in industry for the first time. Since then there have been some relatively extensive investments both by the private and public sectors but mainly dominated by 2 or 3 sub-sectors which are typical for most LDCs in the early stages of industrialisation, these are food processing, tanning, textile and tobacco.

Industry in Sudan is operated on a small scale and most of the production is used within the country. It is still underdeveloped and under-utilised and plays only a secondary role in the GDP of the country by contributing less than 10% (see Table 11.1). The other feature which one can think of and which may not be exclusive to the Sudan is the failure of identifying priorities in projects needed and of choosing between the different means to achieve them. Besides, the under-utilisation of the capacity may be attributed to obsolete and inefficient machinery, lack of spare parts and imported raw materials, lack of skilled labour, etc..

Table 11.1 The Sudanese GDP (in LS million and in %) for 1983-86

Sector	1983		1984		1985		1986	
	Value	Share	Value	Share	Value	Share	Value	Share
Agriculture	2,320	31	2,664	30	2,792	26	4,486	32
Commerce	1,755	24	2,088	23	2,553	24	3,056	22
Manufact. & Mining	627	8	783	9	1,071	10	1,392	10
Transport & Communic.	754	10	887	10	1,153	11	1,466	10
Construction	390	5	502	6	589	5	620	4
Electricity & Water	160	2	203	2	273	3	356	3
Government Services	806	11	969	10	1,294	11	1,481	10
Other Services	709	9	900	10	1,095	10	1,240	9
<b>Total GDP</b>	<b>7,521</b>	<b>100</b>	<b>8,996</b>	<b>100</b>	<b>10,822</b>	<b>100</b>	<b>14,097</b>	<b>100</b>

Source: BOS, Annual Report 1986.

The downward trend in the contribution of the agricultural sector to the GDP between 1982 and 1985 was mainly due to the drought and desertification in the rainfed areas. Recently Sudan suffered even more from severe economic crises in the 1980s. Inflation has been running at more than 80% per annum. Its debt burden is over US\$10bn. There is a widening gap between production and consumption, income and expenditure, savings and investment as well as between imports and exports. Economists attribute this crisis to the failure of the economic, monetary and financial policies (A.A Ali 1985:9). Table 11.2 shows the deteriorating Sudanese trade balance for the period 1981-86).

Table 11.2 Sudan's Trade Balance between 1981 and 1986 (in LSm and in %)

Year	Exports		Imports		Balance	
	Value	Change	Value	Change	Value	Change
1981	357.0	31.6	1,177.6	49.4	-820.6	-
1982	483.1	35.3	1,278.1	8.5	-795.0	2.8
1983	810.7	67.8	2,129.6	66.6	-1,318.9	-65.9
1984	817.3	0.8	1,803.7	-15.3	-986.4	25.2
1985	844.7	4.1	2,128.8	18.0	-1,284.0	-30.2
1986	833.2	-1.4	2,402.2	12.8	-1,569.0	-22.2

Source: BOS, Annual Report 1986

Beside all this, There are structural, organisational, financial and physical constraints, among which one can mentions the following:

- 1- Structural rigidities: Geographical dispersion of the population within the huge size of the country and lack of sufficient transportation, communication and storage facilities;
- 2- Shortage of foreign exchange to buy spare parts and essential inputs and the consequent negligence of maintenance;
- 3- Inadequate farm machinery and lack of spare parts;
- 4- Inadequate credit facilities especially for small peasants who have no collateral to present to the IBBs which do not accept to provide them with the seeds and machinery required and share with them the crop or the profits and losses.
- 5- High worsening rates of inflation, sharply increasing the ces of vital basic needs and of imported inputs such as fuel, fertilisers and pesticides, thus, severely impeding investment, production and employment.
- 6- The shortage of both skilled and unskilled labour. The skilled ones have been attracted by better earning opportunities in neighbouring oil producing countries (Saudi Arabia and the Gulf Emirates). The unskilled labour on the other hand, did not find earning opportunities in cotton picking and in agricultural jobs sufficiently attractive (El-Zubair 1983:86).

### 11.3 THE SUDANESE BANKING SYSTEM (SBS)

Like all Islamic countries, Sudan's experience with modern banking is of recent origin. According to El-Beheiry (1981), Modern financial institutions were first introduced to Sudan with the advent of the British colonial rule. The first recorded fully fledged bank was the National Bank of Egypt (NBE) which opened a branch in Sudan in 1901. This was followed by Barclays Bank DCO in 1913. The government accounts were maintained by the NBE, and after 1914 the issue of Sudan currency was also entrusted to NBE. The NBE obtained notes from Cairo (Egypt) and coins from the U.K. The seniorage from printing and minting accrued to both Egypt and the UK. Until 1949, the NBE and Barclays Bank DCO, were the only 2 banks operating in Sudan, but the unprecedented export boom which was experienced between 1946 and 1951 and which was brought about by the rise in the value of cotton exports, encouraged more banks to come to Sudan and so the Ottoman Bank opened a branch in Sudan in 1949, followed by four banks in the 1950s: the Egyptian Banque Misr (1953), the French Credit Lyonnais (1953), the Jordanian Arab Bank (1956) and the Ethiopian Commercial Bank of Ethiopia (1956). Thus, until the independence in 1956 the whole banking system was under foreign domination

and was concentrated only in the big towns: Khartoum, Kessala and the Blue Nile. It was not until 1960 that a wholly owned Sudanese bank, the Sudanese Commercial Bank was established. In 1964, the French Credit Lyonnais was transformed into a joint-venture: El-Nilein Bank whereby Credit Lyonnais maintained (40%) and the government of Sudan (60%). And in 1969 the Ottoman Bank was replaced by a branch of the British National and Grindlays Bank.

The credit policy of these foreign banks was, as described by BOS (nd:10), cautious, conservative and old fashioned, particularly towards development projects which required medium or long term financing... 80% of commercial bank loans to the private sector were short term and mainly concentrating on financing foreign trade. The failure of the banking system during this period is evident from the meagre contribution to the indigenous economic development and from the huge transfer of profits abroad (see Table 11.3 showing the high rates of profits expatriation by the foreign banks before they were nationalised).

Table 11.3 The Expatriation of Profits Before Nationalisation (in LS000)

Bank	K&R	FK	TLD	TP	TP/K&R
Barclays Bank DCO	1,240	1,240	23,010	1,630	131
National & Grindlays	250	250	7,032	507	202
Com. Bank of Ethiopia	300	300	313	45	14
Arab Bank	150	150	1,760	219	145
El-Nilein Bank	3,000	1,200	7,637	1,221	101
Banque Misr	3,200	3,200	2,563	na	na
Com. Bank of Sudan	1,099	-	7,569	-	-

Source: BOS The Nationalisation of Banks in the Sudan, (nd).

Notes :K&R = Capital and Reserves; FK = Foreign Capital;

TLD = Total Deposits; TP = Transferred Profits.

These huge profits realised by the foreign banks from the deposits of the Sudanese citizens were not invested in Sudan but were transferred abroad in foreign currencies. Not only that but the foreign banks transferred also other funds in the form of insurance of their assets in foreign companies, administration costs, provident funds and commissions to their headquarters abroad (ibid). At the same time the small



scale industries had been unable to obtain finance from these banks for their working capital because of the inherent limitations of these industries to provide a suitable security, the uncertain prospects of their business which makes them poor credit-risk and the difficulty of assessing the demand for their products. This and other reasons made the nationalisation of these banks inevitable. Thus, the seven operating banks became in May 1970 as follows:

- 1- Barclays Bank DCO became the State Bank for Foreign Trade;
- 2- National and Grindlays Bank became the National Bank of Oumdurman;
- 3- The Ethiopian Commercial Bank became the Commercial Bank of Juba;
- 4- The Arab Bank became the Red Sea Commercial Bank;
- 5- Banque Misr became the People's Co-operative Bank;
- 6- Bank El-Nilein remained unchanged and
- 7- The Sudanese Commercial bank also remained unchanged

In 1973, following a new law concerning the organisation of banks and of savings, the National Bank of Oumdurman was merged with the Commercial Bank of Juba under the name of Bank Juba-Oumdurman and the The Red Sea Commercial Bank was merged with El-Nilein Bank under the latter's name. In 1975, the State Bank for Foreign Trade (ex. Barclays Bank DCO, the oldest bank in Sudan) was renamed Bank of Khartoum (BOK).

In 1977, foreign banks were allowed again to operate in Sudan for the first time after the Nationalisation. At the same time the Sudanese banks were allowed to open branches outside Sudan, thus the National Bank of Abu-Dhabi opened a branch in Sudan and El-Nilein Bank started operating abroad by opening a branch in the UAE.

Towards the end of 1978, the Sudanese Investment Bank started its operations as a joint venture with French capital, by opening 2 branches in Khartoum and port Sudan. Moreover, Citibank that was licensed in 1977, started its banking business during 1978. In addition, FIBS also commenced its business according to the Islamic Shariah during the second half of the year, as the first Islamic bank in Sudan.

Towards the end of 1980 a number of banks (Habib Bank, Bank of America and the Islamic Bank for Finance and Investment) were licensed to establish branches in Sudan. Moreover a number of applications for establishing commercial banks (4 of which were Islamic) were approved.

In 1982 the authorised capital of BOK was increased from LS3m to LS10m and the paid up capital from LS2m to LS6m with the objective of strengthening the financial position of the bank. And on 18th April 1983, the People's Co-operative Bank (PCB) was merged with the BOK. This made the TLA of BOK rise from LS475m at the end of 1982 to LS1,049m in 1983 (ie an increase of 121.1%). BOK's TLD for the year went up from LS360.7m in 1982 to LS746.2m in 1983 but this figure includes according to BOK 1983 annual report, LS303m cash margins and inter-branch accounts and therefore the increase in actual total deposits was LS82.5m only ie an increase of 22.9% only instead of 106.9%.

Another reason why perhaps the TLA of BOK was very high in 1983 as compared to 1982 is due to the devaluation of the Sudanese pound in relation to the US dollar from LS0.9 to LS1.3 for the official market and LS1.8 for the free market. This made the balances due to foreign banks increase from an equivalent of LS35.9m to an equivalent of LS51.6m in 1983 an increase of 44%. BOK's balance sheet for 1983 also include LS106m representing bad and doubtful debts of the formerly PCB were charged to the Bank of Sudan) and appeared in the BS as loans under collection on behalf of the BOS. Besides, five new banks were licensed and authorised to operate in the country in 1983. These are

(3) the Tadamon Islamic Bank, (4) the Sudanese Islamic Bank and (5) the Islamic Co-operative Development Bank. In addition 16 commercial banks' branches were opened, thus bringing the total number of banks' branches in Sudan to 160 by the end of 1983.

The most notable development in the Sudanese Banking System in 1984 was the abolition of interest and the switch over to the Islamic Banking System. Moreover, 3 more Islamic banks were licensed to operate in Sudan, these are the Western Islamic Bank, the Saudi-Sudanese Bank and the El-Baraka Islamic Bank. However, credit ceilings were forced on banks that year. This blocked to a great extent the trend of the growth in bank investment. This, together with the economic recession, affec-

ted the banks' activities very badly. Due to this and to the ferocious propaganda and accusation made by EL-Ayam newspaper against FIBS in this year, accusing FIBS to be responsible for what is called 'the dhura crisis' by way of speculation, FIBS's operations decreased dramatically. The case was taken to court and FIBS was cleared and the newspaper apologised in a press release on the 3rd of October 1985. In 1985 another big devaluation of the Sudanese pound was undertaken. The Sudanese pound was devalued from LS1.3 to LS2.5 to one dollar and at the same time the private currency exchanges were closed. Dealings in foreign exchange were allowed only through official government commercial banks like BOK, while private commercial banks were subject to inquest committees since late 1985. This indirectly hindered their operations and inflicted a significant damage to their images and credibility. Only lately, both the BOS and the office of the Attorney General came to realise the significant damage that have been done by these inquest committees. International businesses and money circles as well as local bankers' associations were deeply concerned with this attitude and condemned it. Some of the other factors that hindered banking operations in the second half of the 1980s and consequently obstructed economic growth and development, are:

- 1- The tight monetary and fiscal policies of the government;
- 2- The import and export policies which give the public sector banks a monopoly hand over other banks. For instance the private banks were deprived of export earnings in addition to the transfer of foreign currency purchased and forwarded to the committee for dealing in free market resources;
- 3- The new unrealistic business tax law that imposes retrospectively a 70% tax rate on banks' profits;
- 4- The excessive restrictions on credit to the extent that trading on essential commodities has been severely handicapped.
- 5- The prohibition of refinance of local trade.
- 6- The unjust treatment of private banks as compared to the public ones. For instance public sector banks were given 43% of the local trade volume in contrast to other banks.

The total effect of these factors have been severely negative on the investment activities of the private sector banks such as FIBE. It is against this background, that the performance of FIBS is to be assessed in comparison to those of BOK, OCB and SBS.

## 11.4 PERFORMANCE ANALYSIS OF FIBS, BOK, OCB AND SBS

### 11.4.1 The Establishment and Objectives of FIBS

FIBS started operating as a joint-venture company in May 1978 with an authorised capital of LS6m divided into 600,000 shares valued at LS10 each or the equivalent thereof in convertible currencies. 40% of the shares were allotted to Sudanese nationals; 40% to Saudi nationals and 20% to Muslims from other countries. Three months later, the authorised capital was raised to SL10m, as a result of an unexpected oversubscription. The percentages of share holding were amended to 40% to the Sudanese citizens and 60 % to the Muslims from other countries. Two years later the authorised capital of the bank was raised once again to LS100m, thus becoming the most capitalised bank in Sudan.

FIBS's objectives is to endeavour to stimulate social and economic development through the performance of all banking services, financial transactions, commercial operations and all other investment activities in conformity with Islam. According to its status the Bank may not only establish affiliate companies but also participate in any social or economic development projects inside or outside Sudan. In 1986, FIBS had 20 operating branches, and 10 others waiting for the BOS approval. FIBE has also 3 subsidiary companies: The Islamic Insurance Company, The Islamic Trade and Service Company and The Real Estate Development Company. Now FIBS stands on the top of the private banks and ranks third in the total banking system in terms of capital, deposits, Finance and number of customers after Bank of Khartoum and Unity Bank.

### 11.4.2 Performance in Terms of Capital and Reserves (K&R)

As can be seen from Table 11.4 FIBS's K&R in current prices rose from LS4m in 1979 to about LS133m in 1986 recording thus, a 33 fold increase in the first 8 years of business at an ARG of 96.4%. This is mainly due to the oversubscription to the bank's authorised capital and the raising of this from LS6m to LS100m in such a short time. BOK's K&R in current prices rose during the same period from LS4m to LS38m, thus, recording only nine and a half fold increase despite the fact that it

Table 11.4 Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS In Terms of K&R.

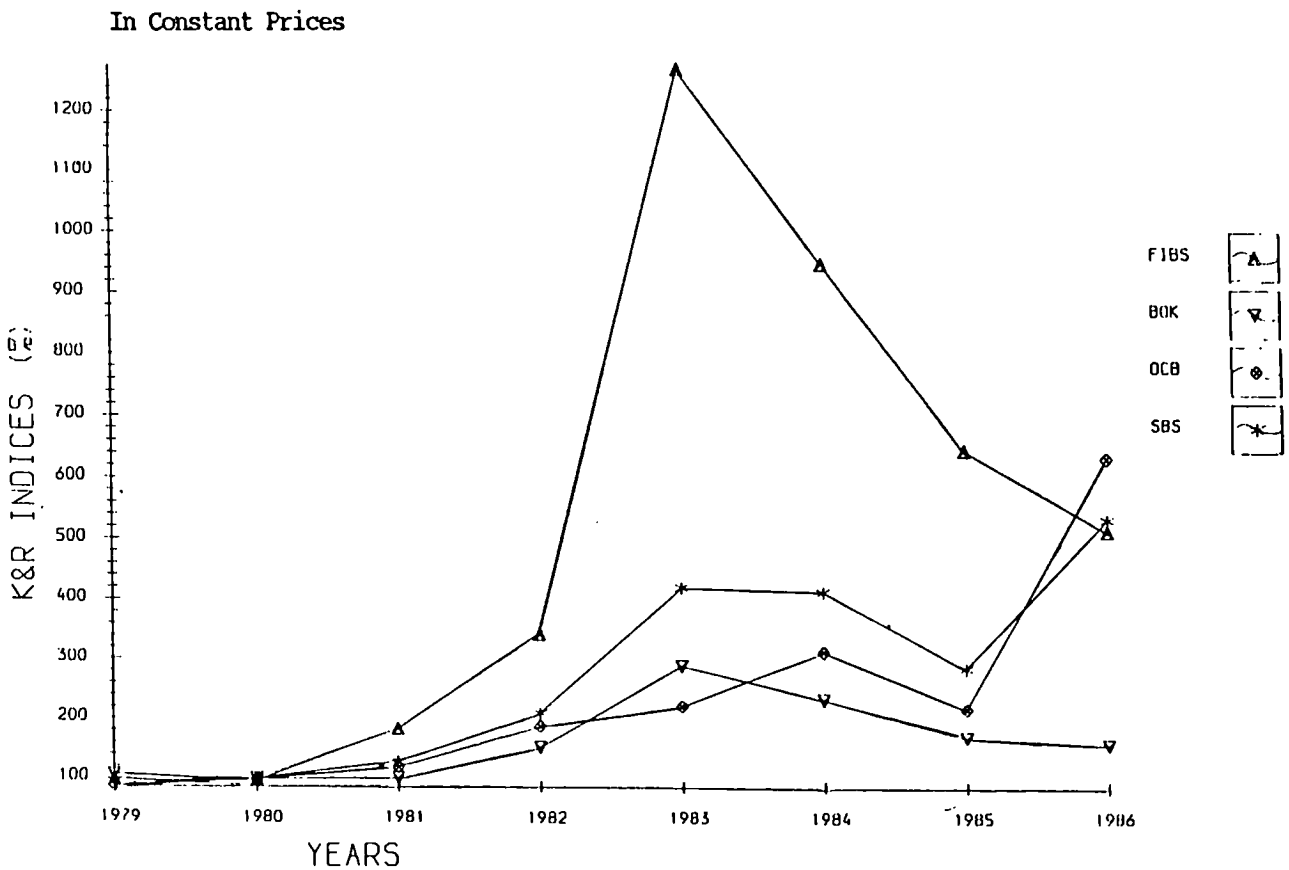
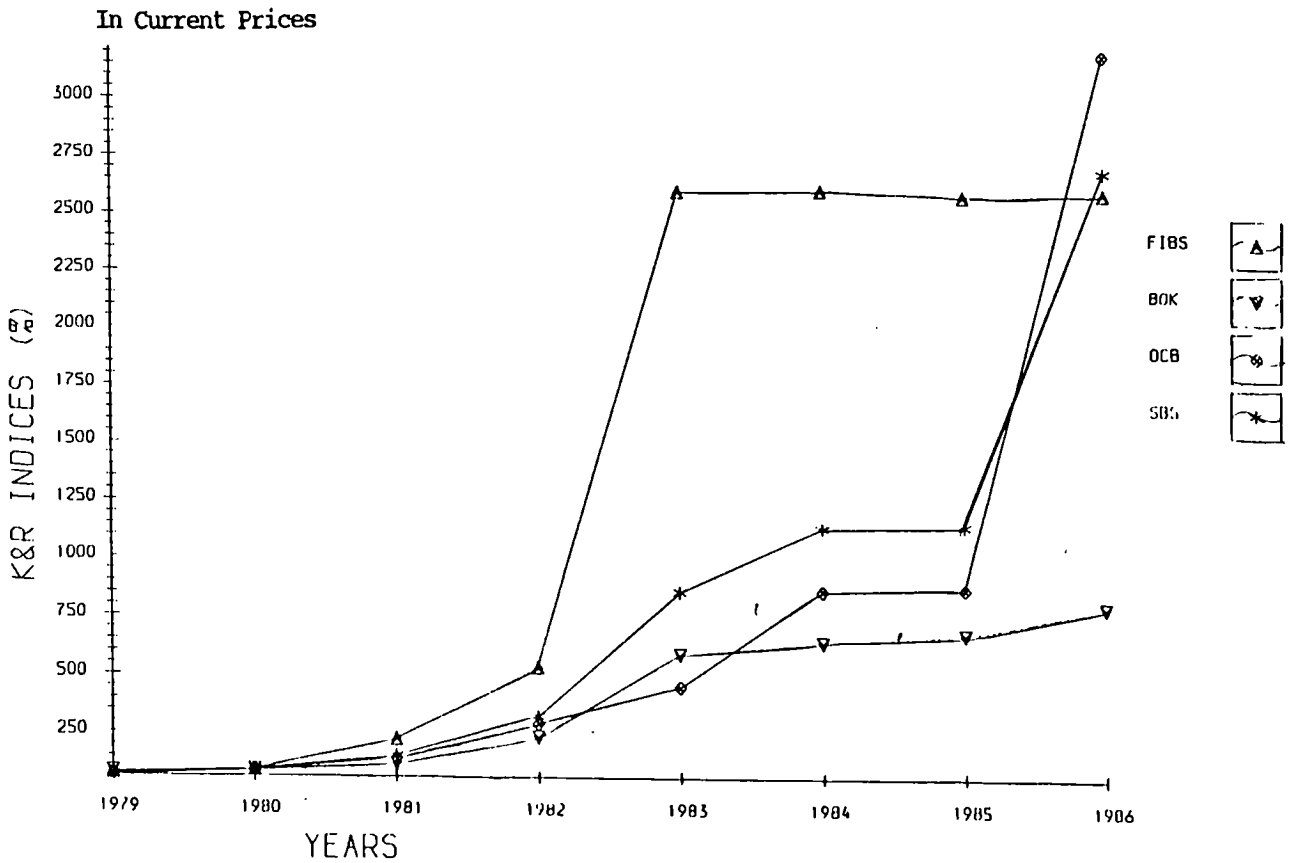
Years	FIBS			BOK			OCB			SBS		
	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change
Current Prices												
1979	4.03	79	-	4.01	85	-	13.07	70	-	21.11	74	-
1980	5.08	100	26.2	4.75	100	18.3	18.71	100	43.1	28.54	100	35.2
1981	11.67	230	129.6	6.00	126	26.3	27.70	148	48.1	45.37	159	59.0
1982	27.42	539	135.0	11.39	240	89.8	55.50	297	100.3	94.31	330	107.9
1983	132.63	2609	383.6	28.30	596	148.4	85.78	459	54.6	246.71	864	161.6
1984	132.98	2616	0.3	30.66	646	8.4	162.34	868	89.3	325.98	1142	32.1
1985	131.72	2591	-0.9	32.32	680	5.4	163.97	877	1.0	328.00	1149	0.6
1986	132.80	2612	0.8	38.06	801	17.8	602.01	3218	267.2	772.88	2708	135.6
ARG			96.4			44.9			86.2			76.0
Constant Prices												
1979	5.05	99	-	5.03	106	-	16.38	88	-	26.46	93	-
1980	5.08	100	0.7	4.75	100	-5.5	18.71	100	14.2	28.54	100	7.9
1981	9.37	184	84.3	4.82	101	1.4	22.23	119	18.8	36.42	128	27.6
1982	17.51	344	87.0	7.27	153	51.0	35.44	189	59.4	60.22	211	65.4
1983	64.86	1276	270.4	13.84	291	90.3	41.95	224	18.4	120.64	423	100.3
1984	48.48	954	-25.2	11.18	235	-19.2	59.18	316	41.1	118.84	416	-1.5
1985	33.03	650	-31.9	8.10	171	-27.5	41.12	220	-30.5	82.25	288	-30.8
1986	26.34	518	-20.3	7.55	159	-7.1	119.40	638	190.1	153.29	537	86.4
ARG			52.1			11.9			44.5			36.5

Sources: BOS: Annual Reports, various issues;  
 BOK: Annual Reports, various issues;  
 FIBS: Annual Reports, various issues.

increased its authorised capital in 1982 from LS3m to LS10m and despite its merger with the People's Co-operative Bank in 1983. The OCB's K&R increased during the same period from LS13m in 1979 to LS602m in 1986 recording, thus, a 46 fold increase and growing at an annual ARG of 86.2%. This is mainly due to the establishment of a number of new banks of which six are originally Islamic. The same may be said about the SBS's K&R which grew from LS21m in 1979 to LS773m in 1986 at an annual ARG of 76% and recording about 37 fold increase during the same period. The striking feature is that FIBS was growing at phenomenal rate of growth between 1979 and 1983 and that it stagnated between 1984 and 1986 because of the reasons mentioned above, namely the competition from the six new Islamic banks whose shares are, unlike those of FIBS, held almost exclusively by Sudanese citizens and from all banks which became Islamic in 1984, the accusation of FIBS of speculating in dhura. The other striking feature is that in 1985 the low rate of growth of FIBS is not exclusive to FIBS, it is also observable in the case of BOK, OCB and SBS (see Table 11.4). After allowing for the effect of inflation which is very high in Sudan, by calculating the constant prices of the K&R of each of FIBS, BOK, OCB and SBS, taking 1980 as a base year, it was found that the K&R of FIBS grew from LS5m in 1979 to LS65m in 1983 then decreased dramatically to LS26m in 1986 because of high rates of inflation but on average it grew at an annual ARG of 52.1% during the period under review. Likewise the K&R of BOK grew from LS5m in 1979 to LS14m in 1984 then dropped to LS7.5m in 1986, growing at an ARG of 11.9% during the same period. As for the K&R of OCB and SBS, they grew from LS16.4m and LS26.5m in 1979 to LS119.4m and LS153.3m in 1986 at annual ARG of 44.5% and 36.5% respectively.

The performance of each of FIBS, BOK, OCB and SBS may better be seen from Figure 11.1 showing the relative development of the K&R in current and constant prices of each of FIBS, BOK, OCB and SBS and from Table 11.5 showing the market share of each of FIBS, BOK and OCB in the K&R of the SBS. It is clear that FIBS was doing very well compared to

Figure 11.1 Performance of FIBS, BOK, OCB & SBS in Terms of K&R



BOK and OCB before 1984 and that it did badly after that. In the first 5 years of business it managed to take over about 54% of the K&R of the SBS as a whole but then its share declined sharply to stand at 17.2% in 1986, however on the whole its annual ARG was 7.5%. BOK's K&R kept declining during the whole period from 19.1% in 1979 to 4.9% in 1986 at an annual ARG of -15.7%. As for OCB, although its share declined from about 62% in 1979 to 34.8% in 1983, it recovered and increased sharply after that to reach 77.9% in 1986, growing at an annual ARG of 7.6%.

Table 11.5 The Market Share of FIBS, BOK and OCB in The K&R of the SBS

	FIBS		BOK		OCB		SBS Total
	Share	Growth	Share	Growth	Share	Growth	
1979	19.1	-	19.0	-	61.9	-	100
1980	17.8	-6.8	16.6	-12.6	65.5	5.8	100
1981	25.7	44.4	13.2	-20.5	61.1	-6.7	100
1982	29.1	13.2	12.1	-8.3	58.8	-3.8	100
1983	53.8	84.9	11.5	-5.0	34.8	-40.8	100
1984	40.8	-24.2	9.4	-18.3	49.8	43.1	100
1985	40.2	-1.5	9.9	5.3	50.0	0.4	100
1986	17.2	-57.2	4.9	-50.5	77.9	55.8	100
ARG		7.5		-15.7		7.6	

Source: Table 11.4 above

#### 11.4.2 Performance in terms of Total Assets (TLA)

In terms of TLA in current prices, FIBS managed during the first 8 years of business to record more than 16.5 fold increase, growing from LS31.14m in 1979 to LS517.57m in 1986 at an annual ARG of 71.1%, while at the same time BOK managed to record 7 fold increase from LS225.84m in 1979 to LS1,795.78m at an annual ARG of 38.4%. The OCB's TLA also grew by 7 fold during the same period, from LS713.01m in 1979 to LS5,060.28m in 1986 at an annual ARG of 33.1% and the TLA of the SBS grew more than 7.5 fold rise from LS969.98m in 1979 to LS7,373.63m in 1986 at an annual ARG of 34% (see Table 11.6 and Figure 11.2). Allowing for inflation, FIBS's TLA grew from LS39m in 1979 to reach LS215.79m in 1984, thus, recording a 5.5 fold increase in real terms in the first five years of business, then decreased sharply to LS102.65m in 1986 to

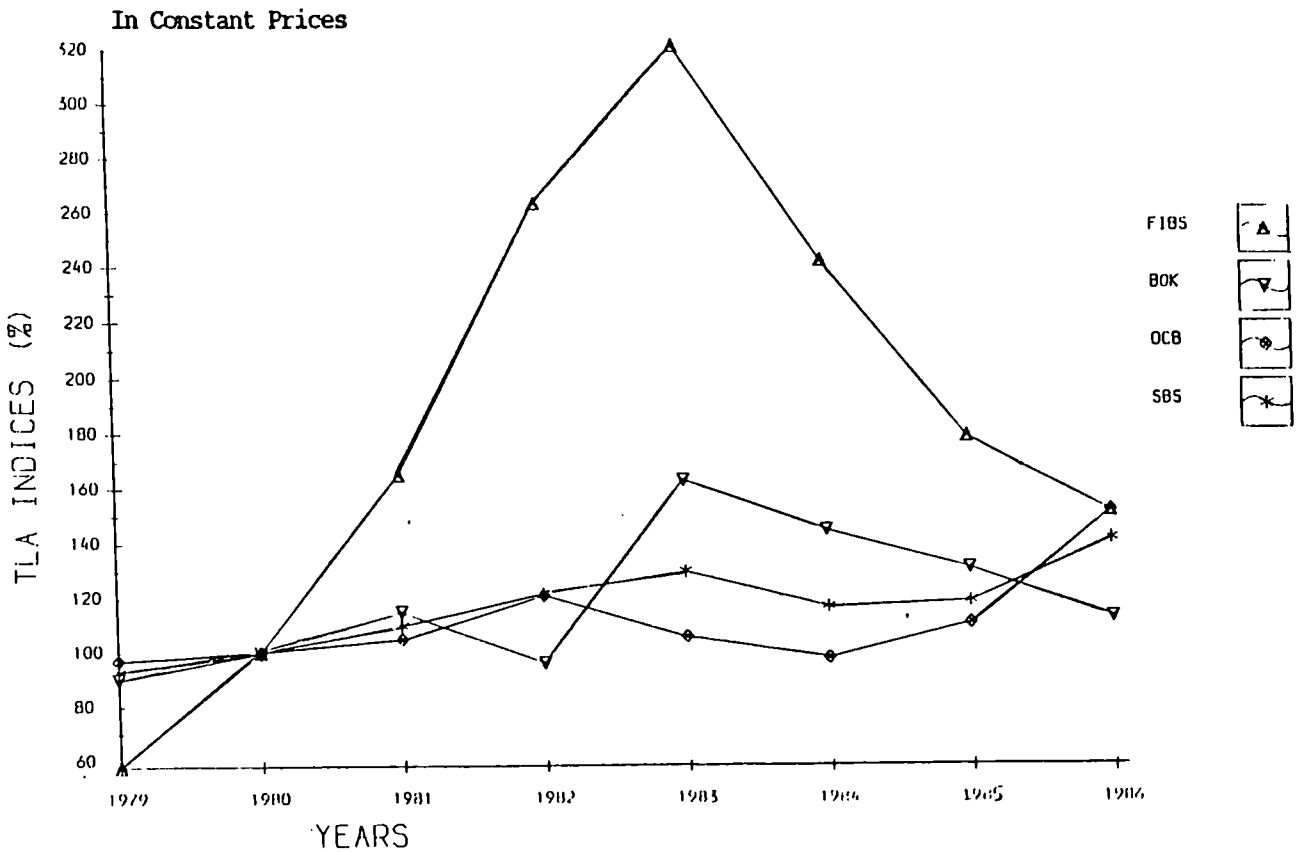
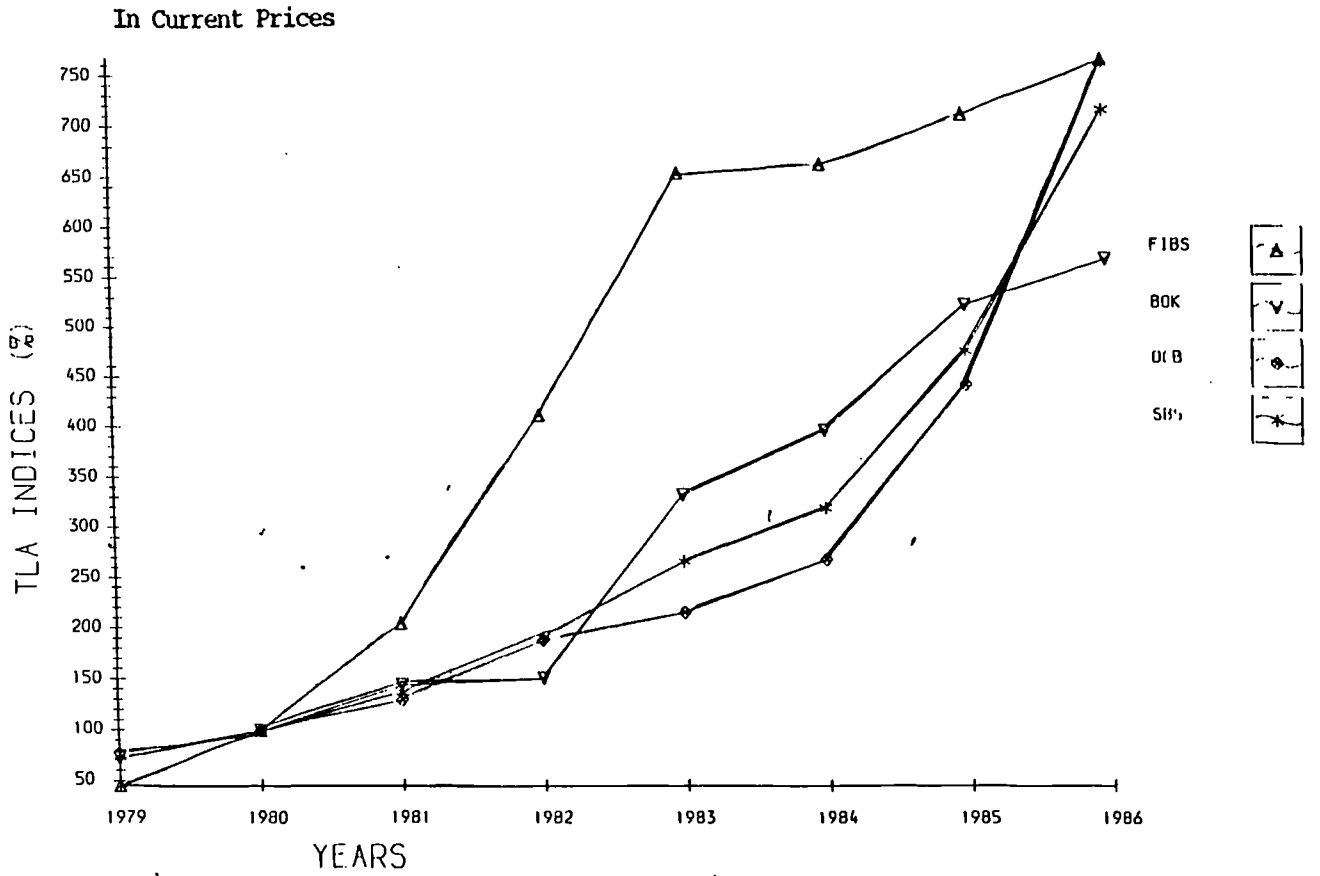


Table 11.6 Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of TLA.

Years	FIBS			BOK			OCB			SBS		
	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change
	Current Prices											
1979	31.14	46	-	225.84	72	-	713.01	77	-	969.98	74	-
1980	67.35	100	116.3	314.65	100	39.3	922.95	100	29.4	1304.95	100	34.5
1981	138.36	205	105.4	451.85	144	43.6	1202.66	130	30.3	1792.87	137	37.4
1982	277.91	413	100.9	474.57	151	5.0	1744.23	189	45.0	2496.70	191	39.3
1983	441.29	655	158.8	1049.05	333	121.1	1996.52	216	14.5	3486.86	267	39.7
1984	447.32	664	1.4	1250.48	397	19.2	2480.57	269	24.2	4178.37	320	19.8
1985	480.17	713	7.3	1647.03	523	31.7	4090.09	443	64.9	6217.37	476	48.8
1986	517.57	768	7.8	1795.78	570	9.0	5060.28	548	23.7	7373.63	565	18.6
ARG			71.1			38.4			33.1			34.0
	Constant Prices											
1979	39.02	58	-	283.00	90	-	893.49	97	-	1215.51	93	-
1980	67.35	100	72.6	314.65	100	11.2	922.95	100	3.3	1304.95	100	7.4
1981	111.04	165	64.9	362.69	115	15.3	973.25	105	5.4	1438.90	110	10.3
1982	177.47	263	59.8	303.04	96	-16.4	1113.81	121	14.4	1594.32	122	10.8
1983	215.79	321	21.6	512.98	163	69.3	976.30	106	-12.3	1705.07	130	6.9
1984	163.08	242	-24.4	455.88	145	-11.1	904.33	98	-7.4	1523.39	117	-10.7
1985	120.40	179	-26.2	412.99	131	-9.4	1025.56	111	13.4	1559.00	119	2.3
1986	102.65	152	-14.7	356.16	113	-13.8	1003.63	109	-2.1	1462.44	112	-6.2
ARG			21.9			6.4			2.1			3.0

Sources: BOS: Annual Reports, various issues;  
 BOK: Annual Reports, various issues;  
 FIBS: Annual Reports, various issues.

Figure 11.2 Performance of FIBS, BOK, OCB & SBS in Terms of TLA



make the overall increase equal to 2.6 fold increase in real terms in comparison to the 16 fold rise it recorded in nominal terms because of the very high inflation in the country which eroded the value of its assets, but on average the annual ARG of FIBS's TLA was 21.9% compared to that of BOK, OCB and SBS which were 6.4%, 2.1% and 3% respectively. The BOK's TLA also increased from LS283m in 1979 to reach LS512.98m in 1983, thus, recording about 2 fold increase but it decreased the following years to stand at LS356m in 1986 making the overall increase 1.2 times that of the 1979. The TLA of OCB and SBS were also hit by the high inflationary effects which reduced their annual ARG from 33.1% and 34% to 2.1% and 3% respectively (see Table 11.6). This inflationary effect is clearly seen from Figure 11.2 exhibiting the relative development of each of the TLA of FIBS, BOK, OCB and SBS.

The market share of FIBS in the SBS's TLA went up from 3.2% in 1979 to 12.7% in 1983, then went down to 7.7% in 1986 growing at an annual ARG of 16.6%. BOK's market share fluctuated between 19% and 30%. It went up from 23.3% in 1979 to reach 25.2% in 1982, declined sharply to 19% in 1983, improved in 1983 to reach 30.1% as a result of its amalgamation with the PCB and then declined back to 24.4% in 1986 because of the improvement of the OCB's TLA which, though declined in the first 5 years from 73.5% in 1979 to 57.3% in 1983, recovered to reach 68.6% in 1986 in view of the establishment of other Banks.

Table 11.7 The Market Shares of FIBS, BOK and OCB in the TLA of the SBS

	FIBS		BOK		OCB		SBS Total
	Share	Growth	Share	Growth	Share	Growth	
1979	3.2	-	23.3	-	73.5	-	100
1980	5.2	62.5	24.1	3.4	70.7	-3.8	100
1981	7.7	48.1	25.2	4.6	67.1	-5.1	100
1982	11.1	44.2	19.0	-24.6	69.9	4.2	100
1983	12.7	14.4	30.1	58.4	57.3	-18.0	100
1984	10.7	-15.7	29.9	-0.7	59.4	3.7	100
1985	7.7	-28.0	26.5	-11.4	65.8	10.8	100
1986	7.0	-9.1	24.4	-7.9	68.6	4.3	100
ARG		16.6		3.1		-5.6	

Source: Table 11.6

#### 11.4.3 Performance in terms of Total Deposits (TLD)

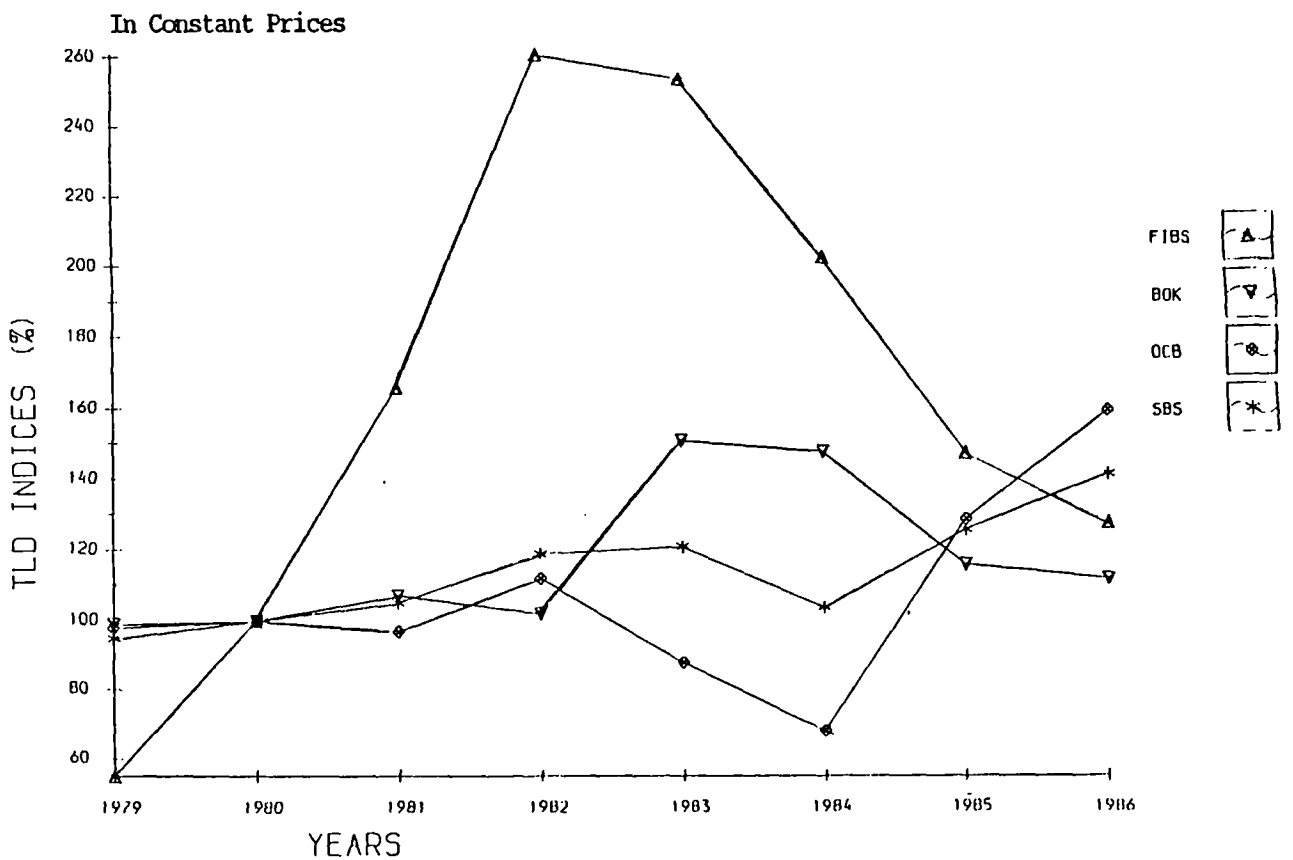
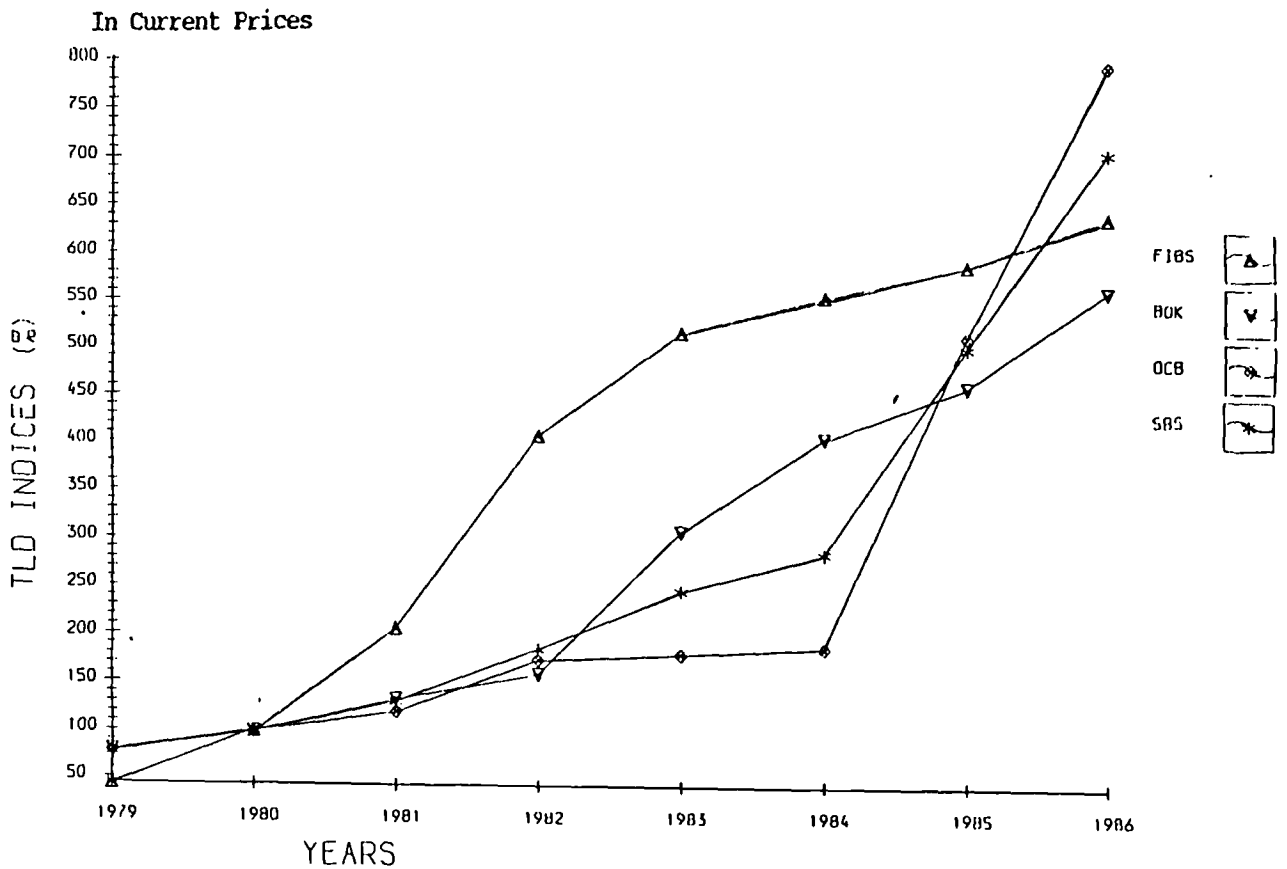
The TLD in current prices of FIBS grew from LS21.8m in 1979 to LS319.4m in 1986, thus, recording an almost fifteen fold increase and increasing at an annual ARG of 54.5%. That of BOK grew from LS191.3m in 1979 to LS1,364.5m in 1986 recording a little bit more than seven fold increase in the 8 years under review and growing at an annual ARG of 34.3%. During the same period, the OCB's TLD grew from LS335m in 1979 to LS3,453m in 1986 recording 10 fold rise and growing at an annual ARG of 47.4%. As for the TLD of the SBS, it increased from LS548m in 1979 to LS5,137m in 1986, registering a little bit less than 10 fold rise and growing at an annual ARG of 38.6%. However, after allowing for inflation which is very high in Sudan and especially from 1983 onwards, FIBS' TLD grew from LS27.3m in 1979 to only LS129.2m in 1982, then declined towards LS63.3m in 1986, growing at an annual ARG of 68.3% in the first 4 years and at an annual ARG of -15.9% in the following 4 years, thus, making the overall annual ARG for the whole period equal to 20.2% only. The TLD in constant prices of BOK grew from LS239.7m in 1979 to LS258.8m in 1981, declined to LS246.9m in 1982, improved to LS364.9m in 1983 because of the merger with the People's Co-operative Bank, then declined again to LS270.6m in 1986, growing on average at an annual ARG of 3.4% only. OCB's TLD in constant prices increased from LS419.8m in 1979 to only LS429.4m in 1980 at a rate of growth of 2.3%, declined in 1983 to LS415.5m at a negative rate of growth of -3.2%, improved to LS479.3m in 1982, declined again in the following two years but this time very sharply to reach a low level of only LS294.0m in 1984. However, in the following two years it reversed the trend and went up very sharply to reach a high level of LS684.9m in 1986, growing thus at an annual real ARG of 11.9% instead of the nominal ARG of 47.4%. And the TLD in constant prices of the SBS grew from LS686.8m in 1979 to LS871.1m in 1983, decreased the following year at a negative rate of growth of -13.6%, then increased sharply to reach LS1,018.8 m in 1986, thus growing at an annual ARG of 6.3% during the period 1979-1986.

Table 11.8 Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of TLD.

Years	FIBS			BOK			OCB			SBS		
	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change
	Current Prices											
1979	21.77	44	-	191.30	79	-	335.00	78	-	548.08	76	-
1980	49.51	100	127.4	241.12	100	26.0	429.84	100	28.3	720.01	100	31.4
1981	102.32	207	106.6	322.48	134	33.7	517.76	121	20.5	942.56	131	30.9
1982	202.37	409	97.8	386.62	160	19.9	750.57	175	45.0	1339.56	186	42.1
1983	256.97	519	27.0	746.21	309	93.0	778.18	181	3.7	1781.36	247	33.0
1984	276.12	558	7.5	980.97	407	31.5	806.52	188	3.6	2063.60	287	15.8
1985	293.01	592	6.1	1115.24	463	13.7	2214.32	516	174.6	3622.57	503	75.5
1986	319.38	645	9.0	1364.54	566	22.4	3453.01	803	55.9	5136.93	713	41.8
ARG			54.5			34.3			47.4			38.6
	Constant Prices											
1979	27.29	55	-	239.73	99	-	419.80	98	-	686.81	95	-
1980	49.51	100	81.5	241.12	100	0.6	429.39	100	2.3	720.01	100	4.8
1981	82.12	166	65.9	258.81	107	7.3	415.54	97	-3.2	756.47	105	5.1
1982	129.23	261	57.4	246.88	102	-4.6	479.29	112	15.3	855.40	119	13.1
1983	125.66	254	-2.8	364.90	151	47.8	380.53	88	-20.6	871.08	121	1.8
1984	100.66	203	-19.9	357.63	148	-2.0	294.03	68	-22.7	752.32	104	-13.6
1985	73.47	148	-27.0	279.65	116	-21.8	555.25	129	88.8	908.37	126	20.7
1986	63.34	128	-13.8	270.63	112	-3.2	684.85	160	23.3	1018.83	142	12.2
ARG			20.2			3.4			11.9			6.3

Sources: BOS: Annual Reports, various issues;  
 BOK: Annual Reports, various issues;  
 FIBS: Annual Reports, various issues.

Figure 11.3 Performance of FIBS, BOK, OCB & SBS in Terms of TLD



The relative growth of TLD in current and constant prices of each of FIBS, BOK, OCB and SBS is perhaps better gauged by their indices taking 1980 as a base year and can be seen from Figure 11.3 or can be also gauged by the market share of each of FIBS, BOK and OCB in the SBS aggregate total deposits (see Table 11.9 below).

Table 11.9 The Market Share of FIBS, BOK and OCB in the TLD of the SBS

	FIBS		BOK		OCB		SBS Total
	Share	Growth	Share	Growth	Share	Growth	
1979	4.0	-	34.9	-	61.1	-	100
1980	6.9	72.5	33.4	-4.3	59.7	-2.3	100
1981	10.9	58.0	34.2	2.4	54.9	-8.0	100
1982	15.1	38.5	28.9	-15.5	56.0	2.0	100
1983	14.4	-4.6	41.9	45.0	43.7	-22.0	100
1984	13.4	-6.9	47.5	13.4	39.1	-10.5	100
1985	8.1	-39.6	30.8	-35.2	61.1	56.3	100
1986	6.2	-23.5	26.6	-13.6	67.2	10.0	100
ARG		13.5		1.1		3.6	

Source: Table 11.8

#### 11.4.5 Performance in terms of Total Finance (TLF)

Table 11.10 and Figure 10.4 exhibit the comparative analysis of the TLF of each of FIBS, BOK, OCB and SBS in current and constant prices. It is quite apparent that, although FIBS recorded very high rates of growth in the first four years (1979-82), in terms of current prices TLF, growing from LS14.7m in 1979 to LS137.8m in 1982 at a staggering annual ARG of 113.5%, it slowed down in 1983 and even declined in 1984 and 1985 for the reasons mentioned in section 11.3 above, however it managed to record a positive rate of growth in 1986 but this was not enough to be a real one because when allowing for inflation the TLF of FIBS recorded positive rates of growth only in the first 4 years (1979-82) and recorded negative rates of growth in all the following years (1983-86). As for the TLF of BOK, OCB and SBS, they all increased at positive rates of growth for the current prices, growing from LS75.5m, LS426.2m and LS516.6m in 1979 to LS798.1m, LS1,748.4m and LS2,697.8m in

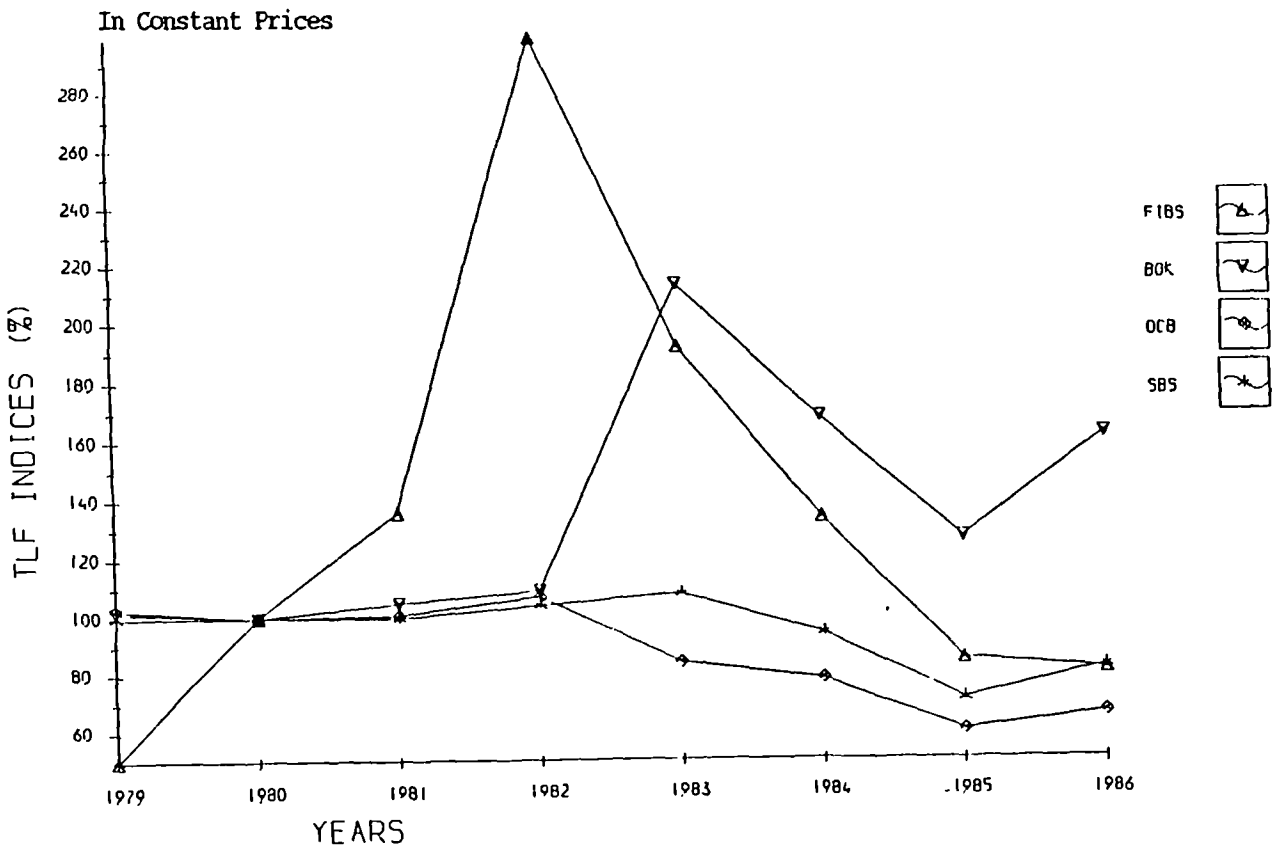
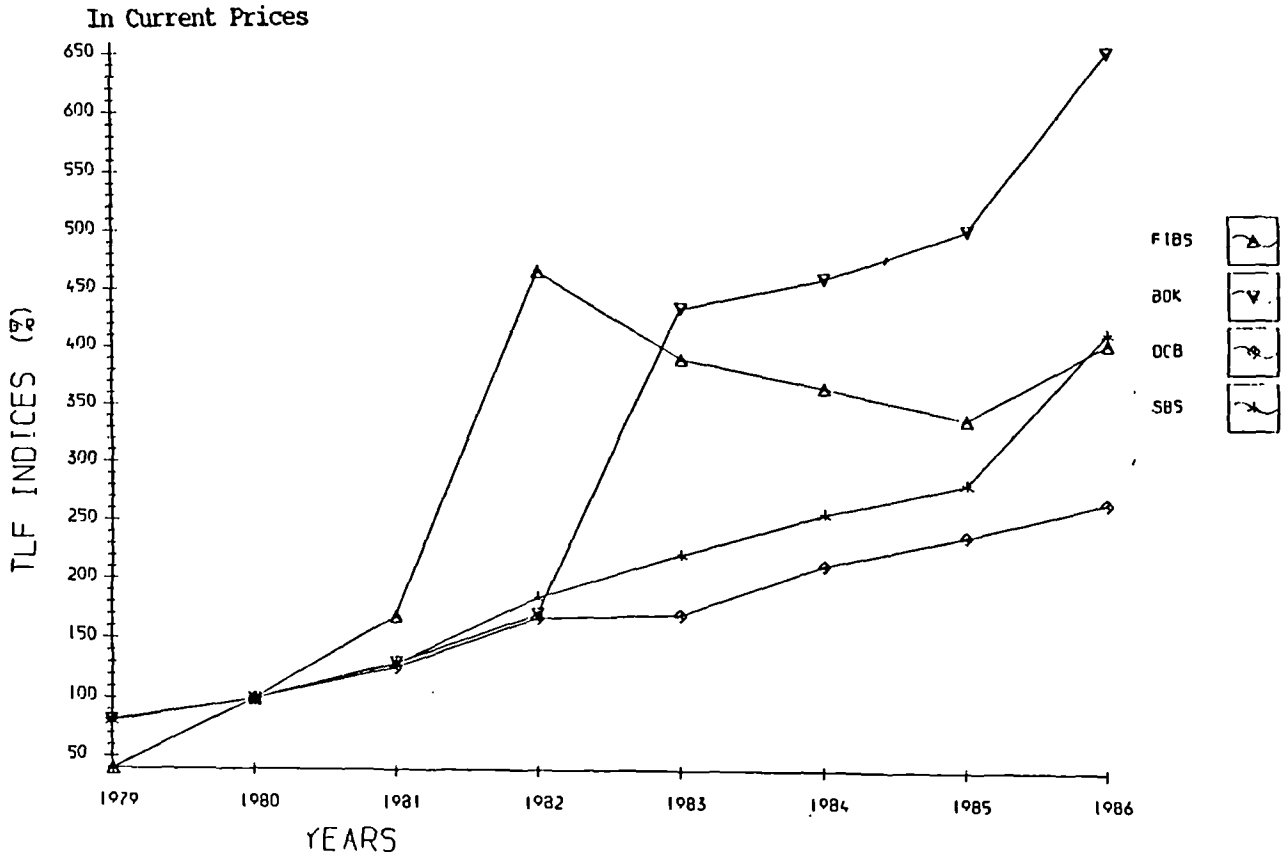
Table 11.10 Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of TLF.

Years	FIBS			BOK			OCB			SBS		
	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change	Amount	Index	Change
	Current Prices											
1979	14.74	40	-	75.70	81	-	426.15	82	-	516.60	80	-
1980	37.16	100	152.0	93.02	100	22.9	518.38	100	21.6	648.56	100	25.5
1981	62.78	169	69.0	121.15	130	30.2	653.29	126	26.0	837.22	129	29.1
1982	137.85	468	119.6	159.28	171	31.5	869.09	168	33.0	1202.22	185	43.6
1983	145.53	392	5.6	405.34	436	154.5	885.75	171	1.9	1436.62	222	19.5
1984	136.25	367	-6.4	429.89	462	6.1	1102.75	213	24.5	1668.89	257	16.1
1985	126.48	340	-7.2	469.90	505	9.3	1240.49	239	12.5	1836.87	283	10.0
1986	151.30	407	19.6	798.06	659	69.8	1748.40	268	40.9	2697.75	416	46.9
ARG			50.3			46.3			22.9			27.2
	Constant Prices											
1979	18.48	50	-	94.86	102	-	534.03	103	-	647.37	100	-
1980	37.16	100	101.1	93.02	100	-2.0	518.38	100	-2.9	648.56	100	0.2
1981	50.39	136	35.6	97.23	105	4.5	524.31	101	1.1	671.93	104	3.6
1982	111.01	299	120.3	101.71	109	4.6	554.98	107	5.8	767.70	118	14.3
1983	71.16	192	-35.9	198.21	213	94.9	433.13	84	-22.0	702.50	108	-8.5
1984	49.67	134	-30.2	156.72	168	-20.9	402.02	78	-7.2	608.42	94	-13.4
1985	31.71	85	-36.2	117.83	127	-24.8	311.06	60	-22.6	460.60	71	-24.3
1986	30.01	81	-5.4	158.28	162	34.3	346.77	66	11.5	535.06	82	16.2
ARG			21.3			12.9			-5.2			-1.7

Sources: BOS: Annual Reports, various issues;  
 BOK: Annual Reports, various issues;  
 FIBS: Annual Reports, various issues.



Figure 11.4 Performance of FIBS, BOK, OCB & SBS in Terms of TLF



1986 growing at annual ARG of 46.3%, 22.9% and 27.2% respectively. However, they all experienced a decline in their TLF in constant prices for the years 1984 and 1985, because of the very high inflation. Consequently, their real annual ARG for the whole period (1979-1986), were 12.9%, -5.2% and -1.7% respectively compared to that of FIBS which was 21.3%. The effect of inflation may clearly be seen from Figure 11.4 exhibiting the relative development of the TLF of each of FIBS, BOK, OCB and SBS in current and constant prices.

As Table 11.11 shows, The market share of FIBS, in the TLF of the SBS, went up in the 4 four years from 2.9% in 1979 to 11.5% in 1982, growing at a staggering annual ARG of 60.5% in the first 4 years; then went down the following 4 years to reach 5.6% in 1986 at an annual negative ARG of of -18.9%, making thus, the overall annual ARG equal to 15.1% for the 8 years under review.

Table 11.11 The Market Share of FIBS, BOK and OCB in The TLF of the SBS

	FIBS		BOK		OCB		SBS Total
	Share	Growth	Share	Growth	Share	Growth	
1979	2.9	-	14.7	-	82.5	-	100
1980	5.7	96.6	14.3	-2.7	80.0	-3.0	100
1981	7.5	31.6	14.5	1.4	78.0	-2.5	100
1982	11.5	53.3	13.2	-9.0	72.3	-7.3	100
1983	10.1	-12.2	28.2	113.6	61.6	-14.7	100
1984	8.2	-28.7	25.7	-8.9	66.1	7.1	100
1985	6.9	-15.9	25.6	-0.4	67.5	2.1	100
1986	5.6	-18.8	29.6	15.6	64.8	-4.0	100
ARG		15.1		11.2		3.2	

Source: Table 10.10

BOK's market share fluctuated in the first 4 years between 14.7% and 13.2%, more than doubled in 1983 because of the merger, declined the following two years (1984 and 1985) and then improved in 1986 to 29.6%, thus growing at an annual ARG of 11.2%, while the market share of the OCB declined in the first 4 years because of what it lost to FIBS and declined further in 1983 because of the merger of the BOK and the PCB, and though they gained ground in the years 1984 and 1985

because of the operations of new banks, they lost ground in 1986 to the BOK which benefited as a public bank from the discriminatory treatment against the private banks that were given only 10% of the local trade as compared with 43% to the public banks and because of the other discriminations mentioned in the end of section 11.3 above.

#### 11.5 Performance of FIBS, BOK, OCB and SBS in terms of Other Proxies

Table 11.13 exhibits the comparative analysis of the performance of FIBS, BOK, OCB and SBS in terms of intermediation, deposits mobilisation and capital adequacy as measured by a number of ratios. Because there is no detail on the liquid assets, profits and number of branches for the SBS and consequently for OCB, the liquidity, profitability and efficiency comparative analysis is made only as far as FIBS and BOK are concerned. In terms of intermediation as measured by the ratios TLF/TLD and TLF/TLA, OCB performed better than FIBS, BOK and SBS, however FIBS performed better than BOK. In terms of deposit ratios as measured by TLD/TLA, BOK with an average ratio of 75.9% outperformed the others followed by FIBS with an average ratio of 66.6%; then SBS (with 55.8%) and lastly comes OCB (with 46.7%). FIBS did not do better than BOK, partly because it was the most capitalised bank in the Sudan during the period under review, its capital ratios, as measured by the ratios K&R/TLA and K&R/TLD, are very high in comparison to those of BOK, OCB and SBS. BOK's capital ratios are the lowest (see Table 11.13).

The comparative analysis of the profitability of FIBS and BOK reveals different results depending on the ratio used. When measured by PBT/TLA, FIBS with an average ratio of 2.9%, performed better than BOK with 2.5%. But when measured by the ratio PBT/K&R, BOK with a staggering 131% outperformed FIBS with only 24.8%. This is so because as mentioned above FIBS is highly overcapitalised and BOK is highly undercapitalised. The other reason is that the depositors' share in FIBS profits is far much greater than the interest paid by BOK to its depositors. The average ratio of FIBS's depositors return is 2.6% compared to the average ratio of depositors' return in case of BOK which

Table 11.13 Comparative Analysis of the Performance of FIBS, BOK, OCB and SBS in Terms of Intermediation (in %), Liquidity (in %), Profitability (%) and Efficiency (in LSm)

Ratio	Bank	1979	1980	1981	1982	1983	1984	1985	1986	Averages
Intermediation as measured by TLF/TLD	FIBS	67.7	75.1	61.4	68.1	56.6	49.3	43.2	47.4	58.6
	BOK	39.6	38.6	37.6	41.2	54.3	43.8	42.1	58.5	44.5
	OCB	127.3	120.6	126.2	115.8	113.8	136.7	56.0	50.6	105.9
	SBS	94.3	90.1	88.8	89.8	80.6	80.9	50.7	52.5	78.5
Intermediation as measured by TLF/TLA	FIBS	47.3	55.2	45.4	60.5	33.0	30.5	26.4	29.2	40.9
	BOK	33.5	29.6	26.8	33.6	38.7	34.4	28.5	44.4	33.7
	OCB	59.8	56.2	54.3	49.8	44.4	44.5	30.3	34.6	46.2
	SBS	53.3	49.7	46.7	48.2	41.2	39.9	29.5	36.6	43.1
Deposits Ratios as measured by TLD/TLA	FIBS	69.9	73.5	74.0	72.8	58.2	61.7	61.0	61.7	66.6
	BOK	84.7	76.6	71.4	81.5	71.1	78.4	67.7	76.0	75.9
	OCB	47.0	46.6	43.1	43.0	39.0	32.5	54.1	68.0	46.7
	SBS	56.5	55.2	52.6	53.7	51.0	49.4	58.3	69.7	55.8
Capital Ratios as measured by K&R/TLA	FIBS	12.9	7.5	8.4	9.9	30.1	29.7	27.4	25.7	16.8
	BOK	1.8	1.5	1.3	2.4	2.7	2.5	2.0	2.1	2.0
	OCB	1.8	2.0	2.3	3.2	4.3	6.5	4.0	11.9	4.5
	SBS	2.2	2.2	2.5	3.8	7.1	7.8	5.3	10.5	5.2
Capital Ratios as measured by K&R/TLD	FIBS	18.5	10.3	11.4	13.6	51.6	48.2	45.0	41.6	30.0
	BOK	2.1	2.0	1.9	3.0	3.8	3.1	2.9	2.8	2.7
	OCB	3.9	4.4	5.3	7.4	11.0	20.1	7.4	17.4	9.6
	SBS	3.9	4.0	4.8	7.0	13.9	15.8	9.1	15.0	9.2
Liquidity ratio as measured by LA/TLD	FIBS	64.3	55.1	59.0	17.4	66.3	64.8	58.6	45.7	53.9
	BOK	63.4	63.9	94.0	64.6	56.7	66.2	91.2	62.2	70.3
Liquidity ratio as measured by LA/TLA	FIBS	44.9	40.5	43.6	12.7	38.6	40.0	35.8	28.2	35.5
	BOK	53.7	49.0	67.0	52.6	40.3	51.9	62.8	47.0	53.0
Profitability as measured by PBT/TLA	FIBS	3.4	3.9	4.3	4.5	3.3	1.2	1.6	1.1	2.9
	BOK	2.4	3.0	3.8	3.3	2.8	1.2	1.8	1.4	2.5
Profitability as measured by PBT/K&R	FIBS	26.3	51.0	50.3	45.5	11.1	4.1	5.9	4.2	24.8
	BOK	135.2	185.0	284.2	138.8	103.1	48.0	89.1	64.5	131.0
Depositors' Return as measured by DR/TLD	FIBS	0.8	1.9	4.3	4.3	3.6	1.4	2.2	2.0	2.6
	BOK	1.7	1.3	1.3	1.7	2.4	2.2	1.2	1.0	1.6
Efficiency as measured by OC/TLA	FIBS	3.2	1.8	1.8	1.6	1.8	1.8	2.6	3.4	2.3
	BOK	1.6	1.9	1.6	1.8	1.9	1.9	1.5	1.6	1.7
Efficiency as measured by TLA/NOF	FIBS	31.1	33.7	27.7	30.9	40.1	29.8	26.7	25.9	30.7
	BOK	7.5	9.5	13.3	13.2	25.0	29.8	39.2	42.7	22.5
Efficiency as measured by TLD/NOF	FIBS	21.8	24.8	20.5	22.5	23.4	18.4	16.3	16.0	20.5
	BOK	6.4	7.3	9.5	10.7	17.8	23.3	26.5	32.5	16.8
Efficiency as measured by TLF/NOF	FIBS	14.7	18.6	12.6	15.3	13.2	9.1	7.0	7.6	12.3
	BOK	2.5	2.8	3.6	4.4	9.7	10.2	11.2	19.0	7.9

Sources: BOS, NBK and FIBS Annual Reports, various issues.

is only 1.6% for the period 1979-86. Because there was no information on the number of staff as far as BOK is concerned, the efficiency comparative analysis is proxied only by the ratios total assets, total deposits and total finance to the number of branches (ie TLA/NOB, TLD/NOB and TLF/NOB). From 1979 to 1983 the efficiency of FIBS as measured by all ratios was far greater than that of BOK, however after 1983 when many political and discriminatory problems faced it and after the amalgamation of PCB with BOK, BOK outperformed FIBS in terms of efficiency but on the average FIBS have higher average ratios for the period 1979-87.

### 11.5 Conclusion

FIBS did not perform well as did KFH in Kuwait or FIBE in Egypt, perhaps because of the many problems that it faced especially after 1983. In fact FIBS did perform quite well in its first four years of business; it is only after Sudan as a whole was struck by the many problems mentioned in section 11.3 above and the introduction of unjust and discriminatory treatment against non public banks, that FIBS did badly in comparison to BOK, OCB or SBS though on the average. Thus, the problem that faced FIBS are not inherent to the Islamic way of doing banking but were the result of the Sudanese policies and circumstances.

## GENERAL CONCLUSION

The main trend of thought in this thesis is that, Islam is not an obstacle to economic growth and development although it prohibits interest, the corner stone of western modern banking. This is because interest is not a necessary component of banking as it is believed and that banking could be based on other mechanisms such as profit and Profit and Loss Sharing (PLS) system. These not only comply with Islam but may prove to be a lot more useful as they may lead to a greater saving mobilisation in Islamic countries than interest and to a greater level of investment and consequently of employment, production and growth.

Basically, it is argued that The Islamic Banking System could be structured, organised and implemented in the same way as interest based banking, except that the Islamic banks will not deal in interest based financial instruments. Moreover, the adoption of PLS system of finance may be of greater benefit than the Interest Based System, since it does not stand as a hurdle in the way of fuller exploitation of available resources, investment and employment. Besides Islamic banking could be adopted without harming the effectiveness of monetary policy or of the central banks in the performance of their traditional roles. With the exception of the discount rate, all other monetary policy tools would be available to the central banks with little changes.

It is pointed out that the implementation of Islamic Banking may prove to be costlier and difficult than interest based banking, however, the benefits behind the high costs and the difficulties in its implementation could be worthwhile in view of the expected benefits. Besides, in its implementation lies the Islamic test for as Prophet Mohammed (PBUH) said: "Paradise is surrounded with hardship and thorns and Hell Fire with desires and flowers".

The conclusions that may be drawn from this study are:

First, Islamic Banking is only a tiny part of the Islamic Economic System which is itself a tiny part of the comprehensive Islamic way of life stipulated by the sources of Islam namely the Koran, the Sunnah and the Ijtihad of Muslim scholars. This is different from all the other ways of life or economic systems such as capitalism or communism.

Second, although no one knows when banking operations first appeared, historical evidence shows that Banking was known far much earlier than thirteenth century Italy and so is not 'Italian by birth' as many economists hold. There is evidence that banking was known to the Muslims, the Romans, the Greeks, the Egyptians and even to the Babylonians and the Sumerians who lived about thirty four hundred years B.C.

Third, the recently emerged Islamic banking movement was the result of the Islamic resurgence that appeared in many Muslim countries after their independence and is also the consequence of the first successful experiment that took place in Egypt in the early 1960s.

Fourth, the prohibition of interest and the permission of profit and PLS are not exclusively Islamic, these were known in earlier religions such as Judaism and Christianity and civilisations like those in Mesopotamia, Egypt and Greece.

Fifth, although a great number of theories were advanced in order to justify interest on loans and profits from sales, none of them is free from flaws and criticisms and none has explained exactly why interest or profits should be paid. It is argued in this thesis that no theory can succeed in justifying interest which is an unnatural predetermined return on loans (the exchange of present money or of a commodity against a future greater money or commodity of the same kind). It is also argued that although the advanced theories of profits did not also escape criticisms, an attempt is made in this thesis to explain profits with what is called: the 'Theory of Sale Residual' (TSR). This attempt has tried to explain why Allah has prohibited interest and permitted sale. Profit is only one of the three outcomes of sale: Pro-

fit, Loss or no profit and no loss which are the natural results of the necessary exchange of goods and services against money. Besides, it is contended that it is quite possible to run a developed economy without recourse to interest but no economy can go beyond the subsistence economy if profits from sale is not allowed. Profit is thus, justified on the basis of sale (the exchange of goods and services against money) since without sale there would be no profit no matter how much risk, uncertainty, advantages, superintendence, etc., are involved and since sale is the main incentive that encourages investment, employment, production and consequently progress and development.

An advanced Islamic Financial System could be organised, structured and run in the same way as an advanced Interest Based Financial System and could adopt many of the techniques of the latter and benefit from them except that no Interest Based Financial Instruments, speculation or other prohibited operations are allowed. Interest based instruments would be replaced by interest-free or PLS instruments that, although may prove to be difficult to implement in the beginning of the process, would perhaps lead to greater social and economic benefits to the savers, investors and the society as a whole.

Although, it is difficult if not impossible to empirically compare the impact of PLS and interest on the different aspects of the economy in view of the fact that there is still no real Islamic Financial System anywhere in the world that is applying PLS instruments, a number of theoretical hypotheses were advanced in this thesis that need further research. It is theoretically argued that PLS system of finance, if implemented in an Islamic Society that believe in Islam and in the superiority of its way of life, may lead to a greater mobilisation of savings, greater involvement of banks and other financial institutions in the promotion of entrepreneurship, employment, production and growth than interest based allows. It is also argued that PLS system may lead to a greater justice in the distribution of income and greater stability in the national and international financial systems than the inte-



rest based system. It is argued that had the LDCs' debts been in the form of PLS finance there would have been no problems of the extent that there is today since the banks would have been more careful in offering finance and more involved in preventing the diversion of funds from the original projects to other purposes and in helping the recipient generate greater benefits of the finance with lesser risk.

From the apparent success of the already established Islamic banks in attracting substantial amounts of savings in very short time as compared to the slow performance of interest-based banks in Muslim countries, one can conclude that Islamic banking is the relevant banking system that serves best the requirement of the economic development at least in the Muslim world. This apparent success has been described by the American magazine Newsweek (7/6/1984, p.52) as follows:

From Malaysia to the Bahamas banks and investment houses founded on the principle of Islamic law are emerging as a force with clout. These institutions vary in size from tiny savings banks to multinational houses... and though most of them are less than a decade old, they already manage assets worth more than \$9bn. In keeping with the Koran's ban on usury, Islamic bankers have devised an unorthodox interest-free system. It is not only gaining acceptance at home but is forcing conventional western banks eager for Muslim dollars to adapt some of their own entrenched rules.

The performance of some of the oldest existing banks (Kuwait Finance House, Faisal Islamic Bank of Egypt and Faisal Islamic Bank of Sudan) shows that despite the fact that these are working in somewhat hostile environments, they have managed to compete with the interest based banks and performed better than expected. Although they have a long way to go, Islamic banks have prove that interest is not a necessary component of banking and that Islam is not an obstacle to economic development but is a promoter of economic growth and development since Islam allows better alternatives to interest: Sale and PLS that may prove to be better instruments which promote investment, employment, entrepreneurship and social justice.

## BIBLIOGRAPHY

- Abdeen, A. and D. Shook (1984) The Saudi Financial System, J. Wiley, New York.
- Abdelhadi, M. (nd) El-Riba Wal-Qurudh Fil-Fiqh El-Islami (Usury and Credits in the Islamic Jurisprudence), Maktabat El-Haramain, Riyadh
- Abdi, A.I. (1977) Commercial Banks and Economic Development: The Experience of East Africa, Preager, New York.
- Abdou, I. (1976) Bunuk Bila-Fawa'id (Banking Without Interest), Dar El-I'tissam, Cairo.
- Abdulrauf, M. (1979) The Islamic Doctrine of Economics and Contemporary Economic Thought, American Enterprise Institution For Public Policy Research, Washington D.C.
- Abu-Saud, M. (1980) "Money, Interest, and Qiradh" in A. Khurshid (ed.) Studies in Islamic Economics, Islamic Foundation, Leicester.
- Abu-Zahra, M. (1957) El-Takaful El-Ijtimae Fil-Islam (Social Solidarity in Islam), Dar El-Fikr, Cairo.
- Adelman, I. and C. Morris (1967) Society, Politics and Economic Development: A Quantitative Approach, John Hopkins Press, Baltimore.
- Afzalur-Rahman, M.A. (1974) Economic Doctrines of Islam, Islamic Publication, Lahore.
- Afzalur-Rahman, M.A. (1979) Banking and Insurance, The Muslim School Trust, London.
- Afzalur-Rahman, M.A. (1982) "Muhammad", Encyclopedia of Seerah, Vol.2, The Muslim School Trust, London.
- Afzalur-Rahman, M.A. (1980) Islam Ideology and the Way of Life, The Muslim School Trust, London.
- Agu, C.C. (1984) Banking Structure and Performance: A Study of the Nigerian Banking System and its Contribution to Nigeria's Economic Development 1960-1980, Ph.D. Thesis, UCNW, Bangor.
- Ahmed, S.M. (1952) Economics of Islam, Ashraf Publications, Lahore.
- Ahmed, S.M. (1975) Social Justice in Islam, Institute of Islamic Culture Lahore.

- Ahmed, S.M. (1980) Islam and New Economic Questions, The Renaissance Bookshop, Cairo.
- Ahmed, Z. et al. (1983) Money and Banking in Islam, Institute of Policy Studies, Islamabad.
- Ahmed, Z. (nd) "Management Aspects of Central Banking", Unpublished Paper, Islamabad.
- Al-Azhar (1965) The Third Conference of the Academy of Islamic Research National Publication House, Cairo.
- Alhadeff, D. (1954) Monopoly and Competition in Banking, University of California Press, Berkeley.
- Al-Jarhi, M. (1983) "A Monetary and Financial Structure for an Interest-Free Economy: Institutions, Mechanisms and Policy" in Z. Ahmed et al. (eds.), Money and Banking in Islam, Institute of Policy Studies, Islamabad, pp.69-101.
- Ali, A.G. (1976) "Money, Banking and Foreign Trade in Sudan" in A. El-Hassan (ed.) An Introduction to the Sudan Economy, Khartoum University Press, Khartoum, Sudan.
- Ali, A.G. (1985) The Sudan Economy in Disarray, Ithaca Press, London.
- Ali, Anwar (1958) "Banking in the Middle East", IMF Staff Papers, Vol.6 1958, pp.51-79.
- Ali, M.M. (nd) The Religion of Islam, The Arab Publishers, Cairo.
- Ali, Mohammed (1979) "The Role of the IDB in the Future Economic Order" in The Islamic Council of Europe (eds.) The Muslim World and The Future Economic Order, London.
- Ali, Yusuf (1975) The Holy Qur'an: Text, Translation and Commentary, The Islamic Foundation, Leicester.
- Al-Nakib, B. and I. Moosa (1984) "Why Interest Will Rise Again?", Euromoney, March 1984, pp.107-110.
- Al-Qusi, A.M. (1982) Riba Islamic Law and Interest, Ph.D. Thesis, Temple University.
- American Institute of Banking (1960) Principles of Bank Operations. American Institute of Banking, New York.
- Amirech, M. (1987) Land Tenure, Class Structure and Political Discourse in Algeria 1830-1982, Ph.D. Thesis, UCNW, Bangor.
- Arabia, The Islamic World Review, various issues.
- Ariff, M. (1983) Monetary and Fiscal Economics of Islam, King Abdul-Aziz University, Jeddah.

- Attia, G. (1985) "Financial Instruments Used by Islamic Banks", Unpublished paper presented at the Islamic Banking and Finance Conference London, 31/10/1985 - 1/11/1985.
- Attigua, A. (1984) "Energy and Development in The Arab world: Present and Future Prospects" OPEC Review, Vol.viii, No.2, 1984, Vienna.
- Austry, J. (1961) "L'Islam face au developement economique", Economie et Humanisme, Paris.
- Baker, J. (1978) "Asset/Liability Management" Banking July/August 1978.
- Banker Research Unit (eds.) (1980) Banking Structure and Sources of Finance in the Middle East, The Financial Times Business, London.
- The Banker, various issues.
- Bashir, B.A. (1982) "Banking Without Interest: The Islamic System", The Banker's Magazine, London.
- Basu, S.K. (1974) A Review of Current Banking theory and Practice, Macmillan, London.
- Beddy, J.P. (1940) Profits: Theoretical and Practical Aspects, Hodges Figgis, London.
- Beheiry, M. (1981) Commercial Banking in Developing Economies: A Study on The Sudanese Experience, M.A dissertation, UCNW, Bangor.
- Bell, F. and N. Murphy (1976) "Economies of Scale in Banking", New England Review, Federal Reserve Bank of Boston.
- Benson, G.J. (1972) "Economies of Scales of Financial Institutions", Journal of Money, Credit and Banking, vol.4, May 1972, pp.312-341.
- Bergier, J. (1979) "From the Fifteenth Century in Italy to the Sixteenth Century in Germany: A new Banking Concept" in The Centre for Medieval and Renaissance Studies, (eds.) The Dawn of Modern Banking, University of California, Los Angeles.
- Bhattia, R. and D. Khatkhate (1975) "Financial Intermediation, Savings Mobilisation and Entrepreneurial Development: The African Experience", IMF Staff Papers, Vol.22, March 1975, 132-159.
- Binhammer, H. (1968) Money, Banking and The Canadian Financial System, Methuen Publications, Toronto.
- Birks, J. and C. Sinclair (1982) "Employment and Development in Six Poor Arab States: Syria, Jordan, Sudan, South Yemen, Egypt and North Yemen.", International Journal of Middle Eastern Studies, Vol.14, 1982, 35-51.

- Birnie, A. (1933) An Economic History of Europe 1760-1930, Mathuen, London.
- Blomquist, T. (1979) "The Dawn of Banking in an Italian Commune: Thirteenth Century Lucca" in The Dawn of Medieval Banking, (ed.) By The Centre For Medieval and Renaissance Studies, California University Press, Los Angeles.
- Boehm-Bawerk, E.V. (1890) Capital and Interest, Macmillan, London.
- Boehm-Bawerk, E.V. (1891) Positive theory of Capital, Macmillan, London
- BOK, (Bank of Khartoum), Annual Reports 1979-1986.
- BOS, (Bank of Sudan), Annual Reports 1979-87.
- BOS, (Bank of Sudan) (nd) The Nationalisation of Banks in the Sudan, Bank of Sudan, Khartoum.
- Boudjellal, M. (1982) The Business of Interest Free Banking with Particular Reference To Kuwait Finance House, M.Sc. Dissertation, Herriot-Watt University, Edinburgh.
- Brucker, E. (1970) "An Economic Approach to Banking Competition", Journal of Finance, Vol.25, No.5, Dec.1970, pp. 1134-44.
- Cameron, R. (1962) "Theoretical Bases of a Comparative Study of the Role of Financial Institutions in the Early Stages of Industrialisation", The Second International Conference of Economic History, Vol.2, 1962, Aix en Provence, France, pp. 567-88.
- Cameron, R. et al. (1972) Banking And Economic Development: Some Lessons of History, Oxford University Press, New York.
- Cargill, T.F. (1979) Money, the Financial System and Monetary Policy, Prentice Hall, New Jersey.
- Carver, T.N. (1901) "The Risk Theory of Profit", Quarterly Journal of Economics, May 1901.
- Cassel, G. (1923) The Nature And Necessity of Interest Macmillan, London.
- CBE, (Central Bank of Egypt), Annual Reports 1979-87.
- CBK, (Central Bank of Kuwait), Annual Reports 1979-87
- Chakravarty, S.P. (1986) The Latin American Debt, European Finance Institute, UCNW, Bangor.
- Chandavarkar, A.G. (1977) "Monetisation of Developing Economies", IMF Staff Papers, Vol.24, Nov.1977, pp.665-721.

- Chapra, U. (1979) The Economic System of Islam, The London Islamic Cultural Centre, London.
- Chapra, U. (1985) Towards a Just monetary System, The Islamic Foundation Leicester.
- Chick, V. (1977) The Theory of Monetary Policy, Blackwell, Oxford.
- Christian, J. and E. Pagoulatous (1973), "Domestic Financial Markets in Developing Countries", Kyklos, Vol.26, 1973, pp.75-90.
- Ciampi, C. (1981) "The Cost of the War Against Inflation", Euromoney, Oct. 1981, pp.96-100.
- Clark, J.B. (1892) "Insurance and Business Profits", Quarterly Journal of Economics, october 1892.
- Clausen, E. (1985) "The Lender of Last Resort Function in the Context of National and International Financial Crises", Weltwirtschaftstlishes Archives, Bond 121, Heft 2, pp.217-237.
- CLCB, (Committee of London Clearing Banks) (1978), The London Clearing Banks, Longman, London.
- Coates, W. and D. Khatkhate (1980) Money and Monetary Policy in Less Developed Countries, Pergamon Press, New York.
- Collyns, C. (1983) "Alternatives to the Central Bank in Developing World", IMF Occasional Papers, No. 20, Washington D.C.
- Conard, J. (1959) An Introduction to the Theory of Interest, University of California Press, Los Angeles.
- Cooper, R. (1981) "A Calculator in one Hand and the Koran in the Other" Euromoney, Nov.1981, pp.44-64.
- Croose, H. and G. Hempel (1980) Management Policies for Commercial Banks, Prentice Hall, Englewood Cliffs, New Jersey.
- Dale, R. (1986) "Universal Banking: The German Model", The Banker, July 1986
- De Kock, M.H. (1974) Central Banking, Lockwood Staples, London.
- Delaporte, L. (1925) Mesopotamia, A.K. Alfred, New York.
- De Roover, R. (1954) "New Interpretation of the History of Banking", Journal of World History, Vol. 2, 1954.
- Divine, T. (1959) Interest: An Historical and analytical Study in Economics and Modern Ethics, Milwankee, Marquette University Press, New York.

- Dobb, M. (1937) Capitalist Enterprise and Social Progress, Routledge, London.
- Dobb, M. (1949) "Economic Planning and Planned Economies" in the New Educational Trust (ed.) Economic Man and his Material Resources, Odhams Press, London.
- Doi, A.H. (1984) Shariah, The Islamic Law, Taha Publishers, London.
- Edgeworth, F.Y. (1888) "Papers Relating to Political Economy: Wages and Profits" Quarterly Journal of Economics, 1888.
- Einzig, P. (1949) Primitive Money, Eyre and Spottiswood, London.
- Einzig, P. (1952) Inflation, Chatto and Windus, London.
- El-Agraa, A. (1984) "An Overview of Underdevelopment", Arabia, Oct.1984
- El-Agraa, A. (1985) "Oiling the Wheels Towards non Dependence", Arabia, February 1985.
- El-Ashker, A. (1987) The Islamic Business Enterprise, Croom Helm, Beckenham, Kent.
- El-Ayouti, Y. (1981) "Egypt", in Grolier Incorporated (ed.), Lands and Peoples, Vol.1.
- El-Banna, J. (1986) El-Riba (Interest), Dar El-Fikr El-Islami, Cairo.
- El-Djahshiary, A. (1938) Kitab El-Wuzara' Wel-Kuttab (The book of Ministers and Writers), Cairo.
- El-Masri, R. (1975) Essai d'Integration d'une Banque de Developement dans une Societe Islamique: Les Problems que pose la Conception Islamique de l'Interet, These de Doctorat de Specialite en Economie du Developement, Universite de Rennes.
- El-Naggar, A. (1974) El-Madkhal Ilal-Nadhariah El-Iqtisadia Fil-Manhaj El-Islami, (Introduction to the Economic Theory Within The Islamic Methodology", Dar El-fikr, Cairo.
- El-Naggar, A. (1978) "Islamic Banks: A Model and a Challenge" in Gauhar (ed.) The Challenge of Islam, Economic Council of Europe, London.
- El-Qalqashandi, A. (1913) Subh El-A'Asha Fi-Sinaat El-Insha, The Dawn of the Blind in the Making of composition), Cairo.
- El-Sadr, M.B. (1980) Iqtissaduna (Our Economics), Dar El-Taarouf Lil-Matbuat, Beirut.
- El-Sadr, M.B. (n.d) El-Bank El-Laribawi Fil-Islam (The Interest Free Bank In Islam), Jami' El-Naqi, Kuwait.

- El-Sarraf, M.F. (1984) "Money Markets Dealings Within the Framework of the Islamic Law", Journal of Islamic Banking and Finance, Vol.1, 1984, pp.57-64.
- El-Sayid, A. (1984) 'El-Muslimuna yunshiuna Awal Masraf Fil-Alam' (The Muslims Establish the First Bank in The World) El-Madinah newspaper Nos. 6214-17.
- El-Zohry, A.H (1978) The Banking System and the Economic Development of Egypt 1952-1966, Msc. Dissertation, UCNW, Bangor.
- El-Zubair, M.K. (1983) Foreign Aid and Economic Development: A Case Study of the Sudan's Experience of Growth and Development 1960-1980, Ph.D. Thesis, UCNW, Bangor.
- Encyclopedia Britannica (1974), University of Chicago, various volumes.
- Erba, R. (1983) "Is the Debt Crisis Getting out of Control?", Inter-Economics, sep/oct.1983, pp.205-206.
- Eshag, E. and M. Kamal (1967) "A Note on the Reform of the Rural Credit System in UAR, Bulletin of the Oxford University Institute of Economics and Statistics, Vol.29, May 1969,
- Euromoney, various issues.
- Evans, K. (1985) "Kuwait Economy at the Crossroads", The Banker, March 1985, p.51.
- FIBE, (Faisal Islamic Bank of Egypt) (1977), Law of Establishment and Statutes, Dar El-Maaref, Cairo.
- FIBE, (Faisal Islamic Bank of Egypt), Annual Reports 1979-87.
- FIBS, (Faisal Islamic Bank of Sudan), Annual Reports 1979-86.
- FIBS, (Faisal Islamic Bank of Sudan), (nd), Objectives and Operational Methods, The Sudanese Colourphotos Laboratories.
- Fisher, I. (1930) The Theory of Interest, Macmillan, New York.
- Frank, T. (1933) An Economic Survey of Ancient Rome, Hopkins, Baltimore.
- Fraser, D. and P. Rose (1976) "Static and Dynamic Measures of Market Structure and the Performance of Commercial Banks", Journal of Economics and Business, Winter 1976.
- Fraser, P. (1982) "How not to Measure Bank Productivity" The Banker, August 1982, PP.103-17.
- French, M. (1987). "Egypt Clobbered by Cairo Irregulars" Euromoney, June 1987 pp. 81-87



- Friedman, M. (1960) A Program for Monetary Stability, Fordham University New York.
- Friedman, M. (1968) "Factors Affecting the Level of Interest Rates", Conference Proceedings of the Conference on Savings and Residential Financing, 1968.
- Fry, M. (1982) "Models of Financially Repressed Economies", World Development, Vol.10, no.9, pp.731-750
- Fuchs, V.R. (ed.) (1969) "Production And Productivity In The Service Industries", Studies in Income And Wealth, no.34, National Bureau Of Economic Research, Columbia University Press, New York.
- Furness, E.L. (1972) An Introduction To Financial Economics, Heinemann, London.
- Gabriel, P. (1981) "Dependency and Development: A critical Overview" in Dudley Seers (ed.) Dependency theory: A Critical Assessment, Printer, London, pp.20-78.
- Galbis, V. (1976) "Structuralism and Financial Liberalisation", Finance and Development, Vol. 13, No. 2, June 1976, pp.33-37.
- Galloway, D.R. (1976) Egypt, Middle East Economic Prospect: Forecast to 1976, Euromoney Publications, London.
- Gardener, E.P.M (1981) Capital Adequacy and Banking Supervision, Bangor Occasional Papers in Economics, No.19, University of Wales Press, Cardiff
- Gardener, E. & P. Molyneux (1987) "Banking Regulation in the UK Converging Towards Complexity", Banking World, February 1987.
- Gerschenkron, A. (1962) Economic Backwardness in Historical Perspective: A Book of Essays, Harvard University Press, Cambridge Mass.
- Gibson, A.H. (1923) "The Future Course of High Class Investment Values" The Bankers' Insurance Managers and agent's Magazine, Vol.115.
- Gibson, W.E. (1970) "The Uses of National Balance Sheets" Income and Wealth, Series 12, No.2, June 1966.
- Goiten, S.D. (1967) A Mediterranean Society, University of California Press, Bekerly.
- Goiten, S.D. (1973) Letters of Medieval Jewish Traders, Princeton University Press, Princeton, N. Jersey.
- Goldsmith, R. (1966) The Determinants of Financial Structure, OECD, Paris.
- Goldsmith, R. (1969) Financial Structure and Development, Yale University Press, New Haven.

- Goldsmith, R. (1975) "Some Reflections on the Past, Present and Future of Financial Institutions" in P. Frantzen (ed.) Problems of Financial Intermediaries, Rotterdam University Press, Rotterdam.
- Gorman, J. (1969) "Alternative Measures of Real Output and Productivity of Commercial Banks" in V. Fuchs (ed.) Production and Productivity in the Service Industries, Columbia University Press, N. York.
- Graham, B. et al. (1978) The Penguin Dictionary of Economics, Penguin.
- Greenbaum, S.I. (1967a), "Competition and efficiency in the Banking System: Empirical Research and its Policy Implications", The Journal of Political Economy, Vol.75, August 1967, pp. 461- 479.
- Greenbaum, S.I. (1967b) "A Study of Bank Costs" in The National Banking Review, Vol.4, June 1967, pp. 415-434
- Gruchy, A.G. (1987) The Reconstruction of Economics: An Analysis of the Fundamentals of Institutional Economics, Greenwood Press, New York.
- Gupta, K.L. (1984) Finance and Economic Growth in Developing Countries, Groom Helm, London.
- Gurley, J. (1967) "Financial Structure in Developing economies" in D. Kirvine, (ed.) Fiscal and Monetary Problems in Developing States, Preager, New York.
- Gurley, J. and E. Shaw (1967) "Financial Structure and Economic Development", Economic Development and Cultural Change, Vol. 15.
- Hahn, F. (1970) "Savings and Uncertainty", Review of Economic Studies, Vol.37, pp.21-24.
- Halm, G. (1974) "Economic Systems", Encyclopedia Britannica, University of Chicago.
- Hamdi, A.R. (1981) The Operations of Faisal Islamic Bank of Sudan, National Printing and Publishing House, Khartoum.
- Hamid, B.S. (1983) "OPEC Investment Strategies: Past and Future", Inter-Economics, no. 1, 1983, pp.38-41.
- Hansen, B. and G. Marzouk (1965) Development and Economic Policy in UAR Worth Holland, Amsterdam.
- Hanson, J.L. (1978) Monetary Theory and Practice, McDonald, Plymouth.
- Harb, M.T. (1911) Ilaj Misr Al-Iqtisadi Wa-Mashru' Bank El-Masri (The Economic Solution to Egypt and The Project of Bank Misr), El-Matbaa El-Djadidah, cairo.
- Harberler, G. (1939) Prosperity and Depression: A Theoretical Analysis of Cyclical Movements, League of Nations, Geneva.

- Harrod, R.F. (1934) "Doctrine of Imperfect Competition", Quarterly Journal of Economics, May 1934.
- Harrod, R.F. (1948) Towards a Dynamic Economics, Macmillan, London.
- Harvey, N. (1981) "World Islamic Finance Based On Community Banks", Saudi Business, 20/3/1981.
- Hassanu-Zaman, M.S. (1981) The Economic Functions of the Early Islamic State, International Islamic Publisher, Karachi.
- Hawley, F.B. (1890) "Profits and the Residual Theory", Quarterly Journal of Economics, July 1890.
- Hawley, F.B. (1892) "The Fundamental Error of Kapital und Kapitalzins", Quarterly Journal of Economics, April 1892.
- Hawley, F.B. (1893) "The Risk Theory of Profits", Quarterly Journal of Economics, July 1893.
- Hawtry, R.G. (1962) A Century of Bank Rate, Frank Cass, London.
- Hawtry, R.G. (1970) The Art of Central Banking, Frank Cass, London.
- Hayes, J.L. (1980) "The Process of Bank Management" in W. Baughn and C. Walker (eds.) The Bankers' Handbook, Irwin, Homewood, Illinois.
- Hazeltine, S. (1980) "The Bank's Board of Directors: Functions and Responsibilities" in W. Baughn and C. Walker (eds.) The Bankers' Handbook, Irwin, Homewood, Illinois.
- Heggstad, A. (1979) "Market Structure, Competition and Performance in Financial Industries: A Survey on Banking Studies", in F.R Edwards (ed.), Issues in Financial Regulation, McGraw-Hill, New York.
- Heichelhein, F.M. (1958) An Ancient Economic History, Leiden, A.W. Sijthoffs Uitgeveraat-Schapping, N.V
- Hitti, F.K. (1970) History of the Arabs, Macmillan, London.
- Hodgman, D.R. (1969) "Alternative Measures of the Real Output and Productivity of Commercial Banks" in V. Fuchs (ed.) Studies in Income And Wealth, no.34, National Bureau of Economic Research, Columbia University Press, New York.
- Hodgson, B. (1983) "Economic Science and Ethical Neutrality: The Problem of Theology", Journal of Business Ethics, Vol.2, 1983.
- Homer, S. (1963) A History of Interest Rates, Reutgers University Press New Brunswick, New Jersey.
- Homoud, S.H. (1985) Islamic Banking, Arabian Information, London.

- Horvitz, P. (1969) Monetary Policy and the Financial System, Englewood Cliffs, Prentice Hall, New Jersey.
- Horwitch, G. (1966) "Tight Money, Monetary Restraint and the Price Level", Journal of Finance, Vol.21, March 1966, pp.15-33.
- Hoston, J. (1966) "Tight Money as a Cause of Inflation", Journal of Finance Vol.21, March 1966, pp.152-155.
- Hoston, J. (1982) "The Present Impass: Is there a Way out?", Unpublished Paper, University of Waterloo, Waterloo, Ontario.
- IDB, (Islamic Development Bank), Annual Reports 1980-85
- IDB, (Islamic Development Bank), Articles Of Agreement, IDB, Jeddah.
- Iqbal, Z. and A. Mirakhor (1987) Islamic Banking, IMF Occasional Papers No. 49, March 1987.
- Issawi, C. (1963) Egypt In Revolution, Oxford University Press, London.
- Issawi, C. (1966) The Economic History Of The Middle-East 1800-1914, University of Chicago Press, Chicago.
- Jaziri, A. (1938) El-Fiqh Alal-Madhahib El-Arbaa (Islamic Jurisprudence According To the Four Sunni Schools), Cairo.
- Johns, R. (1987) "Banking and Finance: Austerity causes strains", Financial Times, 22/06/1987.
- Johnson, H.G. (1966) "Is Inflation The Inevitable Price of Rapid Development or a Retarding Factor in Economic Growth?", Malayan Economic Review, Vol.11, April 1966.
- Johnson, O.E. (1974) "Credit Controls as Instruments of Development Policy in the light of Economic Theory", Journal of Money, Credit and Banking, Vol.6, February 1974.
- Kahf, M. (1978) The Islamic Economy: Analytical Study of The Functioning of The Islamic Economic System, The Muslim Student Association of USA and Canada, Indiana.
- Kaldor, N. (1963) "Taxation for Economic Development", Journal of Modern African studies, Vol.1, No.1.
- Kaldor, N. (1980) "Monetarism and UK Monetary Policy", Cambridge Journal of Economics, 1980.
- Kaldor, N. (1982) The Scourge of Monetarism, Oxford University Press, London.
- Karasten, I. (1982) "Islam and Financial Intermediation", IMF Staff Papers, March 1982, pp. 108-42

- Keynes, J.M. (1930) A Treatise on Money, Macmillan, London.
- Keynes, J.M. (1936) The General Theory of Employment, Interest and Money, Macmillan, London.
- KFH, (Kuwait Finance House), Annual Reports 1979-87.
- KFH, (Kuwait Finance House), Memorandum of Agreement, Kuwait.
- Khan, M.A. (1982) "Inflation and the Islamic Economy: A closed Economy Model" in Ariff (ed) Monetary and Fiscal Economics of Islam, International Centre for Research in Islamic economics, Jeddah.
- Khan, M.M. (1971) Sahih Al-Bukhari, S.B. Mills, Pakistan.
- Khan, M.S. (1986) "Islamic Interest-Free Banking: A Theoretical Analysis", IMF Staff Papers, Vol.33, March 1986, pp.1-27.
- Khan, S.R. (1983) Profit and Loss Sharing: An Economic Analysis of an Islamic financial system, Ph.D. Thesis, University of Michigan.
- Khan, W.M. (1985) Towards an Interest-Free Islamic Economic System, The Islamic Foundation, Leicester.
- Khatkhate, D. and K. Riechel (1980) "Multipurpose Banking: Its Nature, Scope And Relevance for LDCs", IMF Staff Papers, Vol. 27, 1980.
- Khoudja, M. and P. Sadler (1979) The Economy of Kuwait Development and Role in International Finance, Macmillan, London.
- Khouri, R. (1987) "The Spread of Banking For Believers", Euromoney 1987
- Khurshid, A. (1980a) Islam, its Meaning And Message, The Islamic Foundation, Leicester.
- Khurshid, A. (1980b) (ed.) Studies in Islamic Economics, The Islamic Foundation, Leicester.
- Khurshid, A. (1982) Public Duties in Islam: The Institution of Hisba By Ibn Taymiah, The Islamic Foundation, Leicester.
- Kidwell, D. and R. Peterson (1981) Financial Institutions, Markets and Money, The Dryden Press, Hinsdale, Illinois.
- King, W.T. (1936) History of the London Discount Market, Routledge.
- Kinsella, R.P. (1980) "The Measurement of Bank Output", Journal of Institute of Bankers in Ireland, Vol.82, No.3, July 1980.
- Kish, C. and W. Elkin (1928) Central Banks: A Study of The Constitution of Banks of Issue, with an Analysis of Representative Characters, Macmillan, London.

- Klein, M.A. (1971) "A Theory of the Banking Firm", Journal of Money, Credit and Banking, May 1971, pp. 205-218.
- Kloman, F. (1980) "Risk management" in W. Baughn and C. Walker (eds.) The Bankers' Handbook, Irwin, Homewood, Illinois.
- Knight, F.H. (1951) "Profits" in Readings in The Theory of Income Distribution, (ed.) by The American Economic Association, The Blackinton Company, Philadelphia.
- Labib, S. (1969), "Capitalism In Medieval Islam", Journal of Economic History, Vol.29, No.1, March 1969, pp. 79-140.
- Lachab, Y. (1987) International Banking Supervision: Recent Developments, M.A Dissertation, UCNW, Bangor.
- Lachine, F. (1983) Al-Riba Fil-Islam (Interest In Islam), Al-Mawsua Al-Ilmiah wal-Amaliya lil-Bunuk Al-Islamiyah (The Scientific and Practical Encyclopedia of Islamic Banking), Vol.5.
- Land, F. (1980) "Evolution and Overview of Asset and Liability Management" in W. Baughn and C. Walker (eds.) The Bankers' Handbook, Irwin, Homewood, Illinois.
- Lascelles, D. (1985) "Kuwait's Banks Come Under Pressure", The Banker, March 1985, pp. 41-44.
- Laurie, S. (1989) "Egypt tiptoeing towards reform" The Banker July 1989
- Leland, H. (1968) "Savings and Uncertainty: The Precautionary Demand for Saving", Quarterly Journal of Economics, Vol.82, pp.465-73.
- Lemoine, R.J. (1929) Foreign Banking Systems, Willis and Beckart Henry, London.
- Lewis, A. (1954) Economic Development With Unlimited Supplies of Labour, Manchester School of Economics, Manchester.
- Lieber, A.E. (1968) "Eastern Business Practices and Medieval European Commerce", Economic History Review, Vol. 21, 1968, pp. 230-243.
- Lopez, R. (1952) "The Trade of Medieval Europe: the South", Cambridge Economic History of Europe, Vol. 2, Cambridge University Press.
- Lopez, R. (1979) The Dawn of Medieval banking, (ed.) by The Centre For Medieval and Renaissance Studies, University of California, Los Angeles.
- Lutz, Vera and Friederick (1951) The Theory of Investment of the Firm, Princeton University Press, New Jersey.
- Macvane, S.M. (1887) "The Theory of Business Profits", Quarterly Journal of Economics, Oct. 1887.

- Maisel, S.J. (1973) Managing the Dollar, Norton, Washington
- Manes, P. (1982) "International Indebtedness" Banca Nazionale Del Lavoro, March 1982, pp.109-114.
- Mannan, M.A. (1974) Islamic Economics: Theory And Practice, Ashraf Publication, Lahore.
- Marlowe, J. (1966) Four Aspects of Egypt, Allen and Unwin, Working.
- Marx, K. (1911) A Contribution to the Critique of Political Economy, Charles H. Kerr, London.
- Mathias, P. (1973) "Capital, Credit and Enterprise in the Industrial Revolution", Journal of European Economic History, Vol. 2, 1973.
- Mawdudi, A. (n.d) El-Riba (Usury), Maktabat Dar Al-Ansar, Abdine.
- Mawdudi, A. (1984) Economic System of Islam, Islamic Publication, Lahore.
- McDougall, R. (1988) "Egypt back to the good old basics" The Banker July 1988
- McKinnon, R. (1973) Money And Capital In Economic Development, Brooking Institute, Washington D.C.
- Meier, G. (1976) Leading Issues in Development Economics, Oxford University Press, New York.
- Meiselman, D. (1963) "Bonds Yields and The Price Level: The Gibson Paradox Redefined" in Dean Carson (ed.) Banking And Monetary Studies, Homewood Richard,
- Metwally, A. and S. Shahata (1983) Iqtisadiat-Ul-Uqud Fi Itar El-Fikr El-Islami (The Economics of Money in the Islamic thinking), Dar El-Tawfiq El-Namouthajiah Littiba'a wal-Jam'e El-Ali, Cairo.
- Metwally, M. (1984) "The Role of the Stock Exchange in an Islamic Economy", Journal of Research in Islamic Economics, Vol.2, No.1.
- Midgley, J. (1984) "Social Welfare Implications of Development Paradigm", Social Service Review, Vol. 58, June 1984, pp. 181-198.
- Minsky, H.P. (1972) "An Exposition of a Keynesian Theory of Investment" in S. Karl (ed.) Mathematical Methods in Investment and Finance, North Holland, pp. 207-233.
- Miskimin, H.A. (1969) The Economy of Early Renaissance Europe 1300-1460 Prentice Hall, Englewoods Cliffs, New Jersey.
- Mohsin, M. (1982) "A Profile of Riba Free Banking" in M. Ariff, (ed.), Monetary and Fiscal Economics of Islam, King Abdulaziz University, Jeddah.

- Montagu, N. and E. Harvey (1931) Macmillan Committee Minutes of Evidence, Vol.1, London.
- Moore, B.J. (1968) An Introduction to the Theory of Finance, The Free Press, New York.
- Morvitz, P.M. (1969) Monetary Policy and The Financial System, Prentice Hall, Englewoods Cliffs, New Jersey.
- Moullineaux, D. (1978) "Economies of Scale and organisational Efficiency in Banking: A Profit Function Approach", Journal of Finance, Vol. 33, No. 1, March 1978, pp. 259-80.
- Mudawi, Y. (1984) Islamic Banks Problems and Prospects, FIBS Publications, Khartoum.
- Myrdal, G. (1968) Asian Drama: An Inquiry into the Poverty of Nations, Allen Lane, London.
- Nabhani, T. (1953) El-Nidham El-Iqtisadi Fil-Islam (The Economic System of Islam), Liberation Party Publications, El-Quds.
- Nadawi, A.H. (nd) Islam and the World, The Academy of Islamic Research and Publication, Lahore.
- Najam, I. (1984) "Islamic Development Bank", Saudi Gazette, 22/1/1984.
- Naqvi, S.N. (1981) Ethics and Economics: An Islamic Synthesis, The Islamic Foundation, Leicester.
- Nasseef, A. (nd) Islam and Communism, The Crescent Publishing, Delhi.
- NBE, (National Bank of Egypt), Annual Reports 1979-87.
- NBE, (National Bank of Egypt) Economic Bulletin, various issues.
- NBK, (National Bank of Kuwait) Annual Reports 1978-87.
- NBK, (National Bank of Kuwait), Economic Bulletin, various issues.
- Nelson, B. (1969) The Idea of Usury From Tribal Brotherhood To Universal Otherhood, The University of Chicago Press, Chicago.
- Nienhaus, V. (1983) Directions of Trade among Islamic Countries: Levels, Growth Rates, Rank Orders, Concentration and Polarisation, University of Bochum, Bochum.
- Nienhaus, V. (1985a) "Islamic Economics, Finance and Banking: Theory and Practice", paper presented at the London conference on Islamic Banking and Finance, 31/1/1985 - 1/11/1985.
- Nienhaus, V. (1985b) "Principles, Problems and Perspectives of Islamic Banking", Inter-Economics, Vol.20, No.5, Sep/Oct. 1985.



- Nienhaus, V. (1988) "The Performance of Islamic Banks: Trends and Cases" in C. Mellat (ed.) Islamic Law and Finance, SOAS, London.
- Nimeiri, S. (1976) "Industry in Sudan" in A. El-Hassan (ed.) An Introduction to the Sudan Economy, Khartoum University Press, Khartoum.
- Noonan, J. (1957) The Scholastic Analysis of Usury, Harvard University Press, Cambridge.
- Olakanpo, J. (1965) Central Banking In The Commonwealth: A Comparative Study of Monetary Problems and Techniques, Bookland, Calcutta.
- Oluwole, A. (1981) Loan Management in Nigerian Banks, Ph.D Thesis, UCNW, Bangor.
- Orsingher, R. (1967) Banks of the World, Macmillan, London.
- Panico, C. (1985) Interest and Profits in the Theories of Value and Distribution, Ph.D. Thesis, University of Cambridge.
- Parker, P. (1984) "Interest In Islam", Banking World, August 1984.
- Patrick, H. (1966) "Financial Development and Economic Growth In Under-developed Countries", Economic Development And Cultural Change, Vol. 14, No. 2, January 1966, pp. 174-89.
- Pellat, C. and J. Schacht (1965) Encyclopedia of Islam, Luzac, London.
- Penhuyzen, V.D. (1975) "The Interest Elasticity of the Overall Savings Volume" in P. frantzen (ed.) Current problems of Financial Intermediaries, Rotterdam University Press, Rotterdam
- Perkins, J. (1982) The Australian Financial System after the Campbell Report, Melbourne University Press, Melbourne.
- Porter, R.C. (1966) "The Promotion of the Banking Habit and Economic Development", Journal of Development Studies, Vol.2, No.4, 1966.
- Prather, C. (1969) Money And Banking, Richard Irwin, Illinois.
- Presley, J. (ed.) (1988a) A Directory of Islamic Financial Institutions Croom Helm, London.
- Presley, J. (1988b) "A Western Perspective Towards Islamic Banking", Paper presented at a Seminar on Islamic Banking at Loughbourouh, University, July 1988.
- Pressnell, L.S. (ed.) (1973), Money and Banking in Japan, The Bank of Japan Economic Research Department, Japan.
- Pryor, F. (1985) "The Islamic Economic System", Journal of Comparative Economics, Vol.9, 1985, pp.197-223.

- Qaradawi, Y. (1977) Fiqh El-Zakah (Understanding Zakah), Muassasat El-Rissalah, Cairo.
- Qaradawi, Y. (1980) The Lawful And The Prohibited in Islam, Dar El-Shorook, London.
- Qaradawi, Y. (1981) Economic Security in Islam, Kazi, Lahore.
- Qureshi, A. (1977) Islam And The Theory of Interest, Ashraf, Lahore.
- Qutub, M. (1981) Islam The Misunderstood Religion, I.I.F.S.O. Malaysia.
- Qutub, S. (nd) Milestones, Kazi Publications, Lahore.
- Qutub, S. (1980) "Social Justice in Islam", in A. Khurshid (ed.) Islam, its Meaning and Message, The Islamic Foundation, Leicester.
- Radwan, M.A. (1984) "Agriculture: A New Deal", The Egyptian Bulletin, No. 10, September 1984, pp.5-7.
- Raggazi, G. (1981) "Savings Mobilisation In Africa" Savings and Development Quarterly Review, Vol.5, No.1, 1981, pp.45-60.
- Ranlett, J.G. (1969) Money and Banking: An Introduction to Analysis and Policy, John wiley, New York.
- Rashid, A. (1984) "KFH is Banking on Islam", Euromoney, August 1984.
- Ready, R. (1967) "The Egyptian Municipal Saving Banks Projects", International Development Review, Vol.9, June 1967, pp.2-5.
- Reed, et al. (1980) Commercial Banking, Prentice Hall, Englewood Cliffs New Jersey.
- Revell, J.R.S. (1973) The British Financial System, Macmillan, london.
- Revell, J.R.S. (1975) Solvency and Regulations of Banks, University of Wales Press, Cardiff.
- Revell, J.R.S. (ed.) (1978) Competition and Regulation of Banks, University of Wales Press, Cardiff.
- Revell, J.R.S. (1980) Costs and Margins in Banking: An International Survey, OECD, Paris.
- Richard, D. and D. Villanueva (1980) "Relative Economic Efficiency of Banking Systems in a Developing Country", Journal of Banking and Finance, Vol.4, 1980.
- Rizq, J. (1980) "Kuwait Finance House Proves The System works", Middle East Economic Digest, May 1980, pp.35.
- Robbins, L. (1935) Nature and Significance of Economic Science Macmillan, London.

- Robinson, J. (1947) An Essay on Marxian Economics, Saint Martin's Press, New York.
- Roll, E. (1961) A History of Economic Thought, Faber and Faber, London.
- Rostow, W. (1960) The Stages of Economic Growth, Cambridge University Press, London.
- Roth, C. (1961) "The Economic History of the Jews" Economic History Review, Vol.14, 1961/1962.
- Sabiq, S. (1971) Fiqh El-Sunnah (Understanding Sunnah), Dar El-Kitab El-Arabi, Beirut.
- Salama, A. (1984) Islamic Banks economic Significance and Methods of Control, FIBS Publications, Khartoum.
- Sanchez, J.C. (1965) "Money and Banking in the UAR", IMF Staff Papers, July 1965.
- Sargent, T. (1973) "Interest Rates and Prices in the Long Run: A Study of the Gibson Paradox", Journal of Money, Credit and Banking, Vol.5, 1973, pp.395-449.
- Sarwar, G. (1980) Islam Belief and Teachings, The Muslim Educational Trust, London.
- Sayers, R. (1957) Central Banking After Bagehot, The Clarendon Press Oxford.
- Sayers, R. (1967) Modern banking, Oxford University Press, London.
- Sayigh, A.Y. (1978) The Economics of the Arab World: Development since 1945, Croom Helm, London.
- Schumacher, E.F (1974) Small is Beautiful: A Study of Economics as if People Mattered, Abacus, London.
- Schumpeter, J.A. (1949) The Theory of economic Development, Harvard University Press, Cambridge.
- Schumpeter, J.A. (1950) Capitalism, Socialism and Democracy, Allen and Unwin, New York.
- Sealey, C. and J. Lindley (1977) "Input, Output and a Theory of Production and cost at Depository Financial Institutions", Journal of Finance Vol.23, No.4, Sep.1977, pp.1251-66.
- Searle, P. (1980) "Alternative Organisational Structures" in W. Baughn and Walker (eds.) The Bankers' Handbook, D.J. Irwin, Homewood.
- Seldon, A. and F. Pennance (1965) Everyman's Dictionary of Economics, Dent, London.

- Shafi, M.M. (1975) Distribution of Wealth in Islam, B. Aisha, Karachi.
- Shaw, E. (1973) Financial Deepening in Economic Development, Oxford University Press, London.
- Siddiqi, M.N. (1980) "Muslim Economic Thinking: A Survey of Contemporary literature" in A. Khurshid (ed.) Studies in Islamic Economics, The Islamic Foundation, Leicester.
- Siddiqi, M.N. (1983a) Banking Without Interest, The Islamic Foundation, Leicester.
- Siddiqi, M.N. (1983b) Issues in Islamic Banking, The Islamic Foundation, Leicester.
- Siddiqi, S.A. (1948) Public Finance in Islam, M. Ashraf, Lahore.
- Simpson, T.D. (1981) Money, Banking and Economic Analysis, Prentice Hall Englewood Cliffs, New Jersey.
- Smith, A. (1922) An inquiry into the Nature and Cause of the Wealth of Nations, Mathuen, London.
- Steigher, A. (1963) Origin and Spread of Oriental Words in European Languages, New York
- Stoneman, R. (1986) "Choices for Kuwait", The Banker, April 1986.
- Struthers, and Speight (1986) Money: Institutions, Theory and Policy, Longman, London.
- Tadros, H. (1980) "Egypt" Banking Structure and Finance in the Middle-East, Financial Times Business Publishing, London.
- Taha, M.A. (1976) "Financial Institutions and the Mobilisation of Savings", M.Sc. Dissertation, UCNW, Bangor.
- Tarbush, M. (1981) "Tide of Islamic Banking", Financial Times 28/9/1981.
- Tawney, R.H. (1936) Religion and the Rise of Capitalism, Murray, London.
- Taylor, T.W. and J.W.Evans (1987) "Islamic Banking and the Prohibition of Usury in Western Economic Thought", National Westminster Bank Quarterly Review, November 1987.
- Thomas, L. (1979) Money, Banking and Economic Activity, Prentice Hall, Englewood cliffs, New jersey.
- Tobin, J. (1960) "Towards improving the Efficiency of the Monetary Mechanism", Review of Economics and Statistics, Vol.42, 1960.
- Tooke, T. (1844) An Inquiry into the Currency Principle, Longman, London.

- Torrey, C. (1892) The Commercial Technical Terms in the Koran, Leyden.
- Traute, W. and V. Nienhaus (1982) "Arab and Islamic Banks, Petrocapital and Development", Orient-German Journal of Politics and Economics of the Middle-East, Vol.23, june 1982, pp.243-259.
- Traute, W.S. (1983), Arab and Islamic Banks, OECD, Paris.
- Treynor, J. (1975) "Unemployment and Inflation", Financial Analyst Journal, May/June 1975, pp.21-28.
- Udovitch, A. (1970) Partnership and Profit in Medieval Islam, Princeton University Press, New Jersey.
- Udovitch, A. (1979) "Bankers Without Banks: Commerce, Banking and Society in the Islamic World of the Middle-Ages" in The Dawn of Modern Banking, (ed.) by the Centre for Medieval and Renaissance Studies, University of California, Los angeles.
- United Nations, The (1980) Report of the First Group of Experts on Programming Techniques for Economic Development, New York.
- Usher, A. (1943) The Early History of Deposit Banking in Mediterranean Europe, Cambridge Mass.
- Uzair, M. (1982) "Central Banking Operations in an Interest-Free Banking System" in M. Ariff (ed.), Monetary and Fiscal Economics of Islam, King Abdel-Aziz University, Jeddah.
- Uzair, M. (1983) "Socio-Economic Rationale for Islamic System of Financing", Islamic Finance, Pre-launch issue, July 1983.
- Vives, J.V. (1969) Economic History of Spain, Princeton University Press, New Jersey.
- Vogel, R. and S. Buser (1976) "Inflation, Financial Repression and Capital Formation in Latin America" in R.I. Mackinnon (ed.) Money and Finance in Economic Growth and Development, Dekker, New York.
- Wai, U.T. (1972) Financial Intermediaries and National Savings in The Developing Countries, Preager, New York.
- Wai, U.T. (1976) "Role of Financial Markets in Development", Saving and Development, Vol.3, 1976, pp.91-105.
- Walmsley, J. (1988) The New Financial Instruments: An investor's Guide, Wiley, New York.
- Weit, G. (1955) "Les Marchands d'Epices sous les Sultans Mamlouks", Cahiers d'Histoires d'Egypt, Paris.
- Wicksell, K. (1899) "The Influence of the rate of Interest on Commodity Prices" in E. Lindhal (ed.), Selected Papers on Economic Theory, Harvard University Press, Cambridge mass.

- Wilkinson, M. and P. Stephens (1984) "The Need for Lower US Interest Rates", Financial Times, 11th June 1984.
- Williamson, (1968) "Personal Savings in Developing Nations: An International Cross Section from Asia", Economic Record, June 1968.
- Willis, H. (1936) The Theory and practice of Central Banking with Special Reference to Federal Reserves System, Harper, London.
- Wilson, J.S. (1974) "Banks and Banking", Encyclopedia Britannica, Vol.2 15th Edition, University of Chicago.
- Wilson, P.R. (1965) "The Empire of the Prophet: Islam and the Tide of Arab Conquest" in D. Talbot (ed.) The Dark Ages, Thomas and Hudson London.
- Wilson, R. (1983) Banking and Finance in the Arab Middle East, Macmillan, Surrey.
- Wood, P.J. (1984) "Islamic Banking", Bankers' Digest, October 1984.
- World Bank, The (1981) Accelerated Development in Sub-Saharan Africa: an Agenda for Action, The World Bank, Washington D.C.
- World Bank, The, World Development Report, Oxford University Press, Washington, various issues.
- Yohe, W. and D. Karnosky (1969) "Interest Rates and Price Level Changes", Federal Reserve Bank of Saint Louis Review, Dec. 1969.
- Zaman, R. (1986) "The Operation of the Modern Financial Markets for Stocks and Bonds and its Relevance to an Islamic Economy", American Journal of Islamic Social Sciences, Vol.3, No.1, 1986.
- Zehender, W. (1982) "Development Policy in crisis, The Case of Sub-Saharan Africa and its Consequences of Cooperation", Inter-Economics, May/June 1982.