Islamic banking within the financial development of Malaysia

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by

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Abstract

Islamic banking is based on the Muslim precept that interest, riba, is prohibited.

In 1983 an Islamic Bank named Bank Islam was established in Malaysia. This was the first Islamic bank to be supported by a Government and be legislatively accommodated within a mixed financial system. It has succeeded in mobilizing funds from the general public and corporate sector and has introduced a wide range of relatively sophisticated financial services in a short period of time. As with other Islamic banks, Bank Islam's operations have relied upon the use of Islamic pre-determined financial instruments. These instruments, however, are regarded with superstition by Islamic economists who contend that Islamic banks should base their operations solely on the profit-sharing principles of mudarabah and musharakah.

Within the financial development of Malaysia, the introduction of an Islamic bank can be regarded as an extension of the, "Supply-following," and, "Malayanisation," policies pursued since independence by the Central Bank (Bank Negara). The supply-leading policy is based on the theory that active government development of the financial system will induce economic growth. For example, the savings generated from Bank Islam depositors (who as Muslims were previously denied the opportunity to save in a riba-dominated system), will be used in investments within the economy. Bank Islam, however, has had a qualitative, rather than quantitive impact upon financial development, being a development consistent with the Government's policy of building an economy and financial system that meets the indigenous needs. In the case of Bank Islam, this means the indigenous needs of the Muslims.

Contents

List of Tables

Tables

Figures and Graphs

Figures and Graphs

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Introduction

In March 1983, with the establishment of Bank Islam Malaysia Berhad, Islamic banking was introduced into the Malaysian financial sector. Muslim-orientated financial institutions were not new to the Malaysian economy, commercial banks were already competing for savings deposits with the Pilgrims Management and Fund Board, an institution which managed its depositors' funds according to the Shari'ah. The arrival of Bank Islam, however, generated much interest as to whether it would pose a direct threat to existing commercial banks in a country in which Muslims were predominant, or whether it would survive in such a small but well developed market.

Islamic banking is distinguished from conventional banking in that the use of interest(Riba) is specifically prohibited in the Qur'an. Islamic banking is a relatively recent development with the first Islamic-type bank being tested in Pakistan in the late 1950s. The principles upon which Islamic banking is based, however, stem from the times of the Prophet, and in fact are similar to the ethics which were displayed by Christianity in the Western mediaeval economy.

The role of financial institutions in the economic growth process has long been acknowledged. Latter day development economists did not, however, really consider financial institutions to be instrumental to economic growth. Nevertheless, in the late 1960s and early 1970s, the notion that financial institutions may well be major contributors to economic growth was revived among others by Patrick[1] Goldsmith[2], McKinnon[3] and Shaw[4]. Patrick asserted that in the early stages of economic development the creation of a financial system before demand for that system, would in fact induce economic growth. Studies such as Jung[5] have indicated that this relationship may be true, especially in developing countries where higher-than-average economic growth has been achieved.

This thesis seeks to examine the establishment of an Islamic bank within a well developed financial system in a high-growth developing nation. In the context of financial development theory this thesis will illustrate the economic and financial development of Malaysia to indicate the environment in which Bank Islam operates. This is essential so that an evaluation of Bank Islam's relative performance can be properly made. With such an illustration of Bank Islam's environment and potential opportunities, problems can be highlighted and suggestions presented. An important issue concerning Islamic banks is that of the question of what constitutes an Islamic bank? This thesis will examine the controversy existing between the Islamic economists and Islamic bankers, and will apply this debate to Bank Islam itself. Basically, the main aim of this thesis is to examine the operations of Bank Islam and see whether it can be considered a success.

This thesis is divided into five chapters. The first chapter, entitled, "The Relationship between Financing Economic Development and Financial Development," examines why capital accumulation is so important in the developmental process and how the development of a financial system can help mobilize domestic resources. At a micro level, the benefits to the individual enterprises of being able to obtain funds from a financial sector are considered. Also in this chapter, the issue concerning whether financial development is, "demand-following," or, "supply-led," is examined with the significance this has upon government policy being discussed.

The second chapter discusses the development of the Malaysian economy so that both the significance of the financial development and the opportunities available for Bank Islam can be better appreciated in latter chapters. The question of whether the development of Malaysia can be considered a success when compared to other Pacific-Basin economies is discussed with reference to its racial diversity. How Malaysia has managed to diversify its economy and industrialized while still achieving rapid economic growth will be analysed to quite some depth. This provides good background knowledge of the environment in which the Malaysian financial sector has managed to achieve a relatively high level of sophistication.

In the third chapter, dealing with the financial development and structure of Malaysia, the growth and growing sophistication of the financial system is traced from pre-colonial times. In examining the structure, the sources and uses of the funds within the financial system are presented enabling the intermediation process to be understood. Finally, the level of financial development when Bank Islam was established in 1983 is examined, so to indicate the environment in which the Bank began its operations.

Islamic banking is the issue that is outlined in chapter four. Its origins, how the texts from the Qur'an are interpreted and the theory and practice of Islamic banking are examined.

The final chapter, chapter five, looks at Bank Islam itself and addresses such questions as why it was established, in what form it was established, how its operates and what is its performance in the context of the Malaysian financial and economic systems.

Footnotes

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Chapter I

The Relationship Between the Financing of Economic Development and Financial Development

1.1 Introduction

The economic history of Malaysia is that of a developing nation. The Islamic banking sector can be considered as as integral part of Malaysia's financial system. In examining Islamic banking within the financial development of Malaysia, it is first necessary to understand the theory of financial development. Since independence, the Malaysian government has adopted a policy of promoting financial development. The aim of this policy has been to raise the level of domestic saving to help finance economic development. It is important therefore, that the theory that underlies this policy is fully understood, and it is this that will be examined in this chapter.

There are four main sections to this chapter: the first, discusses the importance of economic growth in economic development and states the sources from which such growth can be financed ; the second, examines the three main analytical approaches to the study of the finance of development through the mobilization of domestic resources and the consequences of each of these approaches for financial development; the third part, looks at the individual company techniques in financing and examines the advantages gained in the economy by using indirect finance; and finally, I have discussed the debate concerning whether financial development is, "demand-following," or, "supply-led," and outlined what policy a developing nation should adopt, considering the existing empirical evidence.

This chapter will only outline and discuss the theory concerning financial development of Malaysia. The tracing of the historical development and current structure of the financial system will be discussed further in chapter three.

1.2 Capital Accumulation

Financing economic development refers to the allocation of real resources to investment. This will lead to national income (and therefore possibly income per head), to increase within a developing country. Such an increase in national income is not economic development as such, however, without massive redistribution of world income and wealth it remains the only method by which living standards can be raised. Economic growth provides an easier route for the redistribution of wealth and income, and is a precondition for other development objectives like the provision of employment opportunities or social needs such as education or health services. Economic development is not to be confused with economic growth, which is often the route to economic development.

As economic growth can be considered as the precondition to economic development, so can the increased production of capital goods be considered as the precondition to economic growth. Capital goods are those which are not immediately consumable but continue to provide an income flow throughout their life. An increase in real resources directed towards their production results in greater future income flows being generated and therefore, a higher level of economic growth. Real resources for such capital formation can only be derived from three sources: one, resources generated through gains made by trade; two, resources transferred from abroad whether through borrowing or aid; and finally three; resources released domestically from decreasing the level of consumption and directing this surplus to the production of capital goods.

Even though trade and foreign transfers are extremely important sources of capital, a developing nation's government is unlikely to be able to significantly influence these to its own advantage, as compared to its own domestic resources. Trade, especially in primary products in which developing nations tend to specialise, fluctuates according to the world markets, therefore, any capital derived from this source tends to be unstable. As the, "Third World Debt Crisis," has demonstrated, important changes upon the world capital markets in response to developed countries can have an adverse effect upon borrowing as a source of capital for a developing country. Aid, the other foreign source, depends on goodwill, the economic welfare of the doner nations and also political alignments which are now becoming increasingly irrelevant in this post-cold-war world. All of these factors are outside a developing nation's government control. Only in the domestic sector can a government both influence and promote a long-term stable source of capital, suited to the nature of long-term development investment.

1.3 Domestic Resources

There are three main analytical approaches to the study of the finance of development from domestic resources. These three approaches are Classical, Keynesian and what is known as the Quantity-theory approach. Each different approach will lead to the implementation of different government policies being pursued in order to raise the level of finance obtained domestically. As the Malaysian government has primarily followed a policy of financial development (a policy prescribed mainly by the classical school of thought), it will be the Quantity-theory and Keynesian approaches that will be examined initially. Particular reference will be made to the criticisms of these approaches which explain why the quantity-theory approach was not adopted and why the Keynesian-approach was only partially adopted.

The Quantity-theory approach emphasises the role of government inflationary finance as a method of directing real resources towards the government, who finance investment on society's behalf. This method of inflationary finance to finance goverment expenditure has long been known and used since the time of the Romans. Government inflationary finance acts as a tax on money-holding. As a government finances investment through fiduciary issue, the existing real purchasing power of money (given the condition where capital is already fully employed) will decrease. For holders of money to maintain their purchasing power, they would have to increase the level of their money-balances in line with inflation. Since balances must be accumulated and real resources forgone at the same rate of inflation, the rate of tax is equal to the rate of inflation. The real revenue generated by this fiduciary issue is equal to the sum of the new money printed, multiplied by the fall in its real value due to its increased supply. Inflation, therefore, as a tax on money, redistributes resources from the private sector to the government (as the issuer of money), creating resources as real as those obtained by conventional taxes. The advocators of this form of finance argue that the difficulties of collecting conventional taxes (especially relevent within developing nations), together with the progressive nature of inflation taxes i.e. richer people tend to hold higher money balances, make this inflationary approach superior. Keynes described inflation in his, "Tract on Monetary Reform," as;

> "a form of taxation that the public finds hard to evade and even the weakest government can enforce when it can enforce nothing else."[1]

Money is an extremely convenient medium of exchange. Because of this, people will withstand a high level of inflation before they start to use other alternatives. This enables a government to impose higher levels of taxation than they could otherwise do with convential taxes. All of these factors make up the basis of the argument that inflationary finance is an ideal form of taxation for developing countries.

In practice, however, the policy of inflationary finance leads to a number of major problems within the economy. One problem is concerning the inherent lag between setting conventional tax rates and collecting the tax itself. The longer the time lag (which is more likely in a developing economy) and the higher the inflation rate, the greater the loss in the real tax revenue. Even though money is convenient for maintaining liquidity, if the cost due to inflation becomes too high, people will tend to hold their wealth in real assets rather than money. This will have the effect of decreasing the existing, "tax-base," and the effectiveness of inflation as a source of tax revenue. As with any method of taxation, there are efficiency losses due to the tax's effect. In the case of conventional taxes these efficiency losses can be due to lack of incentives or else substituting actions to avoid tax. In the case of an inflation tax, such efficiency losses are due to people substituting away from money as an efficient medium of exchange or else due to an increased risk in business in advance orders etc. Furstenburg[2] estimated that once inflation exceeded 2 per cent per annum, the incremental efficiency losses from inflation taxes outweigh those from conventional taxes. The following summary taken from Gillis' "Economics and Development," best describes the use of the quantity-theory approach of using inflation as a method to finance economic development;

> "Government mobilization of resources through inflation is a knife-edged strategy, inflation rates must be kept high enough to yield substantial

> inflation taxes, but not so high to cause holders of liquid assets to undertake wholesale shifts into real assets in order to escape the tax. Inflation rates must be kept low enough so that collections from conventional taxes do not lag far behind growth in nominal income and so that the efficiency losses from inflation do not exceed efficiency losses from higher conventional tax revenues. Parodoxically, then, the inflation tax device can work best where it is needed the least: in those countries having tax systems that are responsive to growth in overall GDP and which involved low efficiency cost. Countries with revenue-elastic tax systems do not need to resort to inflation in an attempt to finance expanded goverment investment." [3]

The major problem encountered in such inflationary taxation is not so much on the financing side but rather due to government investment (or lack of it!). Higher taxes whether generated through inflation or conventional methods, lead to higher savings only if the government's marginal propensity to consume out of increased taxes is less than the private sector's propensity to consume out of the marginal income from which it pays the increased taxes. Most developing country's governments fail to do this. With increased taxation revenue financing increased public-sector consumption rather than public-sector investment.

The Keynesian approach to the finance of development emphasises that it is the lack of investible opportunities that hinder saving, not vice-versa. Saving adjusts to the level of investment desired, either through increases in output if resources are unemployed (this case is particulary relevent to developing countries), or through income redistribution from low savers to high savers if resources are fully employed. If an entrepreneur wishes to invest more than his planned saving, he can do so by raising finance in the capital market. An entrepreneur can only do this if a capital market actually exists. Therefore, in this respect, the growth of a developing economy's financial system is quite important for the success of the Keynesian model of development. At full employment, however, the Keynesian approach to development will inevitably result in inflation, at least in the short term. Simply explained, Keynesian theory specifies different saving and investment functions and allows prices to change in response to an excess in demand in the goods market, thereby raising saving through redistributing income. In other words, inflation is the means by which resources are redistributed between consumption and investment. In Keynesian models, investment is not constrained by the level of saving, but by the rate of inflation (and subsequent decline in real income), that wage earners are willing to tolerate. As with the quantity-theory, the disadvantages of inflation can often outweigh any gains from pursuing an inflationary policy.

The classical theory of the prior-savings approach can simply be examined by the application of the demand/supply market process to the capital market. Saving and investment can be considered as one and the same thing. The rate of interest will adjust to bring saving and investment into equilibrium. Therefore, for a developing nation's government to encourage investment, it must increase the supply of capital (saving), which will result in a decrease in its price (a fall in the interest rate), and hence will eventually lead to increased use of capital (investment). In this prior-savings approach the domestic resources released may come from involuntary or voluntary saving, which in practical terms, can be considered as public-sector or private-sector saving respectively.

Saving can be generated from an involuntary public by the government financing investment through the public-sector, whereby the government finances investment from its revenue (tax receipts) that it either undertakes itself or stimulates indirectly through government subsidies or tax-relief. During the 1950s and 1960s, the involuntary method of the prior-savings approach was favoured. It was commonly held that growth in voluntary savings was inherently constrained by such factors as low income per capita and high private consumption propensities among wealthy families with the greatest capacity for savings. Since then, however, limitations have become apparent as to how much tax revenue can be generated from the the tax system and how effective government investment actually is.

A country's, "taxation-potential," relies upon a number of factors such as the level of per capita income, the degree of inequality in the distribution of income, the relative importance of different sectors of the economy (cash crops, subsistence agriculture, mining, foreign trade), political leadership, and its administrative powers of government. Lower per capita incomes not only limit the amount of private savings, but also represent a much smaller tax-base as the margin for taxation after subsistence level is small to non-existent. Taxes on incomes that are already small together with low tax-threasholds can have significant adverse incentive effects in a small developing economy. Tax collection from the agricultural sectors of the economy may be difficult, especially in developing nations where subsistence farming is predominant. Tax on foreign trade is limited by substitution effects and smuggling. The only, "easy," method to increase tax collections is by taxing natural resources, especially in the short-run where alternative sources will be difficult to develop, and possibly in the long-run if producer-cartels can be created. As with the case of inflationary finance, the major problem of this involuntary method is one of goverment investment rather than financing. The governments of developing countries use the resources generated through the public-sector for consumption rather than for investment purposes.

A voluntary policy of raising capital, however, serves to emphasise the development of a financial system, which can encourage greater savings and lead to a more efficient allocation of existing capital stock. This approach which is based on the empirical studies conducted by Goldsmith[4], Mckinnon[5] and Shaw[6] in the late 1960s and early 1970s revived the classical view of the importance of the role of a private-sector financial system. They argued that existing involuntary prior-savings and inflationary Keynesian development approaches had led to financial repression i.e. indiscriminant distortions to financial prices, including interest rates and foreign-exchange rates, reducing the real size of the financial system relative to the real sector of the economy. They advocated the removal of restrictions and the liberalisation of government policies to encourage financial development and incentives to save. The basis of this argument is dealt with in the following section.

1.4 Sources of Finance for the Company

Having established that capital formation is necessary to generate economic growth and that funds are needed to finance capital formation, it is obvious that the availability of finance becomes a pre-requisite for the economic growth process. With these fundamentals in mind, the role of financial institutions and their economic effect upon economic growth can be examined. For an individual company, the funds necessary to finance capital formation can be obtained from three sources of finance: internal, direct and indirect. Each of these sources will be scrutinized, to reveal the limitations of internal and direct finance and the importance of indirect finance.

Internal finance (or self-finance), relates to the funds generated internally within the firm that can be used for investment. Such finance is mainly derived from retained earnings and depreciation allowances. Investment financed by internal finance will therefore be limited by the level of profit made by the firm (for retained earnings) and the existing capital stock owned by the firm (for depreciation allowances). The levels of profit and fixed assets are unlikely to be able to provide sufficient resources for investment, considering the undeveloped economic environment, and many infant industries will need massive amounts of capital during a period in which profits will probably remain low. Internal finance therefore, as a source of funds, is unlikely to be sufficient to solely finance investment.

If a company does not have sufficient funds generated internally, it must seek sources outside the firm to help finance its investments. This is known as external finance. Either the company can approach those with surplus funds directly, or it can approach an institution such as a bank, who manage the surplus funds of depositors on their behalf. Direct finance involves companies seeking finance through the informal money market (moneylenders and/or pawnbrokers) or by selling equity in the form of shares to investors (stockmarket). This method of financing however, has inherent problems associated with the undeveloped nature of these markets. As surplus funds available on the informal money market consists of individual savings, it is unlikely that large amounts of capital can be raised, and given the regional nature of these markets, information costs will be high and therefore charges excessive. Selling equity as an option is only available for incorporated companies. In a developing country the corporate sector is likely to constitute a minute proportion of the business sector and studies have indicated (Maniatis[7]; Wai and Patrick[8]) that investors in developing nations are reluctant to use stockmarkets, assuming that they even exist in the first place. Finally, the funds available through direct finance will be rather limited as with internal finance.

Indirect financing is characterised by the divorce in the relationship between saver and investor. The saver deals directly with the financial institution, as does the borrower, whilst the financial institution solicits loanable funds from surplus units and issues in exchange, liabilities against themselves. On the investment side, they allocate these funds to deficit units and receive in exchange, direct securities for their own portfolio.

Basically there are three main ways in which indirect finance and the development of a financial system influences the availability of finance and capital for economic growth: the first, is a once and for all injection of capital generated from the conversion of tangible assets into more productive financial assets; the second, is the on-going effect of increased efficiency of the allocation of capital between savers and entrepreneurial investors; and the third, is the further saving induced by the increased incentives to save, invest and work.

In an undeveloped economy, people and companies save by holding their wealth in the form of tangible assets. These tangible assets are often in the form of land, land improvements, simple agricultural and handicraft tools, livestock, inventories (mainly foodstuffs and livestock), and consumer goods (housing, precious metals and jewellery). Such saving offers little return to the saver and is of limited productive use to the economy. In the case of holdings in foodstuffs and livestock, the cost of storage, pests and disease can result in negative returns being made. The significance of saving in this form has been demonstrated by the UN ECAFE(1962)[9] sample of undeveloped Asian countries which indicated that households, who probally held between one-half to two-thirds of gross saving, held between one-half and three-quarters of their wealth in a tangible form. The reason why economic units save in such a manner is that without a financial infrastructure and financial asset alternatives, these tangible goods are the only assets with the characteristics of being relatively liquid, divisable and protective against inflation.

Financialisation of saving, refers to the conversion of saving in the form of tangible assets to that of saving in the form of financial assets. Such transformation will lead to an increase in the capital stock which can be invested in the productive sectors of the economy. Patrick[10] calculated the significance of mobilizing this source. Based on simplistic assumptions, he estimated that wealth in the form of tangible assets (excluding land) could be equivalent to two to three times the level of the Gross National Product(GNP), and with only a 10 per cent re-allocation of this tangible wealth into financial assets (which is equivalent to 20 to 30 per cent of the GNP), the level of a country's output could be raised by 10 per cent. It should be noted, however, that this is a once and for all boost to the capital stock, experienced only in the early stages of financial development.

It is argued that a financial system is not essential for the transformation of wealth stored in tangible goods into productive assets. Individual holdings of precious metals and foreign exchange and other foreign assets can be transformed directly into socially productive fixed assets by the foreign trade route rather than the domestic financial system. Japan during their early development in the late nineteenth century is often quoted as an example of the success of this policy. When Japan replaced its commodity based currency (based on gold and silver coins) with fiat money the specie i.e. gold and silver coins, were used to finance a substantial import surplus. Initially a high proportion of Japan's imports were manufactured consumer goods, but eventually, investment goods rose steadily, to become an established base for economic growth and industrialisation. The counter-argument to this trade-orientated policy, is that all developing countries today use fiat money and have no readily available commodity to export in order to finance any imported foreign investment goods. Another consideration, is that the Japanese development policy is not one of mobilizing domestic resources as such, but rather more akin to resources being generated through gains in trade.

Where a developed financial system does not exist, the saver is effectively the investor. A thrifty saver, however, may not necessarily be an enterprising investor. Therefore, with the establishment of financial institutions a division of labour can be achieved between the functions of saving and investing. Financial institutions are then able to specialise in appraising the viability of venture for which finance is required, thereby eliminating the riskier and less productive investments. Also, due to the relative size of the financing conducted by the financial institutions, economies of scale can be realised, thus leading to the reduction in cost of finance. It is, therefore, less expensive for entrepeneurs to conduct capital expendititure, since diversification of the financial institutions investment portfolios reduces the aggregate risk of the economy as a whole. Since financial institutions are basically profit making organisations, they tend to divert their funds to borrowers who are able to pay the highest price, thereby ensuring the migration of funds to the users with the highest yields. As a result, this pricing mechanism directs scarce resources to the most productive investments. As financial institutions mobilise vast amounts of resources, they enlarge the scope for lending, in other words,they allow entrepreneurs to plan and execute investments which require larger amounts of funds, held over longer periods. Hence, it is seen that not only do financial institutions raise the amount of funds available for investment, they also ensure that the funds are channelled towards the most productive investments, a process which will no doubt contribute significantly to the process of economic growth.

The third major influence of financial institutions on economic growth is that the operations of these institutions result in raising the overall propensity to save. This claim has been substantiated by a number of empirical studies including(UN ECAFE 1962[11]; Hooley[12]; and Wai[13] 1972) Three characteristics of financial institutions serve as major causes for the increase in the rate of saving in the economy. Firstly, economic units tend to substitute saving for consumption because of the high yield available on saving. Secondly, as pointed out by Lewis[14] people tend to save more if saving institutions are situated close to them. Thus, the expansion and dispersion in the number of financial offices should lead to the promotion of the, "banking-habit," with the result of more funds being deposited with the financial institutions, as opposed to being abortively consumed. Thirdly, financial institutions provide an array of instruments to suit the needs of economic units, thus making the act of saving more convenient which tends to increase saving. It can be seen therefore, that these three aspects of financial institutions increase the incentive to save, resulting in a higher level of saving in the economy, with larger amounts of saving, more funds become available for investment.

In addition to the three major incentives above, certain other activities of financial institutions can also contribute to the level of saving. One such example is the, "forced," saving that occurs in order to meet loan repayments, and the other being the holding of compensating balances. Since a borrower is, "forced," to save to meet a loan repayment, it can be argued that lending raises the overall volume of saving. In the absence of repayment requirements, funds which represent potential saving may be lavishly consumed. Thus, loan making can increase the volume of saving to some extent. It is common practice among banks, especially in developing nations, to insist that borrowers maintain a balance, which constitutes a predetermined proportion of the amount of the loan. This amount is commonly referred to as the compensating balance. This regular deposit normally amounts to a small percentage of the total loan granted to the borrower. No withdrawls are allowed on this account until the repayment of the loan is complete. While on the part of the banker this procedure produces additional collateral for the loan, the fact remains that such stipulation results in an increase in the volume of saving.

Cameron[15] and Gerschenkron[16], argued that in addition to the important roles played by financial institutions in assisting economic growth, they also provide entrepreneurial talent and initiative to the economy. For example, reference was given to the active involvement of personnel from financial institutions in the administration of firms which have been financed by their respective institutions. This practice is quite common in countries such as Germany and Japan and was particulary relevant to the development in the United States in the early part of this century. By providing entrepeneurial guidance to the economy, financial institutions are then able to contribute to the growth of the economy, especially in countries where entrepeneurs are scarce.

This section has demonstrated the importance of a financial system. It has shown that internal and direct finance do not provide an adequate supply of capital to finance a given investment, especially in a developing nation, whilst indirect finance can offer a potential source for meeting investment requirements. By using indirect finance the following gains in the economy can be made; financial intermediation can lead to the transformation of tangible goods into productive financial assets, increased efficiency in the allocation of the capital stock due to specialisation of the saving and investment functions, economies to scale, and diversification of risk, and increased incentives due to the increased attractiveness of saving and investing. Minor considerations include the influence of institutional factors to raise the level of saving and the provision of entrepreneurial skills by the financial institutions. Having established that a financial system is beneficial to the economy, a developing country's government has the dilemma of whether to let a financial system develop according to the market demand for its services or whether to take an active role in establishing a financial system. This debate is examined in the next section discussing, "demand-following," and "supply-leading," phenomenon together with the consequences of this for government financial policy.

1.5 Demand-following and Supply-leading Phenomenon

The importance of financial institutions as a factor of economic growth has long been recognised. In Adam Smith's, "Wealth of Nations," he recounted;

> "I have heard it asserted that the trade of the city of Glasgow doubled in about fifteen years after the first erection of banks there; and that the trade of Scotland has more than quadrupled since the first erection of the two public banks at Edinburgh ... that the banks have contributed a good deal to this increase cannot be doubted."[17]

The observed characteristic of an absolute and relative increase in the number, variety and importance of financial institutions with growth in a market-orientated economy is not in doubt. Early development economists, however, would question Smith's analysis in attributing financial institutions i.e. the banks, in such an iniatiating role in the economic development. These economists would rather argue that financial development followed a path of what Patrick[18] termed, "demand-following."

"Demand-following," as the name suggests, refers to the growth of financial institutions, "following," the demand created by the growth in the real sector of the economy. Not the reverse, as Adam Smith implied. As the real economy grows, demand by savers and investors leads to the creation of financial institutions, their financial assets and liabilities and related financial services. This demand depends upon the growth in real output, commercialisation and monetization of the traditional sector of the economy (primarily agricultural) and industrialisation. As organisations experience rapid growth, they are less able to finance such growth internally from retained profits or depreciation allowances and therefore, will have to rely upon the saving of others directed through financial intermediation.

A government using a, "demand-following," interpretation of financial development would adopt a passive policy role. The financial sector will develop upon the real growth in output, monetization of the traditional sectors of the economy and upon the development of a modern industrialised economy. Without a higher national income, or demand by companies for external funds (and therefore, financial intermediation), scarce resources directed to the development of a financial system in a developing nation would be a wasted.

The consequence of this argument for government development policy, is that the government should play a passive role in only providing a favourable legal and institutional framework within which a financial system can develop. A financial system will naturally develop to provide the financial services required through the market process. Entrepreneurs will develop the financial sector in response to the growing profit-making opportunities to be made in the provision of financial services. The historical example provided is that of Britain, which given the institutional and legal structure, illustrates a financial system developed without government intervention to become one of the world's leading financial centres.

The, "supply-leading," view of financial development is an extension of Adam Smith's observations concerning trade and the establishment of banks in Scotland. The supply-leading approach maintains that the creation of a financial infrastructure preceding demand for financial services, will induce real growth within the economy. A financial system will have a beneficial impact due to the effects outlined in the previous section. A modern sector demanding financial services does not need to exist , however, for the following benefits to be realised: transformation of tangible goods into productive financial assets, increased efficiency in the allocation of capital, increased incentives to save and the entrepreneurial impact of financial institutions.

As in the initial stages of economic development it is unlikely for a supply-leading financial system to be able to operate profitably by lending to nascent modern sectors, rather the government should undertake an active role in promoting this infant financial industry. It cannot be said that supply-leading finance is a necessary condition or precondition for inaugurating self-sustained economic development. Rather, it presents an opportunity to induce real growth by financial means. It is thus more likely to play a more significant role at the initial stages of economic development.

The historical example given as proof of the success of this policy is that of Japan in the late nineteenth century. A modern financial sector was created in the 1870s, subsidised in effect by having the right to issue banknotes and having the use of government deposits. In the initial stages, the absence of investible opportunities in a non-existant modern sector meant that investment was directed mainly towards agriculture, domestic commerce and foreign trade. With the banks undertaking an entrepeneurial role, however, industrial development followed the creation of financial institutions. As Patrick summarised;

> "The modern financial system thus was not only created in advance of Japan's modern industrialization, but, by providing both funds and entrepreneurial talent on a supply-leading basis, contributed significantly to the initial spurt."[19]

Patrick divides financial development into two distinct but interconnected phases. In the first stage the supply-leading effect of financial institutions inducing economic growth is prominant, however, as the economy develops the supply-leading impetus gradually becomes less important and the demand-following response becomes more important. This shift is gradual as different industries in different sectors of the economy grow at varying rates. Supply-leading and demand-following linkages between the financial sector and the economy will exist concurrently depending upon the level of development of the financial institutions' customers. According to this hypothesis, a government should follow an initial policy of promoting the financial sector in the initial stages of economic development, gradually withdrawing its support as the economy progresses. Obviously, the timing of this change of emphasis will be crucial and very difficult to determine.

Jung[20] examined a sample of undeveloped and developed countries to determine whether Patrick's hypothesis concerning a gradual change from a supply-leading and demand-following financial sector was valid. Using the currency ratio and the monetization varible as proxies for financial development, Jung examined whether there was any causality in either direction between financial development and economic growth. Measurement of financial development is controversial as countries differ in their institutional environment and have drastically different structures according to their development stage. The currency ratio is defined as the ratio of currency to the narrow definition of money (M1), the sum of the currency on demand deposit. This varible is a proxy for the complexity of the financial structure. A decrease in the currency ratio will accompany real growth in the economy, especially in its early stages , as there exists more diversification of financial assets and liabilities and more transactions will be carried out through barter. The second measure of financial development is the ratio of M2, a broader definition of money, to nominal GDP (or GNP), which is widely regarded as the monetization variable. The monetization varible is designed to show the real size of the financial sector in a growing economy as the process of economic growth leads to the rising stream of income and rising stock of financial assets. We expect the ratio to increase over time as the financial sector develops faster than the real sector.

Using annual data on 56 countries, of which 19 were developed, he concluded that when the currency ratio was used as the financial development proxy, undeveloped countries experienced a causality between financial development to economic development and developed countries experienced a causality in the opposite direction. This confirmed Patrick's hypothesis that undeveloped nations would experience the supply-leading characteristic of a fiancial system until they reached development whereby a demand-following nature would be prevalent. Jung also noted that those less developed countries experiencing high economic growth were more inclined to have a greater supply-leading to growth correlation, than those of slower growth. When using the monetization varible as a proxy of economic growth, Jung's results were not so conclusive. The causality pattern, however, that was predicted by Patrick, was moderately well supported.

This empirical examination supports the hypothesis put forward by Patrick of a two-phase initial supply-leading stage, followed by a demand-following stage of financial development. Therefore, as already previously mentioned, a developing nation ought to follow a policy whereby the financial industry is given state support in the initial stages of economic development, this support being withdrawn as the economy develops.

1.6 Conclusion

The function of this chapter in the study of Islamic banking within the financial development of Malaysia, was to provide a theorectical background to the policies conducted by the Malaysian government in promoting financial development since independence. Establishing that economic growth is necessary for economic development and economic growth itself requires finance, it can be shown that the development of the financial sector is consistent to this aim. Trade, aid and borrowing are not sources of finance that can be readily increased, since the government can only influence the domestic sector. Having outlined the disadvantages of investment undertaken by the government itself and the effects of inflation inherent in the quantity-theory and Keynesian approaches, a prior-saving private sector policy of raising finance is considered the best. Given this, and considering that the empirical data indicates that financial institutions tend to be supply-leading in the early stages of development and demand-following in the later stages, a policy of promoting financial development in the early stages of development with a gradual lessening of support as the economy develops, should be adopted.

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Chapter II

The Development of the Malaysian Economy

2.1 Introduction

The development of a financial system will reflect the development of the economy as a whole. To be able to understand why the Malaysian financial sector has achieved a relatively high level of development, it is therefore necessary to consider why Malaysia has achieved a considerable level of economic activity. As funds are supplied to the economy, it is necessary to examine sectors within that economy to see whether the financing of economic development follows a, "supply-leading," or, "demand-following," nature as discussed in the previous chapter. What is relevent to the financial system as a whole, is relevent to the individual sectors within that industry. In the case of this study, the individual sector under examination is that of Islamic banking.

This chapter proceeds in six sections; one, a brief description of the land and its people; two, examines the growth and structural change in the economy with paricular reference to the New Economic Policy and the diversification of the agricultural sector; three, the process of industrialization is examined within the context of conducting the policies of "import-substitution," "export-promotion," and, "heavy-industrialization," phases; four, a brief mention concerning the savings, investment and the financing of Government and public development; whilst in five, the open economy and international payments are discussed; and finally six, the unique price stability of Malaysia is shown.

2.2 Land and People

Malaysia is composed of two distinct regions. The 11 states of Peninsular Malaysia, situated at the southernmost tip of the Asian landmass, Sarawak and Sabah, located in northern Kalimantan (Borneo). Both Peninsular Malaysia and Sarawak are similar in size to England, covering 131,598 sq.km (50,810 sq.miles) and 124,449 sq.km (48,050 sq.miles) respectively. Sabah is smaller, being only 73,711 sq.km (28,460 sq.miles) a comparative size to Scotland. The two regions are separated by almost 1000km (625 miles) by the South China Sea.

Situated in the humid tropics between 1 degree and 7 degrees north of the equator, Malaysia is endowed with an equitable climate and good rainfall. Peninsular Malaysia, Sabah and Sarawak all have similar geographical characteristics; dense equatorial rain forests, mountain ranges and lowlands.

The western flank of Peninsular Malaysia is the most developed and multiracial, due to its location on one of the world's major sea routes (the Straits of Malacca), and the nearby tin deposits in the foothills of the mountain ranges.

Malaysia is a plural society with an estimated population of 17.8 million in 1990, 61 per cent of which are Malays and other indigenous people often referred to as the Bumiputera ("Sons of the Soil"). Chinese constitute 30 per cent with a further 8 per cent being Indians (an ethnic term which applies to people from India, Pakistan, Bangladesh and Sri Lanka), the remaining 1 per cent cover all other races.

2.3 Growth and Structural Change

In the 33 years since Malaysia achieved its independence from Britain, the Malaysian economy has managed to sustain a high economic growth rate (with the exception of the mid-1980s) while undergoing significant transformation.

The economy has averaged an impressive average annual growth rate of 5.8 per cent in gross domestic product since independence. According to recent estimates, Malaysia's economy is set to grow at 8 per cent this year, its fourth straight year of high domestic growth. The 9.4 per cent rate achieved in 1990 is a 14-year record and was also Asia's highest.

Why has Malaysia achieved such continued economic growth while other developing nations have not? Can this high growth rate be considered a, "success," when compared with, "young-tiger," economies within the Pacific Basin? As Malaysia's Chinese ethnic minority are keen to state, at independence Malaysia's economic position in Asia was second only to Japan. Today it has slipped to sixth place

Table 2.1: Annual Growth Rate (%) of GDP

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1985-90
1	2.9	1.4	2.6	10.0	11.6	6.9	1.2
2	2.5	6.9	1.0	9.4	7.8	6.0	5.4
3	0.5	5.5	4.2	11.7	6.7	6.2	8.9
4	4.5	5.8	10.4	8.3	9.3	7.8	8.8
5	9.9	5.6	5.0	0.8	7.4	-1.1	9.4
Average	4.1	5.0	5.4	8.0	8.6	5.2	6.7

Source: Bank Neagara, Treasury and Dept. of Statistics.

behind South Korea, Hong Kong, Singapore, Taiwan as well as Japan, countries that are not so well endowed with natural resources as Malaysia. First, this section will examine the question of growth within the context of the young-tiger economies and of the New Economic Policy. Secondly, how Malaysia has achieved such sustained growth will be addressed.

The Chinese minority attribute this, "lack," of growth to the New Economic Policy(NEP). The was introduced in 1971 to accommondate Malay grievences concerning their economic position that led to the race riots in Kula Lumpur in May 1969. Oversimplified, the Malays have a small class of people who are rich and powerful, and who as the majority group, control the government. They also constitute the overwhelming majority of the remaining poor people on the land and more than their share of low-paid workers on the plantations, in the mines and factories. The Chinese, and to a lesser extent the Indians, dominate the cities, and in particular the upper echelons of commerce, industry and finance. Most of the privately owned plantations and mines not in the hands of foreigners are in the hands of Chinese.

These are the conditions which gave rise to the race riots and the NEP that followed. The NEP is neatly summarised by Khalid Husin of Malaysia's Ministry of Land and Regional Development at the time of the implementation of the NEP.:

> "The NEP seeks the eradication of poverty regardless of race and restructuring of Malaysian multi-ethnic society so as to reduce the identification of race with economic function or employment, within the

context of an expanding economy... By 1990 the Malays and other indigenous populations, collectively termed as, 'bumiputras,' who are hitherto economically underrepresented in relation to their population size are expected to own 30 per cent of the country's wealth. This is to be done through a restructuring of the employment structure by inducing greater bumiputra participation in commercial and industrial activities. In doing so the largely rural bumiputras, who are engaged mainly in agricultural activities, are to be deliberately urbanised to expose them to the demands of the urban environment"[1]

Until the NEP, the Government had followed a general laisse-faire attitude towards the economy. In implementing the policy, however, the Government took an active role, overiding the market in pursuit of the NEP aims. It is this intervention, the Chinese argue, that has led to the Malysian economy to grow at a slower pace than such comparitive economies as South Korea, Taiwan, Hong Kong and Singapore. These countries, however, are not multi-racial and did not need to accommodate racial grievences. Without the NEP, however, in the face of racial conflict, this, "limited," growth might not have been possible at all.

Malaysia's impressive growth performance during the 1960s and 1970s is often associated with its success as an open economy, emphasising export-led growth. At independence, Malaysia was typified as a, "Banana-Republic," with rubber, partly supported by tin, as its only exports. At independence, rubber planting being the most important economic activity accounting for one-quarter of the GDP, one-third of total employment, 60 per cent of total export-earnings and about 20 per cent of the Government tax revenue. Malaysia was already by then the world's largest producer of natural rubber supplying one-third of the total world output of the commodity. In addition, Malaysia in 1957 was also the world's largest producer and exporter of tin metal, accounting for 33 per cent of the world's output. Although activity in mining and quarrying provided only 3 per cent of total employment and accounted for about 6 per cent of the GDP, tin exports were the second most important export commodity, contributing 20 per cent of the total export earnings and 8 per cent of the Government's tax revenue in 1957.

The markets for both rubber and tin faced uncertain futures. Rubber faced potential competition from cheap synthetic substitutes whilst tin faced a market of increasing supply relative to demand. The futures for the mainstays of the Malaysian economy were therefore in jeopardy. The fashionable development theory of this period was that of relying upon import-substitution as the engine of growth, Malaysia conducted this policy successfully for industrialization, however, it based its main development strategy initially upon capitalising on its rich agricultural resource base by primary-commodity investment and diversification. The following data derived from Bank Negara[2] records the success of this policy.

The Malaysian Government invested in research to reduce rubber growing and production costs so as to maintain rubber's competitiveness vis à -vis' synthetics. This policy resulted in rubber export revenues only falling by 15 per cent as measured relative to import prices between the 20 year period of 1960 to 1980. The effect of this decrease was marginal being limited by increased productivity.

Simultaneously the country began to diversify agriculture away from rubber by promoting palm oil production. Between 1961 and 1988, palm oil production expanded at a rate of 15.2 per cent per annum (compared to 2.6 per cent for rubber). Today Malaysia is the largest producer in the world accounting for 57.6 per cent of trade in 1990. In 1989 it surpassed rubber as the most important crop in Malaysia, its export earnings equaling M$4.7 billion.

Exports of logs and timber also grew briskly during this period at 6.9 per cent and 5.5 per cent respectively. Cocoa, coconut and pepper are still relatively small, although they are regarded as having potential for further future diversification of the agricultural base and the promotion of mixed farming.

While the discovery and exploitation of Malaysia's petroleum resources play only a small part in world production, crude production has emerged until only recently as the country's largest export earner.

As a consequence of its investment policy towards primary exports, Malaysia has sustained rapid economic growth while transforming its economy from one that relied on two primary commodities to a broad-based and resilient economy which is characterised by a well-diversified production structure and wide range of exports.

2.4 Industrialization

As with most developing countries, Malaysia at independence had only a rudimentary manufacturing industrial sector. Vigorous encouragement of foreign investment led to its rapid growth during the 1960s and early 1970s. This growth was initially based on the processing and packing of primary products, mainly natural rubber, but over the years rapid shifts in the structure of manufacturing industries have been evident.

The period 1957-1990 can be conveniently divided into the three main phases which roughly correspond to the distinct, though overlapping stages in the process of economic and political transformation of Malaysia; these phases are;

1. Import-Substitution Policy (1957-1968);
2. Export-Promotion Policy (1968-1981) and;
3. Heavy-Industrialization policy (1981-today).

Government policies from the late 1950s favoured import-substitution industrialization, with government intervention largely limited to the provision of infrastructure facilities and other incentives. The strategy encouraged foreign investors to set up production, assembly and packaging plants in the country to supply finished goods previously imported from abroad. To promote such import-substituting industries, the government directly and indirectly subsidised the establishment of new factories and protected the domestic market. Many British companies, previously exporting to the Malaysian market, seized this opportunity to consolidate market monopolies by establishing branch plants behind protective tariff barriers.

Industrial investments were quite responsive to government efforts. After independence, industrial growth proceeded rapidly from its modest beginnings, with manufacturing output rising at an average annual rate of 17.4 per cent between 1959 and 1968. Manufacturing's share of GNP rose by 8.5 per cent in 1965, while employment in the sector rose from 6.4 per cent of the labour force in 1957 to 8.4 per cent in 1965, involving an increase from 137,700 to 214,800 workers.

Import-substituting manufacture's import-absorptive capacity, however, was comparatively low. The number of workers employed in the manufacturing sector were still only one-third of the number in agriculture. With the growth of big industry out-pacing small enterprise, and capital-intensive industries expanding much faster than labour-intensive ones, employment creation lagged considerably behind manufacturing investment growth during the period of import-substitution.

The import-substitution strategy had made some contribution to the development process of the country. It helped to diversify the economy, producing at least some move into manufacturing, and reduced the somewhat excessive overdependence on importing consumer goods. It utilized some of the domestic natural resources, created some employment opportunities, and contributed to economic growth. Nethertheless, since most import-substituting industries were based on imported raw materials or imported intermediate products, the end result was a low ratio of value added to gross output and poor linkage effects with the rest of the economy. The policy encouraged the establishment of industrial enterprises involving substantial capital investment, and employment growth that lagged far behind output growth. In certain cases, the policies also attracted sub-optimal industries that would never become viable without protection. While imports of consumer goods did decline in the 1960s, not only in relative but in absolute terms, the imports of investment and intermediate goods increased somewhat more than proportionally. The import share of consumption goods (food, beverages, tobacco and consumer durables) decreased from 47 per cent in 1961 to 27 per cent in 1970, whereas the share of investment goods (machinery, transport equipment, metal products and others) increased from 17 per cent to 27 per cent, and intermediate goods for manufacturing from 8 per cent to 21 per cent in the corresponding years.

The liberal policy conducted towards foreign investment continued into the second export-promotion phase (after 1968), however, there was a growing awareness that these policies were incompatible in some respects with the targets set by the New Economic Policy(NEP) in 1971. It was mostly during this phase that domestic political considerations finally overcame the laissez-faire philosophy of leaving industrial development to the private sector.

During this phase, there evolved a new set of economic and political attitudes, giving expression to what amounted to a surge of economic nationalism. Official policies started cautiously to discourage foreign investment and to favour joint industrial ventures, and local participation in enterprises geared to the NEP objectives. But the shortage of local management expertise, capital and technological know-how, together with the need to expand the economic pie, meant the Malaysian Government felt that it still had to depend upon foreign participation, and also to a limited extent, on the development of public enterprises in the manufacturing industry.

During the second phase, more liberal industrial legislation was enacted, commencing with the Investment Incentives Act of 1968 , which superceeded the 1958 Ordinance. Tariff protection was increased for infant-industries, and tax concessions were offered to encourage labour intensity (i.e. jobs created), the use of domestic raw materials, location in accordance to government priorities, and increases in efficiency. Special attention was also given to export promotion by tariff subsidy and frequent overseas campaigns to attract foreign investment for the establishment of selected industries. Inducements offered included industrial estates, free trade zones and the opening up of the Malaysian Export Trade Centre in Kuala Lumpur to introduce products to foreign importers.

These policy changes enabled Malaysia to take good advantage of a number of favourable circumstances in the external world conditions and to attract much of the foreign capital, management and know-how that it needed to expand its manufacturing industry. The share of manufactures in gross exports was virtually stable in the 1960s between 8 and 12 per cent, but this increased to around 20 per cent by the end of the 1970s. The rate of growth of manufacturing during the 1970s averaged 12 per cent per annum, which was higher than the previous decade, despite the larger base. The growth rate was impressive compared with that of most other industrializing countries, especially considering the situation prevailing in the World economy.

The third and current phase of Malysia industrialization is strongly associated with the current Prime Minister Dr. Mahathir Mohamad's explicit commitment to the development of heavy industries. Arguing that Malaysia relied far too long with adverse consequences on light import-substitution, raw-material-processing and light export-orientated manufacturing for industrial growth, he has sought to develop heavy industries ever since his tenure as Minister of Trade and Industry in the late 1970s. Towards the end, he established the Heavy Industries Corporation of Malaysia (HICOM) for the government to co-ordinate and support this effort since private investors were reluctant to take the lead. After Mahathir became Prime Minister in 1981, he shifted responsibility of HICOM from his old ministry to his new office, threw government support solidly behind his heavy industrialization plans, and pushed cement, steel and car projects, arguing that such heavy industrialization plans were necessary to transform Malaysia into a newly industrializing country. Heavy industry programmes by 1983 were expected to require over M$8 billion in investments.

From the outset the problems have been formidable. Mehmet[3] indicated the problems of this policy. Malaysia had a small domestic market, the investments were not only massive but had long gestation periods, there were existing gluts in international markets for most, if not all of the chosen heavy industrial projects, this necessitated heavy foreign borrowing and costly protection which burdened the domestic private sector and consumers. The Chinese-dominated manufacturing sector was not involved and mostly inexperienced, often inept and even corrupt elements of the Malay-dominated governmental apparatus were appointed to oversee the projects. Heavy industrialization has become heavily dependent on foreign partners, consultants, and contractors lucratively paid to speed up construction and completion of contracts. Quite a number of them have taken the government for quite expensive rides - especially those awarded the roadbuilding contracts, with foreign contractors having total control over the design, material and construction, and invariably using over-priced imported technology and supplies. To make matters worse, these plans were introduced at a time of global economic recession (and hence even more cut-throat competition) as well as higher interest rates which exasperated Malaysia's balance of payments, fiscal and debt problems. Clearly, it was a very expensive way of transferring technology and creating employment. Instead of seeking the cheapest and most appropriate technology, the government often gave contracts without any open competitive tendering process to the biggest Japanese and South Korean corporations.

Higher interest rates and the recessions of the 1980s, as well as related balance-of-payments problems soon got in the way of Mahathir's heavy industrialization plans, forcing the government to slow down and trim projects in progress, while cancelling or delaying others still at the planning stage. Malaysia's new heavy industries of the early 1980s have generated little employment and few other linked industries, whilst at the same time diverting massive investment funds and burdening the economy in various ways, especially in terms of debt and the balance of payments.

The publication of the Industrial Master Plan(IMP) by the government in the early 1986 was the first such initiative of its kind in Malaysia's history. The IMP offers analysis of the structural problems associated with Malaysia's manufacturing sector. It points out that despite, or rather because of its growth and development record, Malaysia has been a relative latecomer to industrialization. The IMP attributes Malaysia's, "delayed industrialization," to its success in developing primary exports. Malaysia has lagged behind the so-called, "normal pattern," apparently because successful expansion of raw material production has adequately financed import needs, weakening the urgency to industrialize. Similarly, the availabilty of other more profitable alternative investment opportunities has discouraged industrial investments.

The IMP summarises the major problems affecting Malaysian industrialization as follows:

1. technological dependence and lack of indigenous industrial technology capacity.

2. manpower shortages, especially engineers and technicians.

3. deficiencies in existing industrial structure, a) ad hoc and excessive domestic protection; b) neglect of small industry problems and requirements; c) rigidities and inflexibility in existing incentive schemes; d) biases in export incentives; e) inadequate incentives for technological development; f) some major incentives not automatically available to those eligible.

4. inadequate private-sector initiative;

5. constraints imposed by NEP restructuring efforts.

The government's policy instruments to promote industrialized growth include a battery of incentives meant to liberalise industrial investment and reduce market distortions. Some of the major policy changes to this end include:

1. further liberalisation of foreign investment;

2. reduction of public-sector service charges for electricity, water, international telephone calls, telex services etc.;

3. greater incentives for using local material as inputs;

4. reduction in protectionism and more export-orientated growth;

5. greater export-promotion efforts;

6. concentration on a few selected industries with greater potential;

7. acceptance of the "Economies of location," i.e. virtual abandonment of regional dispersal efforts.

The IMP stresses the need to develop further the industries based on natural resources as well as to improve indigenous technology and external competitiveness, while emphasising export expansion of selected priority industries, requiring policy measures such as:

1. reduction and rationalisation of tariffs to limit excessive protection and to promote efficiency;

2. reduction of income tax on export earnings, and strengthening the export credit scheme to encourage exports;

3. relaxation of regulations, including licensing requirements and those relating to foreign equity ownership.

In line with this, foreign-equity-ownership conditions on manufacturing sector were liberalised in July 1985, by linking the permissible share of foreign-equity ownership to the export share of total output. This was followed by further relaxation in 1986 of the 1975 Industrial Coordination Act and legislation of the Promotion of Investment Act in 1986. Additional incentives were introduced in the 1986 and 1987 Budgets, while other government announcements have introduced yet more incentives.

The IMP's Korea team leader acknowledged that industrial progress dependended upon reform of the related bureaucracy, legislation and policies. This is not likely to be achieved in the near future, especially in view of the vested interests involved. The recovery of the manufacturing sector in the late 1980s had little to do with the IMP, and much more to do with the factors that have governed export-orientated industrial performance since the 1970s. If this situation continues, as seems likely, the future rise and fall of Malaysian manufacturing industrial growth is unlikely to contribute significantly towards the development of a more integrated, balanced and consistently dynamic industrial sector.

2.5 Open Economy, Dependence and International Payments.

Despite the marked economic diversification in the past 33 years Malaysia remains an open and international trade-orientated economy. The export sector plays a dominant role in the Malaysian economy and is traditionally the most important determinant of the state of economic activity over the short and medium term. Historically, changes in exports has had a pervasive impact on income, output, investment, the balance of payments, money supply and the general price level.

In 1955, exports of goods and services accounted for nearly 55 per cent of the GNP. Exports had become more important in 1990, accounting for 62 per cent of GNP. In the 1980s, export taxes on the principal primary export commodities accounted for between one-tenth and one-fifth of the Government's total tax revenue, depending on the level of commodity prices. In terms of indirect tax revenue, taxes on exports represented between one-fifth and one-third of the total.

A significant change in the composition of Malaysia's external trade has mainly been brought about by the diversification of the nation's exports over the last 33 years. In 1955, exports of the two primary commodities, namely, rubber and tin, accounted for close to three-quarters of total export earnings; but by 1990, these two commodities represented only 4.9 per cent of the total, while export of manufacturing goods, crude petroleum, tropical hardwoods (logs and sawn timber), and palm oil, which were insignificant up to the mid-1960s rose substantially to account for around 80 per cent of the total export receipts. Of particular significance in recent years has been the rapid increase in exports of crude petroleum since 1973 to become the largest single foreign exchange earner by 1982, contributing 27.4 per cent to total export receipts at its peak. Since 1983, however, exports of crude petroleum have been overtaken by manufactured goods for the lead place in terms of export earnings. In 1990, exports of crude petroleum accounted for 13.4 per cent of total export earnings, compared with a 59.3 per cent share for manufactured goods. Intensive efforts to promote manufactured exports though the 1970s and especially from 1985, has resulted in exports of manufactured goods surpassing the export share of 33.9 per cent for agriculture commodities in 1987. The principal areas of growth in manufactured exports were primary in electronic components, electrical machinery and appliances, textiles, clothing, and footwear, chemical products and other machinery and transport equipment. New growth areas centred on resource-based products, particularly rubber and wood-based products.

The broadening of the domestic economic base as a result of diversification and industrialization has enabled the Malaysian economy to be more resilient in withstanding the destabilising effects of the cyclical economic fluctuations of the industrial countries. Nevertheless, the well diversified export base was not sufficient to totally insulate the economy from the prolonged global recession in the early 1980s, when sluggish world demand led to the fall in prices of Malaysia's major exports, all at the same time, an event never experienced before by the country.

Contrary to a prior expectation, empirical evidence of the Malaysian situation indicates that over the years, the adverse impact of export instability on the whole has not been particularly significant, notwithstanding the experience of the early 1980s. Firstly, the transmission of export instability to the domestic economy has not been as intense as commonly believed in the case of Malaysia because of inherent leakages (especially from the form of imports and profit outflows). The foreign-trade multiplier for Malaysia has been generally placed at less than unity, that is, the change in exports is likely to have a less than proportionate change in income. Secondly, the Malaysian experience does not appear to support the hypothesis that export instability is detrimental to growth in Malaysia, especially since the Government has the capacity to introduce counter-cyclical policies to maintain growth. Indeed, Malaysia has demonstrated that despite the export instabilities, the domestic economy has been able to expand sufficiently over the past 33 years consistently.

On a year to year basis, there has always been positive growth in nominal GDP even during periods of weak exports, except in 1985 and 1986 when nominal GDP declined, unlike in the past such weakness in the external sector would of been countered by an expansionary fiscal stance. The contraction of the domestic economy in 1985 and 1986 was primary due to the decline in exports at an average rate of 3.9 per cent which was accompanied by significant public expenditure cutbacks to meet structural adjustment objectives brought about by the result of the heavy industrialization programme.

As already noted earlier, changes have occured in the structure of imports. Over the years, imports of food and manufactured final consumption goods have clearly been on a declining trend as a result of rapidly rising basic food production and the growth of import-substituting manufacturing industries. At the same time, imports of intermediate inputs and capital goods have registered a strong upward trend in line with the rapid rate of capital formation and the expansion of manufacturing industries, particularly the growth of export-orientated industries.

Despite wide fluctuations in the prices and demand for Malaysia's principal exports and the rapidly rising import bill since independence, the country's overall external payments position has continued to remain strong. The basic strength of Malaysia's balance of payments is the merchandised trade account, which has consistently been in surplus annually since the 1950s, except in 1981-82. The merchandise account, which was adversly affected by the prolonged recession in the major industrial countries, recorded a deficit for the first time in 1981-82. This sharp deterioration reflected the impact of world recession on export earnings, accentuated by the adverse impact of global inflation on import growth, through higher import prices.

Adjustment measures, however, that have been undertaken since 1982 having to served to strengthen the balance of payments over the period 1983-90. Delibrate policies to increase Malaysia's external competitiveness and to reduce imports, together with measures to improve the services account, have had a marked impact on the current account of the balance of payments. Since 1983, the current account deficit had narrowed progressively from the high level of M$4 billion in 1982 to M$207 million in 1986. By 1987, a significant decline in imports in the face of recovery of exports (as a result of higher commodity prices) led to a marked turnaround in the current account to a record surplus of M$6.1 billion, the first surplus since 1979. Movements in the current account of Malaysia's balance of payments for period 1956-90 are summarised in Table 2.2.

Table 2.2 Current Account of the Balance of Payments

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1985-90
Exports f.o.b.	11.71	16.83	21.5	35.96	97.19	162.64	280.12
Imports f.o.b.	8.91	14.91	17.15	32.16	74.34	147.77	226.82
Merchandise balance	+2.79	+1.92	+4.35	+3.8	+22.81	+14.87	+53.31
Net Service Payments	-0.62	-1.63	-2.72	-6.45	-17.37	-42.19	-48.45
Net Transfers Abroad	-0.93	-0.70	-0.75	-0.63	-0.52	-0.28	+1.39
Current Account Balance	+1.25	-0.41	+0.87	-3.28	+4.91	-27.6	+6.25

Source: Bank Negara, Treasury and Dept. of Statistics

Not unlike the experience of most developing economies, however, the current account of Malaysia's balance of payments had been in deficit for most of the years since the beginning of the 1960s, except during the export boom years of 1965-66, 1968-70, 1973, 1976-79 and 1987-90, reflecting deliberate efforts at sustained economic development, which entailed rapidly rising imports (especially of machinery and equipment), outflows on payments of investment income (reflecting the profitability of foreign investments, especially in mining, plantation, agriculture and industries), and increasing payments for services.

Unlike the situation for most developing countries, however, the Malaysian payments position on the current account was supported by strong inflows of both official and private capital from abroad, including new flows of foreign private investments, so that the capital account has always been in surplus, except for 1987. As a result, the overall balance of payments position had consistently been in surplus, except in 1961, 1967 and 1981-83, when new capital inflows were not sufficient to offset the current account deficit. In 1987, the capital account reversed its position to record, for the first time, a net outflow of long-term capital, due mainly to the moves undertaken by both the public and private sectors to take advantage of the favourable conditions to borrow locally at relatively low rates to prepay some of the more expensive external loans, as well as the Government's policy to reduce dependence on external sources of finance for its budgetary operations. The overall balance, however, remained in surplus due to the large current account surplus. The capital account flows of the balance of payments for 1956-90 are summarised in Table 2.3.

Table 2.3 Capital Account of the Balance of Payments

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1985-90
Current Balance	+1.25	-0.41	+0.87	-3.28	+4.91	-27.6	-6.27
Official Long Term Capital (Net)	+0.08	+0.48	+0.86	+2.36	+2.63	+21.67	-8.26
Private Long term Capital (Net)	+0.15	+1.00	+0.93	+3.38	+6.41	+12.7	+8.89
Private Financial Capital (Net)	+0.24	+0.06	+0.18	+0.34	-2.44	+0.74	+2.07
Errors and Ommisions	-1.02	-0.84	-2.26	-1.01	-5.29	-5.75	+1.88
Overall Payments Position	+0.69	+0.29	+0.58	+1.79	+6.23	+1.76	+14.83

Source: Bank Negara, Treasury and Dept. of Statistics

The basic strength of the nation's balance of payments was not fully reflected in the exchange rate until the early 1970s. Prior to 1973, Malaysia adopted a fixed exchange rate regime, under which the Central Bank was obliged to support the exchange rate of the ringgit (the Malaysian dollar prior to 1967) within a very narrow band by acting as buyer and seller of last resort to the commercial banks in respect of foreign exchange. As a matter of policy, the official exchange rate margin was maintained at three-quarters of 1 per cent at either side of parity of one pound sterling = Malaysian Dollar 7.3469. This margin was raised to 1 per cent in line with the maximum limit allowable by the International Monetary Fund during this period of international monetary upheavals. Initially, the official intervention currency for Malysia was pound sterling; but with the floating of sterling in mid-72, Malaysia adopted the United States dollar as its official intervention currency. The ringgit was subsequently floated in June 1973. Therefore the value of the ringgit is being determined in terms of a basket of currencies of those countries which are significant trading partners of Malaysia. The ringgit had appreciated in terms of the composite between 1973 and 1984 and depreciated since 1985. The US dollar has remained the intervention currency in the Malaysian currency exchange market. Since 1973, the exchange rate of the ringgit vis-à-vis' the US dollar appreciated up to the end of 1984. The ringgit, however, weakened against the US dollar since 1985, as depicted in Table 2.4.

Table 2.4: Exchange Rates of Ringgit (M$)

Year	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Average Exchange Rate of M$ to US$1	3.06	3.06	3.00	2.82	2.44	2.41	2.40	2.54	2.46	2.32	2.19
Year	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Average Exchange Rate of M$ to US$1	2.18	2.30	2.34	2.32	2.34	2.48	2.58	2.52	2.60	2.71	2.71

Source: Central Bank of Malaysia

2.6 Savings, Investment and the Financing of Government

Accompaning the changing structure of the economy was the changing pattern of aggregate demand. Trends in the allocation of expenditure components of GNP since 1956 are presented in table 2.5.

Over the past 33 years, gross investment by both the public and private sectors had increased rapidly, more than doubling its share of the GNP by the late

Table 2.5: Changing Pattern of Demand Components

	1960	1970	1980	1990
	(% of GDP)			
Private Sector	84.9	77.6	70.9	74.9
Public Sector	15.1	22.4	29.1	25.1
Consumption	87.2	84.0	68.7	67.3
Investment	12.8	16.0	31.3	32.7
Exports	51.9	45.6	50.8	79.2
Imports	38.5	41.3	53.7	76.8

Source: Bank Negara, Dept. of Statistics

1980s. Malaysia's average investment/GNP ratio of about 32 per cent during the period 1981-88 was high by any standard. The bulk of this investment has been financed by savings from domestic sources, comprising mainly of ploughed-back profits (largely depreciation allowances) and contractual savings primarily in the form of compulsory savings with the national providient fund - the Employees Providient Fund(EPF). In the early 1980s, however, there was an increase resort to foreign borrowing to meet a growing resource gap, especially by the Government in funding development expenditure, as the nation's investment/GNP ratio rose to exceed 37 per cent of the GNP. The high level of private investment in response to booming domestic economic conditions in the latter part of 1970s, and also the subsequent increase in public expenditure on heavy industrialization and development as it pursued counter-cyclical fiscal and heavy industrialization policies in the early 1980s occured at the time when national savings-investment had declined to about 25 per cent of the GNP. As a result, the savings-investment gap, as reflected in the current account deficit in the balance of payments, amounted to nearly 12 per cent of GNP in 1981-83, and was met mainly by foreign borrowing.

The role of the Government had expanded rapidly since independence. The share of public sector expenditure on consumption and investment in aggregate expenditure(GNP) rose from 17 per cent in the late 1950s to 37 per cent in the early 1980s. The expanding share in GNP of the Government reflected its very active role in promoting sustained economic growth (mainly as a counter-cyclic measure) and the implementation of purposeful programmes to effectively restructure the Malaysian society. In developing countries, the market mechanism for guiding the allocation of productive resources that is characteristic of the industrial economies does not operate as effectively because of widespread market imperfection. The Malaysian experience has been no exception. Since the late 1960s, the situation has called for conscious efforts to direct economic resources, whenever appropiate, through Government's direct participation in economic activity, with the objective of promoting economic national goals. The sum total of the Government's direct efforts at promoting economic growth and distribution has been reflected in its development expenditure through the budget. The financing of this massive expenditure over the past 33 years as presented in Table 2.6 is unique.

Table 2.6 Financing Public Development

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1985-90
Public Development Expenditure ($billion)	0.74	3.11	4.24	9.79	27.49	78.62	32.23
Finance By (Percentage of total)							
General government surplus	52.7	40.2	40.8	22.8	28.7	39.9	+52.3
Net Foreign borrowing	17.6	18.0	16.5	21.3	15.8	32.6	-6.9
Use of Reserves	-63.5	8.4	-1.2	10.8	15.2	-2.4	-1.1
Net Domestic borrowing	93.2	33.4	43.9	45.1	40.3	29.9	78.4

Source Money and Banking in Malaysia, Bank Negara (compiled from various development documents and Bank Negara Annual Reports)

Unlike the experience of many developing economies, the financing of the Government's direct development efforts until 1980 came primarily from noninflationary resources; mainly the current surplus of the public sector and the compulsory social security contributions of the private sector (by employers and employees to the Employers Provident Fund). Financing by the Central Bank in the form of holdings of Government securities had been fairly modest. Indeed, if the deposit holdings of the Government with the Central Bank were taken into account, the Central Bank has not been a net contributor to the financing of the Government since independence. Although the efforts of the commercial banks in this regard were relatively more significant, their holdings of Government papers did not prevent the banks from adequately meeting the financing needs of private development and investment due to the high level of savings within the system. As a result, foreign financing of the public development effort had been quite modest, especially during the period up to the end of the 1960s.

In the face of sluggish revenue growth (due to the liberalisation of taxes and the dampening impact on income and commodity prices caused by the world recession), public development expenditure increased markedly from M$27.5 billion in the Third Malaysian Plan, 1976-80, to M$78.6 billion in the Fourth Malaysian plan, 1981-85. As a result of the increasing overall deficit of the public sector, the Government had to resort increasingly to foreign financing, since traditional sources of domestic financing were inadequate relative to the requirements of the Government. The share of net external borrowing in financing public development expenditure rose to nearly 36 per cent in 1981-83, as against 19 per cent in the 1970s.

In order to ensure an orderly growth of the nation's external debt as well as to provide room for the private sector to thrive, measures were implemented by the Government in mid-1982 and 1983 to rein in any further growth in public expenditures by reviewing priorities and the cost effectiveness of programmes and projects. The Government introduced in October 1983 the first series of budgets planned to reduce the overall public sector deficit to a sustainable level as a proportion of GNP. The new direction in public policy also sought to reduce the role of Government, while at the same time, promote the private sector as the main engine of growth for the economy. In line with this shift in public policy, development expenditure under the Fifth Malaysian Plan, 1986-90, was reduced by 35 per cent from M$74 billion to M$47.7 billion in March 1987. The fiscal adjustment also included measures to further consolidate the financial position of the non-financial public enterprises (NFPE), restrain public sector spending and introduce new initiatives to improve revenue collection.

To reduce the financial and administrative burden on the public sector, the privatisation of major public sector enterprises was also actively pursued. As a result of all these austerity measures, the share of the public sector in aggregate expenditure (GNP) declined to 26.6 per cent in 1988, compared with 37.7 per cent in 1983. This in turn led to a marked improvement in the Government's financial position. Indeed, by 1988, the Government's financial position had improved to such an extent that it could afford to prepay some of its external borrowings, thereby improving the nation's external debt profile. Given such a path of adjustment of the Government's financial position, funding of the public sector development programme can be expected to be continued, as a matter of policy, within the bounds of financial prudence, as well as consistent with the need to maintain monetary stability so crucial to growth in the longer term.

2.7 Price Developments and Stability

A unique feature of the Malaysian experience in economic development since independence was that economic growth was achieved with financial and monetary stability, particularly before 1972. As a result, the real income of the majority of Malaysians improved significantly. The general lack of inflation has been the result of the maintenance of an open economy, liberal exports, and general absence of deficit financing of the Government by the monetary system. The price performance since the mid-1950s is presented in Table 2.7.

For the period 1956-70, the rate of growth of consumer prices in Peninsular Malaysia averaged only 0.8 per cent per annum. The consumer price indices for Sabab and Sarawak relate only to the 1970s. For the period 1971-75, the annual increase in the consumer price index averaged 6.4 per cent for Sabah and 6.1 per cent for Sarawak. This remarkable record of price stability was, however, broken in the period of 1972-74 when the general level of consumer prices in Peninsular Malaysia rose sharply in 1974 to average 10.2 per cent a year during this period. On the whole, the Malaysian inflation experienced during the 1970s reflected mainly rapid world inflation, imported primarily through sharp increases in import prices,

Table 2.7 Consumer Prices

Year	1956-60	1961-65	1966-70	1971-75	1976-80	1981-85	1985-90
1	1.0	-0.2	1.4	1.6	2.6	9.7	0.8
2	5.1	0.1	4.1	3.2	4.7	5.7	0.8
3	-1.0	3.1	-0.2	10.5	4.9	3.7	2.5
4	-2.9	-0.4	-0.4	17.4	3.6	3.6	2.8
5	-0.2	-0.1	1.9	4.5	6.7	0.4	3.1
Average	0.4	0.5	1.4	7.4	4.5	4.6	2.0

Source: Bank Negara, Treasury and Dept. of Statistics

although the rapid growth of domestic aggregate demand and supply bottlenecks were also contributory factors, particularly in the 1973 and 1974. The freeing of the exchange rate in mid-1973, which resulted in a significant revaluation of the ringgit, however, was not sufficient to offset the impact of the massive bout of world inflation in the early 1970s. Recourse to stringent monetary, fiscal and administrative measures, however, helped to bring about a significant inprovement in the price situation by 1976, when inflation was reduced sharply to an annual rate of 2.6 per cent. In the remaining period of the 1970s, inflation has continued to remain low, averaging 4.5 per cent annually, despite high rates of world inflation caused partly by the second oil crisis in 1979. Subsequently, in line with relatively lower world inflation rates in the 1980s associated with the prolonged world recession, growth in consumer prices in Malaysia had remained relatively stable except for a brief resurgence in 1981. Over the period 1980-90, the average rate of price increase was 3.3 per cent annually.

2.8 Conclusion

Malaysia's economic progress since independence has generally been characterised by rapid economic growth with relative price stability. The nation's success in the development process has been due to several economic strategies: effective utilization of the nation's economic resources; diversification of the economy and modernization of the rural-agricultural sector; adoption of market-orientated and outward-looking economic system; and the conduct of pragmatic economic macroeconomic policies. At the time of independence in 1957, Malaysia was a typical primary commodity exporter, heavily dependent on rubber and tin for foreign exchange earnings, Government revenue and employment. By 1990, however, the nation had become not only a world leader in the production and export of rubber and palm oil, but also an important producer of timber, pepper and cocoa and a net exporter of crude oil, as well as a growing exporter of manufacturers. Malaysia has also been rapidly industrializing and manufactured exports now account for a sizeable portion of total exports.

Footnotes

1. Hasin, K. (of Malaysia's Ministry of Land and Regional Development) "The Political Economy of Malaysia." *edited by Fisk, E. K., & Osman-Rani, H. Oxford University Press,* 1982.

2. Bank Negara Malaysia. "Money and Banking in Malaysia." *Bank Negara Malaysia: Kuala Lumpur,* 1989.

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Chapter III

The Development and Structure of the Malaysian Financial System

3.1 Introduction

This chapter traces the historical development of the Malaysian financial system and indicates the varying policies of development conducted by the government, within the context of the financial development theory discussed in chapter one. The level of Malaysia's financial deepening is examined so that it is better appreciated that Bank Islam was established in an already quite developed financial system. Finally, so that Bank Islam's operations can be compared with the rest of the banking system, the sources and uses of funds of the banking system is examined.

3.2 The Development of the Malaysian Financial System

The development of the Malaysian financial system can be divided into four main periods.

1. Pre-Independence and the Currency Board Period (-1958);
2. Currency Board and Central Bank Coexistance (1959-67);
3. Adaption and Extension of the Financial System (1968-73);
4. Financial Deepening (1979-today).

3.2.1 Pre-Independence and the Currency Board Period (-1958)

The birth of the Malaysian financial system can be traced to the establishment of the first commercial bank in Penang in 1875. This branch of the Chartered Merchantile Bank of India, London and China (later named Merchantile Bank), together with the further branches opened in Taipang and Kuala Lumpur in 1888, were established to provide financial services to the emerging tin industry. External trade has not only had an impact upon the Malaysian economy, but has also had a significant impact in the forming of financial institutions and their financial instruments. The satisfying of the tin industry's financial needs was not the first occurence of trade affecting the Malaysian financial system. Money itself was first introduced to the Malay Peninsula through trade with the Far-East, and an indigeneous mint was established during the Malaccan Empire, an empire whose strength lay in its ability to control the Straights of Malacca and the growing east-west trade. A key characteristic that can be identified in the development of the Malaysian financial system until the mid-1960s is that of the influence of international trade. Rather than meet domestic requirements, the financial system has been developed to meet the external needs of foreign trade, investment and remittance of profits.

By the end of the nineteenth century, quite a developed banking sector had evolved on the Malay Peninsula to provide financial services to the colonial tin corporations and the rapidly growing rubber plantations. The financial services offered included finance for trade, working capital and foreign exchange remittances between London, India and China. Much of the credit provided by the banks was short-term, with loans in the form of overdrafts, packing credits, advances against shipping documents, trust receipts and the discounting of trade bills.

Existing concurrently, however, was a primitive banking sector that met the needs of the domestic Malay sector. This sector operated through an indirect, "compradore," system whereby prominant Malay and mainly Chinese businessmen and community leaders would act as the foreign bank's agents. They would channel bank loans to business enterprises, acting as guarantors and would also function as a deposit mobilizer for surplus funds. These compradores would then receive commission, depending on the amount and the volume of the business transacted for the foreign banks. This dual nature in the banking system which consisted of a well developed and sophisticated sector for the expatriot plantations and corporations, together with an indirect sector providing for local needs, co-existed well into the 1960s.

An important landmark in the history of the Malaysian financial system was the development of the Currency Board. The inherent instability of a monetary system based on the private issue of banknotes by commercial banks, especially one without a lender of last resort facility, led to a series of legislative reforms which were passed in Malaysia in the early twentieth century in order to establish a standard coin and currency that would be stable in value whilst facilitating the growth of trade. The eventual result of these measures was a currency known as the Malayan Dollar, issued by the Board of Commissioners of Currency of Malaya, Singapore, British Borneo and Brunei.

An important feature of the Currency Board system was its high level of external reserves which were held in sterling balances and deposits, as backing for the currency. The Malayan Dollar was pegged at the constant rate of M$1=2s.4d., this had two advantages: One, the country was able to attract foreign investment into the rubber plantations and the tin mining industries and; two, trade was facilitated not only with the Sterling Area, but also with the rest of the world since sterling was a key currency. In fact, in the 1950s Malaya was the highest US$ dollar exchange earner within the Sterling Area.

The advent of the mass production of the motor car led to a growing demand for rubber for car tyres, resulting in the price of rubber increasing three-fold. This demand, coupled with a boom in tin prices resulted in a thriving economy with many investment opportunities. Given the advantages of the Currency Board system, Malaya attracted increasing investment which led to the spread of the banking network inland. Foreign banks opened further branches in Klang in 1909, Kota Bharu and another in Malacca in 1911 and Ipoh in 1912. The first domestic bank to be incorporated was the Kwong Yik (Selangor) Banking Corporation in 1913. By 1926, there were 18 bank offices throughout Malaya, 3 were domestic bank branches, 2 were Singapore-based bank branches and the remaining 13 branches belonging to foreign (mainly British) banks.

In the late 1920s and 1930s Chinese businessmen established a new informal form of indigeneous bank. They borrowed and lent funds within the close-knet Chinese community. A simular bank was set-up in the Indian community in 1936, and later a Malay bank in 1947 which subsequently failed due to small deposit base and lack of banking experience. These, "clannish," banks were characterised by their informal nature, their relatively small client a base and lack of banking experience (especially in foreign exchange dealings). Due to a lack of a lender of last resort facility they held large liquid balances with the British banks and lending tended to be conservative, relying more on good faith, personal and communual relationships, rather than investment potential.

Although the Currency Board system provided a stable and strong currency and facilitated foreign (mainly British) investment, it also had certain disadvantages for the country's internal stabilization management and long-term economic development. Among the disadvantages was the fact that Malaya's money supply was affected by the economic conditions and policies of participating governments within the Sterling Area. Moreover, the effectiveness of the country's stabilization policy was limited by the dependence of internal stabilization on the external balance of payments. Since Malaya was a very open economy with trade accounting for 40-50 per cent of the nation's GNP, any changes in the external trade conditions affected its external reserves and were automatically transmitted to the country's money supply. In addition, the use of exchange rates as a tool for internal balance was not possible.

Under the currency based system, the country was not able to apply internal stabilization controls, nor could it sterilize or demonetize any sterling movements. It could not regulate the operations of commercial banks directly, nor could the government undertake certain counter-cyclical monetary opertions. Furthermore, the Currency Board's minimum requirement of 80 per cent currency reserves backing had a high opportunity cost, as the country could have deployed these resources internally to finance its own development needs.

3.2.2 Currency Board and Central Bank Coexistence (1959-67)

In 1955, with the independence looming for both Malaysia and Singapore a World Bank Mission was sent to the region to evaluate the economic situation and examine the countries' development potentials. With regard to Malaya, the Mission reported that the country had;

> "...reached a stage of development where this largely external orientation of the economy has been and is being modified by such factors as a

> wide and growing volume of monetary transactions and of local capital and enterprise; a settled labour force; indigenous banking facilites at least as important as those afforded by overseas banks; and a need, as the inflow of new private capital has declined, to depend increasingly on internal savings for further investment in the development of Malaya's resources... These changes in the economy call for a modification of the present currency system to permit a measure of deliberate management of the money and credit situation, with the object of fostering a more favourable climate for the further development of domestic enterprise. As the instrument for this management we recommend the establishment of a Central Bank of Malaya."[1]

In 1959, two years after independence, the Central Bank of Malaya (later renamed the Bank Negara Malaysia with the formation of Malaysia in 1963) was established. The Currency Board, however, still remained the sole currency issuing authority until 1968, this obviously restricted the operations of the Central bank in its management of the money and credit situation. The Central Bank, therefore, concentrated on the "Malayanization," of the nation's financial assets and institutions and the expansion of the country's financial structure. This was a tentitive step towards a supply-leading policy of financial development in the form of institution building.

Mehmet[2] lists the characteristics of the Malaysian financial system as being at independence;

1. Foreign (mainly British) dominated banking sector;
2. Low domestic private savings;
3. Liquid assets held in the form of sterling assets;
4. Limited money and capital markets and;
5. A financial infrastructure barring effective monetary management.

At the start of the Central Bank's, "Malayanisation," campaign in 1959, only eight of the 26 banks operating in Malaya were Malayan corporated. These eight banks only accounted for 12 of the 111 banking offices that existed throughout the country and more importantly, the domestic banks' share of the aggregate assets of the banking system was only about six per cent. The Central bank encouraged and facilitated the establishment and growth of the domestic incorporated banks, and also their branch networks to serve the financial needs of the country's smaller towns and rural areas. By the end of 1967, the number of Malayan-operated banks had doubled to 16, their branch offices constituted just over half of the total network and in terms of aggregate assets of the banking system, the domestic banks accounted for 36 per cent.

With the increasing coverage of Malaysia with banking offices, from 111 to 369, the number of persons per branch office was roughly halved from 71,600 persons to 32,100. During this period savings deposits grew from M$93.6 million to M$512.4 million (adjusted for inflation using 1959 as the base year), an increase of 547 per cent during a period in which per capita income growth measured 142 per cent. Malaysian banks were seen to encourage saving by being extensively widespread thus making it convenient for people to deposit their surplus funds.

The Central Bank also encouraged the transformation of the banking system's holdings in sterling assets into Malaysian assets and balances. In 1959, 40 per cent of the banks' total resources were held abroad and only one-third of their resources were held in the form of bank credit. This changed dramatically, so that by the end of 1967, less than ten per cent of their resources were held overseas and 46 per cent in bank loans and advances.

In building the financial infrastructure to enable an effective role of monetary management, the Central Bank conducted an institution-building policy. Clearing houses were established in Kuala Lumpur and Penang, the Central Bank undertook the management of Treasury Bills, promoting a money-market through supplying the Treasury Bills on tap, providing rediscounting and lender of last resort facilities and establishing a Discount House. It actively encouraged the inter-bank market and this, together with its institution-building programme, provided a nucleus for a viable money market.

In promoting a capital market the Stock Exchange of Malaysia and Singapore was established in 1962. In order to create a more active market in Governament securities (which were usually held until maturity by the institutional investors such as the Post Office Savings Bank and the Employees Providient Fund), the Central Bank issued a range of Securities with varying maturities, interest rates and terms of redemption to meet particular investment needs. The Central Bank, therefore, during this period has started a process of Malayanisation in terms of banking ownership and financial instruments, had encouraged private saving and provided the nucleus for capital and money markets. The continued existence of the Currency Board, however, restricted its operations with regard to using money management to encourage financial development.

3.2.3 Adaption and Extension of the Financial System (1967-73)

In 1967, the failure to establish a common currency between Malaysia, Singapore and Brunei; led to the Central Bank of Malaysia to issue its own currency, the ringgit. The Central Bank had in 1964 (a year after the Federation of Malaysia), given its legal notice to replace the Currency Board and entered into negotiations with Brunei, the only remaining independent government upon the Board. In 1965, however, Singapore withdrew from the Federation leading to its re-establishment as a participatory government on the Currency Board. This prompted further discussions. The result of these discussions was that each government issued their own currencies with each of these currencies being accepted as legal tender in all three nations.

Recognising the increasing inportance of the finance companies (deposit-taking institutions which engaged primarily in instalment credit for retail sales, housing and other personal loans, bridging finance, refinancing , factoring, leasing, wholesale financing and other commercial lending), the Central Bank introduced the Finance Companies Act 1969. This act brought 25 finance companies with 130 branches and deposits of M$314 million under the supervision of the Central Bank.

Further institutions were introduced into the financial system such as the establishment of the Agricultural Bank of Malaysia, as the name suggests, a bank whose main objective was the development of the agricultural sector. Also, The Pilgrim's Management Board, was formed by statute to merge the activities of the Malaysian Muslim Pilgrims Savings Corporation and the Pilgrims Affairs department of the Government to mobilize savings of Muslims and assist them in performing pilgrimage. The first merchant banks were established in 1970 to provide the increasing need for financial expertise in wholesale banking and corporate finance activities. By the end of 1973, four further merchant banks were established and a second Discount House. The final extention to the financial system was in the form of the Credit Guarantee Corporation in 1972. This institution through equity participation by the Central Bank and other commercial banks, provided funds that were readily accessible at reasonable cost to small-scale enterprises.

The development of the financial system accelerated into the 1970s. The process of financial intermediation, already evident in the 1960s, gathered momentum in the second decade. Against the background of a strong and stable currency amidst an uncertain international monetary situation, a comprehensive review of the banking legislation was undertaken with the objective of further strengthening the banking system as well as facilitating the efficient channelling of adequate funds for the development process in both public and private sectors. As a result, legislation was enacted towards the end of 1972 to significantly amend the Banking Ordinance Act 1958. The Banking Act 1973, provided the Central Bank with wider scope for manoeuvre in monetary policy and greater flexibility in the use of policy instruments to promote monetary stability, while at the same time tightening the controls which the Bank would require to more effectively supervise the operations of the banking system.

The end of this phase of the extension and adaption of the financial system witnessed two sets of financial reforms that resulted in a new era of independent financial development of Malaysia. The first set of reforms included the complete separation of the common financial facilities and institutions with Singapore, and the floating of the ringgit. The second set of reforms were introduced by the Central Bank to protect the national interest and to promote the growth of domestic institutions during the uncertain international monetary environment that existed in early 1973. These reforms included the introduction of non-discrimatory and more liberalised system of exchange and control regulations, termination of the currencies interchangeability arrangements with Singapore and Brunei, the preparation for the foundation of an independent Malaysian stock exchange and a five per cent revaluation of the ringgit.

Bank Negara[3] lists the effects of the reforms, as follows;

1. removed the constraints that jeopardised the development of Malaysian financial institutions;

2. provided the new dimension to the development of the foreign exchange market in Kuala Lumpur and opened opportunities for the commercial banks to expand substantially their foreign exchange operations. In addition, the policy to establish an active and modern international exchange in Kuala Lumpur for the marketing of natural rubber imparted a fresh urgency to develop in the city, efficient and dynamic foreign exchange market. As a result, reputable international foreign exchange and money broking institutions started to operate in Kuala Lumpur in partnership with Malaysian interests. Monthly turnover in the inter-bank market in Kuala Lumpur has since expanded substantially and many commercial banks, which were previously inactive in this area, have become active participants in the market;

3. introduced flexibility and greater efficiency in the process of economic adjustment in Malaysia, in response to the continuing unsettled international monetary conditions;

4. assisted in the maintenance of the value of the ringgit broadly stable in terms of the currencies of the country's major trading partners, in order to facilitate the orderly growth of financial institutions;

5. contributed significantly to the task of combating inflation; and

6. provided a further degree of economic independence to Malaysia and created new horizons for more effective implementation of monetary and fiscal policies.

Following the reforms that led to the new foreign exchange control arrangements and the floating of the Malaysian dollar, commercial banks consolidated their positions concerning the opportunities created by the development of a foreign exchange market in Kuala Lumpur. This resulted in international money-brokers establishing, by joint-venture, six money broking firms in Kuala Lumpur. This period was characterised by the Central Bank, renamed Bank Negara, introducing new legislation and gaining new controls which it used to help the Government pursue the aims of the NEP. Its operations were still guided by the supply-leading philosphy, however, demand-following linkages, especially with regard to the commercial banking sector in terms of foreign-exchange operations became apparent.

3.2.4 Financial Deepening (1979-today)

This period witnessed significant developments in both the breadth and depth of financial instruments. In the 1979 budget, bankers acceptances (BAs) and negotiable certificates of deposit (NCDs) were introduced not only to develop the money market but also to raise the efficiency of the market mobilization of savings. A BA is a bill of exchange drawn and accepted by a financial institution for the purpose of facilitating short-term trade finance for importers, exporters, buyers and suppliers. A NCD is a receipt for a time deposit placed with a commercial bank. Unlike the receipts for ordinary, fixed deposits, the NCD is negotiable.

The initial reception of the NCDs was rather lukewarm, partly because of the conservative attitude of the corporations which still placed more weight on high interest rates rather than liquidity. Hence fixed deposits which pay a higher rate of interest were still preferred to NCDs, while liquidity problems were still left to be resolved in the traditional manner by getting an overdraft. Part of the problem was the lack of a secondary market for NCDs, so that discounting the NCD on a tight secondary market was liable to be even more expensive than an overdraft. Fluctuating interest rates further aggravated the situation since in a period of high interest rates the holder might be forced to sell the NCDs at a loss.

In contrast, BAs were doing quite well in the primary market, especially those drawn for thirty days, the cost of borrowing of which could be below the prime rate. The Central Bank also offers a lender of last resort facility for BAs. Since Central Bank regulations require that the BAs must be discounted at least once on the secondary market before it qualifies for rediscounting with the Central Bank, the BAs had an active secondary market, compared to the NCDs. To promote more active trading in the secondary market for NCDs, merchant banks with a minimum capital of M$30 million each were given permission to issue their own

NCDs in 1987. This permission was extended in 1990 to finance companies with the same capital base.

The banking institutions have increasingly turned to non-deposit sources of funds to meet their short-term funding needs. The growth in the use of repurchase agreements or repos provides an example. Repo transactions involve the sale of a security with the condition that, after a set period of time, the original seller will buy it back at a predetermined price.

In Malaysia, repos are undertaken mainly in the form of Government securities, banker acceptances and negotiable certificates of deposit, and are used by the banking institutions to ease temporary shortages of funds. Since repo transactions can be for very short as well as predetermined periods, they allow the banking institutions greater flexibility in managing the maturity structure of their assets and liabilities. With the sharp decline in deposit interest rates during 1987, the relatively higher returns on Government securities combined with an increase in the issue of securities by the Government led to a large increase in the amount of repos done by the banking institutions with their customers.

By the end of 1990, total repos, NCDs and BAs issued accounted for about 16 per cent or close to M$28 billion of the total resources mobilized by the banking system. The popularity of these instruments, in particular Repos NCDs, was reflected by their rapid average annual growth rate of 36.1 per cent and 31.7 per cent respectively during the period 1980-90.

A significant landmark in the development of Kuala Lumpur as a financial centre was the establishment in 1980 of the Kuala Lumpur Commodity Exchange (KLCE) to transact futures contracts in crude palm oil as a first step towards the development of an integrated multi-commodity exchange. In 1983, trading in rubber futures was transferred from the Malaysian Rubber Exchange to the KLCE. The KCLE's twin sister, the Kuala Lumpur Tin Market, began operations in 1984 when the tin market was transferred from Penang to Kuala Lumpur. Indonesia and Thailand were allowed to trade their tin upon this market, which was also the only open forum market for physical tin in the world.

In 1979, a government-owned development bank was established named the

Industrial Bank of Malaysia Berhad (Bank Industri Malaysia Berhad). As part of the Government's industrialization policy, this bank was to ensure that long-term financing beyond the normal maximum maturity period of 7-8 years offered by existing fininacial institutions would be readily available at reasonable cost to the private sector for the expansion of productive capacity in capital intensive and high technology industries, as well as for priority sectors in the economy which have long gestation periods. The bank is currently engaged in the provision of financial assistance to the shipping, ship-building and ship-repairing industry as a priority sector.

During the 1980s there was a significant change in the share ownership structure of the banking industry. In this decade, family shareholding diluted and gradually gave way to a much wider participation in the ownership of domestic commercial banks. For the period between 1980 to 1990, the paid-up capital and reserves of the domestic commercial banks as a whole increased six times, from M$1 billion to M$6 billion, to support the rapidly growing volume of business without breaching minimum capital standards. Total assets of the domestic commercial banks increased about five times from M$20 billion to M$98 billion during this period. Many growth orientated domestic banks could not afford to remain as family concerns because of the massive capital that was required to sustain their expansionary strategies. Inevitably, most of the banking institutions had to source their capital infusion from institutional investors through private placement or from the capital market through public listing.

As at the end of 1990, only a handful of the domestic banks had a family structure intact. Eight commercial banks are now listed on the stock exchange. The legal limit on the maximum shareholding in licensed financial institutions (10 per cent for individuals and 20 per cent for non-individuals) introduced in 1986 will ensure that the trend towards a more widespread share-ownership structure will not be reversed. Increasingly, banks are managed by independent, "professional bankers," and made accountable to a diverse group of shareholders. The internal checks and balances within each banking institution are now much more evident than in the early years when most banks were largely dominated by a single shareholder or groups of individuals acting in concert. A diverse group of shareholders also intensify the pressure on bank management to generate an adequate return on equity since dividend is the only form of compensation receive by the shareholders.

The shareholding structure of the banking sector was further reformed following the 1985-86 recession. The resulting shake-out helped to strengthen the shareholding structure of weaker banking institutions, particularly the small and under-capitalised finance companies. The reorganisation and merger of the weaker banking institutions into stronger banking units has enhanced competition and helped improved the overall resilience of the banking sector. Parts of this industry, however, remained under-financed and faced insolvency.

In 1989 the Banking and Financial Institutions Act, was passed and gazetted effectively replacing the existing Banking Act, 1973 and the Finance Companies Act, 1969 (the Islamic Banking Act, 1983, however, was not affected). The introduction of this act was in responce to the increasingly complex institutional structure, growing competition and blurring of the lines of business between the three traditional financial institutions (the banks, the finance companies and merchant banks). The act is intended to provide for an intregrated supervision of the Malaysian financial system, and to modernise and streamline the laws relating to banking and other financial institutions.

Another aim of this legislation was to attempt to strengthen the country's financial institutions through encouraging the infusion of fresh capital. Such injections of capital were and are needed by a few banks and finance companies to remain solvent. It was hoped that such capital would be provided from the foreign sector. Such capital, however, particularly from foreign sources has yet to appear. Some bankers feel that this legislation has been more of a handicap than a help. It limits equity stakes, whether foreign or local, to 20 per cent in each financial institution. The Central Bank also issued an edict allowing each institution one foreign partner. For example, in the merchant banking sector, ten merchant banks have 22 foreign partners, meaning that 12 foreign partners must go. With the increasingly institutional complexity of financial groups there is confusion regarding whether these edicts refer to a particular institution or the group as a whole. The new law also gives the 16 foreign bank in Malaysia until 1994 to exchange their existing licenses for a new form of operation in which they will have to incorporate locally. No change is required to their shareholding structure, under which the foreign parent can keep control. All this confusion concerning this legislation, however, is not conducive to generate fresh capital injections.

In 1990 the Government launched the Federal Territory of Labuan as an international offshore financial centre (IOFC) as part of its long-term plan to further enhance Malaysia as an investment centre. The Government has designed an attractive legislative and tax package to provide for a conducive regulatory and tax environment and to act as the catalyst for the take-off of Labuan as a viable IOFC. As an IOFC, Labuan is intended to complement the onshore financial system centred in Kuala Lumpur and to enhance the contribution of the financial sector to the Gross Domestic Product.

This decade saw extensive development of the money market and institutional changes in the form of ownership structure. Bank Negara, relaxed many legislatative controls. It still followed a supply-leading policy in such specific areas such as the establishment of the OIFC, the commodity market and industrial bank.

3.3 Sources and Use of Funds of the Malaysian Banking Sector

The sources of funds of the banking system have shifted in favour of higher yielding and more flexible instruments. The traditional sources of funds of the banking system i.e. current, savings and fixed accounts, have declined as a proportion from 76.2 per cent in 1970 to only 53.0 per cent today. Indeed, since 1980, the average annual growth rate of traditional deposits decelerated to 12.5 per cent compared to 22.7 per cent over the 1971-80 period. The decline reflected increasing substitution to new financial instruments, namely Repos, NCDs and BAs. Nevertheless, the traditional deposits remained the principal source of funds.

Among the different types of deposits, demand deposits declined to account for 15.8 per cent of the total deposits mobilized. The shift in preference to interest-earning instruments such as savings and fixed deposits has been attributed as the reason for this decline. The bulk of the deposits mobilized was in the form of fixed deposits, which accounted for 68 per cent of the total deposits mobilized at the end of 1990, while savings deposits accounted for 16.2 per cent. The commercial banks remained the largest mobilizer of funds accounting for 65 per cent of total funds mobilized. Business enterprises and individuals were the main depositors, accounting for about 44 per cent and 26 per cent of the total deposits at the end of 1990.

Table 3.1: Banking System: Sources and Uses of Funds

As at the end of	1960	1970	1980	1990	1970	1980	1990
Sources:							
Traditional Deposits of which:	941.1	3811.6	29382.4	95240.4	15.0	22.7	12.5
Fixed	352.1	2130.6	19503.3	64749.9	19.7	19.7	24.8
Demand	476.5	1068.1	5326.3	15024.8	8.4	17.4	10.9
Savings	112.5	612.9	4552.8	15024.8	18.5	22.2	13.0
NCDs issued	-	-	931.1	14653.1	-	-	31.7
Repos	-	-	458.3	10007.7	-	-	36.7
BAs	-	-	932.2	3003.7	-	-	12.4
Uses							
Loans of which	510.4	2616.1	26115.8	114046.1	17.8	25.8	15.9
Overdrafts	463.6	1917.0	12088.8	25672.8	15.3	20.2	7.8
Term loans	-	415.0	11078.4	68933.3	-	38.9	20.1
NCDs held	-	-	235.7	6283.1	-	-	38.9
Government securities	57.3	297.3	2819.0	10592.4	17.9	25.2	14.2
BAs	-	-	302.8	1784.7	-	-	19.4
Total Resources	1231.9	5002.3	39421.9	179717.0	15.0	22.9	16.4

Bank Negara, Treasury and Dept. of Statistics

Following the structural changes experienced by the economy and the active encouragement of the Central Bank though policy changes, the nature of the credit market has been transformed as the banking institutions responded to the growing and varying needs for financing under changing circumstances. As a result, the uses of funds also changed. Substantial resources mobilized by the banking system were channeled to two main areas, namely, loans and advances, and investment in public and private securities.

The period 1970-90 saw a significant change in the direction of lending. With rapid economic diversification away from the traditional agricultural and trade sectors, loans for manufacturing activities and for building and construction accelerated. In particular, Total credit extended by the banking system to support the growth of the manufacturing sector rose at an average rate of 20.9 per cent over the period 1971-90 to amount to M$21 billion or 18.9 per cent of total loans and advances at the end of 1990, compared with M$481 million at the end of 1970. Likewise, the loans to finance activities in building and construction, including the development of real estate, rose at an average rate of 24.9 per cent during the same period to account for 18.5 per cent of total loans at the end of 1990, compared with 9.4 per cent at the end of 1970. This reflects the rapid development of commercial and industrial property in the late 1970s and early 1980s. In contrast, loans to agricultural sector constituted 4.9 per cent of total loans and advances at the end of 1990, as compared with 11 per cent at the end of 1970. Credit for general commerce also declined, from 22.9 per cent of total loans to 11.9 per cent during the same period.

The onset of securitisation also played a significant role in changing the structure of the banking system. Credit flows changed from traditional lending to holdings in marketable instruments. Consequently, financial markets for short-term instruments expanded substantially over the years. Holdings of Treasury bills by the banking system, for example, rose from M$545 million at the end of 1970 to M$2816 million at the end of 1990 or an increase of 8.8 per cent per annum during the 1970-90 period. Similarly, the market for Malaysian Government securities (MGS) also expanded rapidly with an average annual growth rate of 14.2 per cent over the same period. In addition, the new markets for BAs and NCDs have emerged since the late 1970s. The banking system's holdings of these securities increased from M$539 million at the end of 1980 to M$8060 million at the end of 1990, an increasee of 31.1 per cent per annum. The 1980s also saw the emergence of mortgage bonds and the private debt securities. The holdings in Cagamas bonds by the banking institutions increased steadily to 53.1 per cent of total Cagamas bonds by the end of 1990.

Table 3.2: Banking System: Investments

Year	1960	1970	1980	1990
	$ million			
NCDs held	-	-	235.7	6283.1
Commercial banks	-	-	155.1	4187.2
Merchant banks	-	-	15.5	917.9
Finance companies	-	-	65.1	1178.0
Treasury bills	33.9	545.2	1215.9	2815.7
Commercial banks	33.9	535.7	1205.9	2479.8
Merchant banks	-	-	-	55.3
Finance companies	-	9.5	10.0	280.6
Government securities	57.3	297.3	2819.0	10592.2
Commercial banks	57.3	297.3	2452.2	8345.2
Merchant banks	-	-	161.5	842.6
Finance companies	-	-	205.3	1404.4
Cagamas bonds				1943.7
Commercial	-	-	-	800.5
Merchant banks	-	-	-	680.6
Finance companies	-	-	-	462.6

Source: Bank Negara, Dept. of Statistics

3.4 Financial Development

This final section seeks to demonstrate the extent of Malaysia's financial sophistication at both the time of Bank Islam's establishment in 1983 and today. There are two main reasons why this is important. One, is that Bank Islam's performance in a developed financial market can be better appreciated. This may indicate Islamic banking's potential in other financially developed countries. The second reason, which is quite important in the context of this study, is that any impact Bank Islam has made upon the financial development of Malaysia, will be marginal in quantitative terms as the system was already very well developed before the advent of Islamic banking.

To indicate the importance and sophistication of the financial sector within the economy, the concept of financial deepening is used. This concept has been referred to by Shaw[4] as the utilization of money and financial instruments in the development or modernization process relative to real output. That is, so long as the accumulation of financial assets takes place at a faster rate than the accumulation of non-financial wealth, there is evidence of financial deepening in the economy.

There are many numerous measures of monetization and financial deepening (See Goldsmith and Shaw[5]), but it suffices to examine few in this study. Indicators of the degree of monetization include the ratio of money supply (M1 and M2) to GNP, and the per capita M2 and per capita deposits of the economy. The computation of the ratio of the total assets of the financial system GNP, both in stock and flow concepts, gives a broad measure of the development of the financial superstructure of the economy.

In 1983, Bank Negara conducted a study examining the level of economic development of Malaysia with relation to other members in the ASEAN. It is helpful to examine this study as it shows the comparitive level of financial development existing within Malaysia when Bank Islam was formed. The table below (reproduced from Bank Negara[6] study) summarises the development of monetization and financial deepening in Malaysia and the other ASEAN countries during the period 1965-82. Financial development in Malaysia had been significant. During this period, with the exception of Singapore, Malaysia had performed much better than any of her other ASEAN partners. As witnessed in other ASEAN countries, M2 had increased more significantly than M1, reflected in the rise of the M2/GNP ratio from 0.28 to 0.64 during 1965-82. The degree of monetization in Malaysia is also reflected by the holdings of M2 per capita and total bank deposits, which rose from US$86 to US$1,091 and from US$61 to US$958 respectively between 1965 and 1982 during the same period.

The process of deepening in the Malaysian financial system can be seen in the relationship between the total assets of the financial system and the nation's GNP. The ratio of the financial assets to GNP rose from 0.76 in 1965 to 1.80 in 1982. Although this is second only to Singapore in the ASEAN region, there remains a wide gap between the financial development in the two nations. This reflects the fact that at this time Singapore was relatively (and still is) a major financial centre. The dominance of the banking system (comprising the Central Bank and the commercial banking sector) in the Malaysian financial system is evident, as the banking assets's assets/GNP ratio of 1.06 in 1982 represented almost 60 per cent

Table 3.3:
ASEAN: Selected Measures of Monetization and Financial Deepening, 1965-82

	Indonesia			Malaysia			Philippines			Singapore			Thailand		
Year	1965	1975	1982	1965	1975	1982	1965	1975	1982	1965	1975	1982	1965	1975	1982
M1/GNP	0.11	0.11	0.12	0.18	0.20	0.21	0.11	0.09	0.07	0.30	0.26	0.26	0.15	0.12	0.10
M2/GNP	0.11	0.17	0.21	0.28	0.46	0.64	0.21	0.17	0.23	0.56	0.62	0.73	0.25	0.35	0.44
M2/M1	1.00	1.60	1.72	1.61	2.29	3.02	1.85	1.87	3.35	1.87	2.35	2.8	1.61	2.97	4.64
Currency/M1	0.73	0.49	0.41	0.56	0.51	0.46	0.57	0.46	0.54	0.51	0.47	0.49	0.63	0.78	0.79
M1 per capita income (US$)	-	36	121	86	349	1091	39	62	182	285	1530	4312	32	121	325
Per capita deposits	-	26	89	61	283	958	34	61	169	211	1426	4510	21	101	288
Total financial assets/GNP	0.20	0.43	0.55	0.76	1.23	1.80	0.64	1.07	1.30	0.86	0.46	2.74	0.49	0.65	0.95
Assets/GNP															
Central bank	0.13	0.19	0.24	0.04	0.22	0.23	0.13	0.23	0.27	0.14	0.21	0.27	0.22	0.19	0.21
Commercial banks	0.07	0.22	0.24	0.26	0.50	0.83	0.29	0.43	0.48	0.81	1.08	1.56	0.22	0.39	0.53
Total banking system	0.20	0.41	0.46	0.30	0.72	1.06	0.42	0.66	0.75	1.08	1.29	1.83	0.44	0.58	0.74
Net Issues Ratio															
Financial system		0.55			1.86			1.41			2.87			1.00	
of which: Central bank		0.24			0.26			0.30			0.28			0.21	
Commercial banks		0.24			0.90			0.51			1.62			0.56	
Income elasticity of net issues															
Financial system		1.11			1.43			1.40			1.48			1.32	
of which: Central bank		1.11			1.85			1.42			1.39			0.99	
Commercial banks		1.23			1.58			1.29			1.27			1.42	
Total banking sector		1.16			1.62			1.33			1.34			1.26	

Bank Negara, Economics Dept.

of the ratio of 1.80 for the whole financial system. Furthermore, the commercial banks alone accounted for 46 per cent of the total assets of the financial system at the end of 1982.

In addition to the stock concept the financial assets/GNP ratio, the flow concept is another good, if not superior, indicator of financial deepening. The income elasticity of net issues, for example, measures the ratio of the average rate of growth of the total assets of the financial system to the average annual growth of GNP in current prices. An elasticity greater than unity suggests a faster rate of growth of financial assets compared with national income, implying growing financial deepening. The income elasticity of net issues of the system in Malaysia, at 1.43 in nearly two decades of financial development, between 1966-82, was relatively higher than the average of 1.36 for the ASEAN region.

Financial development had already been quite significant up to Bank Islam's establishment in early 1983, especially within the banking sector. Malaysia's lagging behind Singapore, however, in the process of financial deepening, shows that the process of financial deepening was yet incomplete. The area in which Malaysia lacked, however, was not in its commercial banking sector in which Bank Islam joined, but rather in its secondary and capital markets.

As Malaysia has become more developed, and the standard of living has risen, so the monetization process has continued to deepen. Using the ratios M2/GNP, holdings of M2 per capita, and total bank deposits per capita, it can be seen that still with the exception of Singapore, Malaysia has performed relatively better than its ASEAN neighbours. Its M2/GNP ratio rose from 0.64 to 0.71 during the period of 1982-89, compared with lower ratios in Indonesia (0.21 to 0.31) and Phillipines (0.23 to 0.26), while Singapore recorded higher ratios (0.73 to 0.91) and Thailand caught up with Malaysia, with the pace of financial deepening proceeded rapidly (0.44 to 0.72). The lower M2/GNP ratios in Indonesia and Phillipines are mainly due to the slower rate of penetration of the commercial banking sector in these economies.

The degree of monetization in Malaysia is also reflected in the holdings of M2 per capita and total bank deposits per capita which rose from US$1,091 to US$1,600 and from US$958 to US$1,600 respectively between 1982 and 1989. Both of these levels are significantly higher relative to those in the Phillipines, Thailand and Indonesia, although significantly lower than Singapore. This is due to the fact that Singapore is still a major international financial centre.

The growth of near money in Malaysia reflected not only just growing monetization, but also growing sophistication in financial intermediation. New financial instruments were created to satisfy the demand of a more sophisticated population.

3.5 Conclusion

Malaysia's financial development was initially demand-following. Such demand for financial services derived from the needs of trade based on the rubber and tin industries. A consequence of this external orientation was that the financial system failed to reflect the need of the indigenous domestic economy. Independence and the establishment of a central bank heralded a supply-leading policy. Initially restricted by the continued existence of the Currency Board, the Central Bank actively promoted the development and Malayanisation of the financial system. This policy has been conducted right up to today, being characterised by Government-led establishment of financial institutions and instruments, eventually becoming self-supporting and demand-responsive. The establishment of Bank Islam provides a good example of this policy. Even though the financial system was well developed in 1983, the Government assisted in the incorporation of Bank Islam. This development, however, is consistent to the overall Government financial development policy, as the creation of Bank Islam can be regarded as a qualitative rather than a quantative development. The Government is developing the financial system to meet domestic needs, in the case of Bank Islam, Islamic needs. Today, Malaysia's financial system is relatively small but is very developed, especially for the region.

Footnotes

1. World Bank Mission Report 1955 *"op.cit. Money and Banking in Malaysia," Bank Negara*, 1988, p40.

2. Bank Negara, "Money and Banking in Malaysia," *Bank Negara* 1988, p51.

3. Shaw, E. "Financial Deepening in Economic Development." *New York: Oxford University Press*, 1973.

4. Goldsmith, R.W. "Financial Structure and Development." *New Haven: Yale University Press*, 1969.

5. Shaw, op.cit.

6. Imm, Y. C. & Sing, L. C. The Financial System and the Financial Deepening in Malaysia. (*Economics Dept. Bank Negara, Occasional Papers), 1983.*

Chapter IV

Islamic Banking

4.1 Introduction

This chapter examines the theory and practice of Islamic banking. Islamic banks distinguish themselves from the mainstream banks by rejecting the conventional banking practices of charging interest on loans and paying interest on deposits. The chapter is sub-divided into four sections entitled; Brief History of Islamic Banking and 'Islam in Society'; The Banning of Riba; Theory of Islamic Banking and; Islamic Banking in Practice: The Problems. The first section briefly traces the origin and development of Islamic banking and discusses the place of Islam in society and economics. The following section considers the banning of Riba, examining the relevent verses from the Qur'an, discussing the interpretations within their historical perspectives. The third part of the chapter looks at the multi-dimensional nature of an Islamic bank as an Islamic organization and then, by developing a simple model of an Islamic bank, identifies the key advantages and disadvantages of an Islamic system compared to the Western system. This model is further developed into a more realistic and comprehensive model, to show how an Islamic bank can operate other banking activities. Finally, the problems that have emerged with the practice of Islamic banking are compared to Islamic economists theory of what form Islamic banking should take.

4.2 The Origins of Islamic Banking

In recent years, especially since the Iranian revolution in 1979, there has been a general resurgence of fundamental Islamic values in the Muslim world. "Islamic resurgence," is a phrase often used to describe the endeavour to re-establish Islamic values, practices, institutions and laws, indeed Islam in its entirity, in the lives of Muslims today. This phenomena has often been described as, "Islamic revivalism," however, the use of the term, "revivalism," suggests a desire to revive what is antiquated. While this may be true for some parts of the Islamic movement, the movement as a whole emphasises the eternal values that are seen as inherent in the Qur'an and the Sunnah. It is these values which Muslims try to apply to the modern world.

There have been many reasons put forward as to why this resurgence has arisen. Adaptions of western idealogies such as socialism, free enterprise and nationalism have largely failed in the Islamic world. The Islamic resurgence is explained as being the reaction against these western doctorines and the adoption of an indigenous Islamic idealogy to solve the socioeconomic problems faced by Muslim nations. The emphasis of materialism in western idealogies as opposed to the spiritualist nature embodied in Islam has also been presented as another reason for why there has been a rejection of western concepts and a return to Islamic solutions. At an individual level, the abstract nature of western-orientated education, which has been introduced in many Muslim nations, has been rejected by those Muslims accustomed to the absolute certainties of Islamic teaching. The growth of communication technology has led to the diffusion of Islamic philosphies and ideas throughout the Islamic world, enabling Muslims to formulate their own opinions upon an Islamic viewpoint. The massive wealth generated from oil-revenue has given many Muslim nations (previously colonies or protectorates), renewed confidence and independence from the west, not only in the economic and political sphere, but also from a philosphical viewpoint. It is still premature to judge whether the Islamic resurgence is a permanent or temporary revolution, however, it has already influenced attitudes and government policies in many Muslim nations, which will no doubt remain.

A feature of Islamic tradition that has a distinct concept, is that Islam is a complete, comprehensive way of life. Society is not secular, but rather, religion is an integral, organic relationship with politics, economics and society. This Islamic view is reflected in the development of the Shari'ah, a comprehensive law, incorporating a Muslim's duties to God (worship, fasting, pilgrimage) and duties to one's fellow man (family, commercial and criminal laws). This Islamic tradition, therefore, establishes a normative system in which religion is of major significance in all aspects of a Muslim's life whether political, economic, legal, educational or within the family, as Major Ghaffer states;

> "Islam is not a religion, it is a social system, a composite code, a civilization of which religion is a part."[1]

A novel aspect of Islam compared to other major religions is that it prescribes fundamental tenets for an economic system. The basics of this system are covered in the Qur'an and the Sunnahs (the example of the prophet Mohammad through personal actions, sayings or those approved by the prophet), the Ijime (Muslim consensus among the mujtahids, religious scholars), and the Qiyas (interpretations based upon analogy, precedent and religious doctorines). Islam specifically covers economic aspects such as interest, inheritance, private ownership, taxation, government expenditure, land tenure, natural resources, social and economic welfare (distribution of income, poverty etc.) and wage rates, as well as other factors. All of these economic components are an integral part of Islam. "Islamic Economics," as such, constitutes a distinct alternative approach compared to laissez-faire Capitalism or Market Socialism.

Islamic banking is seen to be an important tool in the initial stages of developing an Islamic economy. Islamic banks distinguish themselves from the mainstream of banks by rejecting the conventional banking practices of charging interest on loans and paying interest on deposits. This is because Islamic law specifically forbids riba(interest) or usury. In a world system dominated by western free-market capitalist principles, it is difficult for an individual nation to isolate its economy, a process necessary for the immediate introduction of Islamic principles. Iran has attempted to do this and has encountered considerable problems. Pakistan, however, has followed a gradual policy, a significant part of which was the initial establishment of a purely Islamic financial system. As will be examined in the later part of this chapter, many Islamic economists argue that due to the competitivness of Islamic banks compared to conventional banks, the market process will lead to the development of an Islamic system without government direction. Once an Islamic financial system is established, it will provide the necessary infrastructure for the rest of the economy to follow an Islamic pattern.

An attempt to establish an Islamic bank in a rural area in Pakistan in the late-1950s failed due to a shortage of funds and depositor interference. A partial success was achieved by the Mir Chamer Savings Bank which was established in the agricultural area of the Nile Delta in Egypt in 1962, and eventually this bank was incorporated by the Nasser Social Bank in 1972, becoming a government-supported Islamic bank. Throughout the 1970s a further eleven Islamic banks were established, mainly throughout the Gulf. A period of rapid expansion followed throughout the 1980s leading to the existence of 55 Islamic banks in 1985, with just over a hundred operating today. Islamic banking has now gained a significant foothold of the banking sector in many Muslim countries. For example, Islamic banking obtained 18 per cent of the deposits of the private sector in Sudan, up to 17 per cent in Egypt, 16 per cent in Kuwait, 9 per cent in Jordan and 7 per cent in Bahrain.

This reaction in Islam against western banking has been attributed by some as a market-orientated response to an increasing demand by devout Muslims demanding financial institutions that followed the Shari'ah. This, however, is only a partial explanation; rather the development of Islamic banking can be seen as another facet of Muslim's returning to traditional Islamic values and applying them to create an indigenous modern Islamic society.

4.3 The Banning of Riba

In studying Islamic banking it is important to examine the sources from which the banning of riba is derived. Linquistically, "Riba," means increase or growth. This linquistic meaning, however, has two derivatives stemming from its usuage by Arabic speaking peoples in the Jahilyyah(Pre-Islamic Era: The Era of Ignorance). Riba refers to two types of transaction: Riba al-fadl and riba al-nasi'ah. The former is an uncommon form of riba which was not used that much by the Arabs during Jahillyyah. It refers to the increase generated when a unit of a given good is sold for two or more units of the same or similar goods. This may occur for example, in the case of differing quality, however, it has been prohibited because it might lead to the defrauding or deception of less sophisticated persons. Riba al-nasi'ah, however, is what was commonly known as riba. This refers to the interest component of the loan and also to the payment charged when a given loan is rescheduled. This is the form of riba that was widely practiced in the Jahillyyah and which is relevent to modern-day banking.

Riba al-nasi'ah is composed of interest and the extra payment due to the rescheduling of the loan. In both cases, time is emphasised. A mere deferment of payment beyond the maturity date is supposed to justify interest. Interest itself consists of earnings derived from wealth using the passage of time as a pretext.

Riba is mentioned in four places in the Qur'an with another seven quotes in the Sunnahs. A further six, specifically riba al-nasi'ah related quotes, are also found in the Sunnahs. The quotes from the Qur'an range from being Makruh (an action which is disliked yet not punishable) to being Harem (an action which is absolutely fobidden, and punishable). To increase our understanding of why there has been some confusion in the interpretation of the ban of riba in the Qur'an, each of the four references will be individually examined in their historical order.

There are four places in the Qur'an which refer to an intended ban on usury; In the Surahs; Al Rum, An Nisa', Al Imran and Al Baqara.

The first reference is in the Surah Al Rum, verse 39;

> "That which ye give in usury in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's countenance, hath increase manifold."[2]"

There are several interpretations of this verse. One, that usury itself is not forbidden, but only when it is used for ones own benefit and not Allah's. This interpretation could lead to usury being used, for example, by a government to induce savings for some project for social benefit. Another interpretation is that those who charge usury will not get any credit from God, as it is only for their own benefit and not society's. Finally, the modern accepted reasoning is that this verse should be placed in the context of the other references in the Qur'an as being part of the absolute ban on riba.

The second reference is in the Surah An Nisa', verses 160-161;

> "Because of the wrongdoing of the Jews We forbade them good things which were (before) made lawful unto them, and because of their much hindering from Allah's way,

> And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretences. We have prepared for those of them who disbelieve a painful doom."[3]

The meaning of this passage cannot be understood unless it is placed in the historical context in which it was set. At the time of the Muhammad, Jews charged interest only on those who were not of the Jewish faith i.e. gentiles. This practice was in accordance to their interpretation of the Bible citing as their evidence;

> Deuteronomy:23-19: "Thou shalt not lend upon usury to thy brother; usury of money, usury of virtuals, usury of anything that is lent upon usury;
>
> 20: Unto a stranger thou mayest lend upon usury; but unto a brother thou shalt not lend upon usury; that the Lord thy God may bless thee in all that thou settest thine hand to in the hand whither thouest guest to possess it."[4]

Muslim scholars, however, point to another verse in the Bible which they say bans usury outright, regardless as to whether it is applied to brother or stranger:

> Ezekiel:18-8: "he that hath not given forth upon usury, neither hath taken any increase, that hath withdrawn his hand from iniquity, usury hath executed true judgement between man and man."[5]

Muslim scholars emphasise the phrase, "man and man," as this means all men regardless to whether they are brothers or not. Therefore, in following the argument, the Jews by misinterpretation, "wrongdoing of Jews... hindering from Allah's way," renders them liable for punishment. Therefore, by using the misinterpretation of the Jews as an example, the Qur'an sets out to clarify and emphasise what God had already revealed in an earlier religious text, the Bible.

The third reference is in the Surah Al Imran, verse 130;

> "O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful."[6]

Interpreters are generally agreed that the expression, "multiples," is not to restrict the ban, but to express it in the way usury was then used in practice. There are other interpreters who say that this verse refers only to excessive, or multiples, of usury.

And finally, the most comprehensive ban can be found in Surah Al Bagara, verses 275-276 and 278-279.

> "Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is like usury; whereas Allah permitteth trading and fobiddeth usury. He unto whom an admonition from the Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returnith (to usury)-Such are the rightful owners of Fire. They will abide therein.
>
> Allah has blighted usury and made almsgiving fruitful. Allah loveth not the impious and guilty.
>
> O ye who belive! Observe your duty to Allah, and give up what remaineth (due to you) from usury, if ye are (in truth) belivers.
>
> And if ye do not, then be warned of war (against you), from Allah and His messenger. And if ye repent, then ye have your principal (without interest). Wrong not, and ye shall not be wronged."[7]

This final quote provides a comprehensive and unambigious ban upon usury. The sentence, "And if ye repent, then ye have your principal." implies that any increase above the amount lent is regarded as riba and therefore, unlawful i.e. usury does not just apply to excessive interest.

It has also been argued that this could be interpreted to refer only to consumer loans. This is not supported by historical evidence, however, as the lending for production purposes was quite common at the time of the prophet Muhammad.

There are three main reasons given by some Muslim scholars as to why riba is prohibited in Islam: Firstly, interest and/or usury increases the tendency to direct wealth into the control of the few, i.e. those with the collateral to secure the loan tend to be the ones with wealth in the first place and those who benefit from giving the loan tend to be those with capital to spare, again the wealthy; secondly, Islam does not allow gain from economic activity unless it is also subject to a risk. (the legal guarantee of at least nominal interest would be viewed as a sure gain); and thirdly, in Islam, wealth should be accumulated through personal activity and hard work as opposed to the selfish motive of getting the highest possible interest.

The importance of the ban on riba in the Islamic religion can be further highlighted by the following quotes found in the Sunnahs, from Abdallah Ibn Hanzalah: The Prophet said,

> "A dirham of riba which a man receives knowing is worse than committing adultery thirty-six times."[8]

and from Abu Hurayrah: The Prophet said:

> "Riba has seventy segments, the least serious being equivalent to a man committing adultry with his own mother."[9]

Riba is not just a crime in Islam. It is a sin.

4.4 The Theory of Islamic Banking

Before the operation of Islamic banking is examined it is important to analyse the conceptual framework developed by Dr. Sayed Al-Hawary[10], in which he identified five multi-dimensional aspects of an Islamic bank.

1. Its Ideological Nature,
2. The Investment-profit-sharing Nature,
3. The Developmental Nature,
4. The Positive Nature; and
5. The Social Nature.

1) The Ideological Nature. The key to such an ideological nature is God. Islamic banks are restricted in their operations by moral as well as by economic limitations. The objective of an Islamic bank is not just that of profit-maximisation,

but rather of social-benefit- maximisation. This objective is derived from the principle of a socially-orientated function of wealth. An Islamic bank should structure itself to serve the community along the lines prescribed by moral values from the teachings of Islam. For example, an Islamic bank cannot finance a gambling casino, breweries or public houses even though it may be profitable to do so, as it is contrary to Islamic precepts.

2) The Investment-profit-sharing Nature. This concept will be developed further in this chapter, but, it is suffice to say at this point that this refers to the commercial nature of the bank as a function of a profit-making organization.

3) The Developmental Nature. The word, "Development," is often only applied in an economic sense. An Islamic bank, being based in Islamic ideology, has a committment to help the total development of the community. This can take the form of free advice to firms, individuals or governments to help them strive towards and develop a true Islamic financial system and economy.

4) The Positive Nature. The investment-profit-sharing and developmental natures of Islamic banks places them not in the role of a, "passive," financier i.e. waiting for entrepreneurs to come and ask for funds, rather, it should be positive in actively searching for investment opportunities to fufil its function not only as a profit-making institution, but as a social-maximising organization. It is against Islamic law for wealth to be hoarded. It is a social as well as a commercial function to see that wealth is put to use in the economy.

5) The Social Nature. Hoarding wealth is a crime in Islam and the social nature of the bank refers to this concept. In using a profit/loss principle, the bank plays its part in sharing wealth throughout society. The returns on deposits can be seen, in the case of high profits, as a way to equalise income distributions. Also as demand accounts do not have interest paid on them, the bank can use this source of funds to lend, free of charge after transaction cost, to the poorer and more unfortunate members of society or else for developmental purposes as discussed above.

The prohibition of interest according to the Shari'ah need not exclude the useful role of financial intermediation by a banking system. An Islamic alternative can still provide the functions of mobilizing and allocating funds from numerous savers and channeling them to investors. It has been argued by some Islamic economists that such an Islamic system can lead to a more socially efficient allocation of resources than the conventional Western banking system.

When Islamic economists initially developed a model for Islamic banking, they proposed that commercial banking in Islam should be based upon the two financial instruments of, "Mudarabah," and to a limited extent "Musharakah."

1. Musharakah, can be compared to the Western practice of partnership. A number of investors (including a bank), can hold an equity stake in a given venture and share any profit or loss derived from this venture according to the size of their equity stake. A management fee may be charged by the entrepreneur for managing the venture, before the profits/losses are allocated.

2. Mudarabah, is also a form of partnership. The difference being in that the bank provides all the necessary capital in return for a share in the profits. Being the sole provider of the capital, however, will result in the bank being the sole bearer of any financial loss. The entrepreneur in such a loss situation would only suffer the loss of the opportunity cost of his labour. This mudarabah form of contract can be applied to the saver-bank relationship. The bank shares its profits according to a predetermined ratio with the return upon deposits.

A simple Islamic model can be developed from this two-tiered mudarabah relationship. Siddiqi[12], a leading Islamic economist, describes such a model;

> "A bank is organised as a joint stock company with the shareholders supplying the initial capital. It is managed by the shareholders through their representatives on the board of directors. Its main business is to obtain funds from the public on the basis of mudarabah and to supply funds to businessmen on the same basis and that of musharakah. Its gross income comprises the share in the actual profits of the fund users, in accordance with an agreed ratio profit-sharing. This income, after deducting for expenses incurred in managing the funds, is distributed

pro-rata on share capital as well as deposits. The bank retains, in favour of its shareholders, a part of the profits accruing to deposits in accordance with the predetermined profit-sharing ratio."

The basic Islamic model can help us identify the key differences between Islamic banks and the conventional interest-based Western banks. Consider the three agents involved in the financial intermediation process i.e. Entrepreneur, bank and depositor(saver):-

Entrepreneur. Under the Western system any capital borrowed is repaid with a fixed rate of return determined by the interest rate. In the Islamic system, there is only an obligation to pay back the principal and a predetermined share of a profit, if profits are made. There is a an incentive in both systems for the entrepreneur to make as much profit as possible. The difference in the Islamic method, however, is that with the burden of financial risk falling upon the bank the entrepreneur will be more willing to undertake the riskier, innovative and promising investments.

Bank. For an Islamic bank there is only an obligation to pay a return on the deposits if the bank itself makes a profit. In an interest-based bank, depositors have claims to returns on their deposits regardless of the bank's profitability. When the bank fails to make a profit due to default or bankruptcy of countries or organizations in which the funds are invested, dis-equilibria will exist between the assets and liabilities of the bank. If this situation is serious and a bank itself becomes bankrupt, it may lead to a lack of confidence in the banking system as a whole resulting in a banking crises. For the Islamic bank, however, there will always be equilibrium between assets and liabilities as the latter is automatically adjusted by the former. The key factor in any investment decision is risk. For an interest-based bank this risk is applied to the probability in having the initial capital invested and the fixed interest determined return, being recovered. This is not primarily a function of the risk of the venture to which the capital is invested, but rather the ability of the company to repay. This ability for the company to repay will itself be a function of the size of existing company assets and how well established the company is in the market. In the profit-sharing-based system the bank has no collateral on which to secure the loan. The return and risk is soley determined by the performance of the project to be financed. Therefore, funds will be invested efficiently according to the soundness and potential of the project rather than the security offered by a large established firm. This profit-sharing method does, however, have the disadvantage of cost. It is more difficult to properly evaluate the risk and return of a given investment and is therefore more expensive, than compared to evaluating the size of a company's assets and its risk.

Depositor(saver). Through the two-tier method of mudarabah, deposits will be an actual function of the returns in the production sector. These deposits will therefore have their values vis-à via' inflation protected as interest rates notoriously lag behind the rate of inflation whereas the average rate of profit in the economy does not. It is unlikely in a normal situation that depositors will make a loss on their deposits as the bank would follow a policy of diversification much the same as a Western bank to avoid this. In fact, with the bank investing according to the return of the project, depositors are more likely to gain a higher return as the bank is likely to make a higher profit.

A major advantage of Islamic banking that is not immediately apparent from analysis of the simple model is the fact that as an institution that follows the Shari'ah, devout Muslims have an opportunity to invest and save. This will not only mobilize massive amounts of capital within a Muslim country, but will open up investment oportunities to those who previously could only borrow via interest-based loans. This will have a significant impact in the initial stages of establishing an Islamic bank, as Muslims transfer their holdings of wealth from tangible assets such as gold, livestock etc. to financial assets in the form of accounts with an Islamic bank.

In the context of free-market theory, Islamic banking can be seen to remove the artificial institutional factors that restrain the operation of the free market. This distortion is due to the economic agents involved in the intermediation process, not bearing the true cost and benefits of their actions. By not taking into account the true cost and benefits, these agents will effectively price their decisions incorrectly, leading to a sub-optimum outcome in the market as a whole. These cost and benefits are a determinant of risk, from which both the banks and the saver are protected. Therefore, when this risk is allocated among all the players in the financial market (banks, savers and entrepreneurs), correctly priced decisions will lead the market to an efficient outcome.

In the simple model depositors are assumed to pool their savings together in a general savings account which is then invested. This simple model can be developed further to include distinct savings, current and portfolio accounts. A different proportion of the predetermined share of the banks profits can be appropiated to different savings accounts according to different time periods depositors place their capital in the bank. Higher returns would thus be achieved for those who are willing and able to tie-up their funds for longer. Current accounts can be operated in the similar manner as they are in the West, with fixed charges or commission being charged on checking facilities and other services. Finally, an Islamic bank can provide portfolio accounts, where the bank manages an investors' funds on his behalf, in accordance to his risk preference much like unit trusts, again on a fixed or commission basis. In all accounts and services operated by an Islamic bank, profit can be made as long as it does not violate the Shari'ah in using usury.

Not only can this simple model be developed on the depositor side, but also on the relationship between bank and entrepreneur, including the bank's operations in its own right. Such banking services as transfers, foreign-exchange, safekeeping, consultancy etc. do not violate Islamic precepts, and therefore can be marketed on a commission or fee basis. Banks need not restrict themselves to investing in companies directly, but can invest in common stocks and shares, any type of investment as long as returns are not based on interest. The bank can undertake an entrepreneurial role in that through a Musharakah contract it can become a partner in a business operation. In its role as a social organization, a bank can also utilize the funds from the demand accounts to provide limited interest-free loans and overdraft facilities (Quard Hasen), in its role as a social organization. This social function could come under government control whereby the bank onlends these funds for government use in development projects for the greater good. The government could issue certificates whose return would be dependent upon the success of these projects so that the bank will make a profit.

This more complete model of an Islamic bank, compared to the basic model, shows the bank playing a more pronounced entrepreneurial role by selling services, engaging in partnerships and selling financial instruments. As with Western commercial banks, the links with trade and industry still remain largely indirect. Mudarabah-based contracts, however, remain central to the banks operation and returns to the use of the banks funds remain uncertain.

4.5 Islamic Banking in Practice

Before the emergence of Islamic banks in the 1970s the above model indicated how academics envisaged Islamic banking. In practice, however, many banks started to conduct operations using instruments which receive a predetermined return. There are basically three such activities: Murabahah, ijara and bai' Salem.

Murabahah. This is a a trading activity permitted under the Shari'ah. The bank buys goods on a client's behalf and sells them to a client on a mark-up basis, i.e. the cost with an agreed profit margin. The client pays for the good in fixed instalments over the time, with the bank effectively receiving a predetermined return. This, however, is a trading activity in name only as the bank will only agree to buy a good for resale when it has a firm commitment from a client to buy that good at a higher price.

Ijara. A form of leasing. Again the bank acquires a good or more usually a piece of industrial equipment and hires it to the client, charging a fixed price periodically.

Ijara Wa Igtina is a varient upon ijara since it is comparative to hire-purchase in that the user client ultimately acquires ownership of the rented asset by paying its cost in instalment along with the rent(often used as an alternative to mortgaging).

Bai' Salem. Salem is a sale contract in which the price is paid at the time of contracting whereas the delivery of the good takes place at a future date. Though generally applied to agricultural produce, it can also also be applied to industrial goods. Immediate payment of the full price is mandatory for agricultural goods but it is not necessary for manufactured goods. It is permissible for the buyer to sell the goods purchased (which are delivered at a future date) to another party, if he so wishes, through a fresh Salem contract.

So far the development of Islamic banking has been impressive. It has spread throughout the world with banks operating under Islamic principles in 29 countries (excluding Iran and Pakistan). The Islamic Development Bank, an inter-Islamic institution, has a record of continuous growth. All Islamic banks so far have shown profits in their operations and none has failed, however, as will be explained later, they did suffer more than conventional banks during the mid-1980s. There has been continous innovations and extensions to the existing transactions and activities. Against this background, however, there has been the emergence of some significant problems.

As a whole, Islamic financial institutions have been successful in eliminating interest from the financial intermediation process and on the liabilities side in particular, this has been a complete success. On the assets side, however, interest modes of financing have mainly only been replaced by fixed predetermined modes of financing, such as murabahah, ijara and bai' salem. This issue, therefore, warrants close scrutiny.

The main advantages of an interest-free banking system as listed above, compared to an interest-based system stems from the replacement of interest by the Mudarabah form of profit-sharing. These advantages are summarised by Siddiqi[12] as:

1. A fixed charge on capital is unjust since the results of a productive enterprise in which capital is invested is uncertain. It will be just, if capital shares the actual profit of the enterpise.
2. Interest results in a less efficient allocation of resources than profit-sharing. Profit-sharing makes investible funds go to the projects with the highest (expected) profitability, whereas, in the interest-based system, funds go to the most credit-worthy borrowers whose projects may not necessarily be the most profitable.
3. A system based on profit-sharing will be more stable than a system based on fixed charge for capital as the cost of capital in a sharing system automatically adjusts itself to variations of productivity under changing business conditions. Besides preventing business failures, this

flexibilty ensures symmetry between a firm's cash inflows and its payment commitments, enabling the financial system to work smoothly. Furthermore, a shock to the assets position is automatically absorbed on the liabilities side, when both of them are based on profit-sharing. In addition, money creation in a profit-sharing would be based on investment, thus preventing an over-supply of money which is always possible in a system of money creation based on lending.

4. A switch-over from interest to profit-sharing is more conducive to economic growth, as this would increase the supply of risk capital for investment, and as the cost of capital in a sharing system is always below the productivity of capital which the interest-based system fails to ensure.

If in practice Islamic banks adopt alternatives to interest that are themselves predetermined in nature then the above rational will no longer apply. The argument that many Muslim scholars put forward concerning the superiority of Islamic banking will then no longer be relevant.

So why have existing Islamic banks failed to base their operations on a mudarabah mode of financing, preferring, murabahah, ijiara and bai' salem instead?

One argument relates to the possibility of fund users to cheat the bank by failing to report their actual profits. To this argument the axiom can be applied that a businessman can cheat banks some of the time but not all, as in the future the businessman will not have access to the capital markets as they acquire a bad reputation. Financiers will not supply funds to fund-seekers who have failed to report good profits in the past. It must be remembered that with the exceptions of Iran and Pakistan, most Islamic banks operate in a mixed system in which they are the minority. Therefore, those who have cheated could always seek finance from the interest-based system, and one-off defaulters could still gain access to the capital markets.

Considering a mixed financial system, there will be an incentive for those whose ventures that promise an above average return to seek funding via a fixed interest-based loan. Likewise, those who feel that their project is quite risky considering its expected return, will tend to prefer profit-sharing loans. This may result in a mixed environment, with the possibility of Islamic banks profitability being lower than that of conventional banks.

A very significant factor which has already been mentioned, is the cost of evaluating and monitoring a given investment. It costs more to investigate and keep track of a venture over time than it does to establish the creditworthiness of an organization. Also, considering that many Islamic banks are founded in the third world, many of the skills needed for investment analysis are not available. A lot of the Islamic banking staff actually originated in the commercial banking sector rather than the more appropiate investment or merchant banking sectors which are limited or non-existent within less developed countries.

For the above reasons, Islamic banks prefer the use of Islamic financial instruments that allow a predetermined return. If these instruments were not used then Islamic banks operating within a mixed environment would be at a distinct disadvantage.

The dependence upon these financial instruments have been used to explain the poor performance of Islamic banks compared to their conventional counterparts in the mid-1980s. The economic recession in the Gulf led to a cut in imports into the region, and because of the reliance of Islamic banks upon these financial instruments they were more dependent upon short-term financing than most other commercial banks, which resulted in the banks suffering more throughout the recession.

Another problem with profit-sharing finance is that it is difficult to apply to companies who only need funds to support day to day operations, as there is no particular project or development on which to base a profit-sharing calculation. Attempts have been made to link such finance to monthly or yearly profit levels according to the length of the loan, but this method has proved to be less than satisfactory and somewhat artificial. Finally, companies themselves find profit-sharing loans rather inflexible in that funds must be allocated to set investments and cannot be used throughout the firm. This has particular significance to larger enterprises making management even more difficult.

One of the methods Islamic economists believe is that the, "problem," of predetermined financial instruments can be solved by Islamic banking being adopted at a national level. Cheating could be minimized by effective standardised accounting procedures, and through governmental policing in the annual audit, fraud could be prevented. In a sole Islamic-based banking system, defaulters would no longer have any interest-based alternative banks to turn to, if their actions led to a bad reputation. In an Islamic system entrepreneurs would no longer have a choice as to whether they received financing from the Islamic or interest-based system. This would result in the higher profitability for Islamic banks as their financing operations would now cover the high-profit-making ventures. At a national level evaluation cost would still remain high, but will be minimized due to economies of scale (i.e. everyone using the same accounting proceedures, educational establishments producing labour with the appropiate skills etc.), and institutional factors.

With only Iran and Pakistan effectively adopting a national Islamic financial system and with no other country following suit, existing Islamic institutions must adapt to their circumstances. If they decide to continue to rely upon the halal (religiously approved) predetermined modes of financing purely on terms of safety and convenience, profit-sharing is doomed to take a subsidiary role. This may in turn result in the long-term, with the Muslim masses becoming disillusioned with the concept of Islamic banking, leading them to withdraw from the system. As Siddiqi[13] states;

> "One wonders if these institutions will not be undermining their very raison d'etre, thereby eroding their credibility,"

This conclusion by the Islamic economists is quite contentious. The practitioners of Islamic banking i.e. the bankers themselves, are quite virulent in their opposition to this accepted view. They insist that the Islamic economist's version of Islamic banking is a distinct theory only vaguely based upon Islam. All the major mazhabs (Islamic schools of jurisprudence) agree that these predetermined financial instruments are mubah (legitimate). These rulings are based upon the principle sources of the Shari'ah i.e. the Qur'an, Sunnahs, Ijma and Qiyas. How, therefore, can Islamic economist's describe the current practices in Islamic banking as un-Islamic? As this difference between Islamic economists and Islamic bankers refers to the important question of what actually constitutes an Islamic bank? it is important to examine the legal precepts for which the banker's claim supports their case.

Tafsir refers to the interpretations of the Qur'an according to respected Islamic scholars. Abdul Halim Ismail (the Managing Director of Bank Islam) in his paper concerning deferred contracts[14]) uses the works of Tafsir from the scholars Ibn al Arabi[15], Al-Qurtubi[16] and Al-Jassas[17] to prove the legitimacy of predetermined future contracts. The central pillars of the banker's argument rests upon the commercial practices that existed at the time of the Prophet and the context in which Mohammed made his revelations regarding the banning of riba.

In Jahilyyah, and at the time of the Prophet, the commercial contracts that existed and are relevent to Islamic banking, are listed by Ibn al-Arabi, Al-Qurtubi and Al-Jassas as being deferred trading contracts and the practice of extending these contracts beyond their maturity dates. All these writers of Tafsir interpret the above practices in terms of, "Al-Bai," and, "Al-Riba." The term Al-Bai relates to all types of contracts of exchange (including deferred) with Ibn al-Arabi and Al-Qurtubi in their writings specifying this term in the deferred contract context. Al-Riba, however, meaning, "addition," is used to decribe the practice of receiving some form of compensation for extending these deferred contracts beyond maturity date.

Ibn Abbas[18] as a witness to the following Hadith related that when the Prophet arrived in Madinah he found that the people had been practicing forward sales and had said;

> "Anyone who wishes to make forward sale he should do so in a specified measure and a specified weight and for a specified period."

This infers that Mohammad condoned forward sales even specifying the method in which such sales were conducted.

The validity in Islam of deferred contracts is further substantiated when it is considered in what context Mohammed made his final and most damning revelation concerning the banning of riba. Ibn al-Arabi[19] states that the reason for this revelation was to clarify earlier revelation with regard to the various trading practices that existed at this time. When the tribe of Thaqif protested, "how could we refrain from Al-Riba it is similar to Al-Bai?" Mohammed replied with the revelation quoted above[20]. By refering Al-Riba to Al-Bai, Allah emphasis that interest is forbidden, but also implies Al-Bai is not and therefore, as part of Al-Bai, deferred contracts of exchange.

4.6 Conclusion

In the past two decades there has been a general Islamic resurgence. Associated with this resurgence is the attempt by Muslims to apply Islamic concepts to the modern world. The Qur'an specifically bans the use of riba, interest, and as the Western financial system is based on interest Muslims have tried to develop their own form of Islamic banking. Islamic banking in theory is not only characterised by the absence of interest, but also by a profit-sharing form of investment known as mudarabah. Mudarabah refers to the contract whereby one party supplies another party's capital in return for a share in the potential profits.In a theorectical Islamic bank, depositors deposit their funds with the bank on a mudarabah basis and likewise, the bank onlends these funds to clients on a mudarabah contract. Islamic economists argue that Islamic banking is superior to the Western form as it is perceived as just and achieves efficient allocation lending according to viability and potential of an investment rather than to a credit-worthy firm. Islamic banks are inherently stable as deposits automatically adjust to business results and it is more conducive to economic growth. Islamic banking in practice is characterised by the prevalence of fixed-return trading financial instruments which are legal under the Sha'riah. Here lies a contradiction between theory and practice which the economists believe will damage the legitimacy of Islamic banking. The bankers counter this arguement by stating that it is not for mortals to decide why the Allah banned riba, and how can they say the current Islamic banks are only, "interest-free," and not Islamic when their banking operations do not run counter to the Sha'riah? This issue should be resolved among Muslims so that the development of further Islamic banking practices can continued without there being suspicion regarding to their legitimacy.

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16. Ibid., p.6.

17. Ibid., p.6.

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Chapter V

Bank Islam - Structure and Operations

5.1 Introduction

Bank Islam Malaysia Berhad (Bank Islam) was established in July 1983, providing an Islamic alternative to conventional Western banking for Malaysia's eight million Muslims. It was the first true Islamic bank to be established in the South-east Asian region. The Philippine's Government formed the Ammanah Bank in 1973 to cater for the Muslim Mindano region, although as interest is used in its operations it cannot be regarded as a true Islamic bank.

Although more than half of Malaysia's population comprises Muslims and the country's constitution specifies Islam as the state religion, the country's banking system remained dominated by riba institutions until the advent of Bank Islam. Prior to 1983, Muslims had no Islamic alternative except from investing their savings in the Hajj Fund (Pilgrim's Management and Fund Board-PMFB), which operates on an interest-free basis. The PMFB was formed by statute in 1969 to merge the activities of both the Malaysian Muslim Pilgrim's Savings Corporation and the Pilgrims Affairs Department of the Government to mobilize the savings of the Muslims and assist them in performing their pilgrimage. From a modest start in 1963 with 1,281 depositors in the then Pilgrim's Savings Corporation and M\$46,600 in deposits, the PMFB has expanded its operations over the past 27 years, to 1,753,678 persons at the end of 1990, with total resources reaching M\$1,234 million.

In the early 1980s there was considerable pressure placed upon the Government to form an Islamic bank. At the Bumiputra Economic Congress in 1980, and similarly at the, "National Seminar on the Concept of Development in Islam," held at the Universiti Kebangsan Malaysia 1981, resolutions were passed calling on the Government to allow PMFB to organise the establishment of an Islamic bank. Against a political climate in which the fundamental Islamic opposition groups were making gains, it was politically expedient for the Government to be seen as addressing the Islamic agenda. The Government encouraged such Muslim organisations as the Muslim Welfare Organisation, PMFB and the Development Bank of Malaysia to study the various aspects of Islamic banking and the possible implementation in Malaysia. The PMFB prompted the Government to establish a National Steering Committee to co-ordinate these independent studies at a national level. This committee was formed in July 1981 with the following tasks, as outlined by Zakariya Man[1]

1. To study and identify various critical aspects of Islamic banking such as the basis of establishment, areas of operation, and business relationship with the customers and other financial institutions.

2. To examine the suitability of Islamic banking in the Malaysian context from the various points of view including religious, legal, social and developmental angles, and;

3. To present to the Government a proposal to establish an Islamic bank in Malaysia in a complete report encompassing the following aspects; fundamental aspects of an Islamic bank, the legal framework, structure of the company, areas of operation and organizational structure.

The first part of this chapter will follow the outline of the report presented to the government with the exception of the fundamental aspects of an Islamic bank as they have been discussed in the preceeding chapter. The second part will examine Bank Islam's operations.

5.2 The Legal Framework

The legal framework that was established to enable the operations of an Islamic bank within Malaysia was based upon the the following recommendations submitted by the National Steering Committee on the 5th. July 1981[2]

1. An Islamic bank which operates according to the principles of Shari'ah should be established.

2. The bank should be incorporated as a limited company under the Companies Act 1965.

3. An act styled as the Islamic Banking Act, 1983, should be legislated and some consequential amendments should be made to other existing Acts.

4. Bank Negara Malaysia should administer the Islamic Act 1983.

5. The bank should set up a Religious Supervisory Council to ensure that the operations of the bank comply with Shari'ah principles.

The Islamic Banking Act was legislated towards the end of 1982, being gazetted in 1983. The Act was based on the already existing Banking Act, 1973, but with modifications so that an Islamic bank could conduct its operations in compliance to the Shari'ah. As with other financial institutions, supervision and regulatory powers were handled by Bank Negara, the main legal differences are concerning the Religious Supervisory Council, and the liquidity requirements which necessitated the introduction of the Government Investment Act, 1983.

The Islamic Banking Act[2], 1983, states on the licensing of Islamic banks;

> "The Central bank shall not recommend the grant of license, and the Minister shall not grant a license, unless the Central bank or the Minister, as the case may be is satisfied:
>
> > a) ...
> >
> > b) that there is, in the articles of association of the bank concerned, provision for the establishment of a Shari'ah advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam."

Accordingly, Bank Islam's Articles of Association[4] provide that;

> a) "A Religious Supervisory Council, whose members would be made up of Muslim religious scholars in the country, shall be established to advise the company on the operations of its banking business ..."

b) "The Religious Supervisory Council shall have a minimum of three members and maximum of seven members whose appointment shall be acceptable to the Minister for a term not exceeding two years and each member is eligible for reappointment."

The Religious Supervisory Council can be considered as the religious auditor. Its role is to ensure that Bank Islam's business operations comply with the Shari'ah. As a semi-independent body, the policing role of the Council provide Bank Islam with the legitimacy to describe itself as Islamic. The Religious Supervisory Council has overturned operational decisions made by Bank Islam regarding the validity in Islam of some proposed financial instruments. It has therefore demonstrated its independence and regulatory power concerning the Bank's operations.

Before Islamic banking operations could start, a further piece of legislation needed to be enacted in order to facilitate Islamic banks meeting their liquidity and reserve requirements. As the existing short-term financial instruments such as Treasury bills, Government bonds and securities were interest-based, an alternative Islamic financial instrument needed to be developed. Through the Government Investment Act, 1982, passed and gazetted 1983, the Government could issue a non-interest-bearing investment certificate that could be used for liquidity and reserve purposes. These investment certificates were purchased under a Qard Hassen principle, whereby the bank's purchase of investment certificates is regarded as a benevolent loan to the public through the Government. The Government only has a legal obiligation to repay the principle on this loan. At its own discretion the Government can award some form of return. In practice, this return is calculated by the Government Investment Certificate Dividend Committee, which takes economic and financial factors into consideration when determining the size of the loan. The issuance of the non-interest-bearing investment certificates is the first time that any government has introduced an Islamic financial instrument into a mixed financial environment.

The practice in which the Government Investment Certificate Dividend committee calculates a return on the Investment Certificates warrants closer examination. The return is primarily determined according to the growth in the Gross Domestic Product (GDP), however, the committee also takes other financial factors into consideration. As part of these, "financial factors," are the returns on interest-bearing Government papers and the prevailing rate of interest. In taking these factors into consideration the Investment Certificates are tainted with riba, even if only by an indirect route. Although Bank Islam has not broken the letter of the Shari'ah law it clearly breaks the spirit. As long as the return on Investment Certificates are calulated in this manner, then Bank Islam's Islamic credentials are open to question. The Bank together with the Government should examine alternative methods of determining returns. An example for such an alternative could be the linking of returns on Investment Certificates under a mudarabah contract to a specific Government development project. Such a method would be Islamically legal as riba is not involved.

In examining the legal framework which has enabled Islamic banks to meet their liquidity and reserve requirements, it is important to understand the conceptual differences (regarding liquidity and reserves) between the deposits of an Islamic bank and the deposits of a conventional bank. In a conventional bank, all deposits whether in the form of current, savings or investment accounts, represent for the bank, a direct liability to its depositors. This is the same for Islamic banks in the case of current and savings accounts, but investment accounts are not a direct liability. Such investment accounts are based upon the mudarabah contract whereby the bank and depositors agree to share the profits or losses from the investment according to some pre-arranged formula. The bank therefore, has no liability to return the full amount deposited to its depositors; instead the amount to be returned depends on the performance of the investments.

In principle, the degree of liability to the customers in respect of their deposits will be lesser in the case of an Islamic bank as compared to a conventional bank. The extent by which will be lesser depends on the proportion of its deposits in the investment accounts, to its total deposits.

Apart from the restriction on granting of loans which is against the principle of the Shari'ah, Bank Islam is also restricted by the Islamic Banking Act, 1983, under Section 24 from granting advances, loans or credit facilities against the security of its own shares. It cannot grant unsecured advances, unsecured loans or unsecured credit facilities in excess of, in the aggregate and outstanding at any one time, M$10,000 to any corporation which is deemed to be related to the Bank.

Section 25[5] of the Act also provides stringent legislation prohibiting the granting of advances, loans or credit facilities to:-

1. any of its directors, officers or employees or other persons being persons receiving renumeration from it (other accountants, advocates and solicitors, architects, estate agents, doctors and any other persons receiving renumeration from it in respect of their professional services);

2. any firm in which any of its directors, officers or employees is interested as a partner, manager, agent or guarantor;

3. any corporation in which any of its officers or employees is a director, manager, agent or guarantor, or any corporation in the shares of which any of its officers or employees has any material interest as determined by the Central Bank.

4. any corporation in which any of its directors is a member, director, manager, agent or guarantor, or any corporation in the shares of which any such director of the Islamic Bank has any interest whatsoever directly or indirectly; or

5. any individual for whom any of its directors, officers or employees is a guarantor.

The provisions of paragraph four of subsection 25.1 shall not apply to the granting of advances, loans or credit facilities by the Bank to a corporation which is listed on a recognised Stoch Exchage and in the Shares of which director of that Islamic Bank has, directly or indirectly, any material interest as determined by the Central Bank. The provision is also applicable to a public company in which a director of that Islamic Bank has no interest in his personal capacity, as determined by the Central bank. For puposes of the subsection the director concerned is not an executive director of the Islamic Bank.

5.2.1 Supervision by Bank Negara

As recommended by the National Steering Committee report on Islamic Bank licensing and supervision, any Islamic bank should be responsible to Bank Negara as are conventional banks. As required under Section 19 (1) of the Islamic Banking Act, 1983, Bank Islam has to submit the following statistical data to Bank Negara.

1. A statement showing the liabilities and assets of its banking offices and branches in Malaysia at the close of business on the last business day of each month within such period as may be prescribed by notice in writing from time to time by Bank Negara;

2. a statement giving an analysis of loans, advances and investment of its banking offices and branches in Malaysia as at such intervals and within such period as may be prescribed by notive from time to time by Bank Negara;

3. not later than six months after the close of its financial year, a statement showing the income and expenditure in respect of its business in Malaysia;

4. a statement showing such credit information of its customers as is required for the purpose of the credit bureau established under Section 20(1) of the Central Bank of Malaysia Ordinance 1958 at such intervals and within such period as may be prescribed by notive in writing from time to time by Bank Neaga; and

5. any such statistical information as may be requested by Bank Negara.

By the power given to Bank Negara under Section 31 of the Act, Bank Negara shall investigate, under conditions of secrecy, the books, accounts and transactions of Bank Islam at any branch, agency or office. The Financial Minister may at any time direct Bank Negara to do this if there is any reason to suspect operations conducted by the Bank which could be detrimental to the interests of its customers.

The establishment of Bank Islam as Malaysia's only Islamic bank was a continuation of the financial development policy guided by the "supply-leading," philosophy. By restricting the issue of further Islamic licences until 1993, Bank Negara has granted Bank Islam a ten-year monopoly status. The intention of this policy is not only to ensure Bank Islam's success, but that of Islamic banking itself. With the end of Bank Islam's restriction in sight, a few banks have expressed an interest in acquiring Islamic licenses. It is not yet publically known which banks have approached Bank Negara or whether they will receive such government support as Bank Islam, but it can be predicted that Bank Negara will only issue Islamic licenses if there is an adequate demand in the Islamic banking market.

5.3 The Structure of the Bank

The capital structure of the Bank's Shareholder's Fund is made from the following relevent items;

- Paid-up capital.
- Share premium.
- Statutory reserves.
- Retained earnings.

At the establishment of Bank Islam, the bank was allowed an authorised capital of M$500 million, divided into 500 million ordinary shares of M$1 each. The initial paid-up capital with which the bank began its operations, was M$79.9 million, which is just over M$20 million less than the amount recommended by the National Steering Committee.

Not only has the Government pursued its, "supply-leading," policy through a legislative framework providing Bank Islam with a ten-year monopoly, but it has also directly supported the Bank as a major shareholder. At the establishment of Bank Islam, the ownership structure was as follows;

- The Government of Malaysia paid M$30,
- Pilgrim's Management and Fund Board M$10,
- Muslim Welfare Organisation of Malaysia M$5,
- State Religious Councils M$20,

- State Religious Agencies M$3 and
- Federal Agencies M$12

As Bank Islam has grown and established itself as a viable financial institution (being no longer reliant upon Government support), then the Government has decreased its ownership share. As this process has been conducted during a period of general privatisation as the Government attempts to reduce the overall public sector deficit, the decrease in Government ownership in Bank Islam has been incorrectly interpreted as being part of the policy.

Ownership of Bank Islam today, include the Government through the Minister of Finance owning 20 per cent, Jami Company (Joint Arab Malaysian Investment) having 17.5 per cent and the Pilgrim's Management and Fund Board owning 13 per cent. There are two shareholders who have about M$5 million shares each, but the rest are minority shareholders who each have less than five million.

At the end of June 1990, the shareholders' Fund stood at M$92.4 million. The difference between this figure and the establishment figure represents the statutory reserve and retained earnings accumulated since 1983.

Currently, Bank Islam intends to increase this paid-up capital through the Employees' Share Option Scheme (ESOS) which was launch in April 1990 and is intended to continue until 1995. When fully subscribed, ESOS will add roughly M$4 million to Bank Islam's paid-up capital and contribute M$200,000 to the share preminium account.

Given the rapid growth since Bank Islam's establishment it has become necessary to increase the Shareholders' Fund in order for the Bank to meet future expansion of business. Basically, there are three main reasons for this need for an increased Shareholders Fund, namely; to meet the Capital Adequacy Requirement (CAR) as the Bank continues to grow, to inject capital into existing and new subsidiaries and to increase the Bank's credit limit to single customers.

A bank's CAR is a gearing ratio between its Free Capital and Assets that the Bank has to maintain (Free Capital is Shareholders' Fund less Fixed Assets and Investments). The Basle Committee has been in the forefront in the endeavour to promote the convergence of international capital standards. Their efforts culminated in mid-1988 of an agreed framework known populary as the Basle Capital Accord, which is based on the concept of weighting assets according to their perceived level of risk and assesing the adequacy of capital on this risk-adjusted basis. The Committee has set a minimum CAR standard at 8 per cent (of which the core capital element will be at least 4 per cent). This level is to be achieved by the end of 1992. In Malaysia, with the coming into force of the Banking and Financial Institutions Act 1989, the new Basle Committee framework was specified. Prior the introduction of the new capital framework, the commercial banks (including Bank Islam), are required to maintain a minimum 'free' CAR of four per cent. An aspect of the previous CAR was that it ignored the varying risks within the structure of a bank's business. The total consequence of these new legal requirements for Bank Islam is that it needs to increase its capital base.

Bank Islam over the next five years expects to inject capital of M$46 million into existing and new subsidiaries. A M$20 million injection proposed for the Syarikat Al-Ijarah subsidiary comprises of M$5 million for its ordinary expansion of business and M$15 million to enable it to purchase a 60 per cent share in the Tower Block where the Head Office is currently located. The other subsidiary Syarikat Takaful (Islamic insurance) requires an injection of M$5 million as Bank Negara will soon require all insurance companies providing both life (family) and general business cover to be capitalised at M$15-20 million. Bank Islam proposed new subsidiaries in Unit Trusts, Property Trusts and Stockbrokerage. These new subsidiaries are estimated to require M$21 million to cover their set-up costs.

Under Bank Negara's ruling, a Bank's credit limit to any single customer is set at 30 per cent of its shareholders' fund. With the Bank Islam's present Sharholders' Fund amounting to M$89.4 million, its credit limit is at M$26.8 million. As the Bank has grown and offered more facilities and services to the bigger corporate clients (especially within the oil producing sector), it has increasingly found this limit to be a constraint. A much bigger Shareholders' Fund will therefore give the Bank a higher limit and a greater competitive marketing advantage.

With respect to the question of capital adequacy, Bank Islam is seriously considering the possibility of a public floatation. This could bring a number of advantages, particularly if the Bank was quoted on the Kuala Lumpur Stock Exchange. Firstly, the move could generate the much needed permanent capital and effectively divert some of the Bank's long-term deposits into shares. Secondly, exposure to the rigours of market scrutiny would be healthy and stimulating experience. It is not unknown for Islamic banks to be quoted on a stock exchange as in the cases in Egypt and Jordan. Thirdly, such a move would reinforce the concept of Islamic banking. Trading in common stocks is an acceptable economic activity in Islam.

5.4 Areas of Operation

The operations of Bank Islam can be conveniently divided into four areas;

1. Customers' Deposits
2. Project Financing
3. Trade Finance
4. Other Services

5.4.1 Customers' Deposits

The bank accepts deposits from its ordinary customers through three types of accounts namely;

- Current Accounts
- Savings Accounts
- General Investment Accounts

and accepts deposits from corporate and government customers through;

- Special Investment Accounts

The Current Account is operated in the same way as it is operated in the conventional banks. Under the principle of Wadiah (Safekeeping), Bank Islam accepts deposits from its customers who are looking for safe custody of their funds and absolute convenience in their use. With the permission of the customers, the bank uses these funds to finance investments where the return entirely belongs to the bank. Bank Islam provides its customers with cheque books and other normal services associated with current accounts, with the customers having the right to withdraw part or whole of their balances at any time. The minimum amount required to open a current account is M$500.

The Savings Account is again based on the Wadiah principle. As with the Current Account, Bank Islam accepts deposits from its customers who are looking for safe custody, but a relative degree of convenience. They may withdraw a part or whole of their balances at any one time, and again Bank Islam requests permission from the customers so that it can use these funds to generate profits. Unlike the Current Account, however, Bank Islam may at its absolute discretion reward the customers by returning a part of the profit generated from the use of their funds.

The General Investment Accounts are operated on an Mudharabah basis. The bank accepts deposits from its customers who are looking for investment opportunities. Bank Islam accepts these deposits on a fixed-period basis for the following periods; 1 month, 2 months, 6 months, 9 months; 12 months 15 months, 18 months; 24 months, 36 months, and 60 months and over.

In this mudarabah relationship it is the bank acts as the, "entrepreneur," and the depositors as the, "provider of funds," and both agree to share profits generated from investments according to a pre-determined formula. Currently this formula offers a profit-sharing ratio of 30:70 (70 per cent to the depositors and 30 per cent to Bank Islam), however, this ratio may be changed. Note Investment Account returns are weighted according to the length for which deposits are held. In the event of a loss arising from the investment, the depositor bears all the loss. The mangement of the funds is entirely under the supervision of the bank. The minimum amount for this General Investment Account is M$500.

The Special Investment Accounts are similar to the General Investment Accounts in that they operate on a profit-sharing mudarabah basis with the bank acting as entrepreneur and investment manager. These Special Investment Accounts, however, are only offered to corporate and government customers with time-periods, modes of investment and ratios of the distribution of profits, all being individually negotiated.

5.4.2 Project Financing

Bank Islam finances customers' projects or asset aquisitions through the following principles acceptable to the Shari'ah;

- Mudarabah (trustee project financing)
- Musharakah (joint-venture financing)
- Murabahah (cost-plus or mark-up)
- Bai'Bithaman Ajil (deffered Sale)
- Ijara (leasing)
- Bai'al-Takjiri (leasing ending in ownership)
- Qard Hassen (benevolent loan)

Project financing under the principle of mudarabah is similar to the relationship underpinning the General Investment Accounts, however, in this financing arrangement it is the bank that acts as, "the provider of finance," and the client acts as the, "entrepreneur." Likewise, as the, "provider of finance," the Bank cannot interfere in the management of the project, although it may undertake supervision and follow-up roles. Profits generated through the project are shared according to some pre-arranged formula. In the event of losses the bank bears all the loss. 23

In project financing under the principle of Musharakah, the bank undertakes an active role in the management of the project. The bank may provide part or all of the funds and the distribution of profits generated from the project are allocated to some agreed formula, not necessarily reflecting the capital stake. In the event of a loss, all parties bear the loss in proportion to their capital share.

With financing the acquisition of assets under the principles of murabahah, the bank purchases an asset or piece of equipment which it subsequently sells at an agreed profit to the customer who pays at a later date.

Financing the acquisition of assets under the principles of bai'bithaman ajil is similar to murabahah financing. The bank purchases an asset which it subsequently sells at an agreed profit to the customer. The customer, however, can pay by instalments. The period and manner of these payments being negotiated between the customer and the bank.

Financing the use of services or assets under the principle of ijara, the bank purchases an asset which it subsequently leases to the customer for an agreed period and price.

Financing the use of services and subsequent acquisition of assets under the principle of bai ul takjiri is the same as that of ijara. At a specified date, however, the customer purchases the asset from the bank at an agreed price with all the previously paid lease rentals constituting part of such a price.

As a social-organization as discussed in chapter four, Bank Islam has at its disposal a source of capital to which it makes benevolent qard hassen loans to truly deserving customers for worthy economic assistence. The borrower is obliged to repay only the principal amount on the loan, according to its terms and condition. The Shari'ah, however, encourages the borrower to pay anything over and above the principal amount at his own discretion without any demand from the bank.

5.4.3 Trade Finance

Bank Islam offers particular services and/or funds, mainly on a short-term basis for the use of facilitating trade or funding working capital for its customers. These services/funds can be given in connexion with the purchase/import and sale/export of goods and equipment, and the acquisition and holding of stocks and inventories, spares and replacements, and semi-finished goods.

The current services/funding offered, include;

1. The Letter of Credit under;
    - Wadiah
    - Musharakah
    - Murabahah
2. Letter of Guarantee

3. Financing Working Capital under Murabahah

Letter of Credit Under the;

a) Principle of Wadiah The customers specify their requirements when requesting the bank to provide a letter of credit facility. Bank Islam asks customers to place a deposit equaling the value of the goods to be purchased/imported, the bank accepting this deposit under the Wadiah principle. The bank then provides the Letter of Credit and utilising the customer's deposits pays the relevent negotiating bank and subsequently releases the documents to the customer. For this service the customer is charged commission under the principle of ujr-wal-umulah.

b) Principle of Musharakah. The Letter of Credit provided under the principle of Musharakah basically operates in the same manner as under the principle of wadiah in that customers specify their requirements and the same proceedure is followed. The difference, however, is that the customer need only deposit a proportion of the value of the goods being purchased/imported, with the bank utilising its own funds to finance the provision of the Letter of Credit paying the proceeds to the negotiating bank. The customer then takes possession of these goods which it either uses or sells with both the bank and the customer sharing any profits generated from this venture as contractually agreed.

c) Principle of Murabahah. Again as in the provision of the Letter of Credit under the principles of wadiah and musharakah, the customers specify their requirements and request the bank to purchase/import the goods, indicating that they intend to buy the goods from the bank on a murabahah principle. The bank issues the Letter of Credit and pay the proceeds to the negotiating bank utilising its own resources. These goods are then sold by the bank to the customer at a profit under the principle of murabahah or can be paid through deferred payment on a bai'bithaman ajil basis.

2) Letter of Guarantee. Under the principle of kafalah, the bank may provide the facility of a letter of guarantee to its customers for certain purposes. The Letter of Guarantee may be provided in respect of the performance of a task, the settlement of a loan, etc. The customer may be required to place a deposit with

the bank which is accepted under the wadiah principle. The customer is charged a fee for this service.

3) In financing working capital under the principle of murabahah, Bank Islam has attempted to overcome the problem of Islamic banks being unable to offer overdraft facilities. Customers may require banks to finance their working capital to buy stock and inventories, spares and replacements, or semi-finished goods and raw materials. The customer is appointed as the bank's agent to purchase the required goods on its own behalf and the bank pays for these from its own funds. The customer is allowed to buy these good at a deferred date of a term of 30 days, 60 days, 90 days, or any other negotiated duration, with the bank selling at an agreed profit.

The relationship between the sources and application of funds is presented in the diagram overleaf.

5.4.4 Other Banking Services

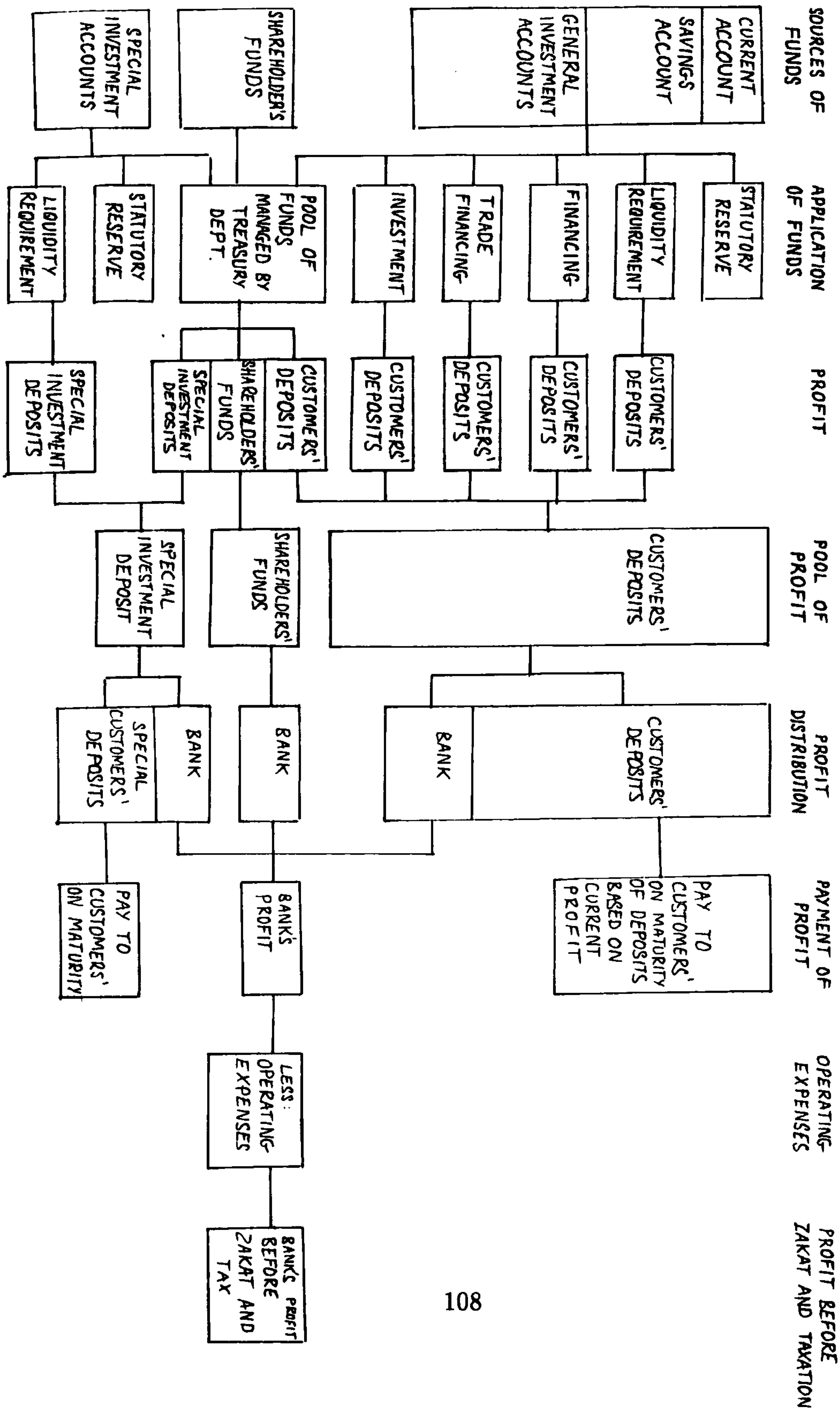
Other banking services are offered by the bank under various rules of Shari'ah which do not dramatically differ from conventional banking practices. Suffice it to mention a few as follows;

- Remittance and Transfers
- Sale and Purchase of Foreign Currency
- Sale of Travellers' Cheques
- Investment/Portfolio Management
- Trustee and Nominee Company Services

5.5 Organizational Structure

The organizational structure as the bank is as depicted in the diagram overleaf. The structure consists of three divisions with line functions (trade, finance, treasury and corporate finance investments) and three divisions with staff functions

**Figure 5.1: Bank Islam
Sources and Application of Funds
and Profit Distribution**



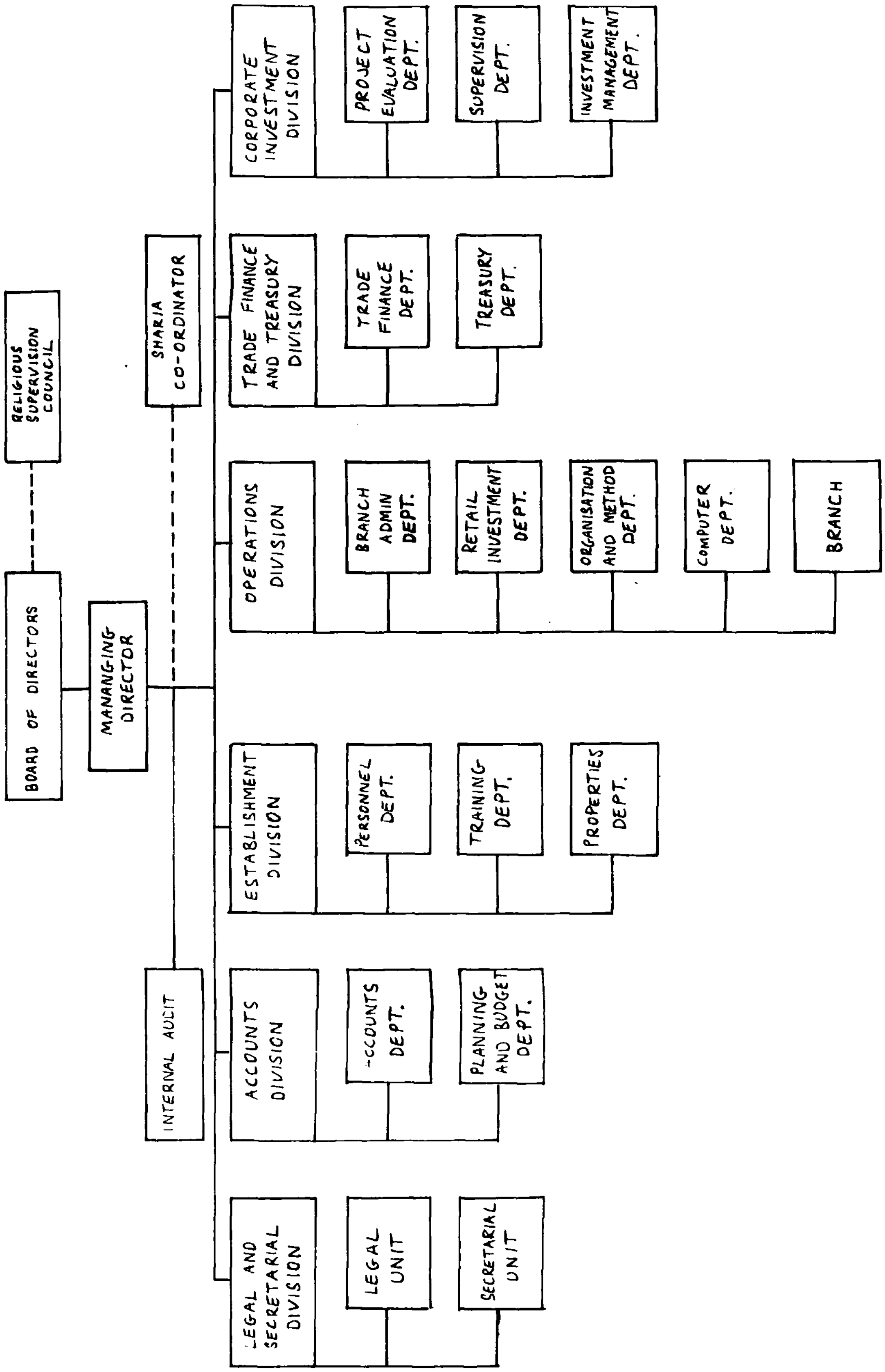
(establishment, accounts, and legal and secretarial). Each division is divided into sub-departments and are further divided as necessary.

5.5.1 Loans Committee

All loans must be approved by the authorised Loans Committee after the appropiate credit assesment has been completed by the Credit or Investment Officer of the Bank. The Approving Authorities are divided into five committees which are resonsible for the deliberation and approval of loans according to the respective amount of loans approved. The following are the list of Loans Committees and the amount of loans which could be approved by them:-

1. **Branch Loans Committee**
    - Clean facilities - up to M$25,000
    - Secured facilities - up to M$250,000
2. **Loans Committee B**
    - Clean facilities - up to M$100,000
    - Secured facilities - up to M$1,000,000
3. **Loans Committee A**
    - Clean facilities - up to M$1,000,000
    - Secured facilities - up to M$5,000,000
4. **Executive Board**
    - Clean facilities - up to M$5,000,000
    - Secured facilities - up to M$25,000,000
5. **Board of Directors**
    - Clean facilities - more than M$5,000,000
    - Secured facilities - more than M$25,000,000

Bank Islam Organization Chart



At the end of 1990, Bank Islam had 27 branches located throughout all fourteen states and Federal territory of Malaysia. Depending on the economic climate, Bank Islam plans to open additional branches at an average rate of three branches a year over the next few years.

5.6 Customer Deposits

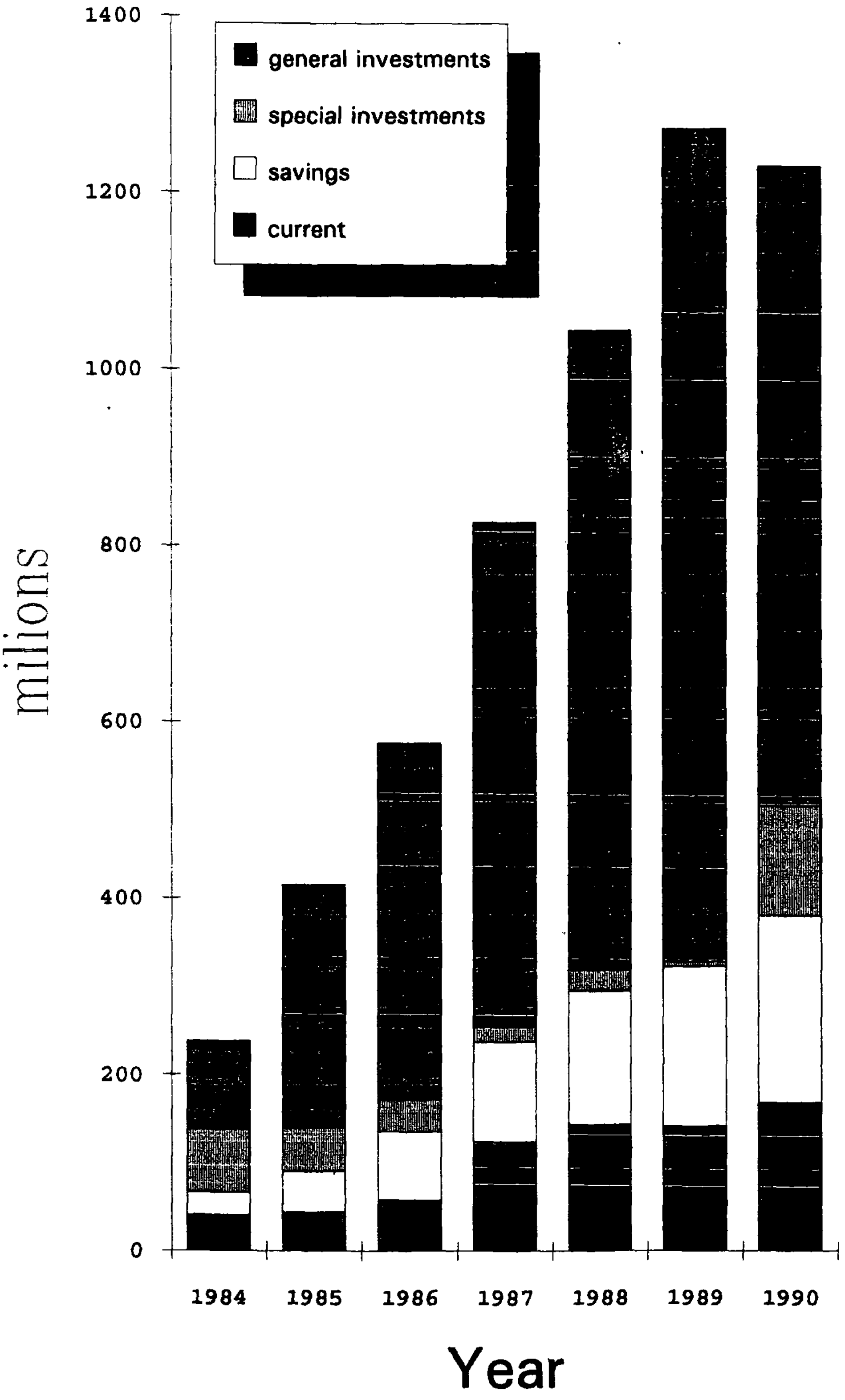
Bank Islam accepts deposits from its customers through Current Account Deposits, Saving Account Deposits and General Investment Account Deposits for periods ranging from a month to five years and over. Deposits from corporate or government customers are accepted through Special Investment Accounts. As at the end of the financial year 1990, total customer deposits amounted to M$1,258.7 million, just over a five-fold increase upon the total deposits which had been mobilized at the end of the bank's first year of operation. This represents an average yearly growth rate of deposits of about 75 per cent since 1984, this compares favourably to the 32 per cent rate achieved during the same period, by the commercial banking sector as a whole.

Bank Islam's deposit structure follows the pattern existing thoughout the industry, with Current, Saving and General Investment (fixed) accounts each constituting 16 per cent, 16 per cent and 68 per cent of total deposits respectively. The graph on the next page depicts the growth and breakdown of deposits since 1984.

The total amount of depositors having Current Accounts, as of June 1990, was 20,371. With these Current Accounts amounting to M$197.4 million, this represents an average account equalling M$970. There are 230,538 depositors operating Saving Accounts, with total deposits being M$212.7 million, this yields an average deposit of M$922. For General Investment accounts the number of depositors is relatively small, being only 19,138, however, with these accounts amounting to M$725.1 million, the average size of an account is M$37,886.

When examining the average yearly growth rates of funds generated through Current Account, Saving Account and General Investment Account Deposits, Bank Islam's performance is slightly lower in terms of Current Account and Saving Account rates. Bank Islam's deposits only grew at 22 per cent and 29 per cent respectively, while the rest of the banking sector achieved the respective rates of

Figure 5.3: Growth and Breakdown of Deposits



23 per cent and 33 per cent. For General Investment Account Deposits, however, Bank Islam had a 89 per cent growth rate, nearly triple the 32 per cent rate witnessed in the rest of the industry.

As the following table demonstrates, the average profit actually paid to depositors on their Saving Account and General Investment Account deposits, has generally been lower than the prevailing rates offered by other commercial banks with the exception of the years 1987 and 1988. Depositors have therefore been willing to use Islamic banking accounts even though they have had lower yields than the industry's norm.

Table 5.1 Bank Islam and Industy's Return Rates

Types of Account	1984		1985		1986		1987		1988		1989		1990	
	BI	Ave	BI	Ave	BI	Ave	BI	Ave	BI	Ave	BI	Ave	BI	Ave
Saving	5.1	7.25	5.3	6	4.8	6	4.1	3.5	3.3	3.5	3.2	3.5	3.4	3.5
Investment														
1	5.7	10	6	7.25	5.4	6	4.7	2	3.7	3	3.6	4.5	4.0	5.5
3	6.0	10.5	6.3	7.25	5.7	6.25	5.0	2.25	3.9	3.5	3.9	5	4.2	5.6
6	6.4	10.5	6.7	7.25	6.0	6.75	5.3	3.25	4.1	3.75	4.1	4.75	4.5	5.75
9	6.7	10.5	7.3	7.25	6.4	7	5.6	3.5	4.3	4	4.5	5	4.8	5.75
12	7.1	10.8	7.5	7.25	6.7	7	5.9	4.25	4.6	4.25	4.5	5.5	5.0	6

Source: Bank Islam and Bank Negara

Bank Islam has been very successful in terms of mobilizing deposits within a short period of time (even though the large percentages are due mainly to small base values). The structure of its deposits do not significantly differ from other commercial banks and in terms of growth in total deposits. Bank Islam has achieved higher rates compared to the rest of the banking industry in total deposits, even though the growth of Current Account and Saving Account deposits has been slightly lower than the industry's norm, Bank Islam's success can be explained by the high 89 per cent annual growth rate in mobilizing deposits through its General Investment accounts, even though these accounts had not performed so well as compared to other commercial banks fixed deposits.

The bank's deposits can be viewed from the various categories of depositors, classified as follows: One, the general public/individuals; two, government departments and statutory bodies; and three, various entities from the corporate sector.

The first category of depositors is considered the most important group that will determine the success of the bank in the future. The saving ratio of Muslim's, however, who are the main potential customers of the Bank Islam is much lower than the national ratio of 24.3 per cent[6]. This has been partly due to their unwillingness to associate themselves with interest-based banking operations. This factor is most obvious among the Muslims living in rural areas. It is therefore important to analyse briefly this catogory of depositors in relation to the Bank Islam.

In terms of depositors, individuals accounted for the largest proportion of the bank's customers. About 98 per cent of the present depositors from this category are Muslims. The Muslim depositors can be further classified into two categories: those who have already had contacts with the commercial banks before coming to Bank Islam and those who have yet to have any bank account at all and who were saving some of their income not by depositing in banks, but by buying real assets. This latter group only constitutes roughly five per cent of the total depositors of the bank.

The first category of Muslim depositors is said to be very sensitive about the rate of return on investments. It is believed that quite a large number of them will continue to be Bank's customers only if the bank can maintain reasonable profit rates. It appears that the present rates of profit distributed by Bank Islam are acceptable to them so that they seem indifferent in the choice between Bank Islam and other banks for depositing their money. This conclusion, however, seems too general and hypothetical and detailed empirical work is needed to verify it. It is important to note that there are some amongst this category of depositors who come to the bank because they fully accept the Islamic principles regardless of rates of profit. Nevertheless, the majority of these depositors, it is believed, still maintain contact with conventional banks as well, at least holding current account deposits. One of the main reasons put forward for this, is that as Bank Islam has yet to install ATMs, customers have current accounts (which are non-interest bearing) with other banks for this facility.

The second category of Muslim depositors is motivated mainly by commitment and conviction. These depositors put their money mainly in Saving Account deposits. Their number, which is presently very small, is expected to increase especially when more branches are opened throughout the country. Obviously, this category of depositors consists mainly of rural Muslims who may well become the main supporters of the Bank in the future.

As would be expected, a high proportion of Bank Islam's depositors are located in the rural predominantly Muslim states of Kedah, Trengganu, Kelantan and Pahang. Even though the eight branches located in these states account for 40 per cent of the Bank's depositors, their deposits only amount to 23 per cent of total deposits. This figure reflects the low level of income in these regions.

5.7 Financing and Investment Activities

Bank Islam distinguishes three forms of funding; Financing, Trade Financing and Investments. "Financing," applies to funding operated upon the following Islamic principles; Mudarabah, musharakah, bai' bithaman ajil, ijarah and qard hassen. "Trade Financing," refers to funding through leters of credit (either on a mudarabah or musharakah basis) and working capital financing. "Investments," specify such operations as owning Goverment Investment Certificates, quoted and unquoted shares, investments in subsidiaries etc. At the end of the financial year 1990, total client financing and bank investments, amounted to M$1,354.8 million. The proportion for which Financing, Trade Financing and Investments each accounted for this total was 59 per cent, 11 per cent and 36 per cent respectively. These figures compare to those of the industry of 61 per cent, 7 per cent and 31 per cent.

The reliance of Islamic banks based in the Gulf on trade finance made them responsive to changes in trade flows which were seriously affected in the early 1980s recession. It is interesting to note that even though Bank Islam conducts a greater proportion of its business by trade financing than the industry's norm above, it is not significantly larger. Although Malaysia is an open trade-orientated economy, Bank Islam has not followed the, "easy," route of trade finance to overcome the problems of applying Islamic principles.

As financing constitutes a major proportion of Bank Islam's funding, it is important that it is examined to quite some depth. The following table depicts a detailed breakdown of the direction of Bank Islam's financing over the last four years compared to the banking sector. It is immediately apparent that not only is the manufacturing sector the most important market for the the bank's funding, but also an increasing one. As indicated in chapter two, the manufacturing sector is rapidly growing compared to the rest of the economy and it is this area that the government is actively promoting. Considering, therefore, Bank Islam's greater involvement compared to other commercial banks, it can be expected that in the future Bank Islam may well perform better than these compatriots.

Table 5.2 Sector Breakdown of Bank Islam and the Banking Sector's Financing

Sector	1987		1988		1989		1990	
	BI	Ave	BI	Ave	BI	Ave	BI	Ave
Agriculture	3.7	6.1	5.2	5.4	5.2	5.4	5.3	5.2
Mining/Quarrying	3.9	-	2.1	1.4	-	1.3	-	1.0
Manufacturing	12.0	17.1	19.6	19.7	28.4	20.9	34.2	23.2
Construction/Real Estate	16.7	21.9	26.9	21.5	25.9	19.8	6.4	18.1
Wholesale/Retail	15.5	17.4	11.9	16.9	6.8	15.7	5.9	14.4
Transport /Storage	4.2	1.4	5.5	1.5	4.5	1.9	3.4	1.7
Business Services	18.4	11.6	3.8	10.2	4.1	11.0	3.8	11.3
Miscellaneous	25.6	23.5	25.0	22.8	25.1	23.6	26.8	24.8

Source: Bank Islam and Bank Negara, Dept. of Statistics

Bank Islam has been very successful in developing a wide financing base. Of its 4,988 clients, 69 per cent borrow funds less than M$50,000. Even though a large proportion of accounts do not exceed M$50,000, 73 per cent of the total financing of M$845,979 are in the form of loans exceeding M$1 milion. As would be expected, Bumiputra individuals and Bumiputra controlled firms and corporations constitute a high proportion of clients with only three per cent being non-Bumiputra. The three per cent, though, account for 40 per cent of total loans. These clients are generally large corporations.

Shell (Malaysia) Sdn, Bhd. a subsidiary of the international oil conglomorate is one of these large corporate customers that seek Islamic finance. In July 1990, the Malaysian banking industry saw the first issuance of Islamic corporate bonds. Sydicated by Bank Islam, the issue raised M$125 million for Shell Malaysia. In

December 1990, Bank Islam again managed the raising of M$560 million in joint participation financing for Shell Sarawak. The oil company issued guaranteed participating certificates to the investors in two tranches, which each have a tenure of five to eight years. The reasons stated by Shell's treasurer Robert Yap[7] of why they have used Islamic finance is quite simple; Bank Islam were capable of providing and managing the raising of the necessary capital for such a large operation, in Malaysia's limited capital market. The fixity of Islamic finance also provided an added bonus to such funding.

Such large financing, however, has highlighted the lack of Bank Islam's resources for providing the necessary capital base that is required under Bank Negara regulations. As already mentioned, the Bank's credit limit to any single customer is set at 30 per cent of its Shareholder's Fund. With the present Shareholder's Fund of M$89.4 million, this limit is at M$26.8 million. With the Bank growing and offering more and more facilities, it has increasingly found this limit to be a constraint. A much bigger Shareholders' Fund will therefore be required to give the Bank a higher limit and a competitive market advantage.

5.8 Liquidity Requirements and Other Investments

As at the end of the 1990 financial year, Bank Islam's statutory deposit held at Bank Negara amounted to M$84.58 million or 16 per cent of Bank Islam's total liabilities.

Perhaps the most serious problem that has faced Bank Islam is the persistent high level of liquidity. Bank Islam's problem has two main causes; Firstly, the growth of deposits has outstripped the growth in the demand for Islamic finance. Secondly, there is a problem of the lack of access to Islamically acceptable avenues for investment, Bank Islam is restricted in what it can do with its funds. These two causes are obviously linked. Growth in deposits has got to be matched with growth in demand of the available products from the bank. The minimum statutory liquidity requirements set for Bank Islam by Bank Negara are for a first liquidity ratio of ten per cent of total eligible liabilities and a second liquidity ratio of five per cent of investment accounts. The 1990 level of liabilities, represents a total liquidity balance of M$75 million, but as of 1990, Bank Islam's liquid balances amounted to M$493 million. The Bank has made attempts to develop new areas for investing excess liquidity, such as trading in bullion and in financing activities through its subsidiaries, but these remain peripheral to the main thrust of the financing activity. In the mean time the Bank's technical staff continue to explore new techniques which are acceptable to the community requiring funds and which are permitted in Islam.

The lack of an Islamic inter-bank market is a serious impediment for Bank Islam. The situation would be alleviated to some extent if further Islamic banks were formed in Malaysia. A large number of banks are needed to create a fully operational Islamic money market and the current size of the Islamic market in Malaysia would be unable to sustain such a large number. With the advent of the International Offshore Finance Centre in Labuan the opportunity may exist for the Bank to develop a cross-border inter-bank activity with Islamic banks in other Muslim countries, but such activity is unlikely to be permitted by Bank Negara under existing legislation. Bank Islam, however, is favoured politically and any opportunity to further enhance its operational efficiency of the Bank will be seriously considered by the Government.

The International Offshore Financial Centre can also be used to obtain funds from foreign Muslim investors. Most Islamic nations do not have such a range of investible opportunities as Malaysia. With such a fast growing economy and with Bank Islam's prominance in the rapidly growing industrial sector in Malaysia, Bank Islam can offer better potential returns than other Islamic banks investing in such areas as the Gulf. This recommendation, however, can only be considered in the long-run, considering the high set-up costs involved in establishing an offshore subsidiary in Labuan.

5.9 Subsidiaries

The Bank has formed three subsidiary companies to supplement the operations of Bank Islam. For the purpose of acquisition of immovable and movable fixed assets, the Bank formed a wholley-owned subsidiary company with the paid-up capital of M$1 million under the name of Syarikat Al-Ijarah Sendirian Berhad. Another wholly-owned subsidiary company with the paid-up capital of M$25,000, known as Al-Wakalah Nominees Sendirian Berhad, was formed to undertake portfolio management for the Bank and its clients. A third subsidiary company is the

Syarikat Takaful Malaysia Sendirian Berhad in which the Bank holds 51 per cent. This company provides Islamic insurance (takaful) which is offered though Bank Islam's branches.

5.10 Assets, Capital and Profits

The following table shows the increase in Bank Islam's assets since the end of its first financial year in 1984. Bank Islam has achieved a high annual average rate of growth of 36 per cent a year which compares favourably with the 27 per cent achieved by the industry.

Table 5.3: Growth in Assets, Deposits and Capital

Years	1984	1985	1986	1987	1988	1989	1990
Total Assets	550.67	778.8	871.82	1223.02	1134	1368.34	1396.25
Customers deposits	241.36	410.03	566.91	809.15	1022.23	1229.21	1220.94
Shareholders' fund	78.13	80.7	82.88	83.82	85.75	89.38	92.4

Source: Bank Islam Annual Reports

Bank Islam's Shareholders' Fund, however, have only grown at just over 16 per cent compared with the industry's annual growth rate of 35 per cent. Even though Bank Islam's capital structure is similar to the rest of the banking sector with capital to total assets being around seven per cent, as already mentioned, the small capital base does limit Bank Islam's operations.

Bank Islam's ratios of financing and investment to capital and customers' deposits to capital have both increased over the seven years to match those of the industry. These ratios indicate that Bank Islam has achieved comparable efficiency in its use of funds with conventional commercial banks in Malaysia.

Bank Islam has managed to achieve a profit in its operations except for its first year in 1984. Apart from the fact that it takes a period of time before a bank becomes fully operational and established, Bank Islam was unfortunate that the year in which it commenced business also saw the worst recession witnessed in the Malaysian economy. Even though profits are modest in terms of assets employed, the recent growth in the face of a small fall in deposits is encouraging. The following table shows the profits achieved since 1984. Zakat is a religious tax that the Bank is required to pay under Islamic law. The Bank is currently lobbying the Government to allow this Zakat payment to be tax-deductable as it is for individuals.

Table 5.4: Bank Islam's Profit

Years	1984	1985	1986	1987	1988	1989	1990
Profit before Zakat & Tax	(1.29)	4.37	3.66	4.52	6.19	10	13.5
Profit after Zakat & Tax	(1.77)	2.56	2.19	.94	3	5.18	6.9

Source: Bank Islam Annual Reports

5.11 Conclusion

Bank Islam began operations in 1983 as Malaysia's and Southeast Asia's first true Islamic Bank. To meet popular pressure the Government actively encouraged the formation of an Islamic bank by reforming and introducing the necessary legislation and providing the major part of the Bank's initial capital. Under the supervision of the Religious Council, Bank Islam has managed to offer an extensive range of financial services that are compliant to Islamic law. On the deposit side, the Bank has mobilized money through its Current, Saving and General investment Accounts under the Islamic principles of wadiah and mudarabah, and for its institutional clients, through Special Investment Accounts, again on a mudarabah basis. The returns paid to the depositors on Saving and Investment accounts have generally been lower than the commercial banking system average, however, this has not significantly deterred depositors as the Bank's growth in total deposits has been great. Bank Islam offers funding through a wide range of Islamic financing and investment techniques based upon the following Islamic principles;

Mudarabah, musharakah, bai' bithaman ajil, ijarah and quard hassen, and such principles as kafalah and ujr-wal-umulah are applied in offering letter of credit services. Bank Islam's capital, and asset and deposits structure is comparable to other banks in Malaysia, however, Bank Islam has continued to maintain high levels of liquidity, compared to the industry norms. It has achieved modest profits which have grown over the last seven years and has shown remarkable performance even though it is a young bank. The Bank has a huge potential of getting better returns in the near future, as it enjoys its last years of monopoly status. In the long term, however, Bank Islam must continue to increase its market share in terms of both depositors and clients. Having a relatively high proportion of its investments directed towards the indurtrial sector, the Bank is well positioned to achieve such an increase.

Footnotes

1. Zakariya, M. Islamic Banking in Southeast Asia. *(edited by Afiff, M. Institute of Southeast Asian Studies), 1988.*

2. *National Steering Committee. Islamic Banking in Southeast Asia. (edited by Ariff, M. Institute of Southeast Asian Studies), 1988.*

3. *Islamic Banking Act, 1983.*

4. *Bank Islam. Articles opf Association*

5. *Islamic Banking Act, op.cit.*

6. *Mid-Term Review of the Fourth Malaysian Plan 1981-1985, (Kuala Lumpur: Government Printers), 1984, p.69.*

Chapter VI

Conclusion

Economic development requires finance. Such finance can be obtained through trade, foreign transfers and from domestic resources released through the abstinence of consumption. The governments of developing nations are unlikely to be able to affect trade and foreign transfers to their advantage, but they can implement policies which may mobilize domestic resources. Since independence, Malaysia has adopted a classical approach rather than the quantity-theory or Keynesian approaches to mobilizing domestic resources. This classical approach emphasises prior saving by economic units before investments are made. The Malaysian Government favours a policy in which this saving and investment is conducted through a financial system rather than through government taxation and public investment. This favoured policy, however, does not preclude an active role for government intervention. The financial development policy conducted in Malaysia has followed the, "Supply-leading," theory. This theory suggests that in the early stages of economic development, if a financial system is established to supply financial services before such services are demanded, then this supply of finance and related services will induce economic growth.

The Malaysian economy has achieved relatively high rates of economic growth with relative price stability. It has made effective use of its economic resources by diversifying away from the traditional mainstays of the economy (rubber and tin), adopting a market-orientated outward-looking economic system and has also industrialized. Concurrently, since the early 1970s, Malaysia as a multi-racial society, has attempted to eliminate the economic differences that exist between different ethnic groups. The relative economic position of the indigenous Malays has improved comparatively to the Chinese, even though the New Economic Policy has failed to achieve complete parity.

Through pursuing a, "supply-leading," financial development policy, the Government, through its agent the Central Bank (Bank Negara), has successfully established a well developed and sophisticated financial system. This policy has been characterised by an interlinked two-stage process in which Bank Negara has initially provided active support in the establishment of a financial institution or introduction of a financial instrument, until they no longer require such support. The establishment of Islamic banking within the Malaysian financial system can be regarded as an extention of this policy.

Islamic banking is distinct from Western conventional banking in that riba (interest), is specifically prohibted in the Qu'ran. There is much debate between Islamic economists and Islamic bankers concerning what actually constitutes an Islamic bank, with the economists accusing the bankers of only complying to the letter rather than the spirit of Islamic law. This criticism has been based on the failure of the banks to devote more finance to the Islamic financing methods of mudarabah and musharaka. These methods are effectively partnerships between a bank and a business customer, whereby the bank finances the equity of the business, in return for a share of the profits. These methods of financing are regarded by Islamic economists as being part of a shift in the emphasis of banking practices associated with the introduction Islamic banking. These methods are referred to as first-line techniques and by implication, involve a long-term relationship between bank and customer. Islamic banks in practice generally imitate traditional commercial banks and offer a range of short, medium and long-term predetermined Islamic financing methods. These are referred to as second-line techniques.

In 1983, the Government participated in the establishment of Malaysia's first Islamic bank; Bank Islam. Even though at the end of seven years of operation Bank Islam has only had a marginal quantitative impact upon the financial development of Malaysia, (its assets and deposits only constituting one per cent and one and half per cent respectively of the banking sector's total), it has had a qualitative impact. This qualitative impact is due to the extension on the financial system so that Muslims can now have the opportunity to bank according to the principles of their religion. In a nation where Muslims are in the majority and Islam is the state religion, such a development is very significant.

The future of Islamic banking in Malaysia depends on a number of factors. At a general level there is the question of continued political support. It cannot be denied that political patronage has played a significant part of the success of the Bank. For an institution that accounts for only just over one per cent of the banking system, Bank Islam receives attention and support well beyond its economic significance. The message from this is clear. Bank Islam has a much wider role to play than simply being the thirty-ninth commercial bank. An Islamic dominated government has an obligation to support the activities which are required to act in accordance to their faith. The prohibtion of riba, or interest, is very clear in Islam. Government support has been well publicised and in apparently given enthusiastically. It is not unreasonable to assume this support will continue, even though the Government is decreasing its share in the ownership of Bank Islam. Government dis-investment is merely the continuation of a financial development policy that is based upon the, "Supply-leading," and, "Demand-following," theory. As Bank Islam has established itself within the banking market, it does not need such government support.

Linked to the question of political support are the opportunites presented by two government programmes. These are the Government's National Economic Policy regarding the ownership of business by indigenous Malays and the privatisation of government enterprises and services. Both programmes present opportunities for Bank Islam to become involved in large-scale financing of business acquisitions by the Bumiputra community and in the financing of tenders for government privatisation proposals. Bank Islam is one of the preferred banks for such financing.

The continued prosperity of Islamic banking in Malaysia therefore appears to have adequate political support. Bank Islam is in a privileged position and is under obligation to perform to expectations. This performance relates not just to economic success, but also to what can be labelled as Islamic performance. As already mentioned, the literature on Islamic banking has in recent years contained severe criticisms of Islamic banks throughout the Islamic world. Bank Islam is no exception with 69.1 per cent of the Bank's financing in the form of bai' bithaman bji. These contracts are deferred sale transactions usually beyond one year, with extended financing being common for large scale enterprise developments as witnessed with the oil industry. The bulk of the remainder of financing is in the form of Al-ijarah (leasing) and murabahah (short-term sale based on cost-plus). The proportion of first-line financing utilised by Bank Islam is negligible. This point has been taken up by writers such as Man who stated that for Bank Islam;

> "there can be no excuse for not actively promoting the first-line techniques which would reflect the true spirit behind Islamic banking."(1)

Statements such as this can be extremely damaging to Bank Islam. The bank has a Religious Supervisory Council which overseas the Islamic validity of its operations. The practices utilised by the Bank are fully with accordance in Islam and cannot be regarded in any way as un-Islamic. The Shari'ah prohibits riba but does not dictate how it is to be replaced. The implication of the support for first-line techniques is that in some way commercial banking will fundamentally change to an equity based method of financing, utilising long term investment to boost the economies of developing Islamic nations. The resolution of this debate concerning first-line and second-line financing is fundamental to the continued success of Islamic banking, not only in Malaysia, but elsewhere. There exists a real danger that an element of doubt may exist in the minds of the depositors that the banks are failing to be truely Islamic in the strict religious sense.

Footnote

1. (1) Man, Z. "Islamic Banking in Southeast Asia." *edited by Ariff, M. Institute of Southeast Asian Studies.* 1988, p92.

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